Notice 2013-22

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July 8, 2013

The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Room 3120
Washington, DC 20220

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Room 3026
Washington, DC 20224

Re: Recommendations for 2013-2014 Guidance Priority List

Dear Messrs. Mazur and Wilkins:

The American Bar Association Section of Taxation welcomes the opportunity to provide recommendations for inclusion in the 2013-2014 Treasury-IRS Guidance Priority List. These recommendations represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

The enclosed list contains recommendations made by the members of various committees within the Section of Taxation. I hope you find the suggestions helpful as you formulate the new Priority Guidance List. The recommendations include items submitted by the following committees:

- Affiliated and Related Corporations
- Civil and Criminal Tax Penalties
- Corporate Tax
- Exempt Organizations
- Fiduciary Income Tax
- Financial Transactions
- Partnerships and LLCs
- Pro Bono and Tax Clinics
- Real Estate
- Sales, Exchanges and Basis
- Tax Accounting
- Tax Exempt Financing

We would be happy to discuss the recommendations with you or your staff, if that would be helpful.

Sincerely,

Rudolph R. Ramelli
Chair

Enclosure

RECOMMENDATIONS FOR THE 2013-2014 TREASURY-IRS GUIDANCE PRIORITY LIST

As requested in Notice 2013-22,[1] the Section of Taxation of the American Bar Association has identified the following tax issues that we recommend be addressed through Regulations, rulings or other published guidance in 2013-2014. In each case, the name and contact information for a representative of the committee making the suggestion are provided.

AFFILIATED AND RELATED CORPORATIONS

Matthew E. Gareau, Affiliated and Related Corporations Committee, (202) 879-5387, magareau@deloitte.com

1. Regulations under section 1502[2] regarding loss transfers of member stock. In particular, guidance is requested with respect to coordination of the application of Treas. Reg. § 1.1502-11, Treas. Reg. § 1.1502-28, and Treas. Reg. § 1.1502-36.

2. Final Regulations under Treas. Reg. § 1.1502-77 relating to the status of the agent for the consolidated group. Regulations were proposed on May 30, 2012.

3. Final Regulations under Treas. Reg. § 1.1502-91 regarding redetermination of consolidated net unrealized built-in gain and loss. Regulations were proposed on October 24, 2011.

4. Regulatory clarification regarding the application of the "end-of-the-day" and "next-day" rules of Treas. Reg. § 1.1502-76(b)(1)(ii), particularly with respect to the treatment of closing day stock option and "success based" consulting fee deductions.

5. Updated guidance on the treatment of consolidated tax credits, including treatment of credits allocated to and from members departing and joining consolidated groups.

6. Regulatory clarification regarding the consolidated group continuation rules of Treas. Reg. § 1.1502-75(d)(2) and (3), in particular coordination of existing Regulations with the principles of Rev. Rul. 82-152 and general "substance over form" principles.

7. Regulations providing guidance on the meaning of "successor" for purposes of section 1504(a)(3).

8. Clarification about how section 336(e) applies to consolidated groups.

CIVIL AND CRIMINAL TAX PENALTIES

Josh Ungerman, Civil and Criminal Tax Penalties Committee, (214) 749-2427, jungerman@meadowscollier.com

1. Guidance on restitution-based assessments under section 6201(a)(4):

    - How will restitution be assessed when a defendant/taxpayer filed a joint return with his or her spouse who is not a defendant (and therefore not

[1] 2013-15 I.R.B. 904.

[2] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

subject to a restitution order)? Will the spouse be liable for the restitution-based assessment, or will the spouse receive a notice of deficiency? If the spouse successfully challenges the merits of the proposed adjustments, will the Service reduce the defendant/taxpayer's restitution-based assessment accordingly? Can the spouse call the defendant/taxpayer as a witness in the audit, administrative appeal and/or court to challenge the amount of the restitution-based assessment, despite the inability to challenge under section 6201(a)(4)(C)?

- Does the Service intend to forego civil audits in most cases where the court orders restitution and the Service makes a restitution-based assessment?

- If the Service audits a defendant and finds the actual tax due is less than the restitution order, what steps will the Service take to reduce the restitution-based assessment? A Chief Counsel Notice suggests that the Service will contact the Tax Division to seek a reduced order of restitution, but does not explain how this will be accomplished after the order becomes final.[3]

- If a defendant paid the restitution and then, after the restitution-based assessment, the Service determines that the tax due is less than the restitution assessed, how will the Service reduce the assessment under section 6404? (Under section 6404, the Secretary is authorized to abate the "unpaid" portion of an assessment which is excessive in amount or erroneously assessed.)

- If the Service does not audit after the criminal proceedings, how does a defendant challenge the amount of the restitution-based assessment if the amount exceeds the tax due, where section 6201(a)(4)(C) prevents any challenge?

- The Service is refusing to consider an offer-in-compromise with respect to a restitution-based assessment.[4] What if the taxpayer truly cannot pay? What are the taxpayer's options?

- Will the Service reduce a restitution-based assessment when a valid net operating loss carryback or carryforward eliminates the liability? If so, how does a taxpayer obtain this relief?

- Where a defendant/taxpayer pays restitution prior to sentencing, will the Service post the restitution as of the date of payment? Or will it assert that the payment is not effective until after the restitution-based assessment is made?

2. Guidance on First Time Abate under I.R.M. 20.1.1.3.6.1:

   - How does the Service define a "significant" amount in determining when a First Time Abate ("FTA") conclusion will not apply?

[3] *See* Chief Counsel Notice CC-2011-018 (Aug. 26, 2011), Q&A 10, p. 6.
[4] Chief Counsel Notice CC-2011-018 (Aug. 26, 2011), Q&A 18, pp. 8-9.

- Is any assessed penalty in the three years prior to the period at issue a "significant" penalty that bars FTA?

3. Guidance on penalty abatements (account posting issues, etc.):

    - Guidance confirming that failure to pay penalties can be abated even where the tax has not yet been paid in full.

    - Guidance requiring that penalty abatements must be entered as of the date the penalty was originally assessed, so taxpayers do not pay interest on an abated penalty. For example, a penalty is imposed on 6/30/2010 and abated on 6/30/2012. Because the Service enters the abatement as of the date of the decision to abate (instead of the date of the original assessment), the taxpayer avoids the penalty, but continues to be liable for the interest that accrued over the last two years.

    - Guidance preventing the accrual of additional penalties during consideration and/or after abatement of penalties based on reasonable cause or FTA.

    - Guidance requiring reduction of an assessed estimated tax penalty when the original tax assessed is reduced due to amended returns or audit adjustments. Furthermore, when the estimated tax penalty is reduced, the reduction should be entered as of the date the initial estimated tax penalty was assessed to avoid the accrual of interest on an amount that is abated.

4. Additional guidance on pre-assessment appeals rights with respect to international penalties, including penalties for failure to file Form 3520-A.

CORPORATE TAX

Martin Huck, Corporate Tax Committee, (202) 327-5819, Martin.Huck@ey.com

1. Guidance relating to the "no rule" positions outlined in Rev. Proc. 2013-3,[5] with priority on:

    - Guidance relating to "north-south" issues where the "north" is a distribution to which section 355(a) otherwise applies;[6]

    - Guidance relating to section 361 distributions to creditors where the debt held by the creditors is issued in anticipation of the distribution, including guidance clarifying what constitutes "in anticipation."[7]

2. Guidance revoking Rev. Rul. 78-130.[8]

3. Guidance relating to application or non-application of the investment company rules under section 351(e) and section 368(a)(2)(F) to common transactions.

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[5] 2013-1 I.R.B. 113.
[6] *Id.*
[7] *Id.*
[8] 1978-1 C.B. 140.

4. Guidance relating to the allocation of earnings and profits in divisive reorganizations.

5. Additional guidance under section 336(e), in particular relating to the application of the consistency rules and the general application of the rules in cases where the qualified stock distribution (QSD) occurs in multiple steps.

EXEMPT ORGANIZATIONS

Robert Wexler, Exempt Organizations Committee, (415) 421-7555, wexler@adlercolvin.com

1. Guidance regarding the measurement and permissible level of political campaign activity by section 501(c) exempt organizations other than those exempt under section 501(c)(3), including but not limited to unified standards distinguishing political campaign advertising from issue advocacy.

2. Guidance for 501(c) exempt organizations, other than those exempt under section 501(c)(3), that have not filed an application for recognition of exemption within 27 months of creation, regarding procedures for requesting retroactive recognition of exemption and standards for granting that treatment.

3. Guidance regarding how to obtain a revised determination letter without the need for filing a new exemption application on Form 1023 or Form 1024, where there is a mere change in the form or state of incorporation, including situations where the change is accomplished by a process of domestication rather than creation of a new entity.[9]

4. Guidance regarding the standards for recognizing organizations engaged in the publication of information that is useful to individuals and beneficial to the community, including general news, as exempt under section 501(c)(3).

5. Guidance updating Rev. Proc. 92-94,[10] including to (i) confirm that support from a non-U.S. governmental entity counts as public support in the same manner as support from a federal, state, or local governmental entity counts for purposes of the public support calculation under section 509(a), (ii) revise the definition of "currently qualified" in light of the current five-year calculation period for public support and to provide that an affidavit is currently qualified if a foreign organization in the first five years of its existence reasonably can be expected to qualify as publicly supported, (iii) clarify that grantors need not evaluate foreign hospitals for compliance with section 501(r), (iv) clarify that foreign schools must attest that they do not discriminate on the basis of race, color or national and ethnic origin, but are exempt from the specific requirements of Rev. Proc. 75-50,[11] and (v) clarify that sponsoring organizations of donor-advised funds may make equivalency determinations pursuant to Rev. Proc. 92-94 when making grants to foreign organizations

6. In addition to guidance pursuant to section 4966 regarding donor advised funds, as included in the 2012-2013 Priority Guidance Plan, guidance pursuant to sections 4958 and 4967.

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[9] Rev. Rul. 67-390, 1967-2 C.B. 179, Case 4.

[10] 1992-2 C.B. 507.

[11] 1975-2 C.B. 587.

7. Guidance updating the definition of "control" in Treas. Reg. § 1.512(b)-1(l)(4) to conform to the changes made by the Tax Reform Act of 1997.[12]

8. Guidance regarding when a member of a tax-exempt organization's board of directors can be considered independent for purposes of the rebuttable presumption of Treas. Reg. § 53.4958-6, notwithstanding a financial relationship between the organization and the director or the director's employer, under a *de minimis* standard or otherwise.

9. Guidance to clarify that borrowing in order to make charitable grants or to support charitable programs does not normally constitute acquisition indebtedness within the meaning of section 514(c), including examples clarifying the application of the "but for" and "reasonably foreseeable" tests under section 514(c)(1)(C) to situations in which a charity borrows to fund charitable programs or grants.[13]

FIDUCIARY INCOME TAX

Lewis J. Saret, Fiduciary Income Tax Committee, (202) 965-7748, lewis.saret@gmail.com

1. Guidance under section 643(i) regarding a deemed distribution by reason of use of foreign trust property. Section 643(i) provides that, if a trustee of a foreign trust permits a United States grantor, beneficiary or relative of a grantor or beneficiary to use property of the trust without payment for the fair market value of the use of such property, such use will be treated as a distribution from the trust. It would be helpful to provide guidance in this area, specifically with respect to the following items: (1) who will be required to determine the fair market value of such property; (2) a standard for the proper valuation of such property; (3) whether the specific allowance of the use of such trust property by the applicable trust agreement will be treated as a distribution under section 643(i); (4) whether there would be a safe harbor for *de minimis* usage of property that would not be treated as a distribution, either by a certain low value of the property or by usage for a short term, such as no more than $50,000 of fair market value or 7 days of usage; and (5) information about how such usage will be required to be reported.

2. Guidance under sections 661, 662, 2501 and 2612 regarding decanting. Decanting is the process by which a trustee exercises its power to distribute trust principal to or for the benefit of a beneficiary by distributing assets to a new trust. The Service includes decanting on its no-ruling list with respect to the following: (a) whether decanting gives rise to a section 661 distribution deduction or results in inclusion in gross income under section 662; (b) whether decanting results in a taxable gift under section 2501; and (3) whether decanting causes loss of GST exempt status or results in a taxable distribution or taxable termination under section 2612.[14] Eleven states have adopted decanting statutes and at least two others are in the process of enacting decanting statutes. Most other states allow decanting under their common law.

3. Guidance under section 1001 regarding severance of trusts. The Service has issued many private letter rulings addressing whether the non-pro rata division of a trust will result in

[12] Pub. L. No. 105-34, 111 Stat. 788.

[13] *See* ABA Section of Taxation, "Comments on the Scope of Section 514 of the Internal Revenue Code" (April 9, 2012), *available at* http://www.americanbar.org/content/dam/aba/administrative/taxation/040912comments.authcheckdam.pdf.

[14] Rev. Proc. 2013-3, 2013-1 I.R.B. 113.

the recognition of gain or loss. Most recently, in a private letter ruling,[15] the trustees of a qualified terminable interest property trust (QTIP trust) proposed to divide the QTIP trust into two separate trusts. The Service ruled that a non-pro rata division of the QTIP trust's assets would not result in gain or loss recognition. In Revenue Ruling 2008-41,[16] however, the Service ruled that the division of a trust that qualifies as a charitable remainder trust under section 664 into separate trusts must be done on a pro rata basis. Thus, there appears to be different treatment of a severance of a charitable remainder trust. Accordingly, it would be helpful to have guidance on whether a non-pro rata division of a trust, including, but not limited to, a charitable remainder trust, will result in the recognition of gain or loss for Federal income tax purposes, and, if so, whether such gain or loss can be avoided by funding each new trust with assets fairly representative of appreciation and depreciation rather than dividing each asset on a pro rata basis.

4. Guidance under section 2010(c)(4) on the mechanics of electing portability of the estate tax exclusion amount, including the extent to which the election may be deemed to have been made and relief measures for the failure to make a timely election.

5. Guidance under section 2631(c) confirming that a taxpayer's GST tax exemption under section 2631(c) may be allocated to testamentary transfers in 2010 even if the executor elects out of the estate tax.

6. Guidance regarding post-2012 GST tax issues.[17] If Congress does not change the law, many of the same uncertainties with respect to the GST tax that troubled taxpayers in 2010 will recur. Current guidance on the application of the GST tax after 2012 to transfers made prior to 2013 could eliminate much of the uncertainty, including, for example, the effect of: (i) previous allocations of GST tax exemption in excess of the 2013 exemption; (ii) deemed allocations to prior transfers under section 2632(c); (iii) elections in and out of automatic allocations under section 2632(c)(5); (iv) retroactive allocations in the case of the death of a non-skip person under section 2632(d); (v) late allocations pursuant to section 9100 relief under section 2642(g); and (vi) qualified severances under section 2642(a)(3).

7. Guidance regarding the coordination of preparer penalties under sections 6694 and 6695A, specifically whether the penalties under the sections are exclusive or may be aggregated.

8. Guidance under section 1411 regarding the application of the new 3.8% tax on unearned income to estates and trusts.[18]

FINANCIAL TRANSACTIONS

Matthew Stevens, Financial Transactions Committee, (202) 327-6846, matthew.stevens@ey.com

[15] PLR 201118007 (May 6, 2011).

[16] 2008-2 C.B. 170.

[17] *See* ABA Section of Taxation, "Options for Tax Reform and Simplification with Respect to Federal Estate, Gift and GST Taxes" (April 4, 2012), *available at* http://www.americanbar.org/content/dam/aba/administrative/taxation/040512letter.authcheckdam.pdf.

[18] ABA Section of Taxation, "Proposed Treasury Regulations under Section 1411" (April 5, 2013), *available at* http://www.americanbar.org/content/dam/aba/administrative/taxation/040513comments-2.authcheckdam.pdf.

1. Guidance on the treatment of distressed debt, including Regulations relating to accruals of interest and discount, application of payment ordering rules when debt is not paid in full, and mitigation of character mismatches with respect to accrued interest and discount that is never paid.

2. Final Regulations under section 263(g) addressing capitalization of interest and carrying costs in the case of straddles.

3. Regulations on notional principal contracts (NPCs) relating to the inclusion in income or deduction of a contingent nonperiodic payment, and guidance relating to the character of payments made pursuant to an NPC.

4. Guidance on the characterization of credit default swaps and other credit derivatives.

5. Guidance under section 1058 addressing securities lending in light of recent case law.[19]

6. Guidance regarding cross-border securities lending.[20]

7. Final Regulations under section 871(m) on dividend equivalent payments.[21]

8. Guidance on application of Treas. Reg. § 1.1001-3(f)(7)(ii), relating to deterioration in financial condition of the obligor, in the case of section 368(a)(1)(F) reorganizations, check-the-box elections and other circumstances where there is a change in either the corporate legal obligor or the tax obligor.

9. Guidance on the characterization, particularly for withholding tax purposes, of consent fees for debt modifications and waivers.

10. Guidance on characterization, including for withholding tax purposes, of standby letter of credit fees and commitment fees.

11. Regulations on prepaid forward contracts.[22]

12. Regulations under sections 163(e)(5) and 163(i), including treatment of variable rate debt instruments (VRDIs) and contingent payment debt instruments (CPDIs).

PARTNERSHIPS AND LLCS

Adam Cohen, Partnerships and LLCs Committee, (303) 295-8372, acohen@hollandhart.com

1. Guidance providing a safe harbor for determining when a party will be respected as a partner in a tax credit partnership, including transactions giving rise to low-income housing credits, new markets credits, rehabilitation credits, or energy credits.[23] In addition, guidance is requested under section 7701(o) regarding the application of the

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[19] *Calloway v. Commissioner*, 135 T.C. 3 (2010), *Anschutz v. Commissioner*, 135 T.C. 5 (2010), and *Samueli v. Commissioner*, 132 T.C. 4 (2009).

[20] Notice 2010-46, 2010-1 C.B. 757.

[21] *See* ABA Section of Taxation "Comments on Proposed Regulations Issued Under Section 871(m)" (May 15, 2012), *available at* http://www.americanbar.org/content/dam/aba/administrative/taxation/051512Comments.authcheckdam.pdf.

[22] *See* Notice 2008-2, 2008-1 C.B. 252, and Rev. Rul. 2008-1, 2008-1 C.B. 248.

[23] *See Historic Boardwalk Hall v. Commissioner*, 136 T.C. 1 (2011), *rev'd*, No. 11-1832 (3rd Cir. 2012).

economic substance doctrine to these transactions. In particular, guidance is requested with respect to the applicability of language in the Joint Committee on Taxation report which states that the doctrine is not intended to disallow tax benefits if the realization of those tax benefits is consistent with the Congressional purpose or plan that the tax benefits are designed to effectuate.

2. Proposed Regulations under section 751(b) on unrealized receivables and inventory.

3. Proposed Regulations under sections 704, 734, 743, and 755 arising from the American Jobs Creation Act of 2004,[24] regarding the disallowance of certain partnership loss transfers and no reduction of basis in stock held by a partnership in a corporate partner. Interim guidance was issued in Notice 2005-32.[25]

4. Proposed Regulations under section 752 regarding related person rules.

5. Final Regulations regarding series LLCs.

6. A notice requesting comments prior to issuing Proposed Regulations regarding a bottom guarantee or a minimum net worth requirement under the section 752 and/or section 707 Regulations. It is our understanding that Treasury and the Service may propose a modification to the Regulations under section 752 and/or section 707 that would require a partnership to disregard a bottom guarantee of a partnership liability in determining whether any portion of the liability is treated as a recourse liability. We also understand that Treasury and the Service may impose a net worth requirement under section 752 and/or section 707. We recommend that prior to making such a fundamental change, Treasury and the Service should issue a notice and request for comments prior to issuing Proposed Regulations.

7. Guidance on the definition of a limited partner for SECA purposes.

8. Guidance on whether a partner can be an employee of a partnership.

9. Proposed Regulations under Treas. Reg. § 1.337(d)-3 relating to partnership transactions involving a corporate partner's stock or other equity interests.

10. Guidance regarding the application of Treas. Reg. § 1.267(b)-1(b) to partners and partnerships.

11. Proposed Regulations establishing a new *de minimis* rule under section 704(b).[26]

PRO BONO AND TAX CLINICS

George Willis, Pro Bono and Tax Clinics Committee, (714) 628-2531, gwillis@chapman.edu

1. Guidance under section 61(a) relating to the exclusion of attorneys' fees from the prevailing individual's income where the fees are awarded directly to a Legal Aid

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[24] P.L. 108-357, 118 Stat. 1418.

[25] 2005-1 C.B. 895.

[26] *See* ABA Section of Taxation "Comments on Proposed Regulations Removing the Substantial Economic Effect De Minimis Rule" (May 22, 2012), *available at* http://www.americanbar.org/content/dam/aba/administrative/taxation/052212comments.authcheckdam.pdf.

Organization in connection with its representation of an individual (or group of individuals) in cases where the taxpayer has no obligation to pay attorneys' fees to the Legal Aid Organization.[27]

2. Updated guidance under Treas. Reg. § 1.6050P-1(e)(1)(ii) with respect to what procedure taxpayers should follow to prevent taxation of the full amount of discharged debt to multiple individuals when a creditor complies with the requirement in that provision that:

> In the case of multiple debtors jointly and severally liable on an indebtedness, the amount of discharged indebtedness required to be reported under this section with respect to each debtor is the total amount of indebtedness discharged. For this purpose, multiple debtors are presumed to be jointly and severally liable on an indebtedness in the absence of clear and convincing evidence to the contrary.

   If each debtor who receives a Form 1099-C for the full amount of the debt reports that full amount as income, the forgiveness of that debt will result in taxation of the same amount to multiple individuals, an inappropriate result. It would be helpful for the Service to provide guidance on how taxpayers should address this situation, particularly when only one of the debtors received and used all of the funds loaned.

3. Guidance updating Treas. Reg. § 1.152-1 to clarify support-related issues as these pertain to the dependency exemption. Treas. Reg. § 1.152-1(a)(2), last updated in 1971, needs to be updated. There are two problems with the Regulations. First, the Service continues to apply a support test where the taxpayer is claiming a qualifying child. The support test was eliminated in 2005, and the Service should not continue to request this documentation. Second, the Service continues to treat public benefits such as TANF and SSI as support provided by the child. In fact, this is not support provided by the child, but rather it is being supplied to a parent or guardian by a government entity.

4. Updated guidance concerning section 32(k). Section 32(k) places restrictions on taxpayers who improperly claim the earned income tax credit. There are different penalties for fraudulent, reckless and improper claims which culminate in the taxpayer being banned from claiming the credit for a period of years. The Service does not provide prior notice to taxpayers of the consequences of an improper claim, nor is adequate guidance provided as to what constitutes an improper claim. Unfortunately, both Treas. Reg. § 1.32-3 and I.R.S. Significant Service Advice Memorandum 200245051[28] lack detailed guidance and as a result taxpayers and examiners have no guidance to understand the ban. We recommend (1) the development of more detailed criteria for determining whether and when the ban may be imposed, (2) the development of a process for providing the taxpayer with notice and an opportunity to contest the ban prior to its imposition (and that notice be provided well before a Notice of Deficiency is issued), and (3) the development of a process whereby a taxpayer may apply to have the ban lifted early if the taxpayer becomes compliant with his or her Federal tax obligations and is in fact eligible to claim the credit.

5. Guidance under section 7434(d). The Code provides for civil damages to a person harmed by another person's fraudulent filing of information returns. Section 7434(d)

[27] PLR 201015016 (Apr. 16, 2010).

[28] Nov. 8, 2002.

states that any person bringing an action "shall provide a copy of the complaint to the Internal Revenue Service upon the filing of such complaint with the court." There is no guidance as to what documents are sufficient, where they should be submitted, etc. Therefore, more detailed guidance is needed by taxpayers and practitioners.

6. Guidance expanding preparation authority for Volunteer Income Tax Assistance ("VITA") program preparers. Tax return preparers participating in the VITA program are precluded from preparing certain returns with issues common to the low income community. For example, current rules state that a VITA site is allowed to prepare Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness) only when a Form 1099-C has been issued for a debt related to (1) a home foreclosure or (2) an unsecured credit card.[29] Therefore, in situations where a taxpayer has both a Form 1099 for a home foreclosure (VITA-allowable) *and* a Form 1099-C for a repossessed car (VITA-unallowable), the site cannot prepare the return. VITA preparers should not be precluded from preparing Form 982 where the reported cancelled debt is from a common consumer transaction.

7. Individual Taxpayer Identification Number (ITIN) procedures require a more thorough revision and update. In 2012 the Service updated the ITIN application process and imposed new rules on Certified Acceptance Agents effective January 1, 2013.[30] Among other things, the new process creates certain verification procedures for Certified Acceptance Agents (CAAs) and also limits the method by which ITINs for minors may be obtained. These rules hinder effective representation and tax compliance.[31] We recommend that the Service further review and revise ITIN procedures and the CAA requirements.

REAL ESTATE
Jon Finkelstein, Real Estate Committee, (202) 756-8426, jfinkelstein@mwe.com

1. Guidance under section 108(c), with particular focus on the definition of "secured by real property."

2. Final Regulations under section 460 relating to the home construction contracts exemption.[32]

3. Guidance regarding the meaning of "actively and regularly engaged in the business" of lending money for purposes of section 465.

4. Guidance regarding the treatment of cancellation of indebtedness income as unrelated business taxable income under section 512.

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[29] *See* VITA Screening Worksheet, available at http://www.irs.gov/pub/irs-pdf/p4731.pdf and the VITA Instructor Guide, available at http://www.irs.gov/pub/irs-pdf/p4555.pdf (at section 10-20.)
[30] IR 2012-98 (Nov. 29, 2012).
[31] *See* ABA Section of Taxation, "Comments on the November 29, 2012 Changes to the Individual Taxpayer Identification Number ("ITIN") Procedure" (April 2, 2013), *available at* http://www.americanbar.org/content/dam/aba/administrative/taxation/040213comments.authcheckdam.pdf.
[32] *See* ABA Section of Taxation, "Comments Concerning Proposed Regulations under Section 460" (Apr. 27, 2009), *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2009/090427regsundersec460.authcheckdam.pdf.

5. Guidance simplifying section 514(c)(9)(E) and the fractions rule.[33]

6. Guidance regarding the treatment of a guaranteed payment under section 707(c) to a REIT for purposes of section 856.

7. Guidance regarding the treatment of a deemed loan arising under section 467 in connection with prepaid rent for the use of real property as a real estate asset for purposes of section 856(c)(5)(B).

8. Guidance revising Treas. Reg. § 1.856-5(c) addressing distressed debt acquisitions and modifications.

9. Guidance reconsidering, revising or withdrawing Notice 2007-55[34] addressing the treatment of certain distributions under section 897(h)(1).

10. Regulations providing that the 5% publicly traded FIRPTA stock test in section 897(c)(3) is applied to stock owned by partnerships at the partner level (rather than at the partnership level).

In addition to the foregoing, we requested suggestions from the Tax Credit and Equity Financing Committee and the New Markets Tax Credit Committee. Those suggestions follow.

1. Guidance under section 42(d)(1) on the inclusion of tax-exempt bond issuance costs that would amortize during the construction period of a project and thus be capitalized into depreciable basis.

2. Guidance under section 42 on casualty losses in a non-presidentially declared disaster area as to the availability of tax credits in a year where a building has a casualty, is repaired within a reasonable time, but is not repaired prior to the end of the tax year of the casualty. Rev. Proc. 2007-54[35] provides guidance for presidentially declared disaster areas, but does not address other casualties. Chief Counsel Advice 200134006[36] and 200913012[37] conclude credits are lost for the year of the casualty if the casualty is not repaired by the end of the year. Guidance is requested to address unintended hardships for projects which have a casualty late in the year, repair the casualty quickly, but appear to be at risk of permanently losing credits for such year because the repair is not completed by the end of the year.

3. Formal guidance under section 42 with respect to the continued qualification of over-income tenants covered by an extended use agreement after a transfer of the project and the applicability of the conclusions in the Guide for Completing Form 8823, the Low-

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[33] *See* ABA Section of Taxation, "Comments Concerning Partnership Allocations Permitted Under Section 514 (c)(9)(E)" (Jan. 19, 2010), *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/comments_concerning_partnership_allocations.authcheckdam.pdf.
[34] 2007-2 C.B. 13.
[35] 2007-2 C.B. 293.
[36] May 4, 2001.
[37] March 27, 2009.

Income Housing Credit Agencies Report of Noncompliance or Building Disposition.[38] While the Guide addresses the issue, it provides that taxpayers may not use or cite to the Guide.

4. Formal guidance concerning the exception under section 42(d)(6) for any federally-assisted or state-assisted building.

5. Guidance on whether the otherwise lawful non-renewal of the lease of a tenant by reason of such tenant's income exceeding the maximum income limitation required upon initial occupancy or some higher income limitation violates section 42. Guidance is requested whether the answer changes if renewal of the lease would cause a termination or diminution of rights or benefits under other government programs.

6. Guidance under section 142 on whether low-income housing projects which have lost their rural status are held harmless at the highest national non-metropolitan median income that the project achieved if the projects' income limits were originally determined using the national non-metropolitan median income afforded to rural projects under section 42(i)(8).

7. Guidance addressing when allocations of state tax credits to members of a partnership will be respected as allocations rather than as a disguised sale of credits.[39]

8. Guidance with respect to the definition of "control" for the reasonable expectations test in Treas. Reg. § 1.45D-1(d)(6)(ii)(B) where a Community Development Entity (CDE) makes an equity investment in a Qualified Active Low-Income Community Business (QALICB) but does not acquire management control.

9. Guidance to extend the safe harbor for construction period expenditures set forth in Treas. Reg. § 1.45D-1(d)(4)(i)(E)(*2*) to better match construction periods for large projects which commonly extend beyond 12 months.

10. Guidance with respect to the definition of "redemption" set forth in Treas. Reg. § 1.45D-1(e)(3)(i) applicable to a CDE taxable as a corporation where such entity has made qualified low-income community investments in multiple years and would like to dispose of an investment and distribute proceeds from the disposition that would exceed its accumulated earnings and profits.

11. Guidance under the redemption safe harbor set forth in Treas. Reg. § 1.45-1(e)(3)(iii) to address the application of the safe harbor to changes in taxable income due to the application of the original issue discount rules.

SALES, EXCHANGES AND BASIS

Mark E. Wilensky, Sales, Exchanges and Basis Committee, (516) 747-0300, mwilensky@meltzerlippe.com

1. Guidance clarifying the effect of a non-recognition transaction under section 351, 721, or 731 immediately before or after an exchange of like kind property upon the like kind property exchange qualifying for non-recognition under section 1031. In Rev. Rul. 75-

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[38] Revised Oct. 2009.

[39] *See Virginia Historic Tax Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011).

292,[40] and Rev. Rul. 77-337,[41] the Service held that a non-recognition transaction under section 351, 721, or 731 immediately before or after a like kind property exchange disqualifies the like kind exchange under section 1031, because the taxpayer has not "held" the property in question "either for productive use in a trade or business or for investment." Subsequent case law casts doubt upon these Revenue Rulings, recognizing that an indirect interest in like kind property before or after another non-recognition transaction should satisfy the purposes and intent of section 1031. In the absence of an official change in position by the Service, however, taxpayers use burdensome or contorted transaction structures that would otherwise be unnecessary to satisfy the requirements of section 1031. We recommend that a new Revenue Ruling permit taxpayers to engage in a non-recognition transaction under section 351, 721, or 731 before or after a like kind exchange without disqualifying the like kind exchange under section 1031, so long as title to the like kind property passes through the taxpayer pursuant to the like kind exchange.[42]

2. Guidance clarifying the scope of the "routine financial services" exception for acting as a section 1031 exchange accommodator. Under Reg. § 1.1031(k)-1(k), a so-called "disqualified person" (generally defined to include family members and agents of the taxpayer, as well as entities 10% or more of the equity interests of which are owned directly or indirectly by a taxpayer or the taxpayer's family members or agents) cannot act as a qualified intermediary, trustee of a qualified trust or holder of a qualified escrow account (a "1031 Accommodator") in connection with a section 1031 deferred like-kind exchange. An exception to this general rule permits financial institutions to provide "routine financial services" (a term not defined in the Regulations) without giving rise to disqualified person status. A recent case involving a dispute over the acquisition of a 1031 Accommodator business highlights the practical difficulties encountered by both taxpayers and bank-affiliated 1031 Accommodators due to the lack of clarity regarding the scope of "routine" versus "non-routine" financial services.[43] The Service has recognized the important role played by banks (as defined in section 581) among 1031 Accommodators as "closely regulated entities that have historically acted as neutral and independent holders of funds."[44] To eliminate the ambiguity in the current Regulations and allow taxpayers the freedom to select bank-affiliated 1031 Accommodators without fear of disqualifying their exchanges, we recommend an amendment to the current Regulations to clarify that any services which the Office of the Controller of the Currency (in the case of a national bank) or the relevant state regulatory agency (in the case of a state-chartered bank) permits the bank to provide (directly or through an affiliated entity) shall be considered "routine."

3. Guidance under section 1031 regarding offsetting "mortgage boot" where unsecured debt is retired by a purchaser of relinquished property (or by a qualified intermediary using buyer funds).

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[40] 1975-2 C.B. 333.
[41] 1977-2 C.B. 305.
[42] We note that such guidance could be limited to circumstances in which no binding commitment exists to engage in the exchange under section 1031 or the other non-recognition transaction at the time of the first transaction.
[43] *See NES Fin. Corp. v. JPMorgan Chase Bank, Nat'l Ass'n,* 891 F.Supp.2d 558 (S.D.N.Y. 2012).
[44] REG-107175-00, 2001-1 C.B. 971, 972.

4. Guidance under section 1031 regarding the treatment of nonrecourse debt retired by a deed in lieu of foreclosure or by foreclosure as "mortgage boot" without regard to the fair market value of the property secured by the debt. A similar issue was narrowly addressed in PLR 201302009.[45] Because this is an issue that is important to many taxpayers, we recommend the issuance of guidance upon which all taxpayers may rely.

5. Guidance under sections 167 and 1031 pursuant to Notice 2013-13[46] as to whether property held simultaneously for sale and for lease (also known as "dual-use property") is eligible for depreciation deductions and/or like kind exchange treatment.

TAX ACCOUNTING

Jan Skelton, Tax Accounting Committee, (202) 220-2082, janskelton@deloitte.com

1. Revenue Procedure under section 168(k)(4) regarding the election to accelerate carryover AMT credits in lieu of claiming bonus depreciation.

2. Proposed Regulations under section 174 regarding procedures for adopting and changing methods of accounting for research and experimental expenditures.

3. Revenue Procedure under section 179(f) regarding qualified real property.

4. Proposed Regulations under section 199 related to amendments by the Tax Extenders and Alternative Minimum Tax Relief Act of 2008.

5. Guidance under section 199 addressing benefits and burdens of ownership.

6. Final Regulations under section 263(a) regarding the capitalization of costs related to tangible property.

7. Revenue Procedure under section 263(a) regarding the capitalization of electric generation property.

8. Revenue Procedure under section 263(a) regarding the capitalization of natural gas transmission and distribution property.

9. Revenue Procedure under section 263(a) regarding the capitalization of cable network property.

10. Final Regulations under section 263A regarding the inclusion of negative amounts in additional section 263A costs.

11. Final Regulations under sections 263A and 471 regarding sales-based royalties and sales-based vendor allowances.

12. Proposed Regulations under section 263A to update and clarify the Regulations.

13. Revenue Procedure under section 446 updating Revenue Procedure 97-27.[47]

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[45] Jan. 11, 2013.
[46] 2013-12 I.R.B. 659.
[47] 1997-1 C.B. 680.

14. Proposed Regulations under section 453 addressing the exchange of property for an annuity.

15. Proposed Regulations under section 460 addressing the application of the lookback interest rules to certain pass-through entities with tax-exempt owners.

16. Final Regulations under section 460 regarding home construction contracts.[48]

17. Proposed Regulations under Treas. Reg. § 1.461-4(d)(5) addressing contingent liabilities assumed in connection with a sale of a trade or business.

18. Proposed Regulations amending Treas. Reg. § 1.472-8 regarding the inventory price index computation (IPIC) method.

19. Proposed Regulations on the carryover of last-in, first-out (LIFO) layers following a section 351 or section 721 transaction.

TAX EXEMPT FINANCING

Nancy Lashnits, Tax Exempt Financing Committee, (503) 890-9385, nancy.lashnits@steptoe-johnson.com

1. Guidance on and expansion of the safe harbors for determining private use of management contracts for bond financed facilities through updates to Revenue Procedure 97-1.[49]

2. Guidance on the definition of "issue price" for tax-exempt bonds, Build America Bonds, and other direct pay tax credit bonds.[50]

3. Final Regulations on the public approval provisions of section 147.

4. Guidance with respect to the financing of short-term and long-term working capital deficits.

5. Guidance on bond financing of grants.[51]

6. Guidance with respect to arbitrage rules related to qualified hedge and yield reduction payments.

[48] *See* ABA Section of Taxation, "Comments Concerning Proposed Regulations under Section 460" (April 27, 2009), *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2009/090427regsundersec460.authcheckdam.pdf.

[49] 1997-1 C.B. 632. *See* ABA Section of Taxation, "Comments on Management Contract Guidelines under Rev. Proc. 97-13" (May 9, 2012), *available at* http://meetings.abanet.org/webupload/commupload/TX334500/otherlinks_files/CommentsonManagementContractguidelines.pdf.

[50] *See* ABA Section on Taxation, "Comments on Issue Price" (November 9, 2010), *available at* http://meetings.abanet.org/webupload/commupload/TX334500/newsletterpubs/CommentsonIssuePrice.pdf.

[51] *See* ABA Section of Taxation, "Comments on Bond-Financed Grants" (January 5, 2011), *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2011/010511comments.authcheckdam.pdf.

7. Guidance on record retention requirements for tax exempt bonds and tax credit bonds, including safe harbor guidance regarding any records required to support the periodic returns required to be filed in the case of direct pay Build America Bonds, and other direct pay tax credit bonds.

8. Final Regulations on the allocation and accounting provisions of section 141.

Notice 2013-22

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May 1, 2013

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Re: Recommendations for 2013-2014 Guidance Priority List Pursuant to Notice 2013-22

Dear Sirs and Mesdames:

On behalf of the Charitable Planning and Organizations Group of the American Bar Association's Section on Real Property, Trust and Estate Law (the "Section"), we are pleased to provide the following recommendations for inclusion on the 2013-2014 Guidance Priority List (the "Guidance Priority List") issued by the Department of Treasury ("Treasury") and Internal Revenue Service ("IRS"). We have prepared these recommendations in response to the request for recommendations in IRS Notice 2013-22. These recommendations have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association. These recommendations do not represent the views or positions of the law firms, financial institutions, or universities of which the principal authors are shareholders, partners or employees.

These recommendations were prepared by members of the Charitable Planning and Organizations Group (the "Group") of the Section. Carol G. Kroch, Supervisory Council Member of the Group, supervised the preparation of these recommendations and participated in their preparation. The principal drafting responsibility was exercised by Elaine Waterhouse Wilson with substantive contributions from Ramsay Slugg. A schedule of contact information for the principal authors is attached to this letter. Finally, the recommendations were reviewed by Carlyn S. McCaffrey of the Section's Committee on Coordination of Governmental Submissions.

Although members of the Section who participated in preparing these recommendations have clients who are affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these recommendations.

Summary of Recommended Guidance

Exempt Organizations

- *Supporting Organizations*. Carry forward the projects in the 2012-2013 Guidance Priority List to issue final regulations under Sections 509 and 4943 regarding the new requirements for supporting organizations, as added by Section 1241 of the Pension Protection Act of 2006 ("PPA") and to issue additional guidance under Section 509(a)(3) as needed.[1] We note that on December 28, 2012, the IRS issued final regulations on some supporting organization issues and issued proposed and temporary regulations on additional issues. In the preamble to the December 28, 2012 final regulations, the IRS notes that additional issues will be addressed in further guidance. We recommend that the IRS provide guidance on supporting organization issues as follows:
    - Finalize Section 1.509(a)-4(i)(5)(ii) of the Proposed Regulations as set forth on December 28, 2012 regarding the amount and manner of calculation of the mandatory payout for the non-functionally integrated Type III supported organizations. **Priority: Very High**
    - As discussed in the preamble to the December 28, 2012 regulations, provide additional guidance in Section 1.509(a)-4(i)(3)(iv) of the Proposed Regulations regarding the types of activities that would meet the responsiveness test for charitable trusts. **Priority: High**
    - Provide transition guidance in Section 1.509(a)-4(i)(3)(v) of the Proposed Regulations for charitable trusts created between November 20, 1970 and the effective date of the PPA that will be unable to meet the revised responsiveness test. **Priority: High**

- *Donor Advised Funds*. Carry forward the project in the 2012-2013 Guidance Priority List to issue proposed regulations regarding the new excise taxes on donor advised funds and fund management under Section 4966 as added by Section 1231 of the PPA.[2] We recommend that proposed regulations be issued under Section 4967 as well as Section 4966. We recommend that the proposed regulations under these Sections provide guidance as follows:

[1] 2012-2013 Priority Guidance Plan (hereinafter, "2012-3 Plan"), Exempt Organizations Items 5 and 6.
[2] 2012-3 Plan, Exempt Organizations Item 9.

- Whether the fulfillment of a charitable pledge of a fund advisor by a donor advised fund is a "more than incidental benefit" under Section 4967(a)(1). **Priority: High**
- Whether the payment of the charitable portion of a bifurcated gift by a donor advised fund is a "more than incidental benefit" under Section 4967(a)(1). **Priority: High**
- Provide guidance regarding the application of the advisory committee requirements for scholarship funds in Section 4966(d)(2)(B)(ii)(II) when the donor to the scholarship fund is a non-charitable tax-exempt membership organization. **Priority: Medium**
- Provide guidance regarding under what circumstances payments may be made "for the benefit of" a single named charitable beneficiary consistent with Section 4966(d)(2)(B)(i). **Priority: Medium**

Gifts and Estates and Trusts

- *Charitable Lead Trusts.* We recommend one piece of guidance regarding existing projects and two pieces of new guidance.

  - In light of the issuance of final regulations under Section 642(c), provide additional guidance as follows:
    - o Provide additional guidance regarding certain income ordering and characterization issues in the context of charitable lead trusts. **Priority: High**
  - We recommend two new guidance projects with regard to charitable lead trusts:
    - o Review and reviseTreas. Reg. Section 1.170A-6(c), Rev. Proc. 2007-45, and Rev. Proc. 2008-45 to clarify the manner in which the recapture of the charitable income tax deduction under Section 170(f)(2) is calculated when a charitable lead trust ceases to be treated as a grantor trust. **Priority: Medium**
    - o Revise Treas. Reg. Section 20.2055-2(e)(2)(vi)(a) and Treas. Reg. Section 25.2522(c)-3(c)(2)(vi)(a) to provide further guidance regarding the types of fluctuating annuities that a charitable lead trust may provide. **Priority: Medium**

General Tax Issues

- *Qualified Appraisal Proposed Regulations.* Carry forward the project in the 2012-2013 Guidance Priority List to issue final regulations under Section 170 regarding qualified appraisals.[3] We recommend that the final regulations provide guidance in the following areas:

  - Further guidance regarding the definition of "generally accepted appraisal standards" under Section 1.170A-17(b)(2)(ii) of the Proposed Regulations. **Priority: High**
  - Further guidance regarding the definition of a "recognized professional appraiser organization" under Section 1.170A-17(b)(2)(iii) of the Proposed Regulations. **Priority: High**

[3] 2012-3 Plan, General Tax Issues Item 25.

- *Charitable Contribution Deduction.* On August 27, 2012, the IRS issued Notice 2012-52, which allows a taxpayer to take an income tax deduction for a charitable contribution made directly to a disregarded entity (such as a single member limited liability company ("SMLLC")) organized within the United States of which an organization described Section 170(c) is the owner.[4] In light of this notice, we recommend that the IRS and Treasury consider amending either Notice 2012-52 or the Regulations under Section 170(f) to provide additional guidance regarding the whether the substantiation letter required by Section 170(f) may be sent by the SMLLC or must be sent by the Section 170(c) charitable owner itself. **Priority: Low.** In addition, we recommend that the consideration be given to extending the scope of Notice 2012-52 to include SMLLCs that are organized outside the United States. **Priority: Medium**

Specific Comments on the Guidance Priority List Recommendations

1. Supporting Organizations. The Exempt Organizations section of the 2012-2013 Guidance Priority List includes two projects with regard to supporting organizations: the issuance of final regulations and additional guidance not covered by the Proposed Regulations. To the extent not complete by the end of the 2012-2013 guidance year these items should be carried forward.

   By way of background, on January 3, 2008, the Section provided commentary regarding various supporting organization issues, as requested by the IRS in an Advanced Notice of Proposed Rulemaking dated August 2, 2007. On the IRS issued its initial set of proposed regulations on September 24, 2009 (the "Initial Proposed Regulations"). On December 23, 2009, the Section submitted to the IRS extensive comments on the Initial Proposed Regulations (with the Section's January 3, 2009 comments, collectively, the "SO Comments"). On December 28, 2012, the IRS finalized some of the Initial Proposed Regulations (the "Final Regulations"), revised some portion of the Initial Proposed Regulations and re-issued that portion as a Temporary Regulation (the "Temporary Regulation"), and indicated its intent to issue further regulations or other guidance in the future. We believe the following three critical areas should be addressed, whether in the finalization of the Temporary Regulations or in other future guidance:

   a. *Mandatory Payout for Non-Functionally Integrated Type III Supporting Organizations.* The Initial Proposed Regulations were revised to address concerns regarding the amount and manner of calculation of the mandatory payout for non-functionally integrated Type III supporting organizations and re-issued as a Temporary Regulation. This Temporary Regulation will have a significant operational impact on affected organizations and their charitable beneficiaries. We respectfully refer you to our SO Comments, in which we extensively discuss our recommendations regarding the appropriate payout rate and the methodology used to calculate the mandatory distributions.

      Evaluation Criteria. We believe this issue to be of paramount importance to all non-functionally integrated Type III organizations and the charities they support. Affected supporting organizations and their charitable beneficiaries will need to review their operations in order to comply with the final regulations. Regardless of what the

[4] 2012-3 Plan, General Tax Issues Item 26.

mandatory final payout may be, affected organizations may need to adjust the investment of their funds, and the short-term and long-term operating budgets of their supported charities will need to be reviewed and possibly amended. Because of the significant impact these regulations will have on both supporting organizations and their supported charities, we strongly recommend that finalizing the Temporary Regulations should have a **Very High priority**.

b. *Meeting the Responsiveness Test.* Section 1.509(a)-4(i)(3)(iv) of the Initial Proposed Regulations contains two examples that address the manner in which a charitable trust may comply with the alternate responsiveness test. These two examples leave a number of open issues, specifically including but not limited to the frequency and manner in which meetings with beneficiaries may be conducted and whether contact with multiple beneficiaries may vary depending on the nature of their respective interests. In the preamble to the Final Regulations, the IRS indicated that it made one small change to this section of the Initial Proposed Regulations, but that it intended to solicit comments on and issue further guidance on this issue.

   Evaluation Criteria. In the absence of additional examples, conservative trustees will use Example 1 of the Final Regulations (requiring quarterly in person or telephonic meetings with the charitable beneficiary) as a "safe harbor," which will likely prove to be burdensome and inflexible without providing additional meaningful responsiveness under the applicable test. Further guidance would hopefully forestall future controversies between the IRS and trustees regarding compliance with the fact-intensive responsiveness test. The uncertainty caused by the lack of additional examples and the potential for the erosion of charitable assets due to high administrative compliance costs is significant. We believe that the effort to provide addition examples of trust compliance should have **High priority.**

c. *Transition Relief.* The Proposed Regulations provide that a supporting organization that cannot otherwise meet the responsiveness test and that was supporting or benefiting a supported organization before November 20, 1970, may take into account additional facts and circumstances, such as a historic and continuing relationship between the organizations. There is no similar transition relief for organizations created between November 20, 1970 and the effective date of the PPA.

   Evaluation Criteria. For affected supported organizations and their trustees, this guidance will be crucial in evaluating the manner in which such organizations remain in compliance with the tax laws in a cost effective manner. Providing transition relief for organizations formed prior to the effective date is consistent with the transition rules adopted for existing entities when the private foundation requirements were first enacted in the Tax Reform Act of 1969. We believe this project has a **High priority.**

2. Donor Advised Funds. The Exempt Organizations section of the 2012-2013 Guidance Priority List includes issuing proposed regulations regarding the new excise taxes on donor advised funds and fund management under Section 4966 as added by Section 1231 of the PPA. In addition, we believe that proposed regulations under Section 4967, regarding taxable distributions from donor advised funds, should be issued as well. To the extent not complete by the end of the

2012-2013 guidance year, this item should be carried forward. On April 9, 2007, individual members of the Group submitted comments on certain donor advised fund issues in response to a request for comments in IRS Notice 2007-21 (the "DAF Comments"). We believe the following four critical areas should be addressed in proposed and final regulations, as follows:

a. *Payment of Charitable Pledges*. Section 4967 imposes an excise tax when a donor receives, directly or indirectly, a "more than incidental benefit" from a distribution from a donor advised fund. It is unclear whether payment of a donor's legally binding charitable pledge would be a "more than incidental benefit" under Section 4967(a)(1).

   Evaluation Criteria. The uncertainty in this area imposes a significant burden on all donor advised funds, their charitable beneficiaries, and their donors, as well as the IRS. Given the difficulty in administration and the potential for uneven results in the absence of further guidance as well as the widespread nature of the issue, we give this project **High priority**.

b. *Bifurcated Gifts*. Similarly, it is unclear whether payment by a donor advised fund of the charitable portion of a bifurcated gift would give rise to a "more than incidental benefit" under Section 4967(a)(1).

   Evaluation Criteria. In the absence of further guidance, different donor advised funds are taking different approaches to these types of distributions. Guidance would promote uniformity among taxpayers. Given the widespread nature of the issue and the uneven manner in which it is currently addressed by donor advised funds, we give this project **High priority**.

c. *Scholarship Funds*. The scholarship fund exception from the definition of a "donor advised fund" requires, among other things, that "no combination of *[donors or people appointed or designated by donors]* (or persons related to such persons) control, directly or indirectly, such committee." Section 4966(d)(2)(B)(ii)(II). The wording of this requirement is difficult to apply when the donor is a non-charitable exempt membership organization (such as a fraternal society, business league, or veterans' post) that sponsors a scholarship fund.

   Evaluation Criteria. We believe that additional clarifying guidance may encourage private charitable giving by such membership organizations. The lack of guidance is burdensome on organizations that may wish to set up such funds, as the conservative course in the absence of additional guidance is to locate individuals otherwise unrelated to the organization to serve on scholarship advisory committees. We believe this project has a **Medium priority**.

d. *Payments for the Benefit of Single Charitable Beneficiaries*. The definition of a "donor advised fund" excludes "any fund or account which makes distributions ***only to*** a single identified organization or governmental entity." Section 4966(d)(2)(B)(i) (emphasis added.) We request guidance with regard to whether payments may be made "for the benefit of" a single named beneficiary consistent with the statutory language of Section 4966(d)(2)(B)(i).

Evaluation Criteria. This recommended guidance would reduce the burdens on donor advised funds and the organizations they support. In the absence of additional guidance, the conservative course is to use a two-step process for distribution, which costs charitable organizations time and money. Because this recommendation could simplify the administration of charitable organizations, we give this project a **Medium priority.**

3. Charitable Lead Trusts. The Gift and Estate and Trust section of the 2011-2012 Guidance Priority List included the issuance of final regulations under Section 642(c) concerning the ordering rules for charitable payments made by a charitable lead trust ("CLT"). Proposed regulations were published on June 18, 2008. Final regulations under Section 642(c) were issued on Friday, April 13, 2012 effective on Monday, April 16, 2012. We note that the need for additional guidance in this area was omitted from the 2012-2013 Guidance Priority List. We believe that a number of significant issues remain with regard to CLTs, and request that additional guidance be issued as follows:

   a. *Specific Ordering Issues for CLTs under Section 642(c).* Although a non-grantor CLT is treated simply as a complex trust under Subchapter J, it is a unique vehicle that gives rise to specialized income tax issues. In light of the final regulations under Section 642(c), it would be helpful to have administrative guidance giving examples of how the *pro rata* income ordering rules should work specifically in the context of CLTs, including such issues as distributions from a prior year's undistributed gross income and the amount and timing of income received from pass-through entities.

   Evaluation Criteria. Subchapter J is an extremely complex area of federal tax law. We believe that additional guidance will make this area easier for trustees and their tax advisors to understand and will lead to uniformity in the manner in which CLT income is reported. This should reduce the oversight burden on the IRS and promote tax compliance. Although there are a relatively small number of CLTs in existence, the complexity of the issues and the potential for confusion are significant; therefore, we give this project **Medium priority**.

   b. In addition, we believe two new projects regarding CLTs should be included in the Guidance Priority Plan.

      i. *Grantor CLT Recapture Issues.* If a CLT structured as a grantor trust loses its grantor trust status, then the charitable income tax deduction under Section 170 that was allowed to the donor upon creation of the CLT is subject to recapture. There is some question, however, as to how recapture should be calculated. *Compare* Section 170(f)(2), Treas. Reg. Section 1.170A-6(c), Rev. Proc. 2007-45, section 8.01(5) *and* Rev. Proc. 2008-45, section 8.01(5). We recommend that Treasury and the IRS issue guidance clarifying the manner in which recapture is calculated, given the apparent discrepancies among the Code, the Regulations, and the Revenue Procedures.

Evaluation Criteria. Due to the discrepancies among the statutory language, the Regulations, and the Revenue Procedures, substantial uncertainty exists among taxpayers regarding the appropriate application of the recapture rules. Such uncertainty leads to taxpayers taking different, but supportable, tax positions, resulting in a lack of uniformity among similarly situated taxpayers. While the number of affected CLTs and taxpayers may be fairly small, the confusion on this issue is significant. Therefore, we give this project a **Medium priority**.

ii. *Fluctuating Annuity Amounts in CLATs*. The charitable interest in a charitable lead annuity trust ("CLAT") must be a "guaranteed annuity interest" in order to qualify for an estate or gift tax deduction. Sections 2055(e)(2)(B) and 2522(c)(2)(B). In general, a guaranteed annuity interest is the right to receive annual payments, the amounts of which are determinable at the inception of the trust for a fixed period of years. Treas. Reg. Section 20.2055-2(e)(2)(vi)(a) and Treas. Reg. Section 25.2522(c)-3(c)(2)(vi)(a); *see also* Rev. Proc. 2007-45, section 5.02. We recommend that Treasury and the IRS issue guidance regarding the limits, if any, on the structure of the variable annuity payments in CLATs.

Evaluation Criteria. The current guidance on the permitted structure of a CLAT's variable annuity payments is ambiguous, leading to significant uncertainty among taxpayers and their advisors. Although the number of taxpayers that would create a CLAT with a variable annuity payment may be fairly small, CLATs can provide important support to charitable organizations. Clarifying the extent to which variable payment CLATs are permitted will encourage donors who may presently be concerned about making such gifts. While we think it is very important to bring certainty to this issue, we give it a **Medium priority** because of the limited number of taxpayers it may affect.

4. Qualified Appraisal Proposed Regulation. The General Tax Issues section of the 2012-2013 Guidance Priority List includes a project to issue final regulations under Section 170 regarding charitable contributions. Proposed regulations were published on August 7, 2008. To the extent not complete by the end of the 2012-2013 guidance year this item should be carried forward. We recommend that two definitional issues be addressed in the final regulations, as follows:

   a. *"Generally accepted appraisal standards."* The Treasury Regulations under Section 170 require a taxpayer to submit a "qualified appraisal" to support the charitable income tax deduction for certain types of charitable gifts. In order for an appraisal to be a "qualified appraisal," current law requires that the appraisal comply with "generally accepted appraisal standards." We recommend that Treasury and the IRS clarify further the definition of "generally accepted appraisal standards."

   Evaluation Criteria. This guidance would be of great assistance to all taxpayers that make charitable gifts that require the submission of a qualified appraisal. We believe that the definition contained in the Proposed Regulations is sufficiently vague as to be impossible to apply, unless one simply chooses to use the USPAP standards. The USPAP

may not be appropriate or cost-effective in all circumstances. Because of the large number of taxpayers impacted and the mandatory nature of the qualified appraisal requirement, we give this project **High priority**.

b. *"Recognized professional appraiser organization."* Similarly, a qualified appraisal must be performed by a "qualified appraiser." One of the criteria for a "qualified appraiser" is that he or she must have a "recognized appraisal designation," which is defined as "a designation awarded by a recognized professional appraiser organization on the basis of demonstrated competency." Prop. Treas. Reg. Section 1.170A-17(b)(2)(iii). The Proposed Regulations give four examples of recognized appraisal designations: MAI, SRA, SREA, and SRPA. While these examples are helpful, all four designations relate to real estate and are awarded by a single entity, the Appraisal Institute. We recommend that the final regulations include additional guidance regarding the term "recognized professional appraiser organization."

Evaluation Criteria. As with the discussion above regarding the definitions of "generally accepted appraisal standards", this recommended guidance applies to all taxpayers making charitable gifts subject to the qualified appraisal requirement. The Proposed Regulations simply do not provide sufficient guidance to taxpayers attempting to comply with the requirements necessary to support a charitable income tax deduction for affected property. Given the burden placed on these taxpayers and the mandatory nature of the qualified appraisal requirement, we give this project **High priority**.

5. Contributions to Disregarded Entities. The General Tax Issues section of the 2012-2013 Guidance Priority List contained a project regarding the allowance of deductions under Section 170 for charitable contributions made directly to a disregarded entity (such as a single member limited liability company) that is wholly owned by an organization described in Section 170(c). On August 27, 2012, the IRS issued Notice 2012-52, which allows a taxpayer to take an income tax deduction for a charitable contribution made directly to a disregarded entity (such as a single member limited liability company ("SMLLC")) owned by a United States charity if the SMLLC is organized in the United States. No guidance was provided as to the treatment of contributions made to a SMLLC organized outside the United States. In this Notice, the IRS stated, "The U.S. charity is the donee organization for purposes of the substantiation and disclosure required by §§ 170(f) and 6115. To avoid unnecessary inquiries by the Service, the charity is encouraged to disclose, in the acknowledgment or another statement, that the SMLLC is wholly owned by the U.S. charity and treated by the U.S. charity as a disregarded entity." We recommend that additional guidance be issued under Section 170(f) clarifying the procedural substantiation requirements for charitable owners of SMLLCs, specifically including whether, in order to address state law liability or similar concerns, the substantiation letter could be sent from the SMLLC with an acknowledgement that the charitable owners is deemed to be the recipient of the grant for Internal Revenue Code purposes. We also recommend that guidance be issued as to the proper treatment of contributions to SMLLCs that are organized outside the United States. Treating these contributions in the same manner as contributions to SMLLCs organized in the United States would seem to be consistent with the rationale of Notice 2012-52.

Evaluation Criteria. Providing further guidance in this area would promote uniformity and ease the administrative burdens on charities. We give this project **Medium priority**.

Thank you for the opportunity to provide our thoughts regarding the Guidance Priority List. Should you have any further questions, please do not hesitate to contact any of the principal authors.

Sincerely,

/s/ Tina Portuondo

Tina Portuondo, Chair
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Notice 2013-22

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May 1, 2013

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Internal Revenue Service
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1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Notice 2013-22, 2013-2014 Guidance Priority List

Dear Sir/Madam:

On behalf of the American Council of Life Insurers ("ACLI"),[1] we request that the items described below be included on your Guidance Priority List for 2013-2014. We appreciate the significant efforts by the Department of Treasury ("Treasury") and Internal Revenue Service ("IRS") to provide guidance on important issues for our member companies. We look forward to continuing a dialogue with Treasury and IRS on guidance projects.

The following items are of critical interest to life insurers and are appropriate for inclusion on your priority list, as guidance would both enhance tax compliance and administration, as well as assist and clarify issues for policyholders and insurers. For each of the listed matters, we are prepared to provide information to Treasury and IRS for their analysis of the specific guidance matters.

[1] ACLI represents more than 300 life insurers and fraternal benefit societies. Our membership represents over 90% of the assets and premiums of the U.S. life insurance and annuity industry.

- Guidance on tax issues arising under section 807 as a result of the adoption on December 2, 2012 by the National Association of Insurance Commissioners ("NAIC") of a principle-based approach to certain life insurance reserves;

- Guidance on annuity contracts with a long-term care insurance feature under sections 72 and 7702B, so-called "combination long-term care/annuity" contracts, and exchanges of annuity contracts for long-term care contracts under section 1035;

- Guidance clarifying that for taxable years ending on or after December 31, 2009, the aggregate Conditional Tail Expectation amount in excess of the Standard Scenario Amount for annuity contracts falling within the scope of Actuarial Guideline 43 should be taken into account in computing the amount of statutory reserves under section 807(d)(6);

- Guidance on Qualifying Longevity Annuity Contracts;

- Guidance on the circumstances in which annuity payments constitute substantially equal periodic payments ("SEPPs") within the meaning of sections 72(t)(2)(A)(iv) and 72(q)(2)(D);

- Guidance updating the life/nonlife consolidated return regulations;

- Guidance modifying rules for correcting of failures of variable life insurance or annuity contracts due to inadvertent violations of the diversification rules of section 817(h) by the segregated asset accounts underlying the contracts;

- Guidance clarifying that the current Form 1099 reporting rules for controlled foreign corporations of U.S. life insurers do not apply to life insurance companies prior to the January 1, 2014 effective date for chapter 4 reporting; and

- Guidance on group trusts under Revenue Rulings 81-100 and 2011-1.

1. Guidance on Principle-Based Life Insurance Reserves

The NAIC adopted a new model standard valuation law in 2009. This law will be considered by the legislatures of various states during the next couple of years. On December 2, 2012, the NAIC adopted a Valuation Manual to be used under the new law. The Valuation Manual provides for a principle-based approach for reserves ("PBR") for certain types of life insurance contracts. Now that the Valuation Manual has been adopted, the provisions relevant to the Federal income tax analysis are known, and it is important that guidance on tax issues arising as a result of the adoption of the Valuation Manual be addressed. While we hope that the IRS can provide guidance on the tax issues that will not necessitate any changes to the Valuation Manual, if such changes are necessary, it may be possible to seek them in 2013, but it will be

very difficult to amend the Valuation Manual after 2013 as increasing numbers of states introduce legislation to enable PBR.

When the NAIC began considering new approaches to life and variable annuity reserves, the IRS issued Notice 2008-18 which described certain areas of concern and invited comments. The NAIC adopted new guidance for variable annuity reserves ("AG 43") in 2009. The invitation and subsequent comments and dialogue led to useful guidance on variable annuity reserves in Notice 2010-29. Given the NAIC's adoption of its valuation manual for life reserves, guidance on tax issues that may arise similarly would be extremely helpful to life insurers and regulators.

2. Guidance on Annuity Contracts With A Long-Term Care Insurance Feature Under Sections 72 And 7702B, So-Called "Combination Long-Term Care / Annuity" Contracts, And Exchanges of Annuity Contracts For Long-Term Care Contracts

The changes made under section 844 of the Pension Protection Act of 2006, P.L. 109-280 ("PPA of 2006") permitting issuance of contracts that combine life insurance,[2] annuity and qualified long-term care ("LTC") coverage and providing for the expansion of section 1035 tax-free exchanges to include long-term contracts became effective January 1, 2010.

Guidance for annuity contracts with a long-term care feature has been on the Priority Guidance Plan for the past few years. Treasury and IRS released Notice 2011-68[3] in August 2011 which provided some guidance and posed specific questions and requested comments on those questions. We appreciate the guidance provided in Notice 2011-68 and submitted a detailed comment letter on November 9, 2011. We specifically request that you issue guidance that confirms:

- Inclusion of Premiums in Investment in the Contract. All premiums paid into a combination contract should be included in the investment in the contract under Internal Revenue Code ("Code") section 72. The investment in the contract will be reduced by the long-term care insurance charges that are imposed.

- Effect of Long-Term Care Insurance Charges. The investment in the contract should be reduced by the charges for long-term care insurance coverage that are imposed.

- Effect of the Payment Long-Term Care Insurance Benefits on the Investment in the Contract. The investment in the contract should not be reduced by qualified long-term care benefit payments that are made under a combination contract.

[2] Long-term care insurance has been permitted to be combined with life insurance since 1997, so the major emphasis of this letter will concern the combination of long-term care insurance with annuities.

[3] I.R.B. 2011-36 (September 6, 2011).

- The determination of the exclusion ratio in situations where a contract owner of a combination annuity/long-term care insurance contract elects to receive annuity payments. The charges for the long-term care coverage could continue to apply to each payment.

- Treatment of Qualified Long-Term Care Benefits Paid Under a Combination Contract. Notice 2011-68 does not address the tax treatment of long-term care benefits paid to a chronically ill insured under a combination contract. We believe that the full amount of qualified long-term care benefits paid under a combination contract should be excluded from income, whether or not the cash value of the annuity contract is adjusted as a result of the payment.

- Partial Exchanges of Deferred Annuity and Life Insurance Contracts for Long-Term Care Insurance. We request clarification that the additional requirements in Revenue Procedure 2011-38, 2011-30 Internal Revenue Bulletin 66 that apply to partial exchanges of annuity contracts for other annuity contracts do not apply to partial exchanges in which annuity amounts are used pay for long-term care insurance premiums.[4] Further, we request that guidance confirm that the payment of long-term care insurance premiums by means of a direct transfer of funds from a life insurance contract or an annuity contract will be treated as a tax-free exchange.

- Partial Exchanges of Immediate Annuity Contracts for Long-Term Care Insurance. Notice 2011-68 does not address the exchange of an immediate annuity for long-term care insurance. We request guidance that the assignment of one or more annuity payments to the issuer of a long-term care insurance contract is a tax-free exchange, as long as the insurance company remits the payment(s) directly to the issuer of the long-term care insurance contract.

- The amount of long-term care insurance risk in a combination annuity/long-term care insurance contract. When a contract combining annuity and long-term care coverage has been approved by a state insurance regulator, the contract will contain the necessary prerequisites for treatment as an insurance contract.

3. Guidance clarifying the computation of the amount of statutory reserves under section 807(d)(6) for annuity contracts falling within the scope of Actuarial Guideline 43

Notice 2010-29 provides interim guidance to issuers of variable annuity contracts on issues that arise under sections 807 and 816 as a result of the adoption by the National Association of Insurance Commissioners ("NAIC") of Actuarial Guideline XLIII, Commissioners' Annuity Reserve Valuation Methodology ("CARVM") for Variable Annuities ("AG 43"). Section 3.02 of that Notice provided interim guidance on the statutory reserve cap of section 807(d)(1) for taxable years ending on or after December 31, 2009 for annuity contracts

[4] The revenue procedure applies to "transfers of a portion of the cash surrender value of an existing annuity contract for a second annuity contract." Consequently, partial exchanges of annuity contracts for long-term care insurance are not within its scope and not subject to the recharacterization that might apply in the case of exchanges involving annuity contracts only.

falling within the scope of AG 43. Specifically, the Notice provided that the term "statutory reserves" under section 807(d)(6) includes the Standard Scenario Amount ("SSA") determined under AG 43. The Notice is silent regarding the treatment of the AG 43 Conditional Tail Expectation amount ("CTE amount").

In the past, we had requested the issuance of guidance that for taxable years ending on or after December 31, 2009, the aggregate CTE amount in excess of the SSA for annuity contracts falling within the scope of AG 43 should be taken into account in computing the amount of statutory reserves under section 807(d)(6) and in applying the limitation based on statutory reserves in section 807(d)(1). This item appeared on the 2012-2013 Guidance Priority List, and we ask that the IRS continue to include this item on the 2013-2014 Guidance Priority List.

4. Guidance on the circumstances in which annuity payments constitute substantially equal periodic payments ("SEPPs") within the meaning of sections 72(t)(2)(A)(iv) and 72(q)(2)(D)

In PLR 201120011 (February 11, 2011), the IRS concluded that payments made under an acceleration feature option in an annuity contract that could only be exercised if the contract owner was over age 59 ½ were not "substantially equal periodic payments" ("SEPP"s) within the meaning of section 72(q)(2)(D). In reaching its conclusion, the IRS has left the industry without any published guidance on when annuity payments made for the life or life expectancy of the annuitant will qualify for the SEPP exclusion in section 72(q)(2)(D) or section 72(t)(2)(A)(iv) relating to qualified plans for that matter. The issue of whether annuity payments meet the SEPP requirement is a significant one for the life insurance industry. It is therefore important that guidance on this issue be included in the 2013-2014 Guidance Priority List.

5. Guidance on Qualifying Longevity Annuity Contracts

On February 2, 2012, Treasury and the IRS released Proposed Regulations under section 401(a)(9) relating to the purchase of longevity annuity contracts. The Proposed Regulations would revise the regulations to provide an exclusion for certain qualified longevity annuity contracts. This revision would remove an impediment to the use of these contracts in defined contribution qualified plans and IRAs. The regulations would help participants and retirees address longevity risk. ACLI intends to comment on these Proposed Regulations. We recommend these regulations be placed on the 2013-2014 Guidance Priority List to be made final following consideration of public comment.

6. Guidance Updating the Life/Nonlife Consolidated Return Regulations

Regulation section 1.1504-47 provides extensive rules for the treatment of life/nonlife consolidated returns. These regulations were originally promulgated in 1983, and although there have been amendments over the years, the basic structure remains unchanged. In 1984, the Deficit Reduction Act ("Act") substantially changed the method of life insurance company taxation. The life/nonlife consolidated returns regulations that pre-date the Act, however, do not reflect these changes to life insurance company taxation.

ACLI has requested guidance in this area in the past, because these regulations provide an unduly intricate set of rules for the treatment of losses and should be revised to more fairly reflect the statutory requirements for use of these losses. In 2009, we wrote a letter that highlighted three such restrictions and requested that Treasury modify the regulations within the scope of the existing statutory provisions to make consolidated returns regulations for affiliated groups including life insurance companies more consistent with the statutory provisions.

The Code contains no limitations on the use of life insurance company members' losses to offset the profits of nonlife insurance company members. The consolidated return regulations, however, continue to: (1) prohibit the cross-subgroup carryback of certain losses; (2) limit the utilization of subgroup capital losses; and (3) allocate losses to ineligible members first. The statute does not require these restrictions on absorption of losses between subgroups of a consolidated group, and justifications no longer exist for treating life insurance companies differently from other corporations. Thus, we request that the regulations be modified to:

- ***Permit Cross-Subgroup Carryback of Capital and Life Operating Losses***

  ACLI recommends that Treasury remove these prohibitions on the carryback of capital losses or life operating losses in Treas. Reg. sections 1.1502-47(h)(2)(ii) & (iv), 1.1502-47(h)(4)(i), 1.1502- 47(k)(5)(i), and 1.1502-47(l)(3), and retain the portion of the regulations that excludes the cross-subgroup carryback of a nonlife CNOL against life income.

- ***Allow One Subgroup's Capital Losses to Offset the Other Subgroup's Capital Gains***[5]

  ACLI recommends that Treasury amend Treas. Reg. sections 1.1502-47(m)(3)(iii) & (n)(2) to conform to the normal consolidated return rule that allows capital losses to offset capital gains, and to limit only the use of ordinary losses of the nonlife subgroup.

- ***Apply the General Consolidated Return Pro Rata Loss Absorption Rules Within a Nonlife Subgroup.***[6]

  ACLI recommends that Treasury modify Treas. Reg. section 1.1502-47(m)(3)(vi) & (vii) to conform to the general consolidated return pro rata loss absorption rules. In the loss year, the portion of the CNOL allocated to an ineligible nonlife loss member should be determined on a pro rata basis under the rules of Treas. Reg. section 1.1502-21(b), and in the carryback or carryover years, the allocated loss should be utilized on a pro rata basis against the income of all members of the nonlife subgroup.

[5] Previous ACLI submissions provide a more detailed discussion of this issue. *See, e.g.*, ACLI 2002 letter, at p. 9.
[6] Previous ACLI submissions provide a more detailed discussion of this issue. *See, e.g.*, ACLI 2002 letter, at p. 4.

7. *Guidance Modifying Rules For Correcting of Failures of Variable Life Insurance or Annuity Contracts Due to Inadvertent Violations of the Diversification Rules of Section 817(h) by the Segregated Asset Accounts Underlying the Contracts*

The RIC Modernization Act of 2010 amended section 851 to provide a de minimis exception to the diversification requirements under section 851. Effective December 23, 2011, section 851(d)(2)(B) provides that a corporation is considered to meet the diversification requirements for any quarter during which it is technically out of compliance if (1) the failure to comply is due to the ownership of assets, the total value of which does not exceed the lesser of (i) 1% of the total value of the corporation's assets at the end of the quarter for which the measurement is done or (ii) $10 million and (2) the corporation disposes of the assets in order to meet the requirements within six months after the last day of the quarter in which the failure was identified. Violations falling within the de minimis exception can be corrected without the necessity of any reporting to the IRS or the payment of any toll charge.

During 2007, the ACLI worked with the IRS to develop streamlined correction procedures for inadvertent failures of variable contracts under section 817(h). That process resulted in the issuance of Revenue Procedure 2008-41 related to corrections under section 817(h). Revenue Procedure 2008-41 requires that if there is an asset diversification failure, the insurer must submit a request for an IRS ruling and pay a toll charge. The toll charge is calculated as (1) the tax payable on the income on the failed contracts or (2) 100% of the amount of the excess over the applicable limit(s), capped at the lesser of $5 million or 5% of the total value of the non-diversified segregated asset account. The cap is determined separately for each segregated asset account that contains non-diversified assets. Although the ACLI was and is very appreciative of Revenue Procedure 2008-41, it did not contain a de minimis rule.

Enacted many years after section 851, section 817(h) is based, at least in part, on the rules in section 851 and is similar in many respects. The addition of a de minimis rule under section 851(d) represents Congress' most recent view on the proper level of correction necessary for diversification violations impacting regulated investment companies (mutual funds). Because of the addition of the de minimis rule, the correction mechanism for regulated investment companies is now more effective and less burdensome than the correction procedure outlined in regulations under section 817(h) and Revenue Procedure 2008-41 for variable contracts that often invest in regulated investment companies. To maintain the parallel structures of sections 851 and 817(h) on diversification, we believe that the correction procedures available under section 817(h) and regulations thereunder should be amended to provide for a de minimis exception consistent with the de minimis exception approved by Congress in conjunction with the recent amendment to section 851(d).

Although the de minimis rule was added to section 851 by statute, Treasury has clear authority to add the de minimis exception to the regulations promulgated under section 817(h). The statutory language of section 817(h)(1) does not address the correction of violations under section 817(h) but, instead, grants the Treasury broad authority to issue regulations and related guidance on the proper diversification standards under the section. Pursuant to that regulatory authority, Treasury established the diversification tests set out in Treas. Reg. 1.817-5(b)(1) and made the 30-day cure provision of Section 851 applicable to the diversification requirements of section 817(h). Treas. Reg. 1.817-5(c)(1). Pursuant to that same authority, Treasury can further

harmonize sections 851 and 817(h) by extending the new section 851 de minimis provision to the current diversification tests of section 817(h).

8. Guidance clarifying that the current Form 1099 reporting rules for controlled foreign corporations of U.S. life insurers do not apply to life insurance companies prior to the January 1, 2014 effective date for chapter 4 reporting.

Section 6041 requires that payments of $600 or more consisting of enumerated items, including annuities or other fixed or determinable gains, profits, and income are reported to the IRS if paid by a U.S. payor engaged in a trade or business. The regulations describe a controlled foreign corporation ("CFC") as a U.S. payor. Thus, under the current regime, CFCs are required to document the status of their customers, and to file information returns for income payments to customers that are known or presumed to be U.S. persons.

Payments made to U.S. customers or customers whose status cannot be determined and are presumed to be U.S. persons, are reportable on forms 1099. In this regard, the presumptions rules treat any undocumented individual as a U.S. person. Thus, any failure by a CFC to collect documentation sufficiently reliable to treat the payee as a foreign person creates an obligation for the CFC to report all reportable payments on forms 1099.

As a result of the compliance rules, the CFCs' only choice is between 1) filing annual forms 1099 returns for all of their existing and future customers since all of them would be presumed to be U.S. taxpayers in the absence of documentation, or 2) inserting the following legend on all application and/or other distribution forms relating to U.S. information reporting requirements:

> By opening this account and signing below, the account owner represents and warrants that he/she/it is not a U.S. person for purposes of U.S. Federal income tax and that he/she/it is not acting for, or on behalf of, a U.S. person. A false statement or misrepresentation of tax status by a U.S. person could lead to penalties under U.S. law. If your tax status changes and you become a U.S. citizen or a resident, you must notify us within 30 days. [7]

We recommend that foreign life insurance companies that are CFCs be treated as having complied with all their reporting obligations under the Code if they fulfill the requirements of chapter 4 as proposed for foreign life insurers in this submission.

The chapter 4 Final Regulations'[8] due diligence rules rely extensively on a foreign financial institution's ("FFI") existing customer intake procedures allowing identification of U.S. persons based on information normally collected. If based on this information there are indicia that an account owner is a U.S. taxpayer, the FFI will inquire further to determine if the account holder is a U.S. person. We applaud Treasury and IRS for adopting this approach. We request that Treasury and IRS modify the current provisions under sections 6041 and 6049 related to current information reporting and documentation applicable to CFCs of life insurance companies

[7] Treas. Reg. § 1.6049-5 (c)(4)(ii) requires the legend appear near the signature line.

[8] TD 9610 issued by Treasury and IRS on January 28, 2013.

so they may conform to chapter 4. These rules currently presume that payees are U.S. persons, and place the extraordinary burden on the CFC of life insurers to collect reliable documentation to overcome that presumption in order to treat the payee as a non-U.S. person. Updating the regulations under Code sections 6041 and 6049 to include the non-U.S. person presumption as to accounts sold overseas and the objective standards for identification of U.S. persons among the accounts is sound tax policy and levels the playing field for U.S. and non-U.S. owned FFIs and is consistent with the chapter 3 and chapter 4 conformity rules in the Foreign Account Tax Compliance Act Final Regulations. Similar rules conforming reporting obligation standards for CFCs are warranted.

We request that in light of the industry's numerous and consistent requests for reasonable and updated guidance with respect to such CFC reporting since the rules were adopted, that it be clarified that the 1099 reporting rules not apply to life insurance companies prior to the January 1, 2014, the effective date for chapter 4 reporting and that chapter 4 reporting will replace 1099 reporting for such CFCs that are life insurance companies.[9]

9. Guidance on group trusts under Revenue Rulings 81-100 and 2011-1

In Revenue Ruling 2011-1, IRS requested comments on whether annuity contracts and/or other tax-favored accounts held by plans described in 401(a) or 403(b), such as pooled separate accounts supporting annuity contracts that are treated as trusts under 401(f), should be permitted to invest in the group trusts described in the Revenue Ruling. ACLI submitted a comment letter urging IRS to continue to permit separate accounts to invest in collective investment trusts that are "group trusts" within the meaning of Revenue Ruling 81-100 where the assets of such separate accounts are derived solely from such plans and accounts that are identified in Revenue Ruling 81-100 and any successor rulings. Notice 2012-6 addressed other issues described in Revenue Ruling 2011-1 (extending relief for trusts qualified under Puerto Rico law), but it did not address the issue of annuity contracts investing in group trusts. We urge the IRS to keep 2011-2012 Priority Guidance Plan item 31, Employee Benefits – Retirement Benefits (Guidance on group trusts under Revenue Rulings 81-100 and 2011-1), on the 2013-2014 Priority Guidance Plan until this issue is addressed.

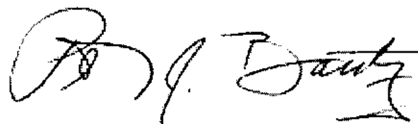
* * *

[9] *See,* ACLI letters dated November 9, 2001, November 8, 2009, and April 29, 2011.

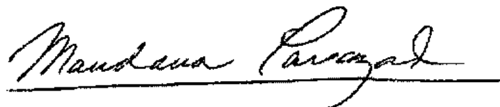
We appreciate your time and attention to this request for inclusion of items for the Priority Guidance Plan for 2013-2014. We look forward to working with you on these issues in the coming months.

Sincerely yours,

Walter C. Welsh



Peter J. Bautz



Mandana Parsazad

Lisa Strikowsky

Notice 2013-22

JUN 13 2013

LEGAL PROCESSING DIVISION
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December 17, 2012

Stephen B. Tackney
Office of Chief Counsel
Internal Revenue Service
Room 4300
1111 Constitution Ave., NW
Washington, D.C. 20224

Thomas Scholz
Office of Chief Counsel
Internal Revenue Service
Room 4300
1111 Constitution Ave., NW
Washington, D.C. 20224

RE: Request for Administrative Relief from Penalties for Failure to Timely Deposit Employment Taxes with respect to Restricted Stock Units and Restricted Stock

Dear Sirs:

The American Coalition of Stock Plan Administrators ("ACSPA") respectfully requests that the Internal Revenue Service ("IRS") issue guidance providing administrative relief from the penalties for failure to timely deposit employment taxes on the day following any day that an employer accumulates $100,000 or more of employment taxes, where such employment taxes arise upon the vesting of restricted stock units or restricted stock, so long as the deposit of employment taxes is made within one day after the settlement date of the restricted stock units or restricted stock and provided the settlement date is not later than three days after the vesting date of the restricted stock units or restricted stock.

This request for administrative relief is nearly identical to the administrative relief provided by the IRS in its Field Directive dated March 14, 2003 (a copy of which is enclosed for your reference) in which IRS examiners were instructed for penalty purposes not to challenge the timeliness of employment tax deposits due on the day following any day that an employer accumulates $100,000 or more of employment taxes that arise upon the exercise of nonqualified stock options, so long as the deposit of employment taxes is made within one day after the settlement date of the option exercise and provided the settlement date is not later than three days after the exercise date.

ACSPA also respectfully requests that the IRS issue guidance clarifying that the guidance provided with respect to nonqualified stock options in its Field Directive dated March 14, 2003 applies to any exercise of nonqualified stock options, regardless of the manner in which the exercise price is paid to purchase the shares or the tax withholding obligation is satisfied.

American Coalition of Stock Plan Administrators

ACSPA is an industry trade association focused specifically on the United States equity compensation plan administration industry. Our members include Accurate Equity, Bank of America Merrill Lynch, Charles Schwab, EASi, E*Trade, Fidelity, Global Shares, Morgan Stanley Smith Barney, Solium Capital and UBS. Collectively, ACSPA administers the interests of thousands of plan sponsors and millions of participants within corporate stock plans.

ACSPA is, in part, dedicated to promoting awareness among regulators, law-makers and key industry constituencies to the needs and challenges of stock plan sponsors, to reducing administrative costs and burdens associated with stock plan administration, and to increasing overall compliance by stock plans with all applicable rules, all of which ACSPA believes is to the benefit of both taxpayers and the government.

Background on Nonqualified Stock Options, Restricted Stock Units and Restricted Stock

Nonqualified Stock Options

A nonqualified stock option is a contractual right to purchase shares. To exercise a nonqualified stock option, the holder must pay the purchase price (or exercise price) for the shares and typically must satisfy any applicable tax withholding obligation that arises upon exercise of the option and complete any required paperwork related to the exercise. The exercise price, and any tax withholding amount due upon exercise, may often be paid by cash or check, by withholding shares that would otherwise be delivered upon exercise of the option or by selling shares subject to the option in the public market.

In many cases, the settlement of the nonqualified stock option, and the actual delivery of the shares upon exercise of the option, does not occur on the exercise date. This may be due to the administrative mechanics related to the delivery of shares or may be due to the fact that shares are withheld or sold on the exercise date or, in some cases, the day following the exercise date, in order to satisfy the exercise price and/or tax withholding obligations that arise upon exercise of the option (see below for a discussion of the tax relevant rules applicable to nonqualified stock options).

From a mechanical perspective, when shares are to be issued upon the exercise of a nonqualified stock option, the issuer company or a securities broker must generally make a request to the company's transfer agent to transfer shares held in the company's account with the transfer agent through the Depository Trust Company (the "DTC") to the broker's account

with the transfer agent (this transfer request is referred to as a Deposit or Withdrawal at Custodian or "DWAC"). The securities broker will then hold such shares on behalf of the participant until the participant decides to sell the shares. If, at the time of exercise, the participant elects to sell shares to pay the exercise price or tax withholding obligations that arise upon exercise of the option, the securities broker must again provide instructions to the transfer agent to transfer the shares and then the transfer must be effected through the DTC using the Fast Automated Securities Transfer (FAST) System or the Direct Registration System (DTS).

Due to Securities and Exchange Commission (the "SEC") regulations that apply to transfer agents and securities brokers, there is generally no more than a three day delay between the exercise of the option and settlement of the option exercise/sale of shares (see below for a discussion of the relevant SEC rules applicable to transfer agents and securities brokers).

Restricted Stock Units

A restricted stock unit award is a contractual right to acquire shares in the future. No purchase price is required to be paid in order to receive shares pursuant to a restricted stock unit award. Rather, in most cases, shares subject to a restricted stock unit award are simply released upon the vesting of the award (in some cases, the release of shares subject to a restricted stock unit award is deferred to a date or event that occurs after the award vests, however, for purposes of this request for relief, we are assuming that shares will be released upon vesting of the restricted stock unit award).

In many cases, the settlement of restricted stock unit awards, and the actual delivery of the shares earned pursuant to restricted stock unit awards, does not occur on the vesting date. This may be due to the administrative mechanics related to the delivery of shares or may be due to the fact that shares are sometimes withheld or sold on the vesting date or, in some cases, the day following the vesting date, in order to satisfy the tax withholding obligations that arise upon vesting of restricted stock unit awards (see below for a discussion of the tax rules applicable to restricted stock unit awards).

From a mechanical perspective, when shares are to be issued upon the vesting of a restricted stock unit award, the issuer company or a securities broker must generally make a DWAC request to the company's transfer agent to transfer shares held in the company's account with the transfer agent through the DTC. The securities broker will then hold such shares on behalf of the participant until the participant decides to sell the shares. If, at the time of vesting, the participant elects to sell shares to pay tax withholding obligations that arise upon vesting of the award, the securities broker must again provide instructions to the transfer agent to transfer the shares and then the transfer must be effected through the DTC using the FAST System or DTS.

Due to SEC regulations that apply to transfer agents and securities brokers, there is generally no more than a three day delay between the vesting of a restricted stock unit award and settlement of the award/sale of shares (see below for a discussion of the SEC rules applicable

to transfer agents and securities brokers).

For a variety of reasons, including pressure placed on companies by institutional investors to minimize shareholder dilution resulting from stock plans, the prevalence of restricted stock unit awards has increased significantly since 2003.

Restricted Stock

Restricted stock is issued and outstanding shares subject to contractual restrictions (e.g., vesting provisions). For public companies, no purchase price is typically required to be paid in order to receive restricted stock.

In many cases, the settlement of restricted stock awards, and the actual delivery of the shares earned pursuant to restricted stock awards, does not occur on the vesting date. This may be due to the administrative mechanics related to the delivery of shares or may be due to the fact that shares are sometimes withheld or sold on the vesting date or, in some cases, the day following the vesting date, in order to satisfy the tax withholding obligations that arise upon vesting of restricted stock (see below for a discussion of the tax rules applicable to restricted stock awards).

From a mechanical perspective, when shares are to be issued upon the vesting of a restricted stock award, the issuer company or a securities broker must generally make a DWAC request to the company's transfer agent to transfer shares held in the company's account with the transfer agent through the DTC. The securities broker will then hold such shares on behalf of the participant until the participant decides to sell the shares. If, at the time of vesting, the participant elects to sell shares to pay tax withholding obligations that arise upon vesting of the award, the securities broker must again provide instructions to the transfer agent to transfer the shares and then the transfer must be effected through the DTC using the FAST System or DTS.

Due to SEC regulations that apply to transfer agents and securities brokers, there is generally no more than a three day delay between the vesting of a restricted stock award and settlement of the award/sale of shares (see below for a discussion of the SEC rules applicable to transfer agents and securities brokers).

For a variety of reasons, including pressure placed on companies by institutional investors to minimize shareholder dilution resulting from stock plans, the prevalence of restricted stock awards has increased significantly since 2003.

Applicable Tax Rules

Section 83(a) of the Internal Revenue Code (the "IRC") provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—(1) the fair market value of such property

at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount (if any) paid for such pròperty, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

Treasury Regulation Section 1.83-7(a) provides that if a nonqualified stock option is granted to an employee or independent contractor and the option does not have a readily ascertainable fair market value at the time of grant, IRC Sections 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of and, if the option is exercised, IRC Sections 83(a) and 83(b) shall apply to the transfer of property pursuant to such exercise, and the employee or independent contractor will realize compensation upon such transfer at the time and in the amount determined under section 83(a) or 83(b).

Treasury Regulation Section 1.83-3(a) provides that a transfer of property occurs when a person acquires a beneficial ownership interest in such property.

IRC Section 83 and the treasury regulations thereunder do not define "beneficial ownership interest". However, other guidance generally makes it clear that a beneficial ownership interest arises when an individual has substantially all of the benefits, and burdens, of ownership.[1]

IRC Sections 3101(a) and (b) impose social security and Medicare taxes on wages received by employees.

IRC Section 3121(a) generally defines "wages" for purposes of social security, Medicare and unemployment taxes to include all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash.

IRC Section 3102(a) generally requires the employer to deduct social security and Medicare taxes from wages as and when the wages are paid.

IRC Section 3402(a) generally requires the employer to deduct and withhold income taxes upon wages paid to employees.

IRC Section 3401(a) generally defines "wages" for purposes of the income tax rules as all remuneration for services performed by an employee, including all remuneration paid in any medium other than cash.

[1] Stanley v. United States, 436 F. Supp. 581 (N.D. Miss. 1977), aff'd, 599 F.2d 672 (5th Cir. 1979); Rolfs v. Comm'r, 58 T.C. 360 (1972), aff'd, 488 F.2d 1092 (9th Cir. 1973); cf. IRS Field Service Advice Memorandum 200111011 (March 16, 2001) and the cases cited therein.

Treasury Regulation Section 31.3121(a)-2(a) generally provides that wages for purposes of social security, Medicare and unemployment taxes are received by an employee at the time that they are actually or constructively paid by the employer to the employee.

Treasury Regulation Section 31.3121(a)-2(b) generally provides that wages for purposes of social security, Medicare and unemployment taxes are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. Further, to constitute payment in such a case the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition.

Treasury Regulation Section 31.3402(a)-1(b) generally provides that the employer is required to collect income tax by deducting and withholding the amount thereof from the employee's wages as and when paid, either actually or constructively. Further, wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case, the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition.

IRC Section 6302(a) generally authorizes the Secretary of the Treasury to establish the mode and time for collecting tax.

Treasury Regulation Section 31.6302-1(e) defines "employment taxes" as income taxes and the employee and employer portion of social security, Medicare and unemployment taxes that are required to be withheld.

Treasury Regulation Section 31.6302-1(c)(3) generally requires that, if an employer has accumulated $100,000 or more of employment taxes on any day within a deposit period, those taxes must be deposited by electronic funds transfer in time to satisfy the tax obligations by the close of the next day.

In a Field Directive dated March 14, 2003, the IRS provided that "[w]hile I.R.C. Sec. 83 and the Regulations thereunder generally point to exercise date as the trigger for inclusion of income from exercise of nonqualified stock options, the FICA and income tax withholding provisions do not impose a withholding obligation on the employer until wages are actually or constructively paid...There is presently no specific published guidance relative to whether the date of exercise or date of settlement is the applicable date for considering assertion of the penalty for failure to deposit employment taxes attributable to the exercise of nonqualified stock options."

Applicable SEC Regulations

Rule 15c6-1(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), generally requires broker dealers to deliver securities pursuant to a purchase or sale contract no later than the third business day after the date of the contract.

Rule 17Ad-2(a) of the Exchange Act generally requires any registered transfer agent to turnaround within three business day of receipt at least 90 percent of all routine items received for transfer during a month. Further, for purposes of this rule, items received at or before noon on a business day shall be deemed to have been received at noon on that day, and items received after noon on a business day, or received on a day that is not a business day, shall be deemed to have been received at noon on the next business day.

Request for Administrative Relief & Clarification of Prior Guidance

As noted above, in a Field Directive dated March 14, 2003, the IRS instructed examiners not to challenge the timeliness of employment tax deposits attributable to the exercise of nonqualified stock options, provided that the deposits are made within one day of the settlement date and provided the settlement date is not more than three days after the date of exercise. In issuing this guidance, the IRS noted that "it has been argued that the shares...are not available to the exerciser of the options until settlement date, and therefore no actual or constructive payment of wages takes place until that time." The IRS further explained that a three day safe harbor was justified because "[t]here is generally only a three day delay between time of exercise and time of settlement resulting from such exercise."

Thus, while not directly stated, it appears clear from the Field Directive that the IRS was focused on Treasury Regulation Sections 31.3121(a)-2(a) and (b) and Treasury Regulation Sections 31.3402(a)-1(b) that collectively provide that the wages to which employment taxes attach are not considered "received" until they are "actually or constructively paid" to the employee and, more specifically, until they are "set apart for an employee so that they may be drawn upon by him at any time, without any substantial limitation or restriction" although not then actually reduced to possession.

Further, similar to the delay in the delivery of shares upon exercise of nonqualified stock options, there is frequently a delay in the delivery of shares upon the vesting of restricted stock unit awards and restricted stock. In either case, until such shares are actually delivered to the employee, they are generally not available to be drawn upon at any time by the employee.

In addition, similar to nonqualified stock options, the reasons for the delay in the delivery of shares upon vesting of restricted stock unit awards and restricted stock include, but are not limited to, administrative mechanics related to the delivery of shares or the fact that shares are sometimes withheld or sold on the vesting date or, in some cases, the day following the vesting date, in order to satisfy the tax withholding obligations that arise upon vesting of restricted stock unit awards or restricted stock.

Notably, the Field Directive does not seem to focus on the reason for the delay in the delivery of the shares upon exercise of a nonqualified stock option. Rather, the IRS simply notes that "there is generally only a three day delay between the time of exercise and the time of settlement resulting from such exercise" and then notes the SEC rules requiring that broker-dealer trades must be settled within three days of the applicable contract.

Due to the similar nature of the issues with complying with the employment tax deposit rules with respect to employment taxes arising upon exercise of nonqualified stock options and upon vesting of restricted stock units and restricted stock, ACSPA respectfully requests that the IRS issue guidance providing administrative relief from the penalties for failure to timely deposit employment taxes on the day following any day that an employer accumulates $100,000 or more of employment taxes, where such employment taxes arise upon the vesting of restricted stock units or restricted stock, so long as the deposit of employment taxes is made within one day after the settlement date of the restricted stock units or restricted stock and provided the settlement date is not later than three days after the vesting date.

ACSPA further respectfully requests that the IRS issue guidance clarifying that the guidance provided with respect to nonqualified stock options in its Field Directive dated March 14, 2003 applies to any exercise of nonqualified stock options, regardless of the manner in which the exercise price is paid to purchase the shares or the tax withholding obligation is satisfied.

Conclusion

On behalf of all of its members, ASCPA appreciates the opportunity to present its views on the need for administrative relief from penalties associated with the next day employment tax deposit rule as it applies to restricted stock units and restricted stock and clarification of the administrative relief provided with respect to such rules as they apply to nonqualified stock options.

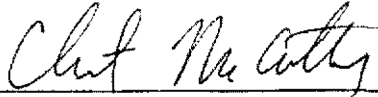
If you have any questions or would like to discuss this request, please do not hesitate to contact ASCPA's General Counsel and Secretary, Christine McCarthy, at:

c/o Orrick, Herrington & Sutcliffe
1000 Marsh Road
Menlo Park, CA 94025

Phone: (650) 614-7634
Fax: (650) 614-7401
Email: cmccarthy@orrick.com

Very truly yours,

AMERICAN COALITION OF
STOCK PLAN ADMINISTRATORS



Christine McCarthy, General Counsel & Secretary

enclosure

cc:

George H. Bostick, Benefits Tax Counsel, Office of Tax Policy, Department of Treasury (with enclosure)

Assertion of the Penalty for Failure to Deposit Employment Taxes

March 14, 2003

MEMORANDUM FOR INDUSTRY DIRECTORS, LMSB
DIRECTOR, PFTG, LMSB
DIVISION COUNSEL, LMSB

FROM: Keith M. Jones /s/ Keith M. Jones
Director, Field Specialists LM:FS

SUBJECT: Field Directive on Assertion of the Penalty for Failure to Deposit Employment Taxes

The purpose of this memorandum is to establish guidelines for examiners on assertion of the penalty for failure to deposit employment taxes owing as a result of exercise of nonqualified stock options. These guidelines are intended to promote the efficiency and consistency of employment tax examinations and to redirect audit resources to other issues. This Field Directive is not an official pronouncement of the law or the Service's position and cannot be used, cited or relied upon as such.

Treas. Reg. § 31.6302-1(c)requires an employer to deposit employment taxes with an authorized financial institution on the next banking day after $100,000 or more of employment taxes have been accumulated during the deposit period.

I.R.C. Sec. 83(a) provides that if in connection with the performance of services, property is transferred to any person other than the person for whom services were performed, the excess of the fair market value of such property at the first time the rights of the person having a beneficial interest are transferable or are not subject to a substantial risk of forfeiture over the amount paid for such property shall be included in income of the service performer in the first taxable year in which the rights of that person in the property are transferable or are not subject to a substantial risk of forfeiture.

Treas. Reg. § 1.83-7 provides that with regard to a nonqualified stock option without a readily ascertainable fair market value at date of grant, Sec. 83(a) and (b) shall apply at the time the option is exercised or otherwise disposed of.

Treas. Reg. § 1.83-7 further provides that Sec. 83(a) and (b) apply to the transfer of property pursuant to such exercise, and the employee realizes compensation upon such transfer at the time and in the amount determined under Sec. 83(a) and (b).

For purposes of taxes imposed under the Federal Insurance Contributions Act (FICA), Treas. Reg. § 31.3121(a)-2(b) provides that wages are paid by an employer at the time they are actually or constructively paid. Wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not actually reduced to possession. To constitute payment in such a case the wages must be credited or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is made, and must be

made available to him so that they may be drawn upon at any time, and their payment is brought within an employee's own control and disposition. The regulations related to income tax withholding contain a similar definition. See Treas. Reg. § 31.3402(a)-1(b).

I.R.C. Sec. 3402(a) requires every employer making a payment of wages to deduct and withhold upon such wages. Treas. Reg. § 31.3402(a)-1(b) requires the employer to withhold the amount of the tax at the time the wages are actually or constructively paid. The provisions related to FICA impose a similar obligation on the employer.

Rev. Rul. 67-257, 1967-2 C.B. 359 specifically holds that an employee has the unconditional right to receive stock upon payment of the option price. The excess of the FMV of the stock on the date of exercise over the option price is compensation includible in the employee's income at the time of exercise. An employer's obligation to withhold under I.R.C. Sec. 3402 arises at that time.

Rev. Rul 78-185, 1978-1 C.B. 304 holds that the FMV of stock at the date of crediting it to the employee's account over the cost to him is wages for FICA, FUTA and income tax withholding purposes.

While I.R.C. Sec. 83 and the Regulations thereunder generally point to exercise date as the trigger for inclusion of income from exercise of nonqualified stock options, the FICA and income tax withholding provisions do not impose a withholding obligation on the employer until wages are actually or constructively paid. It has been argued that the shares (or the value of the shares) are not available to the exerciser of the options until settlement date, and therefore no actual or constructive payment of wages takes place until that time.

There is generally only a three day delay between time of exercise and time of settlement resulting from such exercise. In fact, under 17 C.F.R. Sec. 240.15c6-1(a), the SEC generally established a maximum three day settlement period for broker- dealer trades. There is presently no specific published guidance relative to whether the date of exercise or date of settlement is the appropriate date for considering assertion of the penalty for failure to deposit employment taxes attributable to the exercise of nonqualified stock options. Until such time as guidance is issued or this Field Directive is modified or revoked, LMSB Employment Tax Specialists should not challenge the timeliness of deposits required under Treas. Reg. § 31.6302-1(c), if such deposits are made within one day of the settlement date, as long as such settlement date does not fall more than three days from date of exercise.

If you have any questions or concerns you may contact me at (202)-283-8290, or Pam Christensen, Employment Tax Program Manager, at (775) 824-2234 ext 266.

cc: Commissioner and Deputy Commissioner, LMSB
Commissioner and Deputy Commissioner, SB/SE
Area Directors, SB/SE
Employment Tax Program Manager, LMSB

LEGAL PROCESSING DIVISION
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Notice 2013-22

APR 30 2013

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Miami, Florida

Executive Director
DEBORAH O. MCKINNON

Please Address Reply to:

April 30, 2013

Internal Revenue Service
CC:PA:LPD:PR (Notice 2013-22)
Room 5203
Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

Via Electronic Mail: Notice.Comments@irscounsel.treas.gov

Re: Recommendations for 2013-2014 Guidance Priority List (Notice 2013-22)

Dear Ladies and Gentlemen:

The American College of Trust and Estate Counsel (the "College") is pleased to submit these recommendations pursuant to Notice 2013-22, I.R.B. 2013-15 released on March 22, 2013, which invites recommendations for items that should be included on the 2013-2014 Guidance Priority List.

The College is a professional organization of approximately 2,600 lawyers from throughout the United States. Fellows of the College are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of the College have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift, and GST tax planning, fiduciary income tax planning, and compliance. The College offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

The recommendations include items in the following categories and, as encouraged by the Notice, we have placed the items under each category in what we believe to be the order of their priority.

EMPLOYEE BENEFITS

1. Guidance identifying the "successor beneficiaries" of a trust who may be disregarded in determining a decedent's designated beneficiary when a non-conduit "see-through" trust is named beneficiary of qualified plan or IRA benefits.

2. Guidance concerning spousal rollovers of qualified plan and IRA benefits when an estate or trust is named beneficiary of a decedent's interest.

GIFTS AND ESTATES AND TRUSTS

1. Clarification that QTIP elections in estate tax returns required only to elect portability are valid.

2. Regulations or other guidance defining "GST Trust" under section 2632(c), particularly relating to trusts that give beneficiaries continuing withdrawal rights attributable to prior year gifts to a trust and trusts that make distributions to a nonskip beneficiary dependent upon both the death of a person more than ten years older and the beneficiary attaining a specified age.

3. Guidance regarding the completion of gifts and includibility in the gross estate in the context of self-settled asset protection trusts.

4. Safe Harbor Guidance concerning the application of the Reciprocal Trust Doctrine.

INTERNATIONAL ISSUES

1. Guidance concerning the tax consequences under Section 643(i) of the undercompensated use by a U.S. person of property owned by a foreign trust.

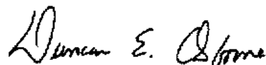
2. Regulation changing the due date for filing Form 3520A from March 15 to April 15.

3. Guidance concerning the application of the Foreign Account Tax Compliance Act ("FATCA") provisions of the Hiring Incentives to Restore Employment ("HIRE") Act (P.L. No. 111-147, 124 Stat. 71 (2010) on reporting and withholding with respect to trusts and their beneficiaries.

4. Guidance concerning the coordination of the foreign corporation anti-deferral rules and Subchapter J.

If you or your staff would like to discuss the recommendations, please contact Ellen Harrison, Chair of the ACTEC Washington Affairs Committee, at (202) 663-8316, or ellen.harrison@pillsburylaw.com; or Leah Weatherspoon, ACTEC Communications Director, at (202) 688-0271, or lweatherspoon@actec.org.

Respectfully submitted,



Duncan E. Osborne
President

Enclosure

The American College of Trust and Estate Counsel (ACTEC)
Recommendations for the
2013-2014 Guidance Priority List (Notice 2013-22)
April 30, 2013

EMPLOYEE BENEFITS

1. **Guidance identifying the "successor beneficiaries" of a trust who may be disregarded in determining a decedent's designated beneficiary when a non-conduit "see-through" trust is named beneficiary of qualified plan or IRA benefits.**

2. **Guidance concerning spousal rollovers of qualified plan and IRA benefits when an estate or trust is named beneficiary of a decedent's interest.**

GIFTS AND ESTATES AND TRUSTS

1. **Clarification that QTIP elections in estate tax returns required only to elect portability are valid.**

2. **Regulations or other guidance defining "GST Trust" under section 2632(c), particularly relating to trusts that give beneficiaries continuing withdrawal rights attributable to prior year gifts to a trust and trusts that make distributions to a nonskip beneficiary dependent upon both the death of a person more than ten years older and the beneficiary attaining a specified age.**

3. **Guidance regarding the completion of gifts and includibility in the gross estate in the context of self-settled asset protection trusts.**

4. **Safe Harbor Guidance concerning the application of the Reciprocal Trust Doctrine.**

INTERNATIONAL ISSUES

1. **Guidance concerning the tax consequences under Section 643(i) of the undercompensated use by a U.S. person of property owned by a foreign trust.**

2. **Regulation changing the due date for filing Form 3520-A from March 15 to April 15.**

3. **Guidance concerning the application of the Foreign Account Tax Compliance Act ("FATCA") provisions of the Hiring Incentives to Restore Employment ("HIRE") Act (P.L. No. 111-147, 124 Stat. 71 (2010) on reporting and withholding with respect to trusts and their beneficiaries.**

4. **Guidance concerning the coordination of the foreign corporation anti-deferral rules and Subchapter J.**

EMPLOYEE BENEFITS

1. **Guidance identifying the "successor beneficiaries" of a trust who may be disregarded in determining a decedent's designated beneficiary when a non-conduit "see-through" trust is named beneficiary of qualified plan or IRA benefits.**

Reg. §1.401(a)(9)-4, A-5 provides that if a trust is named as beneficiary and certain threshold requirements for a "see-through trust" are satisfied, the beneficiaries of the trust (and not the trust itself) will be treated as having been designated for purposes of determining the minimum required distribution period under Section 401(a)(9). Reg. §1.401(a)(9)-5, A-7 provides that "contingent beneficiaries" of such a trust must be counted among the trust's beneficiaries for purposes of determining the distribution period, but "successor beneficiaries" will be disregarded. The distinction between the two is not articulated in the regulations apart from two examples. From one example (Reg. §1.401(a)(9)-5, A-7, Ex. 2), one may extrapolate that remaindermen of a conduit trust (a trust under which all plan or IRA distributions are required to be paid out currently as opposed to accumulated in the trust) that lasts for the lifetime of the conduit beneficiary will be treated as successor beneficiaries. The second example (Reg. §1.401(a)(9)-5, A-7, Ex. 1) deals with a non-conduit trust, but is of limited utility since it describes a trust which in the real world would not exist.

Non-conduit trusts are widely used as estate planning vehicles for time-honored reasons having nothing to do with income tax planning. The lack of guidance on the contingent beneficiary and successor beneficiary concepts since 2002, when the regulations were issued, has complicated standard planning for millions of plan participants and IRA owners and has introduced unnecessary uncertainty. These issues continue after the death of the participant or IRA owner who has named a trust as beneficiary, when a decision needs to be made as to the applicable payout period. The ad hoc process of private letter rulings is an expensive and, for most taxpayers, unfeasible way of obtaining certainty.

Please see the attached March 27, 2003 ACTEC letter addressed to Marjorie Hoffman, Esq., Senior Technician Reviewer, Employee Benefits & Exempt Organizations, Internal Revenue Service (also transmitted to George Bostick, Esq., Benefits Tax Counsel, Office of Tax Policy at the Department of Treasury by the attached July 1, 2010 ACTEC letter). The 2003 letter provides examples of six non-conduit trusts named as beneficiaries of qualified plan or IRA benefits, suggests which beneficiaries should be identified as successor beneficiaries in each case, discusses the rationale for the results, and emphasizes the need for clear rules to make these determinations. The 2003 letter reviews the "snapshot rule" that has been applied in many private letter rulings and compares that rule to a suggested "life expectancy rule" that might instead be applied to a greater number of non-conduit trust provisions.

The 2003 letter also proposes for consideration a rule to apply to trusts that defer distributions to a younger beneficiary until a specified age is attained. The proposed rule is contrary to the result reached in certain private letter rulings, but it is supported by strong policy considerations [recognized in the generation-skipping transfer (GST) tax law] and produces a simpler, more understandable method of determining successor beneficiaries in this common form of non-conduit trust. Finally, the 2003 letter discusses instances where a trust beneficiary's estate is the recipient or potential recipient of trust benefits upon the beneficiary's death and the

reasons such a circumstance should not prevent the trust beneficiary from being treated as a designated beneficiary.

2. Guidance concerning spousal rollovers of qualified plan and IRA benefits when an estate or trust is named beneficiary of a decedent's interest.

Spousal rollovers of qualified retirement plans and IRAs are allowed under Sections 402(c) and 408(d). More than a hundred private letter rulings have been issued since the late 1980s allowing a spousal rollover when an estate or trust (not the surviving spouse) is named as beneficiary. In the vast majority of these rulings, the spouse as executor, trustee and/or beneficiary may unilaterally effect the rollover, and this appears to be key to the result reached. The preamble to the final Section 401(a)(9) regulations, however, suggests a broader approach, which would permit a surviving spouse who does not unilaterally control distributions from an IRA but who does actually receive a distribution from a decedent's IRA to complete a spousal rollover.

The basic fact pattern found in the private letter rulings arises frequently. Therefore, we believe that a published ruling is needed. Currently, after the death of a plan participant or IRA owner, the spouse may be obliged to obtain his or her own ruling at considerable cost and inconvenience, either because the plan administrator or IRA sponsor insists on a ruling or simply because the spouse knows that even numerous private letter rulings issued to others may not be relied on. A Revenue Ruling would provide assurance to plan sponsors and guidance to taxpayers as to the circumstances (whether a spouse's unilateral control over the decision to distribute the decedent's interest in the plan or account, the spouse's actual receipt of a distribution, or both) under which a spousal rollover is valid if an estate or trust is named as the beneficiary.

Please see the attached April 15, 2009 ACTEC letter addressed to Henry S. Schneidermann, Assistant Chief Counsel, Internal Revenue Service (also transmitted to George Bostick, Esq., Benefits Tax Counsel, Office of Tax Policy at the Department of Treasury by the attached July 1, 2010 ACTEC letter). The 2009 letter provides more detail of the issues, requests clarifying guidance, underscores the need for that guidance, and presents a proposed resolution that would avoid the current need for private letter rulings.

GIFTS AND ESTATES AND TRUSTS

1. Clarification that QTIP elections in estate tax returns required only to elect portability are valid.

Rev. Proc. 2001-38, 2001-24 I.R.B. 1335, announced circumstances in which the IRS "will disregard [a QTIP] election and treat it as null and void" if "the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes." The procedure "does not apply in situations where a partial QTIP election was required with respect to a trust to reduce the estate tax liability and the executor made the election with respect to more trust property than was necessary to reduce the estate tax liability to zero." The procedure "also does not apply to elections that are stated in terms of a formula designed to reduce the estate tax to zero."

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Thus, the paradigm case to which Rev. Proc. 2001-38 applies is the case where the taxable estate would have been less than the applicable exclusion amount anyway, so the estate would not be subject to federal estate tax, but the executor listed some or all of the trust property on Schedule M to the estate tax return and thus made a redundant QTIP election.

Rev. Proc. 2001-38 is a relief measure. The transitional sentence between the summary of the background law and the explanation of the problem states that "[t]he Internal Revenue Service has received requests for relief in situations where an estate made an unnecessary QTIP election."

The American Taxpayer Relief Act of 2012 made permanent the "portability" of the unused exclusion amount of a predeceased spouse for the use of the surviving spouse. By statute (section 2010(c)(5)(A)) and regulation (Reg. §20.2010-2T(a)) portability is available only if it is elected on a federal estate tax return for the estate of the predeceased spouse. The regulations (Reg. §§20.2010-2T(a)(1) & (7)(ii)(A)) contemplate that a federal estate tax return will be required for the purpose of electing portability even if it would not be required for federal estate purposes alone, such as a return for an estate where the gross estate, and thus necessarily the taxable estate, are less than the applicable exclusion amount, the paradigm case to which the relief of Rev. Proc. 2001-38 applies.

This leads to the question whether a QTIP election that is "not necessary to reduce the estate tax liability to zero," because it is made on a federal estate tax return filed to elect portability but not otherwise required for federal estate tax purposes, is therefore "null and void," by reason of Rev. Proc. 2001-38. The "relief" origin of Rev. Proc. 2001-38, the likelihood that a revenue procedure announcing the Service's administrative forbearance would not be used to negate an election authorized by statute, and the unseemliness of denying a QTIP election to smaller estates while allowing it to larger estates all suggest that a QTIP election *will* be respected in such a case. This view is reinforced by the explicit reference in Reg. §20.2010-2T(a)(7)(ii)(A)(*4*) to QTIP elections in returns filed to elect portability but not otherwise required for estate tax purposes.

Clarification of that result would be appropriate and welcome.

2. **Regulations or other guidance defining "GST Trust" under section 2632(c), particularly relating to trusts that give beneficiaries continuing withdrawal rights attributable to prior year gifts to a trust and trusts that make distributions to a nonskip beneficiary dependent upon both the death of a person more than ten years older and the beneficiary attaining a specified age.**

Section 2632(c)(3)(B) defines the type of trust to which GST exemption will be automatically allocated in the absence of an election to the contrary (a "GST Trust"). The definition is in the form of a very broad general rule ("a trust that could have a generation-skipping transfer with respect to the transferor"), followed by six exceptions. The six exceptions are designed to exclude trusts to which donors are unlikely to want GST exemption to be allocated, most often because, although a generation-skipping

transfer is possible under the terms of the trust, it is unlikely that a generation-skipping transfer will occur with respect to more than 75% of the trust property.[1] The exceptions are in turn followed by "flush language" excepting certain situations from their reach (the exception to the exception).[2]

In the more than a decade since the subsection 2632(c) was enacted, it has become increasingly apparent that this goal of conforming the automatic rules to a transferor's likely intent based on the terms of the trust has been frustrated in certain common types of trusts by a literal reading of two parts of the definition – the second exception to the general rule and a portion of the flush language exception to the exception. We believe that it is possible to interpret both of these provision by regulation in a manner that will cause them to be applied as necessary to better accomplish the goals of the provision. However, because many taxpayers have relied on the literal language of these provisions, any such regulations should apply prospectively and allow a period for taxpayers to elect into their retroactive allocation.

a. The second exception.[3]

Under the second of the six exceptions, a trust is not a GST trust if the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more non-skip persons who are living on the date of death of another person identified in the instrument (by name or by class) who is more than ten years older than such individuals. For example, a trust that will terminate in favor of a child of the transferor on the death of the transferor or the transferor's spouse (if more than ten years older than the child) would fit within this exception and as a result GST exemption would not be automatically allocated to it.

Unfortunately, in the absence of a regulation to the contrary, this exception may be read to not apply to the following common types of trusts to which we believe the exception was intended to apply: (1) a trust that provides for a parent and his or her child or children until the parent's death and then holds the trust property in further trust until the child reaches a specified age, with an outright distribution of the property thereafter, or (2) an insurance trust that provides for distribution of the trust property on the last to occur of the insured's death, the insured spouse's death or when the insured's child reaches a specified age (often younger than age 46, the age specified in the first exception)[4] because no portion of the trust property would be distributed to the child at

[1] According to the House Report to H.R. 8 as passed by the House on April 4, 2001, the "Committee recognizes that there are situations where a taxpayer would desire allocation of generation-skipping transfer tax exemption, yet the taxpayer had missed allocating generation-skipping transfer tax exemption to an indirect skip, *e.g.*, because the taxpayer or the taxpayer's advisor inadvertently omitted making the election on a timely-filed gift tax return or the taxpayer submitted a defective election. Thus, the Committee believes that automatic allocation is appropriate for transfers to a trust from which generation-skipping transfers are likely to occur." House Report, p. 35.

[2] I.R.C. § 2632(c)(3)(B)(flush language).

[3] I.R.C. § 2632(c)(3)(B)(ii).

[4] I.R.C. § 2632(c)(3)(B)(i), which provides that a trust is not a GST trust if the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more non-skip persons before

the death of a person unless the child had already reached the specified age. Therefore, assuming that none of the other exceptions apply,[5] the trusts would be GST trusts and GST exemption would be allocated automatically in the absence of an election to the contrary and except in the case of an addition to the trust after the child has attained the specified age. **However, in both types of trusts at least 25% of the trust principal is likely to pass to a non-skip person (the child) because most individuals outlive their parents and reach age 46 (if the specified age is younger than age 46).** As a result, it is likely that most transferors would not want to allocate GST exemption to the trust.

We believe regulations could and should make it clear that the second exception to the general rule applies (1) even if in addition to surviving a person who is at least 10 years older than the non-skip person, the non-skip person has to reach an age younger than age 46, the age specified in the first exception and (2) even if the non-skip person needs to survive more than one person, as long as each is at least 10 years older than the non-skip person. A narrower approach to the second suggested clarification would be to provide that for purposes of this exception a married couple is treated as a single person.

b. The flush language exception to the exceptions.[6]

Several of the exceptions,[7] without more, would apply to trusts in which one or more non-skip persons are granted a temporary right to withdraw trust property whenever property is contributed to the trust. Such lapsing withdrawal rights are often limited to the amount of the annual exclusion and lapse during or at the end of the year of the contribution, at least to the extent the lapse will not cause the power holder to be treated as having made a taxable gift by reason of the so called 5 x 5 rule of Code section 2514(e). Because many trusts that grant these powers are likely to give rise to generation-skipping transfers, an exception to this deemed allocation exceptions provides that the value of transferred property is not considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the annual exclusion amount referred to in I.R.C. § 2503(b) with respect to any transferor. Thus, a trust with such a withdrawal right that does not fall within any of the other exceptions will be a GST trust and the deemed allocation will occur.

Unfortunately, in the absence of a clarifying regulation, this special rule for withdrawal rights tied to the annual exclusion may not always apply to trusts with powers

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that individual reaches 46 years of age, on or before one or more dates specified in the trust instrument that will occur before such individual attains 46 years of age, or upon the occurrence of an event that in accordance with Treasury regulations may reasonably be expected to occur before the date that such individual attains age 46. I.R.C. § 2632(c)(3)(B)(i) That exception applies, for example, to a trust that will terminate in favor of its beneficiary when the beneficiary reaches age 45.

[5] Note that these type of trusts do not fit within the first exception because the death of an individual's parent or parents, in most instances, may not reasonably be expected to occur before the child reaches age 46.

[6] I.R.C. § 2632(c)(3)(B)(flush language).

[7] The fourth exception, for example, provides that a trust is not a GST trust if any portion of it would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer. I.R.C. § 2632(c)(3)(B)(iv).

that lapse each year only to the extent of the 5 x 5 rule. Put differently, it may not apply to transfers made at a time when the total amount that may be withdrawn (the sum of the withdrawal right arising by reason of the transfer in the current year and all prior year withdrawal rights that have not lapsed as of the date of the transfer) exceeds the current year's annual exclusion with respect to any transferor. Without this exception to the exceptions, such a trust will meet the fourth exception (and perhaps the first exception if the withdrawal amount exceeds 25% of the value of the trust property, which would not be unusual in the early years of an insurance trust) and thus will not be a GST trust for those transfers Thus, in the first year that transfers are made to such a trust, if the amounts that could be withdrawn are within annual exclusion amount, the trust will be a GST trust and the deemed allocation will apply. In future years, the continuation of a portion of a power from one year to the next may cause the trust to no longer be a GST trust such that no deemed allocation will apply.

We believe regulations could and should rectify this confusing and complicated situation by providing that the exception to the exceptions for annual exclusion withdrawal rights applies if at the time of any transfer that gives rise to a withdrawal right, the amount subject to the withdrawal right "does not exceed the amount referred to in section 2503(b) with respect to any transferor" without regard to whether in future years all or a portion of the withdrawal right from a prior year remains outstanding. Put differently, we believe regulations could provide that once it is determined pursuant to the flush language that a withdrawal amount is not to be taken into account in applying the exceptions to the broad definition of a GST trust, such withdrawal amount is not to be taken into account in any year even if unlapsed.

3. **Guidance regarding the completion of gifts and includibility in the gross estate in the context of self-settled asset protection trusts.**

In an environment of increasing concern that wealth can attract claims and create risks, it is becoming more common for grantors to create trusts in which, for their lives, they themselves (and sometimes others too) have an interest, often in a trustee's discretion. The trust is designed to protect the trust assets from both opportunistic claims and the unwise decisions of grantors themselves. Because the amount of wealth involved in such self-settled trusts is often substantial, it is important for those grantors to know the gift and estate tax consequences – that is, whether and to what extent the transfer will be complete enough to be a taxable gift for federal gift tax purposes and whether and to what extent the value of the trust property will be included in the grantor's gross estate for federal estate tax purposes. Of those two issues, the completed gift issue is the most important, because it has immediate impact.

The principle typically applied to determine whether a transfer is a completed gift is in Reg. §25.2511-2(b):

> As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the

donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined.

The completed gift issue was spotlighted by the disclosure of an Office of Chief Counsel Internal Revenue Service Memorandum dated September 28, 2011 (opened to public inspection on February 24, 2012, as CCA 201208026). Quoting the above regulation, CCA 201208026 concludes that Donors had made completed gifts to a Trust (albeit not a "self-settled" trust from which the Donors themselves could receive distributions). CCA 201208026 has attracted attention among practitioners because it finds a completed gift despite the Donors' testamentary powers over the disposition of the trust property upon their deaths, powers that estate planners have frequently used specifically to prevent a transfer from being a completed gift. This in turn has raised questions about the continued application of the published guidance on which those practitioners have relied, including in the context of self-settled trusts.

As an example, Rev. Rul. 62-13, 1962 C.B. 180, ruled a transfer in trust incomplete because trustees had discretion to pay income and/or principal to the grantor and others during the grantor's life and there was therefore "no assurance that anything of value would ever pass to the remaindermen," even though the grantor retained no power to direct the disposition of the remainder. Thus, CCA 201208026 presents the anomaly that its Donors with a power of appointment over the trust property at death were left with "no power to change [the trust property's] disposition," while the grantor in Rev. Rul. 62-13 who retained no power had not "parted with dominion and control." But CCA 201208026 does not cite Rev. Rul. 62-13 (or Rev. Rul. 77-378, 1977-2 C.B. 347, which "clarified" it).

As another example, CCA 201208026 rests its holding on the fact that the Donors' "limited power to appoint so much of [the trust property] as would still be in the Trust at his or her death" would be reduced or eliminated – in effect terminated – by the trustee's discretionary distributions during the Donors' lives. Reg. §25.2511-2(f) specifically addresses the "termination" of such a power, including termination by the "receipt of income or of other enjoyment of the transferred property by the transferee or by the beneficiary (other than by the donor himself)," which "operates to free such income or other enjoyment from the power." But CCA 201208026 does not cite Reg. §25.2511-2(f).

We appreciate that CCA 201208026 is necessarily a part of a larger file, that it is addressed to Area Counsel and thus possibly written in contemplation of litigation (or at least serious pursuit of issues in audit), and that it recites that it "may contain privileged information" (although no redaction other than identifying details, including identification of the jurisdiction, is apparent), and for all those reasons it may not tell the whole story. We also appreciate that CCA 201208026 may not be used or cited as precedent (and it so recites). Nevertheless, such documents, when made available for public inspection, are used by practitioners to guide their own best practices and assist

them in advising clients. Thus, balanced (and citable) guidance that seeks to resolve questions rather than to pursue a litigation position would be desirable and would foster uniform treatment and compliance. As we have seen in other contexts (such as Rev. Rul. 81-51, 1981-1 C.B. 458, and Rev. Rul. 2004-64, 2004-2 C.B. 7), such guidance could and perhaps should address the extent to which it will be applied prospectively under Section 7805(b)(8).

4. Safe Harbor Guidance concerning the application of the Reciprocal Trust Doctrine.

Since 1940, the courts have recognized there were circumstances when trusts can be so interrelated that the economic positions of the persons who created the trusts have not changed enough to honor the separate trusts for certain tax purposes. As a result, it is possible that trusts created at about the same time may be "uncrossed" and one or more of the retained power provisions (Sections 2036-2038) applied to cause a portion or all of the value of a trust to be included in the settlor's gross estate. This result can obtain even though the settlor was not a beneficiary of that included trust and did not retain a power with respect to that trust which would cause such inclusion absent the existence of the so-called reciprocal trust. This has come to be known as the "Reciprocal Trust Doctrine."

Even though the Doctrine was recognized and applied by the United States Supreme Court in United States v. Grace (395 U.S. 316 (1969)) the federal courts and the Internal Revenue Service have been required to define and apply the doctrine in a variety of settings with varying results. See, for example, Estate of Bischoff (69 T.C. 32 (1977)), Estate of Herbert Levy (T.C. Memo 1983-453 (1983)), Estate of Green v. United States (68 F. 3d 151 (6th Cir. 1995)), and Private Letter Rulings 199643013 and 200426008. Taxpayers and their advisors frequently are faced with a planning situation where both spouses are planning to engage in an arrangement concerning the wealth of the spouses and their family that is best structured using two trusts, which ideally might be identical in terms but for the identity of the settlors. This is most common when spouses are designing mirror image arrangements for themselves and younger family members. Skilled practitioners are able to create degrees of difference which should decrease the possibility of uncrossing such trusts. However, in the absence of a definitive set of rules addressing this issue, taxpayers and their advisors are left to speculate, which can lead to extreme variations in plans solely to assure that one does not run afoul of the Doctrine.

While it may not be necessary to address the full range of variations that should result in trusts that need not be uncrossed, it should be possible to create greater clarity by acknowledging a set of safe harbors such as the existence of separate trustees (or co-trustees when the settlors have been named as fiduciaries) or differences in the powers granted to the spouses, both of which would make it possible to have trusts with a common purpose without requiring some of the differentiation and distortion commonly applied currently to avoid the application of the Doctrine.

INTERNATIONAL ISSUES

1. **Guidance concerning the tax consequences under Section 643(i) of the undercompensated use by a U.S. person of property owned by a foreign trust.**

Section 643(i) was amended by the Foreign Account Tax Compliance Act ("FATCA") provisions of the Hiring Incentives to Restore Employment ("HIRE") Act (P.L. No. 111-147, 124 Stat. 71 (2010) to provide that the use by certain U.S. persons of property owned by a foreign trust would be deemed to be a distribution by the trust equal to the fair market value of the use of such property except to the extent adequate consideration for such use was timely paid. The amendment was effective on date of enactment, March 18, 2010. Prior to this amendment, the statute applied only to loans of cash or marketable securities and not to "loans" of other property, such as residences or works of art.

The statute applies to use by a U.S. person who is a grantor, a beneficiary or any other person who is related to a grantor or beneficiary. A person is related to a grantor or beneficiary by application of the rules in section 267 or section 707(b) applied as if family members included spouses of members of the family.[8] If the person using the trust property is not a grantor or beneficiary, the deemed distribution is treated as made to the grantor or beneficiary to whom such person is related rather than to the person who is or was actually using the trust property. If the person using the property is related to more than one grantor and/or beneficiary, the deemed distribution to the grantor and/or beneficiaries is to be allocated among them in accordance with regulations. No regulations or other guidance has been issued.

If compensation is paid for the use of property other than cash or marketable securities, the deemed distribution is reduced by the amount of such compensation if it is paid within a reasonable period of time of such use.

If the statute applies to deem a distribution to have been made, any subsequent transaction, such as the return of such property to the trust, shall be disregarded.

Guidance is needed concerning the following issues:

[8] Thus, related persons include members of the family (sibling, brother or sister-in-law, spouse, ancestors and their spouses, and descendants and their spouses), an individual and a corporation more than 50% owned by such individual, two corporations which are members of the same controlled group, a grantor and a fiduciary of a trust created by such grantor, fiduciaries of separate trusts created by the same grantor, a fiduciary and a beneficiary, a fiduciary and a beneficiary of another trust if the same person is the grantor of both trusts, a fiduciary of a trust and a corporation more than 50% owned by the trust or by the grantor of the trust, a person and an exempt organization if the organization is controlled by the person or a member of such person's family, a corporation and a partnership if more than 50% of the stock or more than 50% of the capital or profits interest in the partnership interests are owned by the same persons, S corporations if the same persons own more than 50% of the stock of both, an executor of an estate and a beneficiary of an estate, a partner and a partnership if the partner owns more than 50% of the capital or profits interest and two partnerships in which the same persons own more than 50% of the capital or profits interest. In applying the related party rules, a person is treated as indirectly owning stock held through a corporation, partnership, estate or trust in which such person has an interest, and is treated as constructively owning stock owned by a family member.

- How should the trustee and the taxpayer determine the fair market value of the use of property where there is inadequate data for determining the fair market value of the use of such property? An example would be the fair rental value of fine art. To make compliance easier, a rule of convenience would be helpful. A similar rule of convenience exists, for example, for determining fair market interest rates and the present value of life estates, annuities and remainders. A similar rule could be used for determining the fair rental value of property for which no market data is readily available.

- How should the trustee and the taxpayers allocate the deemed distribution where more than one person uses the property owned by the trust or the person using such property is related to more than one beneficiary and/or the grantor?

- What are the tax consequences of the receipt by the trust of compensation for the use of trust property paid by a grantor, beneficiary or related person? For example, will a beneficiary realize gross income from payments such beneficiary herself made to the trust which are distributed or required to be distributed back to her? If the rental is for the use of U.S. property, is tax withholding required? Will compensation for the use of property include expenses of use (such as utilities and condominium fees) paid by the person who uses the property and, if so, will the foreign trust be deemed to have received gross income where such person pays such expenses?

- It would be helpful to confirm that the deemed distribution carries out trust income and accumulated income but does not create income.

- It would be helpful to confirm that the statute does not apply to grantor trusts covered by Subpart E of Subchapter J.

- It would be helpful to clarify the provisions of section 643(i)(3) providing that subsequent transactions, such as the return of property to the trust, will be disregarded.

2. Guidance under Section 6048 changing the due date for filing Form 3520-A from March 15 to April 15.

Under section 6048(b), U.S. persons treated as "owners" of a foreign trust ("U.S. Owners") must annually file a return confirming such status and must also ensure that the trust files a return providing a full and complete accounting of all trust activities and operations. The trust's return is filed on Form 3520-A. The Form 3520-A instructions and Notice 97-34, 1997-1 C.B. 422, indicate that Form 3520-A is due by the 15th day of

the third month following the close of the trust's tax year.[9] Because section 644 provides that all trusts other than tax exempt and charitable trusts must adopt a calendar year as their taxable year for U.S. tax purposes, as a practical matter most Forms 3520-A are due on March 15th.

The Form 3520-A filing was conceived as the filing obligation of a foreign trust. However, because it is the U.S. Owner, not the trust itself, who is responsible for ensuring the form is filed, in practice the preparation and filing of the form falls to the U.S. Owner. As a result, the March 15th due date for the Form 3520-A acts as a trap for the unwary. In most cases, the U.S. Owner has an April 15th deadline for his own income tax return and therefore may not consider the filing obligations with respect to the trust until after the March 15th deadline has passed.

The likely rationale for the March 15th deadline is to ensure that the U.S. Owner has time to review the Form 3520-A information and include it on his own return and Form 3520. Because the U.S. Owner is responsible for ensuring that the Form 3520-A is filed, however, in most cases the U.S. Owner's tax preparer is charged with completing the Form 3520-A, making this lead time unnecessary. Thus, we would suggest that the IRS issue guidance adopting an April 15th due date the Form 3520-A to avoid confusion and simplify administration. In addition, the IRS should consider issuing guidance that the filing of a Form 4868 by the U.S. Owner to extend his own return is effective to extend the due date for the Form 3520-A.

3. **Guidance concerning the application of the Foreign Account Tax Compliance Act ("FATCA") provisions of the Hiring Incentives to Restore Employment ("HIRE") Act (P.L. No. 111-147, 124 Stat. 71 (2010) on reporting and withholding with respect to trusts and their beneficiaries.**

ACTEC submitted comments to representatives of the Department of the Treasury on January 7, 2011, concerning the application of FATCA to trusts and their beneficiaries. A copy is attached. Since that time, proposed and temporary regulations were issued under Section 6038D, final Form 8938 was issued, and final regulations were issued concerning Sections 1471-1474. This guidance clarified a number of important issues, but some additional guidance would be very helpful. In addition, a number of intergovernmental agreements ("IGAs") have been signed modifying the rules for purposes of Sections 1471-1474.

The regulations under Sections 6038D and Sections 1471-1474 were extremely helpful in providing bright line tests for determining when a beneficiary has a beneficial interest that must be reported and quantifying the value of such interest. In particular, the regulations are helpful in stating that a person whose interest is mandatory is deemed to own a portion of the trust based on his or her mandatory distribution rights valued using the rules under Section 7520, a beneficiary whose interest is wholly discretionary is considered to own only the value of what he or she actually received from the trust in the

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[9] Confusingly, regulations under section 6048 applicable solely to foreign grantor trusts described in section 679 specify an April 15th deadline for filing the Form 3520-A. Treas. Reg. § 401.6048-1(c)(1). These regulations pre-date the current version of section 6048.

relevant year, the interest of a beneficiary in a trust that is deemed owned by another U.S. person under the grantor trust rules may be disregarded (so that only the U.S. person who is deemed to be the owner under Sections 671-679 is considered to own the trust) and certain de minimis interests may be disregarded. This rule acknowledges the difficulty of allocating beneficial interests to discretionary beneficiaries. However, certain questions remain such as whether mandatory distribution rights include remainder and contingent interests, whether the de minimis rules apply to trusts classified as foreign financial institutions ("FFIs") as well as to trusts classified as non-financial foreign entities ("NFFES"), whether the rules for determining beneficial interests are applicable to owner reports filed by owner-documented FFIs, and whether Treas. Reg. section 1.1473-1(b)(2)(v) (attributing ownership among related parties) applies to related parties who are foreign persons and to trusts that are FFIs. For example, if a foreign person is treated as owning all or a portion of a trust, will a U.S. relative of that foreign person be attributed ownership even though the U.S. relative received no distribution?

In addition, the regulations under Sections 1471-1474 do not allow the bright line test for determining beneficial ownership of a trust to be applied for purposes of determining indirect ownership of shares of a holding company owned by a trust. Instead, Treas. Reg. section 1.1473-1(b)(2) requires that a "facts and circumstances" test be used. The same bright line rule is necessary to determine indirect ownership of the holding company in order to make administration of the withholding rules practicable. The use of different rules for determining ownership of the trust and holding company may lead to illogical results. For example, it may be possible for a beneficiary whose interest in the trust is zero percent to be considered to indirectly own some of the shares of the underlying holding company owned by the trust.

A simplified method for determining ownership of shares of foreign corporations held indirectly through foreign trusts also is necessary to comply with the new passive foreign investment company ("PFIC") information reporting rules under Section 1298(f). FATCA requires annual reporting of PFIC interests held or deemed held indirectly through a foreign trust even if the taxpayer has not received a distribution or made any of the elections available to PFIC shareholders. A preferable alternative to aggressive application of indirect ownership rules would be adoption of reforms to the treatment of corporations owned through trusts which are discussed in paragraph 4 below.

The rules and regulations under Sections 1471-1474 are extremely complex. It would be very helpful if the IRS would issue simplified guidance as to how these rules apply specifically to trusts and estates. In addition to the specific guidance described above, clarification of the following would be helpful:

a. How to determine who is the "payee" for purposes of withholding under Section 1471 when payment is made to a trust (i.e., is the payee the trustee, the custodian, the holding company owned by the trust, the trust itself as an entity, the grantor in the case of a grantor trust, or the beneficiary in the case of a beneficiary-owned trust), is the payee different depending upon whether the trustee is an FFI or an NFFE, whether the payment is U.S. source fixed and determinable annual periodic income and whether the trust beneficiaries are exempt persons? In particular, the rules of Treas. Reg. section 1.1471-3(a)(3)(ii) are confusing.

b. Whether an estate is disregarded as a specified U.S. person for all withholding tax purposes or whether the exception to the definition of U.S. accounts to exclude accounts held by an estate[10] applies only to accounts held directly by a U.S. estate. For example, is a trust that has only a U.S. estate and foreign persons as beneficiaries considered to be a U.S. owned entity?

c. Whether a trust that is a participating FFI must report "accounts" deemed held by U.S. beneficiaries or may report account information in the aggregate in the same manner as an owner-documented FFI or NFFE may report or in the alternative whether the trustee may elect to instead file those forms that a U.S. trustee would file, such as Forms K-1 (in lieu of Forms 1099 or FATCA reports).[11]

d. Guidance for determining when and how a beneficiary of a foreign trust can claim a refund of overwithheld tax as the "beneficial owner" of the income. The beneficiary is the beneficial owner to the extent of distributions made to such beneficiary that carry out income of the trust to the beneficiary. However, the beneficiary could not be the beneficial owner of that portion of trust income that has been withheld to pay tax unless the trustee were able to assign that tax refund to the beneficiary.

e. Guidance for determining the "controlling persons" of foreign trusts subject to an IGA. The IGA defines controlling person to include the grantor and beneficiaries or class of beneficiaries, as well as trustees, protectors, holders of powers of appointment and any other person in control of the trust. The definition is confusing because grantors and beneficiaries would not normally have any control over the trust, so that the adjective "controlling" is misleading (as is the reference to any other person in control of the trust). Does a "controlling person" include a beneficiary whose discretionary beneficial interest is disregarded under the bright line test in the regulations?

f. Clarification of when a trust is eligible to avoid withholding by becoming an owner-documented FFI, and in particular, those affiliations that make a trust *ineligible to be an owner-documented* FFI.[12]

g. Guidance concerning an election by a foreign trustee to file US information returns.

h. Further clarification of the distinction between an FFI and an NFFE including: whether a private trust company and/or a trust managed by a private trust company is an FFI or an NFFE, whether a trust managed by a professional individual trustee is an FFI or an NFFE, and whether a trust managed by an individual trustee who hires a financial institution to advise on investments but doesn't delegate investment authority is an FFI or an NFFE.

[10] Treas. Reg. section 1.1471-5(b)(2)(iii) and 1.1471-2(a)(4)(vii).
[11] Treas. Reg. section 1.1471-4(d)(3).
[12] Treas. Reg. section 1.1471-3(d)(6).

4. Guidance concerning the coordination of the foreign corporation anti-deferral rules and Subchapter J.

ACTEC submitted comments to representatives of the Department of the Treasury on June 23, 2010. A copy is attached. The corporate anti-deferral rules applicable to controlled foreign corporations ("CFCs") and passive foreign investment companies ("PFICs") and the accumulation distribution rules applicable to trusts serve the same purpose – preventing the use of foreign entities to defer payment of tax or imposing an interest charge if tax payment is deferred. Proposed regulations on the corporate anti-deferral rules for passive foreign investment companies were issued on April 1, 1992, and have not been finalized. The preamble notes the need to coordinate the accumulation distribution rules of Subchapter J and the PFIC tax regime. We agree, but there has been no further published guidance in twenty years. The need for guidance is increased by the penalties imposed by new Section 1298(f) for a beneficiary's failure to report indirect ownership of PFIC shares. ACTEC comments suggested a set of rules that would better coordinate the overlapping rules with the objective that tax would be owed at the time a person received distributions (and not before) but the interest charge on delayed payment of tax would be preserved.

The possible issues include:

a. Whether beneficiaries should be deemed to indirectly own CFCs and PFICs through a discretionary non-grantor trust and if so, how the allocation of ownership will be made and how adjustments will be made to avoid double tax when income imputed to a beneficiary is later distributed to that person or another person or when the trust disposes of shares.

b. Whether, instead of imputing income to beneficiaries, beneficiaries should be taxed when they receive distributions (as under Subchapter J) but the interest charge under the accumulation distribution rules would be modified to treat the trust as having accrued income at the time the income accrued to the CFC or PFIC owned by the trust.

c. Clarification of indirect ownership of PFICs through US entities.

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Re: Request for Published Ruling Clarifying Reg. § 1.401(a)(9)-5, A-7(b) and (c)

Dear Marjorie:

This letter is submitted by the American College of Trust and Estate Counsel on behalf of its Employee Benefits Committee.[1] It follows up on your suggestion to your fellow panel members prior to the ALI-ABA Video Law Review program this past May that with the issuance of "final" regulations under Section 401(a)(9) the Internal Revenue Service would be amenable to issuing further guidance in the form of published rulings. You also said you would welcome the input of practitioners as to where such guidance was needed.

At the time, some panel members suggested that one area that remained unclear after the final regulations, and as to which further guidance would be welcome, was the distinction between a "contingent beneficiary" and a "successor beneficiary" under Reg. § 1.401(a)(9)-5, A-7(b) and (c), respectively. This distinction is crucial to the determination of whether there is a "designated beneficiary" of a qualified plan or IRA where a *trust is named as beneficiary:* a potential recipient of funds under the trust that is treated as a "contingent beneficiary" will be taken into account in determining the designated beneficiary, whereas a potential recipient that is treated as a "successor beneficiary" will not be. One or more qualified plans or IRAs are the largest financial asset of many individuals, and as a result standard estate planning principles will call for the beneficiary of all or some portion of the plan or IRA to be a trust. Estate planning practitioners need to know what are the consequences under the distribution rules of naming one or another kind of trust as a beneficiary. In addition, if it is important that the plan or IRA have a designated beneficiary, practitioners need to know what are the rules that must be followed in order to achieve that result.

Recent private letter rulings have only heightened the confusion surrounding this subject and thus the need for published guidance. Private letter rulings, issued on an

[1] The American College of Trust and Estate Counsel is a professional association of over 2,600 lawyers throughout the United States, elected to membership by their peers on the basis of their professional reputation, ability, and contributions in legal matters affecting estate planning.

ad hoc basis in response to particular fact situations, are not intended to provide general guidance and are a poor vehicle for this purpose. The purpose of this letter, therefore, is to illustrate for you by example the questions which need to be answered, and to offer our suggestions in each case as to what the result should be. It is hoped that the examples could form the basis for a published ruling.

In all the following examples, it is assumed that the trust described is named as beneficiary of a qualified plan or IRA, and that the trust is not a "conduit" trust, so that some portion of the distributions from the plan or IRA will or may be accumulated in the trust and not paid out currently.

1. Trust provides for all income to be paid to X for life, remainder at the death of X to Y, who is younger than X, if Y is then living. If Y does not survive X, the remainder will go to C, which is a charity.[2]

Suggested result:. C is a successor beneficiary and not a contingent beneficiary. Thus C will not be taken into account in determining the identity of the designated beneficiary, and X is the designated beneficiary.

There are two possible rules which could lead to this result, either of which would be equally workable. Since the rules may lead to different results in different situations, however (see, for instance, Example 2, below), it is important for practitioners to know which rule is operative.

One rule is that a contingent remainderman under a trust (C in the above example), who will take only if the primary remainderman (Y in the above example) does not survive to take, will be treated as a successor beneficiary except a primary remainderman who is older than the current beneficiary. The rationale behind this rule is that a primary remainderman who is younger than the current beneficiary will be presumed to survive the current beneficiary and thus to take. By contrast, if the primary remainderman is older than the current beneficiary, the primary remainderman will be presumed not to survive the current beneficiary, so that the contingent remainderman will take on the death of the current beneficiary. Applying this principle, which we will call the "life expectancy rule," to Example 1, since Y is younger than X and C will take only if Y does not survive X, C is treated as a successor beneficiary.

The other rule which could be applied in this circumstance is that a remainderman under a trust will be treated as a contingent beneficiary if and only if he or she would take upon the hypothetical death of the current beneficiary on the beneficiary determination date. All remaindermen who would not take in this circumstance will be treated as successor beneficiaries. Under this principle, which we will call the "snapshot rule," contingent remaindermen would always be treated as successor beneficiaries. Applying this rule to Example 1, since Y would take if X were to die on the beneficiary determination date, and C would take nothing, C is treated as a successor beneficiary.

We note that if instead the Service were to take the position in the above example that C was a contingent beneficiary, a position which we strongly feel is ill-advised, it would be incumbent upon the Service also to make it clear to practitioners under what circumstances, if at all, the naming of a charity, or intestate heirs, or some other beneficiary which was not an individual, as a contingent remainderman would *not* cause the trust to fail to have a designated beneficiary. For instance, assume the trust in the above example instead provided on the death of X for distribution to the descendants of the grantor by right of representation (per stirpes) with C charity to take only if no descendants survived X, and on the beneficiary determination date the grantor had five children, twelve grandchildren and three great-grandchildren. Would C be treated as a contingent beneficiary in that circumstance? If not, what rule would be applied to differentiate that case from the trust described in Example 1?

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[2] This example is identical in substance to Example 1 in Reg. § 1.401(a)(9)-5, A-7(c)(3) except for the addition of C as contingent remainderman. The example in the regulation postulates that no one has a beneficial interest in the trust other than the primary remaindermen, the children of the grantor. This is a somewhat puzzling statement, since the trust property must pass to some person or entity, either by the terms of the governing instrument or applicable state law, if the children do not survive the income beneficiary.

2. Trust is the same as in example 1 except that Y, the primary remainderman, is older than X.

Suggested result: The result depends on whether the operative rule is the life expectancy rule or the snapshot rule. We are indifferent as to which rule is to be applied, so long as the rule is clearly stated and consistently applied.

Under the life expectancy rule, C would be a contingent beneficiary and thus there would be no designated beneficiary, because Y is older than X and thus will be assumed not to survive to take on the death of X. Thus, one must look to the next remainderman, which is C. Note, however, that if the trust provided that if Y did not survive X Y's children would succeed to Y's interest, and C would take only if none of Y's children survived, and if at the beneficiary determination date Y had one or more children who were younger than X, C would be treated as a successor beneficiary under the life expectancy rule, and the designated beneficiary would be X.

Under the snapshot rule, C would be a successor beneficiary, because if X died at the beneficiary determination date Y would take. The fact that Y was older than X would be irrelevant.[3]

3. Trust is the same as in example 1 except that X also has a testamentary special power of appointment exercisable in favor of the grantor's children and more remote descendants, all of whom are younger than X.

Suggested result: The result is the same as in Example 1 and is not affected by the special power of appointment, regardless of whether the life expectancy rule or the snapshot rule is applied. Under either rule, all the possible appointees are contingent beneficiaries: under the life expectancy rule because they are all younger than X, and under the snapshot rule because any of them could take on the hypothetical death of X on the beneficiary determination date depending on how the power of appointment was exercised. Because all possible appointees are younger than X, X remains the designated beneficiary. This result would be the same no matter how the class of appointees was defined, so long as members of the class were "identifiable" within the meaning of Reg. § 1.401(a)(9)-4, A-1 and were all younger than the holder of the power of appointment.[4]

4. Trust is a discretionary trust for the benefit of minor child A until A reaches age 30, whereupon the trust will terminate by distribution outright to A. If A does not survive until age 30, the trust will terminate in favor of A's children or, if none, in favor of charity C. A has no children at the beneficiary determination date.

Suggested result: All remaindermen other than A, who will take only if A does not survive until age 30, will be treated as successor beneficiaries, so that A is the designated beneficiary.

We feel that there are powerful policy reasons for this result. This kind of trust is a standard vehicle for the holding of property for young children; its sole purpose is to defer outright ownership until the child

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[3] PLR 200252097, although it did not by its terms apply the final regulations, suggests that the Service is applying the snapshot rule. There the trust named as beneficiary was for the benefit of Taxpayer C for life, terminating in favor of C's children at C's death or, if none, in favor of the heirs of the grantor living at C's death. At the beneficiary determination date, C was childless, and the grantor's heirs were C's siblings, all of whom were older than C. The Service held that D, the oldest of C's siblings, was the designated beneficiary.

[4] The result we suggest is consistent with what appears to be the view of the Service as stated in PLR 200235038. There the beneficiary of an IRA was a trust for the benefit of child C, under which C had a testamentary power of appointment exercisable in favor of anyone other than C's estate, his creditors, or a "Disqualified Appointee". A "Disqualified Appointee" was defined as any individual older than C, any person other than a trust or an individual, or any trust having as a beneficiary an individual older than C. The Service held that the designated beneficiary under the trust was C because "any potential beneficiary of taxpayer C's interest in IRA X must be no older than taxpayer C."

reaches sufficient maturity to be able to deal responsibly with the assets. The probability that the child will survive to the termination date of the trust is overwhelming. To require that someone else be treated as a designated beneficiary, or that there be no beneficiary at all, based on a hypothetical disposition of the trust which almost certainly will not happen, seems arbitrary and not in accordance with the reality as to who is the beneficiary of the trust. We note also that in this circumstance, a determination that the designated beneficiary is anyone other than the minor child is likely to have a severe adverse consequence in terms of the permissible payout period.

We understand that there might be concern about abuse if a rule were adopted that the designated beneficiary of all trusts which by their terms terminated in favor of the current beneficiary during the beneficiary's actuarially determined life expectancy was the current beneficiary. At some point, if the trust terminates at age 50, 60 or beyond, the likelihood that the current beneficiary will in fact take becomes less than overwhelming, and the likelihood that the trust will terminate in favor of remaindermen other than the current beneficiary becomes more than negligible. We suggest, therefore, that the Service adopt a cut-off age beyond which, if the trust does not by its terms terminate, the designated beneficiary will be determined on the same basis as if the trust by its terms lasted for the beneficiary's lifetime. Extrapolating from the generation-skipping transfer tax (IRC § 2632(c)), we would further suggest age 46 as the cut-off age.[5] In other words, if a trust will terminate in favor of the current beneficiary at age 45 or before, remaindermen other than the current beneficiary will be disregarded; if, however, the trust will terminate in favor of the current beneficiary at age 46 or older, remaindermen who take if the current beneficiary does not survive to take will be taken into account on the same basis as if the trust by its terms went for the life of the current beneficiary.

We are aware that our suggested result is contrary to the result reached in PLR 200228025, which was decided under the 1987 proposed regulations. PLR 200228025 involved a trust for the benefit of two grandchildren, which would terminate with respect to 50% when each grandchild reached age 30. If one grandchild died before that age, the other would take the entire trust. If *both* grandchildren died before age 30, a collateral relative, age 67, would take. The ruling does not state who would take if the 67 year old was not alive to take, which was surely highly probable in the extremely unlikely event that both grandchildren died before age 30; that evidently was not considered relevant. The ruling held that the designated beneficiary was the 67 year old. We respectfully submit that at least under the final regulations this result is wrong, and that the older of the two grandchildren should instead have been treated as the designated beneficiary.

5. Trust is a discretionary trust for A for life, terminating at A's death in favor of A's estate.

Suggested result: A is the designated beneficiary, because A's estate should be treated as "stepping into the shoes of" the beneficiary for 401(a)(9) purposes and thus as the equivalent of the beneficiary.

A position the Service has recently taken in the charitable remainder trust ("CRT") area strongly supports this result. Normally, a CRT set up for the benefit of a second trust for an individual, rather than for the benefit of the individual directly, may last only for a term of up to 20 years rather than for the individual's lifetime. In Rev. Rul. 2002-20, however, the Service held that in certain circumstances, a trust as beneficiary of a CRT will be treated as the equivalent of an individual beneficiary, thus permitting the CRT to run for the life of the individual beneficiary of the second trust.

Rev. Rul. 2002-20 involved three CRTs established for the benefit of three slightly different trusts for the benefit of C, a disabled individual. All three of the beneficiary trusts lasted for C's lifetime and provided for distributions to be made solely to C. On C's death, two of the three beneficiary trusts terminated in favor of C's estate; the other gave C a general power of appointment over all funds which were not required to reimburse Medicaid for assistance provided to C during life, in default of which the trust assets would be distributed to charity. The ruling holds that in all three situations, the CRT may

[5] Section 2632(c) defines a "GST trust" in part in terms of whether or not the trust will distribute to a "non-skip person" (*i.e.* a member of the generation immediately below the grantor) before age 46. If so, there is a statutory presumption that the non-skip person will take.

last for C's lifetime, because "Upon C's death, the assets remaining in Trust B will be distributed either to C's estate or, after reimbursing the state for any Medicaid benefits provided to C, will be subject to C's general power of appointment. In these situations, the use of the assets in Trust B during C's life and at C's death is consistent with the manner in which C's own assets would be used. C, therefore, is considered to have received the unitrust amounts directly from Trust A [the CRT] . . .". Similarly in this context, payment of the trust assets to the beneficiary's estate on termination of a trust should be treated as the equivalent of payment to the beneficiary himself, because it is the same ultimate disposition of the property which would have occurred had the beneficiary received the trust assets during life.

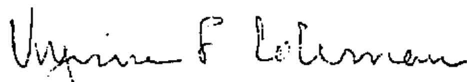
We are aware, of course, that the estate *of the employee* cannot be a designated beneficiary because only an individual can be a designated beneficiary. Reg. § 1.401(a)(9)-4, A-3. There is no inconsistency between this rule, however, and a recognition that the estate *of an individual, named beneficiary* will be treated in the same way as the named beneficiary.

6. Same as in example 5, except that upon A's death A has a testamentary general power of appointment, exercisable in favor of any person or persons including A's estate. In default of appointment, distribution will be made to C charity.

Suggested answer: A is the designated beneficiary, because a testamentary general power of appointment, exercisable in favor of the estate, should be treated in the same way as if the estate were directly named as beneficiary. To draw a distinction between the two would elevate form over substance. Rev. Rul. 2002-20 treats the two as indistinguishable in the CRT context, and they should likewise be treated as indistinguishable in this context.

We would very much appreciate your consideration of these questions for a published ruling, and would be pleased to work with you toward this end in any way that you felt was helpful. Although in all cases, as described above, we have our own views as to what we feel the answer should be, at this point we feel any answers at all, so long as they are clear, would be preferable to the current state of confusion.

Yours sincerely,



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Re: Notice 2008-47: Request for Revenue Ruling Regarding Spousal Rollovers – IRC Sections 402(c) and 408(d)(3)

Dear Mr. Schneiderman:

I am writing on behalf of The American College of Trust and Estate Counsel (ACTEC), a professional association of more than 2,500 lawyers skilled and experienced in estate planning and administration and dedicated to the improvement of the law as it affects estate planning and administration.

We request that the Internal Revenue Service (IRS) issue a Revenue Ruling or similar pronouncement upon which all taxpayers may rely dealing with spousal rollovers of qualified retirement plan accounts and IRAs. The issuance of such a ruling would be in the public interest.

<u>Background:</u>

The qualified retirement plan and individual retirement account (IRA) have become some of the most significant assets in a person's estate. The income tax treatment of these assets affects a very large number of taxpayers. One of the most important federal income tax provisions relating to these assets involves the IRA "spousal rollover" provided for under Internal Revenue Code (Code) sections 402(c) and 408(d)(3)(A).

Under these provisions, eligible distributions from a qualified retirement plan or IRA that are paid into an IRA for the benefit of the surviving spouse of the qualified retirement plan participant or IRA owner within sixty days of the distribution date (a "spousal rollover") are not subject to inclusion in gross income under Code section 72. Such spousal rollovers are very important, because they allow the surviving spouse to take distributions over his or her own life expectancy, redetermined annually using the Uniform Table, and also to name his or her own beneficiary, who in turn can take distributions over that beneficiary's life expectancy.

The preamble to the Final Income Tax Regulations promulgated under Code section 401(a) (9) (the "Preamble Language") states as follows with respect to the circumstances in which a spousal rollover is available:

> If [a surviving] spouse actually receives a distribution from the IRA, the spouse is permitted to roll that distribution over within 60 days into an IRA in the spouse's own name to the extent that the distribution is not a required distribution, regardless of whether or not the spouse is the sole beneficiary of the IRA owner. Further, if the distribution is received by the spouse before the year that the IRA owner would have been 70 1/2, no portion of the distribution is a required minimum distribution for purposes of determining whether it is eligible to be rolled over by the surviving spouse.

These "spousal rollover" portions of the Code and regulations thereunder are extremely complicated, and often are poorly understood by the average estate planning attorney or accountant, when they are applied to circumstances in which the surviving spouse is not named directly as a beneficiary. Most troubling is the fact that a significant number of retirement plan and IRA plan sponsors are now requiring that a surviving spouse obtain a private letter ruling before the plan sponsor will allow a spousal rollover to be made when an estate or trust, and not the spouse, is named as beneficiary. As a result, the many private rulings addressing this issue (discussed below) and the Preamble Language itself in many cases effectively have been rendered moot. The cost to both the IRS and taxpayers of each taxpayer having to request a private ruling in this circumstance will be enormous.

Therefore, a Revenue Ruling is needed addressing spousal rollovers of a decedent's interest in a Retirement Plan or IRA (the "Decedent's Interest") where an estate or trust (<u>not</u> the surviving spouse) is the named beneficiary of such Decedent's Interest.

Private Rulings:

The IRS has issued many private letter rulings, going back more than a decade,[1] in which a surviving spouse was allowed to roll over a Decedent's Interest even though the beneficiary of the Decedent's Interest in the Retirement Plan or IRA was the decedent's estate or trust. In each of the private letter rulings, the rollover was valid because the surviving spouse was either the executor or trustee of the estate or trust, was in control, and was the sole person who could make the decision to distribute the Decedent's Interest to the surviving spouse. In other words, the Decedent's Interest was *not* treated as having passed through a third-party estate or trust. Instead, the surviving spouse was treated as having received the Decedent's Interest from the decedent.

A recent ruling, PLR 200807025 (Nov. 23, 2007), allowed a spousal rollover where an IRA passed to an estate and became part of a grantor trust which became irrevocable upon the grantor's death. The IRA could have been allocated to any one of four separate subtrusts. The surviving spouse was *not* in complete control of the distributions from the trust. One Co-Trustee of the Marital Trust was the spouse. She and the other Co-trustee of the Marital Trust were required to approve the allocation of the Decedent's Interest to the Marital Trust. The spouse then withdrew the Decedent's Interest from the Marital Trust and requested a favorable ruling that she could roll over the withdrawal to an IRA maintained in her name. The IRS granted her request and quoted the Preamble Language for justification.

In a recent Webcast, however, an IRS representative indicated that the Preamble Language should be read as applying only when the surviving spouse has control and that PLRs similar to 200807025 will likely *not* be granted. He explained that the taxpayer in that private ruling represented that there was no choice as to how the IRA would be allocated among the trusts presented in that fact pattern.

Need for Guidance:

A Revenue Ruling is necessary in order to provide assurance to plan sponsors and guidance to taxpayers as to the circumstances under which a spousal rollover is valid if an estate or trust is named as the beneficiary. As mentioned above, such a ruling will avoid the very significant cost to taxpayers and to the IRS of compelling taxpayers faced with these circumstances to request a private ruling to address this issue, a requirement that is being placed on taxpayers by a significant number of plan sponsors.

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[1] *See, e.g.,* PLR 200324059 (Mar. 18, 2003); PLR 200634065 (April 7, 2006); PLR 200637033 (June 20, 2006), for three examples of more recent rulings.

Further, taxpayers may not rely on private letter rulings granted to others.[2] This means that, regardless of the interpretation applied to the Preamble Language in private letter rulings, practitioners may not wish to recommend spousal rollovers when an estate or trust, rather than the spouse, is named as the beneficiary unless they obtain a private letter ruling for the client or the IRS makes its position official, such as by issuing a revenue ruling. Given the ubiquitous nature of retirement plans and IRAs, such an official position would be of great benefit to all.

In addition, clarifying the meaning of the Preamble Language would be beneficial. Based upon the private letter rulings and informal statements from IRS representatives, it is unclear whether a surviving spouse must be in complete control of the distribution for a rollover to be valid, or whether the spouse can roll over the distribution to a spousal IRA regardless of whether the spouse is in control of the distribution as long as a spouse receives a distribution pursuant to the terms of the estate or trust.

Proposed Resolution:

We respectfully request that the IRS issue as soon as practicable a revenue ruling (or other pronouncement upon which taxpayers may rely) that a spousal rollover may be accomplished by a surviving spouse with a distribution (other than a required minimum distribution) actually received by him or her from a deceased spouse's qualified retirement plan or IRA even though a trust or estate is named as the beneficiary of that qualified retirement plan or IRA.

In addition, the ruling should clarify whether spousal control over the distribution from the trust or estate named as beneficiary is or is not required.

In our view, based on the Preamble Language, it seems that it is sufficient for a valid spousal rollover that the spouse actually receives a distribution of the Decedent's Interest in accordance with the terms of the decedent's estate or trust or governing state law. Therefore, control by the spouse should not be required. However, clarification of this point, regardless of the outcome, is essential to provide certainty in this area and eliminate the need for seeking individual private letter rulings in order to complete a spousal rollover.

We appreciate your attention to this request.

Very truly yours,

Dennis I. Belcher,
President

[2] Internal Revenue Code §6110(k)(3).

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Please Address Reply to:

Executive Director
DEBORAH O. MCKINNON

January 7, 2011

Honorable Michael F. Mundaca
Assistant Secretary of the Treasury
 for Tax Policy
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Re: Comments on the Hiring Incentives to Restore Employment ("HIRE") Act, Pub. L. No. 111-147, 124 Stat. 71 (2010) and Notice 2010-60

Dear Mr. Mundaca:

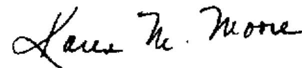
The American College of Trust and Estate Counsel ("ACTEC") submits the enclosed comments on the Hiring Incentives to Restore Employment ("HIRE") Act and the preliminary guidance provided under Notice 2010-60.

These comments discuss only those aspects of the HIRE Act that impose information reporting obligations on U.S. beneficiaries of foreign trusts and estates and the fiduciaries of foreign trusts and estates that have U.S. beneficiaries. We propose that the Treasury adopt rules to make the new information reporting obligations imposed on fiduciaries and beneficiaries administrable, understandable, and as consistent as possible with other obligations imposed on those fiduciaries and beneficiaries.

ACTEC is a national professional association of approximately 2,600 lawyers elected to membership by their peers on the basis of professional reputation and ability in the field of trusts and estates and on the basis of having made substantial contributions to this field through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in rendering advice to taxpayers on matter of federal taxes, with a focus and estate and gift tax planning and compliance. ACTEC offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

The principal authors of these comments were Ellen K. Harrison and Henry Christensen. Helpful comments were provided by Carlyn S. McCaffrey, Duncan E. Osborne, Carolyn A. Reers, Marnin J. Michaels and G. Warren Whitaker. Principal contacts for a discussion of the enclosed proposals are Ellen K. Harrison of Pillsbury Winthrop Shaw Pittman, LLP in Washington, D.C. (202.663.8316) and Henry Christensen, III of McDermott Will & Emery in New York, New York (212.547.5658). Members of your staff should not hesitate to contact either of them for more information regarding these proposals.

Very truly yours,



Karen M. Moore
President

KMM:ls
attachments

cc: Emily McMahon, Esquire
Manal Corwin, Esquire
Honorable William Wilkins
Honorable Douglas Schulman
Michael Plowgian, Esquire
Catherine V. Hughes, Esquire

ACTEC COMMENTS ON HIRE ACT

REPORTING REQUIREMENTS FOR FOREIGN ACCOUNTS

The Hiring Incentives to Restore Employment ("HIRE") Act of 2010[1] was signed into law by President Obama on Thursday, March 18, 2010. As its title suggests, the HIRE Act is primarily aimed at providing businesses with tax incentives to help finance the hiring and retention of new employees. To offset the projected revenue loss from these incentives, the Foreign Account Tax Compliance Act ("FATCA") was added to the bill.[2] FATCA was originally introduced in the House by Ways and Means Committee Chair Charles B. Rangel, Democrat of New York,[3] and in the Senate by Finance Committee Chair Max Baucus, Democrat of Montana,[4] on October 27, 2009.

The purpose of FATCA is to "detect, deter, and discourage offshore tax evasion" by Americans through the use of financial institutions outside of the United States as well as to close certain information reporting loopholes that allowed U.S. persons to avoid disclosure of offshore assets and income.[5] Additionally, FATCA attempts to regulate certain perceived abuses concerning the use for the benefit of U.S. persons of property held in trust that were identified by the Senate Subcommittee on Investigations in its 2006 Report on tax haven abuses.[6]

These comments discuss only those aspects of the HIRE Act that impose information reporting obligations on U.S. beneficiaries of foreign trusts and estates and the fiduciaries of foreign trusts and estates that have U.S. beneficiaries. We propose that the Treasury adopt rules to make the new information reporting obligations imposed on fiduciaries and beneficiaries administrable, understandable, and as consistent as possible with other obligations imposed on those fiduciaries and beneficiaries.

I. Foreign Entities Subject to the Provisions of FATCA

The HIRE Act imposes an obligation on withholding agents[7] to withhold a 30 percent tax of "withholdable payments" to foreign financial institutions ("FFIs")[8] and certain non-financial foreign entities ("NFFEs").[9] Withholding is not required for payments to an FFI that has entered into an agreement with the IRS to obtain and report information regarding its U.S. account holders or certifies that it has no U.S. account holders. Withholding is waived for payments to a NFFE that certifies that it has no "substantial U.S. owners" (a defined term) or identifies such owners. On August 27, 2010, the U.S. Treasury issued Notice 2010-60, 2010-37 I.R.B. 329 ("the Notice"), which was the first preliminary guidance in this area.

A. Definition of "Financial Institution"

Section 1471(d)(4) of the Internal Revenue Code (the "Code") provides that an FFI is a "financial institution" that is a foreign entity. Under § 1471(d)(5) of the Code, the term "financial institution" means any entity that:

(A) accepts deposits in the ordinary course of a banking or similar business;

(B) holds financial assets for the account of others as a substantial portion of its business; or

(C) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities or any interest in such securities, partnership interests or commodities.

The Notice discusses each of the above categories and also identifies certain classes of foreign entities that will not be subject to the new withholding tax regime in any case. These include FFIs that the IRS believes should be either (1) excluded from the definition of a financial institution and treated as NFFEs, (2) deemed to be compliant without the need to enter into an FFI Agreement or (3) identified as posing a low risk of tax evasion and thus exempt from the new withholding tax regime. The different categories of FFIs are discussed under the Notice as follows:

1. Accepts Deposits

According to the Notice, this category of financial institution generally includes (but is not limited to) entities that would qualify as banks under Code § 585(a)(2), savings banks, commercial banks, savings and loan associations, thrifts, credit unions, building societies and other cooperative banking institutions. The Notice points out that being subject to banking and credit laws, or subject to regulatory oversight by a regulatory authority, is not necessarily determinative of whether the entity qualifies as a financial institution.

2. Holds Financial Assets for the Account of Others

The Notice describes this category of financial institution as including entities that, as a substantial portion of their business, hold financial assets for the account of others. Such institutions may include, for example, broker-dealers, clearing organizations, trust companies, custodial banks and entities acting as custodians with respect to the assets of employee benefit plans. As above, whether the entity is subject to banking and credit laws or regulatory supervision is relevant but not necessarily determinative of whether the entity is a financial institution.

3. Engaged Primarily in the Business of Investing, Reinvesting or Trading in Securities, etc.

Under the Notice, this category has potentially the broadest sweep of the three categories, and includes any entity engaged (or holding itself out as engaged) primarily in the business of investing, reinvesting or trading securities, partnership interests, commodities or any interest in such instruments. According to the Notice, this category of financial institution generally includes (but is not limited to) mutual funds, funds of funds, exchange-traded funds, hedge funds, private equity and venture capital funds, other managed funds, commodity pools and other investment vehicles.

According to the Notice, the term "business" differs in scope and content from the term "trade or business" as used elsewhere in the Code. The example given in the Notice explains that while an isolated transaction may not give rise to a trade or business in other sections of the Code, it may cause an entity to be considered a financial institution depending on such factors as the magnitude and importance of the transaction in comparison to the entity's other activities. From this, it would appear that a foreign legal entity that simply buys and holds portfolio investments would, potentially, be in the "business" of investing in securities. The Notice indicates that whether an entity is in such a "business" will depend on all the facts and circumstances, but promises that future guidance will provide guidelines to determine what types of activity constitute a "business," and when an entity is "primarily" in such a business.

B. Entities Excluded from the Definition of Financial Institution and/or Exempt from Some or All of the New Withholding Tax Rules for FFIs

Given the extremely broad scope of the definition of an FFI, it is not surprising that the Notice contains a substantial discussion of entities that, on one basis or another, the IRS proposes will not be subject to the new withholding tax regime for FFIs.

Certain foreign entities that would be FFIs ***solely*** because they are engaged primarily in investing, reinvesting or trading in securities will ***not*** be classified as FFIs, providing they fall within one of the categories of entities described below. Generally, if a foreign entity is not an FFI, it will be an NFFE, and NFFEs are subject to their own new withholding tax regime. Despite this, these types of entities would not be subject to either the new FFI or NFFE withholding tax rules, because the Notice states that they will be exempted. The specific categories of exempted entities in the Notice include:

1. Certain holding companies

   A holding company may not be classified as an FFI if it is an entity whose primary purpose is to act as a holding company for a subsidiary or group of subsidiaries that primarily engage in a trade or business other than that of a "financial institution." The Notice specifically excludes from this exemption any entity functioning as an investment fund, such as a private equity fund, venture capital fund, leveraged buyout fund or any investment vehicle whose purpose is to acquire or fund the start-up of companies and then hold those companies for investment purposes for a limited period of time.

2. Start-up companies

   Start-up entities that intend not to operate as financial institutions, but are not yet operating their intended business, will be excluded as FFIs for the first 24 months after their organization. This does not include venture funds or other investment funds that invest in start-up entities.

3. Non-financial entities that are in liquidation or emerging from reorganization or bankruptcy

   Non-financial entities that are in liquidation or emerging from reorganization or bankruptcy are excluded as FFIs if they intend to continue or recommence operations as non-financial institutions, but only if they were not previously a financial institution.

4. Hedging/financing centers of a non-financial group

   Foreign entities that primarily engage in financing and hedging transactions for members of its expanded affiliated group, i.e., group finance companies, will not be treated as FFIs, provided that they render no services to non-affiliates and the group as a whole is not engaged in the business of being a financial institution.

The Notice requests comments on how to define the foregoing categories, and whether new categories of entities should also be excluded as FFIs.

C. Treatment of NFFEs

Non-financial foreign entities are defined by Code § 1472(d) as any foreign entity which is not a financial institution. Code § 1472(a) requires withholding agents to withhold tax at a 30 percent rate on all payments to NFFEs unless the beneficial owner of the NFFE has provided the withholding agent with a certification that it has no substantial United States owners, or has provided the withholding agent with the name, address and TIN of every substantial U.S. owner. Importantly, Code § 1474(b)(3) denies a credit for the 30 percent tax withheld to a U.S. person who did not provide the identifying information to the withholding agent required by Code § 1472(a), effectively negating the credit historically provided by Code § 1462.

D. Definition of Substantial U.S. Owner

Code § 1473(2)(A)(iii) provides that a beneficiary of a trust is a substantial U.S. owner of the trust if (i) he or she is treated as the owner of the trust under the grantor trust rules and, (ii) to the extent provided in regulations or other guidance, he or she holds directly or indirectly more than 10 percent of the beneficial interest in the trust.

In the case of an FFI described in § 1471(d)(5)(C) – an FFI that is engaged primarily in the business of investing or trading securities – a substantial U.S. owner includes a person who owns any interest in the entity, even if less than 10 percent. The Notice implies that a trust is treated as an FFI under § 1471(d)(5)(C). If so, then the 10 percent threshold for reporting beneficial interests in trusts is rendered meaningless. As discussed below, we believe that the issue to consider is whether a trust (as opposed to a trust company) should be treated as an FFI or as an NFFE.

It is not clear what the reporting threshold is when a beneficiary has less than a 10 percent interest in a trust which owns an interest in an FFI that is engaged primarily in the business of investing or trading securities.

E. Treatment of Trusts and Trustees

1. Trustees

Section II. A. 2 of the Notice cites "trust companies" as an example of an FFI that is included in the second category of financial institutions described in new Code § 1471(d)(5)(B) – an entity that holds financial assets for the account of others as a substantial portion of its business.

2. Trusts

The Notice implies that trusts will be treated as FFIs. While the reference on page 332 of 2010-37 I.R.B. to trusts is not definitive, the suggestion that small family trusts settled by a single person for the sole benefit of his or her family should be treated as deemed compliant FFIs implies that other trusts will be treated as FFIs rather than as NFFEs on the theory that under Code § 1471(d)(5)(C), a trust is an entity that is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest in such securities, partnership interests, or commodities.[10] The Notice advises that Treasury and the IRS intend to issue guidance under which certain foreign entities that are FFIs described in Code § 1471(d)(5)(C), but which are not described in § 1471(d)(5)(A) or (B), would be treated as deemed compliant FFIs if the withholding agent (i) specifically identifies each individual, specified U.S. person, or excepted NFFE that has an interest in such entity, either directly or through ownership in one or more other entities, (ii) obtains from each such person the documentation that the withholding agent would be required to obtain from such person under the guidance described in the Notice if such person were a new account holder or direct payee of the withholding agent, and (iii) reports to the IRS, in such manner as will be provided in future guidance, any specified United States person identified as a direct or indirect interest holder in the entity.

It is important to note that the Notice provides no *de minimis* threshold for the obligation of a "deemed compliant FFI" to report ownership, including beneficial ownership in a trust. Literally, the Notice could be read to require reporting of remote contingent interests even in deemed compliant FFIs.

II. Collection and Reporting of Information by Covered Foreign Entities

Although the new withholding regime generally requires that withholding agents withhold 30 percent on withholdable payments to either FFIs or NFFEs, the new withholding requirements may be avoided. In particular, an FFI can avoid withholding on payments it receives if it enters into an FFI Agreement with the IRS, thus becoming a "Participating" FFI ("PFFI"). NFFEs can also avoid 30 percent withholding by providing information on their "substantial" U.S. owners, or certifying that they have no such U.S. owners. The Notice describes the proposed FFI Agreement's requirements, as well as the procedures for NFFEs to avoid withholding.

A. FFI Agreement

An FFI can avoid withholding if it enters into an FFI Agreement thereby becoming a PFFI. When entering into the agreement the FFI agrees, among other requirements, to:

1. Obtain such information regarding each holder of each account maintained by the FFI as is necessary to determine which (if any) of such accounts are U.S. accounts,

2. Comply with due diligence procedures the Secretary may require with respect to the identification of U.S. accounts,

3. Report certain information with respect to U.S. accounts maintained by the FFI and

4. Withhold on certain payments to non-participating FFIs and recalcitrant account holders.

B. Duplicative Reporting

The Notice provides that Treasury and the IRS intend to issue regulations providing that in the case of a PFFI that maintains an account of another PFFI, only the PFFI that has the more direct relationship with the investor or customer will be required to report.

III. Recommendations

A. Application of HIRE Act to Trusts and Trustees

We suggest that the approach of the proposed regulations to be issued under FATCA for foreign trusts should focus upon what trusts are, what information the Trustees are able to provide, what information needs to be made available to the United States Treasury concerning interests held by United States persons in foreign trusts and how duplicative reporting may be avoided.

1. Trustees

We agree with the position taken in the Notice that foreign trust companies, which often are banks, should be treated as FFIs and are capable of supplying all of the information required of FFIs, and entering into FFI Agreements. Trust companies are for profit business organizations that hold themselves out to the public as managers of investment assets, which act as investment advisors, and which hold bank deposit and custody accounts. They should be treated as FFIs.

However, not every trustee is a trust company. Individuals frequently serve as trustees. Sometimes the individual serves as co-trustee with a trust company, but not always. The ordinary meaning of the term "financial institution" would not include an individual. Moreover, it is not clear that every entity serving as a trustee should be treated as an FFI. For example, a private trust company serving

as a trustee of trusts for a single family is an entity, but by statute a private trust company usually cannot accept business from the public and indeed cannot engage in business in the ordinary sense. A private trust company can only act as Trustee of trusts for the family creating the private trust company.

Further, unlike a commercial trust company, a private trust company, as well as an individual trustee, typically would custody its securities accounts with a financial institution. To avoid duplicative reporting, we recommend that a trustee be classified as a deemed compliant FFI if it maintains accounts with another FFI which has entered into an agreement to provide information to the IRS or maintains accounts with a U.S. financial institution.

2. Trusts

We suggest that trusts should be treated as NFFEs, not FFIs.

We believe that trusts should not be treated as FFIs fundamentally because, unlike traditional investment companies, (i) trusts are not entities engaged in the business of soliciting customers to make investments on their behalf and (ii) the beneficiaries are not the owners of trust investments.

Treasury regulations define a "trust" as an arrangement "whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the rules applied in chancery or probate courts."[11] The regulations further provide that in order to be a trust, an arrangement must be one "for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility." If the beneficiaries voluntarily associate to participate in the trust and the trust is engaged in a business, the trust will be classified as an association taxable as a corporation. In the seminal Supreme Court case which was the genesis of the Treasury Regulations under Code § 7701, *Morrissey v. Commissioner*,[12] the Supreme Court in setting forth seven factors that distinguished among trusts, partnerships and associations (corporations) for Federal income tax purposes, held that trusts lack two essential characteristics of associations: associates (owners), and "an objective to carry on business and divide the gains therefrom." We submit that the definition of investment company FFIs in new Code § 1471(d)(5)(C), particularly in referring to entities which "hold themselves out" as being engaged in the business of investing, contemplates entities which hold themselves out to the public (thereby soliciting "associates") to engage in the business of investing, which is something that trusts do not and cannot do. Section 1471(d)(5)(C) is not referring to trusts when it speaks of a class of entities that are engaged in the business of investing securities.

Although trusts are arrangements and not entities, for some purposes trusts have long been treated as entities under the Code. While they have their own rate brackets, and are taxed as "modified conduits," paying tax themselves upon

income accumulated in the trust, and distributing to the beneficiaries for taxation to the beneficiaries any income which the trust distributes, in all relevant sections of the Internal Revenue Code, trusts are taxed in a manner similar to that of individuals, not in a manner similar to corporations. Indeed, Code § 641(b) now states, in its final sentence with regard to foreign trusts, "For purposes of this subsection, a foreign trust or foreign estate shall be treated as a nonresident alien individual who is not present in the United States at any time."

We believe that the fundamental issue which should be recognized in any regulations under Code § 1471 is that trusts are not business enterprises and trusts have no owners. The beneficiaries of trusts do have beneficial interests in the assets, which may be enforced in courts of equity, but they are not owners. Only the Trustee owns the trust assets. But the trustee owns the assets for the benefit of the beneficiaries. This difference between corporations and trusts is recognized in the way the Code taxes the income of foreign trusts, delaying taxation of income to the United States beneficiaries until it is actually distributed to them, and then applying proper penalty interest charges under Code §§ 665 through 668. By contrast, in the case of corporations with United States owners, Subpart F of the Code (§§ 951 through 965) will tax currently to the "United States shareholders" (defined as direct or indirect owners of 10 percent or more of the total combined voting power of the foreign corporation) their share of Subpart F passive income which was accumulated in, not distributed currently from, the foreign corporation.

For all of these reasons, we do not believe that a trust meets the definition of an entity in Code § 1471(d)(5)(C) that should be treated as an FFI.

There are further practical reasons why a trust should not be treated as an FFI. Beneficiaries do not have separate accounts representing their interest in the trust. The reporting requirements of Code § 1471 relate to "United States accounts" in the FFI. A "United States account" is defined under new Code § 1471(d)(1) as "any financial account which is held by one or more specified United States persons or United States owned foreign entities." A foreign trust with United States beneficiaries may have a "United States account" at an FFI in the name of the trust, but the trust itself does not hold "accounts" for each of its United States beneficiaries. In the case of the typical foreign trust which is a discretionary trust for the benefit of a class of beneficiaries, for example, the descendants of the creator of the trust, no one of the beneficiaries has an "account" with the trust. This inconsistency is further demonstrated by the definition of "financial account" in new Code § 1471(d)(2) that defines a financial account to mean a depository or custodial account. A trust creates neither a depository account nor a custodial account in the name of any trust beneficiary. An FFI will only have a depository or custodial account in the name of the trust.

New Code § 1471(c) defines the information which an FFI will have to agree to supply with respect to United States accounts. The information includes the

account number of each United States account (again, the only account number will be for accounts in the name of the trust itself), the TIN of each United States beneficiary (a foreign trustee could supply this information for all eligible beneficiaries known by the Trustee to be United States persons), the account balance or value (there will be no account balance or value for each individual beneficiary, but rather only for the trust as a whole) and the gross receipts and gross withdrawals from the account (there will be no gross receipts or withdrawals allocable to an individual United States beneficiary, but all distributions to individual United States beneficiaries will be disclosed on Forms 3520).

New Code § 1473(2)(A)(iii) states that the term "substantial United States owner" means, in the case of a trust which is not a grantor trust, a United States person who holds, directly or indirectly, more than 10 percent of the beneficial interests in such trust. Further, in the case of a payment made by a United States withholding agent to a non-financial foreign entity, the NFFE must, under new Code § 1472(b), certify to the withholding agent the name, address and TIN of every substantial United States owner of the foreign account. Thus, the focus of the statutory provisions applicable to trusts is on the holders of more than 10 percent beneficial interests. Yet, at the same time, new Code § 1473(2)(B) sets forth a "Special Rule for Investment Vehicles" by providing that "[i]n the case of any financial institution described in § 1471(d)(5)(C), clauses (i),(ii) and (iii) of subparagraph (A) shall be applied by substituting '0 percent' for '10 percent'". If the provisions of new Code § 1473(2)(B) were deemed to apply to trusts (because trusts were deemed to come within the definition of a financial institution under § 1471(d)(5)(C)), the 10 percent threshold expressly applicable to trusts would be rendered meaningless. The fact that the statute adopts a 10 percent ownership threshold for trusts and a zero percent ownership threshold for investment companies is persuasive that there was no intention to classify trusts as FFIs.

Thus, trusts should not be classified as FFIs under Code § 1471(d)(5)(C) so that new Code § 1473(2)(B) will not be applied to trusts and contradict the 10 percent reporting threshold adopted for defining a substantial owner of a trust. This result will be achieved by treating trusts as NFFEs, not FFIs, in the Regulations.

In sum, trusts are not in the "business of investing," within the meaning of Code § 1471(d)(5)(C), and individual United States beneficiaries of foreign trusts are not the owners of trust assets and do not have "accounts" as to which there can be disclosure. Moreover, any reporting required of a foreign trust will be duplicative of the reporting provided either by the trustee, if a trust company (and thus, an FFI), or by the FFI at which the foreign trust will have deposited or custodied its funds.

B. Regulation to Define "Substantial U.S. Owner"

The withholding obligations imposed by the HIRE Act will be very difficult to administer if a facts and circumstances test is used to determine whether a trust or estate has a

substantial U.S. owner; a bright-line test is essential. A test based on actual distributions in excess of a *de minimis* threshold will be easier to administer in many cases than a test based on percentage interests. Even though the statute defines a substantial U.S. owner by reference to a percentage interest, in most cases an individual's percentage interest in a trust or estate will be very difficult to determine. Even where a fixed income interest is granted to a beneficiary, if the beneficiary's interest terminates upon the happening of some event, including the death of the beneficiary, actuarial calculations will be necessary to value the income interest. But in many cases, a beneficiary's interest is discretionary, and where the interest is discretionary it will not be possible to determine a person's percentage interest. We would urge adopting as the bright-line test the $50,000 *de minimis* amount which new Code § 1471(d)(1)(C) applies to individual accounts of U.S. persons with FFIs, which is that the total of all accounts maintained with the FFI by such individual does not exceed $50,000.

1. We propose that a *de minimis* bright-line test be adopted for determining whether a nongrantor trust has a substantial U.S. owner regardless of the percent of beneficial interest held in the trust by U.S. persons. We propose that a beneficiary of a discretionary trust shall not be treated as a substantial U.S. owner of a nongrantor trust if all of the following apply:

   (i) With regard to a wholly discretionary trust, if the distribution to such beneficiary in the preceding calendar year does not exceed $50,000;

   (ii) With regard to a wholly discretionary trust, if the average distributions to such beneficiary during the three preceding calendar years do not exceed $50,000; and

   (iii) If the amount of income or principal required to be distributed to such beneficiary or that may be withdrawn by such beneficiary does not exceed the amounts described in (i) or (ii) above.

   Of course, if a beneficiary has a fixed percentage interest in a trust – both income and principal – which exceeds 10 percent, the beneficiary should be treated as a substantial U.S. owner. However, even a fixed right to a dollar amount should not cause the beneficiary to be treated as an owner unless the dollar amount exceeds the threshold amounts set forth above. Any other rule would require the valuation of the trust to determine whether the percentage threshold was exceeded, and this is administratively impractical. It should be remembered that in all events Code § 6048 will require a beneficiary of a foreign trust who actually receives a distribution to report that distribution currently on an income tax return.

2. We suggest that the thresholds discussed in section 1 above be coordinated with the information reporting rules for new Code § 6038D, discussed below.

3. In the case of a grantor trust, we recommend that the grantor, and no other beneficiary, be treated as the owner of the portion of the trust that the grantor is treated as owning.

4. In the case of an estate, we recommend that the estate will have a substantial U.S. owner if any beneficiary of the estate (including a U.S. trust) is entitled to receive a bequest of more than $50,000 or at least 10 percent of the residuary estate is payable to a U.S. beneficiary.

5. We recommend that a U.S. beneficiary who does not satisfy the $50,000 *de minimis* threshold for being deemed a U.S. substantial owner of an estate or trust also not be treated as a substantial owner of an FFI engaged primarily in the business of investing or trading securities (for example, a hedge fund) that is owned by the estate or trust.

6. We recommend that reporting of interests in foreign trusts be limited to disclosure of all United States persons having a substantial interest in the trust as defined in § 1473(2)(A)(iii) of the Code.

7. We suggest that an underlying holding company wholly owned by a trust be treated either as an NFFE or a deemed compliant FFI if the only account to which receipts and disbursements will be allocated is the trust. Moreover, reporting would be duplicative since the trust will disclose U.S. beneficial owners and the holding company is likely to maintain its accounts with an FFI.

IV. Code § 1298(f): Passive Foreign Investment Company ("PFIC") Reporting and Attribution from Trusts to Beneficiaries

A. Background of PFIC Rules

A foreign corporation is a PFIC if 75 percent of its income is from passive sources or 50 percent of its assets produce or can produce passive income. Prior to enactment of the HIRE Act, PFIC shareholders were required to file an annual return on Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund," only if the U.S. person recognized gain on a direct or indirect disposition of PFIC stock, received certain direct or indirect distributions from a PFIC or was making certain elections.[13] If no election is made, U.S. shareholders pay tax on certain income or gain realized through the PFIC, plus an interest charge intended to eliminate the benefit of deferral, and are required to file Form 8621 only if a taxable event occurs.[14] If an election is made for the PFIC to be a "qualified electing fund" ("QEF"), electing U.S. shareholders currently include in gross income their respective shares of the company's earnings (and a separate election may be made to defer payment of tax, subject to an interest charge) on income not currently received.[15] Another election may be made for PFIC shares that are publicly traded under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[16]

Prior to the HIRE Act, the Code included a general reporting requirement for certain PFIC shareholders which was contingent upon the issuance of regulations.[17] Although Treasury issued proposed regulations in 1992 requiring U.S. persons to file annually

Form 8621 for each PFIC of which the person is a shareholder during the taxable year, such regulations have not been finalized and current IRS Form 8621 requires reporting only based on one of the triggering events described above.[18] In a conforming amendment, Section 521(b) of the HIRE Act removes the general reporting requirement by deleting the reference to § 1246(f) in Code § 1291(e).

B. HIRE Act Reporting

Section 521 of the HIRE Act adds § 1298(f) to the Code to require annual reporting by U.S. persons who own, directly or indirectly, stock of a PFIC.[19] The new section states:

> Except as otherwise provided by the Secretary, each United States person who is a shareholder of a passive foreign investment company shall file an annual report containing such information as the Secretary may require.

A person who meets the reporting requirements of new Code § 1298(f) may also meet the reporting requirements of new Code § 6038D (enacted by Section 511 of the HIRE Act) requiring disclosure of information with respect to foreign financial assets. The legislative history of the HIRE Act states that it is anticipated that the Secretary will exercise regulatory authority to avoid duplicative reporting.[20]

Although new Code § 1298(f) is effective on March 18, 2010, the date of enactment, Treasury promptly issued Notice 2010-34[21] postponing the new filing requirement until the IRS develops guidance *for tax years beginning before March 18, 2010.* Persons who were required to file Form 8621 prior to enactment of Code § 1298(f) would continue to be required to file.

Section 513(b) of the HIRE Act amended Code § 6501(c) (8) to add the reporting obligation under Code § 1298(f) to the list of information returns that must be filed before the statute of limitations will begin to run on assessments of tax with respect to any event or period to which such information relates until the information return is filed.

C. Recommendations

1. We recommend that a *de minimis* rule be adopted exempting from the expanded reporting obligation shareholders who own less than a threshold amount of stock of a PFIC.[22] We note that under new Code § 6038D, a person whose beneficial interest in a foreign entity is less than 10 percent is not required to file information returns. The threshold would not affect shareholders who otherwise were required to file, e.g., because a taxable event had occurred or a QEF or mark to market election were in place.

2. A U.S. person who is a discretionary or remainder beneficiary of a foreign nongrantor trust may be treated as an indirect shareholder of a PFIC owned by the trust. A beneficiary is treated as the indirect owner of shares owned by a trust in proportion to his or her beneficial interest. Under Proposed Treasury Regulations,[23] a person's beneficial interest is determined based on all relevant facts and circumstances. Because the rules for determining indirect ownership are

vague, at least until clear guidance is issued to determine indirect ownership, a discretionary or remainder beneficiary of a foreign nongrantor trust that owns PFIC shares should not be required to file Form 8621 (or another information return under Code § 1298(f)), particularly if the beneficiary has not received distributions from the trust (and therefore may not be aware of the existence of the beneficial interest).

We recommend that the expanded reporting obligation under Code § 1298(f) not apply to a beneficiary of a trust that owns PFIC shares if such beneficiary is not required to file under Code § 6038D. *See* Recommendation at III.C.3 below.

3. Because a U.S. person who receives, or is deemed to receive, a distribution from a foreign trust is required to file Form 3520, we recommend that the expanded filing obligation a trust beneficiary may have with respect to PFIC shares owned by a foreign trust under Code § 1298(f) be included as part of Form 3520, and that the "beneficiary statements" that are required to be filed with Form 3520 be amended to clarify the disclosure required with respect to any PFIC income or gain that may be taxable to a beneficiary.[24] Currently, the explanation for line 30 of Form 3520 says that the statement should include "[a]n explanation of the appropriate U.S. tax treatment of any distribution or deemed distribution for U.S. tax purposes, or sufficient information to enable the U.S. beneficiary to establish the appropriate treatment of any distribution for U.S. tax purposes." This statement could be revised to specifically require whatever information is required under Code § 1298(f). Form 8621 still would be required if a taxable event occurred or a QEF or mark to market election were in place.

4. A beneficiary may not have information necessary to determine whether he or she should be reporting under Code § 1298(f). In recognition of this practical problem, Form 3520 allows the beneficiary who does not receive a beneficiary statement providing the information needed to calculate tax on a trust distribution to calculate tax using a so-called "default method" that mimics the PFIC tax rules. The filing required by Code § 1298(f) should address the alternatives available to a U.S. beneficiary who does not have information to satisfy his or her reporting obligation.

5. If the trustee of a foreign nongrantor trust, or a U.S. agent for the trustee, provides the information required by Code § 1298(f), a trust beneficiary should not be required to file such form. This is an approach adopted in proposed FBAR regulations.

6. If a trust is a U.S. nongrantor trust, the beneficiaries should not be required to file information returns under Code § 1298(f). Instead, the U.S. trustee should have the filing obligation. Filing by beneficiaries would be duplicative and unnecessary because any taxes imposed under the PFIC regime should be payable from the U.S. trust.

7. If a U.S. grantor or another U.S. person is treated as the owner of the PFIC shares under Subpart E of Subchapter J, the grantor or other owner (and not the trustee or another beneficiary of the trust) should be required to file the information required by Code § 1298(f).[25]

8. If the grantor who is treated as the owner of the trust is a foreign person, such foreign grantor should not be required to file the information required by Code § 1298(f), nor should the trustee or beneficiaries be required to file, except for a U.S. beneficiary who receives a distribution.

V. New Code § 6038D

Under current law, an individual who is a beneficiary of a foreign trust is obligated to report distributions received from the trust and may be required to file an FBAR if his or her beneficial interest is 50 percent or more. The HIRE Act expands the reporting obligations of beneficiaries of foreign trusts.

A. Filing Threshold for Individuals

Section 511 of the HIRE Act, provides:

> Any individual who, during any taxable year, holds any interest in a specified foreign financial asset shall attach to such person's return of tax imposed by subtitle A for such taxable year the information described in subsection (c) with respect to each such asset if the aggregate value of all such assets exceeds $50,000 (or such higher dollar amount as the Secretary may prescribe).

While the statute says that the threshold is met if "the aggregate value of all such assets exceeds $50,000," we believe that the clear intent of Congress was for the threshold to be met only if the aggregate value of ***the individual's interests in*** all such assets exceeds $50,000. For instance, if an individual held a .00001 interest in a foreign mutual fund with total assets under management of $1 billion, the individual's interest would be $10,000 and he or she would have no filing requirement, even thought the aggregate value of the foreign financial asset in which the individual has an interest exceeds the threshold. This should be clarified.

B. Filing Rules Applicable to Beneficiaries of Foreign Trusts

The Technical Explanation to the HIRE Act indicates that beneficiaries of foreign trusts must report their trust interests under the new law under the concept that a foreign trust is itself a "foreign financial asset":

> For example, a beneficiary of a foreign trust who is not within the scope of the FBAR reporting requirements because his interest in the trust is less than 50 percent may nonetheless be required to disclose the interest in the trust with his tax return under this provision if the value of his interest in the trust, together with the value of other specified foreign financial assets, exceeds the aggregate value threshold.[26] (Emphasis added.)

New Code § 6038D (b)(2) includes in the definition of Foreign Financial Assets "any interest in a foreign entity (as defined in section 1473)."

Code § 1473(5) provides that "[t]he term 'foreign entity' means any entity which is not a United States person."

Therefore it appears that a foreign trust is itself a foreign financial asset, and the beneficiary of a foreign trust must report his interest if its value (i.e. the percentage interest of the beneficiary in the trust multiplied by the aggregate value of all assets of the foreign trust) exceeds the $50,000 threshold, regardless of whether any of the assets of the foreign trust are themselves "foreign financial assets."

C. Recommendations

1. A beneficiary should not be required to report any foreign financial assets held by the foreign trust. It is the beneficiary's interest in the trust itself, and not the trust's assets, that gives rise to the filing requirement under Code § 6038D. Underlying financial accounts held in the trust would remain subject to the reporting requirements under Title 31 (the Bank Secrecy Act) of the United States Code[27] and Treasury Department Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts" ("FBAR") as they pertain to trust beneficiaries.[28]

2. While foreign trustees are not obligated to file under Code § 6038D, it may sometimes be more convenient for the trustee to file, particularly if the trust has many U.S. beneficiaries. It should be clarified that if the trustee files, there is no requirement under Code § 6038D for each trust beneficiary to file as well. (A similar rule for avoidance of duplication is found in the Title 31 FBAR proposed regulations.) The Technical Explanation states that it is anticipated that the Secretary will exercise regulatory authority to avoid duplicative reporting.[29]

3. Questions arise as to how the interest of a beneficiary in a foreign trust should be computed. If the beneficiary has a fixed income interest or the current right to withdraw a percentage of the capital (an "ascertainable trust interest"), this is a relatively straightforward task. With a wholly discretionary trust, valuation is more problematic. Some foreign trusts may have dozens of permissible beneficiaries and the power in the trustee to add almost anyone as a beneficiary, and most of these potential beneficiaries will never receive a distribution. We believe that it would be reasonable and administratively workable to establish by regulation that an individual who is a potential discretionary beneficiary (current or contingent) of a foreign trust, or a potential appointee under a power of appointment held over a foreign trust, has no reportable interest in that trust under Code § 6038D until he or she receives a distribution. Once the first distribution has been made to that person, we suggest that the value of his or her interest be computed using a bright-line test based upon the value or average value of those distributions. We suggest that the beneficiary's interest for any calendar year be equal to the greater of the amount distributed to her in such year or the amount of the average distributions she received in such calendar year and the prior 2 years.

4. If a U.S. grantor or another U.S. person is treated as the owner of the foreign trust under Subpart E of Subchapter J of the Code, the grantor or other owner (and not the trustee or another beneficiary of the trust), should be required to file the information required by Code § 6038D.[30]

5. If the grantor who is treated as the owner of the trust is a foreign person, such foreign grantor should not be required to file the information required by Code § 6038D, nor should the trustee or beneficiaries be required to file, except for a U.S. beneficiary who receives a distribution.

6. Code § 6038D applies only to individuals and not to domestic entities.[31] Thus, any obligation to report ownership of a foreign financial asset owned by a domestic trust should rest with the trustee and not with the individual trust beneficiaries. This should be true even if the domestic trust owns PFIC shares and the beneficiary's beneficial interest is ascertainable.

7. Clarification would be helpful that Code § 6038D does not apply to individuals who are not U.S. taxpayers.

8. Avoiding duplicate filings:

    (i) We believe that it will be necessary for the IRS to introduce a new form to meet the reporting obligations for foreign financial assets under Code § 6038D. In the case of an individual with only foreign bank and financial accounts, both an FBAR filing and a filing under new Code § 6038D will be required (subject to the different thresholds), with the same information contained on both forms. A single form should be used to satisfy both filing obligations. Individuals should be given the option of filing the FBAR with their income tax return in satisfaction of their Code § 6038D reporting obligation.

    (ii) A U.S. person who is treated as the owner of a foreign trust under the grantor trust rules for income tax purposes must file a report on Form 3520, which will contain the same information as the Code § 6038D filing. The Form 3520 filing (including the attached Form 3520-A signed by the foreign trustee) should be sufficient for Code § 6038D purposes.

    (iii) Whether or not a trust is a grantor trust, if a U.S. individual receives a distribution, he or she must report the distribution on Form 3520. In order to avoid duplicative filing, the Code § 6038D reporting obligation for trust beneficiaries should be included as a new Part to Form 3520, and there should be no requirement of a separate filing on a different form.

    (iv) We recommend that Form 3520 be amended to allow it to be used to satisfy the expanded filing obligations imposed by Code § 6038D so that all trust filing obligations can be consolidated. A U.S. individual may have a reporting obligation under Code § 6038D even if she does not have

an obligation under Code § 6048 to file Form 3520 (for example because she did not receive a distribution).

(v) We suggest that a foreign trustee (although not obligated to file under Code § 6038D) be able to satisfy the Code § 6038D reporting requirement for all U.S. trust beneficiaries on Form 3520-A. We suggest that Form 3520-A be amended to permit such a report, in order to consolidate all foreign trust filing in one place.

9. Section 534 of the HIRE Act added language to Code § 6048 specifically imposing an obligation upon a U.S. person treated as the owner of a foreign trust under Subpart E of Subchapter J of the Code to "submit such information as the Secretary may prescribe with respect to such trust for such year..." This is in addition to the pre-HIRE § 6048 requirement that such a person "ensure" that the trust files Form 3520-A. Form 3520-A is signed by the trustee; however, a foreign trustee has no U.S. filing obligations. The new language provides an affirmative filing duty upon a U.S. owner of a foreign trust, presumably to encompass foreign trusts that are not filing Form 3520-A because the foreign trustee has no U.S. filing obligation and the U.S. owner has no control over the trustee to "ensure" filing. We recommend that the new language be interpreted to mean that the information required by the Secretary is the information required on Form 3520-A, and that all Code § 6048 filing obligations are satisfied if either the U.S. grantor or the foreign trustee files the form.

10. Finally, we suggest that Forms 3520 and 3520-A clarify that the filing deadlines prescribed on such Forms override the language in Code § 6048 requiring filing on or before the 90th day after any reportable event. Code § 6048 specifically gives the Secretary discretion to prescribe a different filing date. We also suggest that the due date for Form 3520-A be the same as the filing date for Form 3520 and that extensions of time to file Form 1040 also extend the time for filing Form 3520-A.

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1 Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (2010).

2 *Id.* § 501, at 97.

3 H.R. 3933, 111th Cong. (2009).

4 S. 1934, 111th Cong. (2009).

5 Cong. Rec. S10785 (daily ed. Oct. 27, 2009) (statement of Sen. Max Baucus, Chair, S. Comm. on Finance).

6 Staff of the S. Perm. Subcomm. on Investigations, 109th Cong., Tax Haven Abuses: The Enablers, the Tools and Secrecy (Aug. 1, 2006).

7 Withholding agent is defined broadly to include "all persons, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of any withholdable payment." *See* Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, § 501, 124 Stat. 71, 106 (2010).

8 *Id.* § 501, at 97.

9 *Id.* § 501, at 102.

10 We do not think that trusts should be classified as FFIs. However, if Treasury does decide to treat trusts as FFIs, clarification of what constitutes a "small family trust" is needed.

11 Treas. Reg. § 301.7701-4.

12 Morrissey v. Commissioner, 296 U.S. 344 (1935).

[13] Instructions to IRS Form 8621 state that reportable elections include the following: (i) an election to treat the PFIC as a QEF; (ii) an election to recognize gain on the deemed sale of a PFIC interest on the first day of the PFIC's tax year as a QEF; (iii) an election to treat an amount equal to the shareholder's post-1986 earnings and profits of a CFC as an excess distribution on the first day of a PFIC's tax year as a QEF that is also a controlled foreign corporation under section 957(a); (iv) an election to extend the time for payment of the shareholder's tax on the undistributed earnings and profits of a QEF; (v) an election to treat as an excess distribution the gain recognized on the deemed sale of the shareholder's interest in the PFIC, or to treat such shareholder's share of the PFIC's post-1986 earnings and profits as an excess distribution, on the last day of its last tax year as a PFIC under section 1297(a) if eligible; or (vi) an election to mark-to-market the PFIC stock that is marketable within the meaning of section 1296(e).

[14] Code § 1291.

[15] Code §§ 1293-1295.

[16] Code § 1296.

[17] Code § 1291(e) by reference to § 1246(f).

[18] Prop. Treas. Reg. § 1.1291-1(i).

[19] A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consist of assets that produce, or are held for the production of, passive income. Code § 1297.

[20] Joint Committee Staff, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the Hiring Incentives to Restore Employment Act (JCX-4-10) 2/23/2010, p. 66.

[21] 2010-17 I.R.B. 612, 4/6/2010.

[22] Compare for example Code § 1246(f) prior to its repeal by the American Jobs Creation Act of 2004 (P.L. 108-357) which waived filing of information returns for shareholders of foreign investment companies if the shareholder did not own as much as 5 percent of the stock of the company. While the HIRE Act repeals the vestiges of § 1246(f) by amending Code § 1291(e) to delete references to subsection (f) of §1246, some *de minimis* rule for filing information returns is appropriate.

[23] Proposed Treasury Regulation § 1.1291-1(b)(8).

[24] Clarification is needed as to how beneficiaries are appropriately taxed when a trust owns PFIC shares. There is an overlap and lack of coordination between the trust and PFIC rules.

[25] Cf., Treasury Regulation § 1.958-1(b).

[26] Joint Committee Staff, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the Hiring Incentives to Restore Employment Act (JCX-4-10) 2/23/2010, p. 60.

[27] 31 U.S.C. 5311 et seq.

[28] The Technical Explanation specifically provides "Nothing in this provision is intended as a substitute for compliance with the FBAR reporting requirements, which are unchanged by this provision." Ibid.

[29] Technical Explanation at 66.

[30] In his comments to Congress, Senator Levin expressed that the purpose of Sections 531 through 535 of the HIRE Act is to "tighten U.S. tax rules for foreign trusts and address a variety of abuses…exposing how U.S. taxpayers use foreign trusts to evade their U.S. tax obligations." Until a trust beneficiary receives a distribution from a foreign nongrantor trust, he has no U.S. tax obligation. And if the foreign trust is a grantor trust with a U.S. grantor, it is already subject to U.S. reporting and income tax. Providing a clear formula for the computation of a beneficiary's interest in a wholly discretionary foreign trust, premised on the receipt of actual trust distributions, promotes the purpose of assuring that U.S. tax obligations are reported.

[31] The Technical Explanation states that "[section 6028D] permits the Secretary to issue regulations that would apply the reporting obligations to a domestic entity in the same manner as if such entity were an individual if that domestic entity is formed or availed of to hold such interests, directly or indirectly."

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1500 Pennsylvania Avenue, NW
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Re: Proposals for Guidance With Respect to the Coordination of the Foreign Corporation Anti-Deferral Rules and Subchapter J

Dear Mr. Mundaca:

The American College of Trust and Estate Counsel ("ACTEC") submits the enclosed memorandum setting forth proposals for guidance with respect to the coordination of the foreign corporation anti-deferral rules and subchapter J.

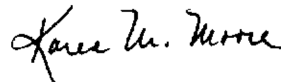
The Internal Revenue Code of 1986, as amended (the "Code") contains rules to protect the right of the U.S. to tax U.S. citizens and residents on their worldwide income, including income which has been accumulated offshore. These rules prevent U.S. taxpayers from using foreign trusts and foreign corporations to avoid payment of U.S. tax. However, the rules overlap and create problems and inconsistencies when both foreign trusts and foreign corporations are involved. The preamble to the Proposed PFIC regulations, issued on April 1, 1992, notes the need to coordinate the accumulation distribution and the PFIC tax regimes. We believe that adjustments to the trust accumulation distribution rules and adjustments to and coordination with certain of the PFIC rules are necessary to achieve the result of preserving the interest charge on untaxed income. We recommend that Treasury adopt one or more

regulations that will integrate the rules for taxation of PFICs with the taxation of accumulation distributions from foreign trusts, under the structure of Subchapter J.

ACTEC is a national professional association of approximately 2,600 lawyers elected to membership by their peers on the basis of professional reputation and ability in the field of trusts and estates and on the basis of having made substantial contributions to these fields through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in rendering advice to taxpayers on matter of federal taxes, with a focus and estate and gift tax planning and compliance. ACTEC offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

Principal contacts for a discussion of the enclosed proposals are Henry Christensen, III of McDermott Will & Emery in New York, New York (212.547.5658) and Ellen K. Harrison of Pillsbury Winthrop Shaw Pittman, LLP in Washington, D.C. (202.663.8316). Members of your staff should not hesitate to contact either of them for more information regarding these proposals.

Very truly yours,



Karen M. Moore
President

cc: Emily McMahon, Esquire
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June 23, 2010

American College of Trust and Estate Counsel ("ACTEC") Proposals for Guidance With Respect to the Coordination of the Foreign Corporation Anti-Deferral Rules and Subchapter J*

The Internal Revenue Code of 1986, as amended (the "Code") contains rules to protect the right of the U.S. to tax U.S. citizens and residents on their worldwide income, including income that has been accumulated offshore. These rules prevent U.S. taxpayers from using foreign trusts and foreign corporations to avoid payment of U.S. tax. However, the rules overlap and create problems and inconsistencies when both foreign trusts and foreign corporations are involved.

This memorandum addresses certain aspects of the rules currently applicable to controlled foreign corporations ("CFCs") and passive foreign investment companies ("PFICs") that in some instances permit U.S. beneficiaries of trusts that hold interests in such entities to avoid or postpone taxation on income generated by such corporations and in other instances subject such beneficiaries to inappropriate income taxation on such income. It contains ACTEC's proposals for a regulatory approach to the coordination of the foreign corporate anti-deferral rules with the rules of Subchapter J that would ensure that the U.S. beneficiaries of foreign trusts that hold investments in foreign corporations are taxed in a manner that is more consistent with the objectives of the anti-deferral rules.[1]

Foreign trust tax rules

A foreign trust is subject to U.S. tax only on U.S. source income. However, U.S. persons who are the beneficiaries of foreign trusts are taxed on all of their worldwide income from the trust, either currently or at some future date when the accumulated income is finally distributed to them.

Various rules prevent or inhibit the use of foreign trusts to avoid U.S. income tax, or even to postpone tax. In particular, section 679[2] treats as grantor trusts, owned by the grantor, foreign trusts created by U.S. persons if they have U.S. beneficiaries. This memorandum will deal only with the U.S. income taxation of foreign trusts that are not taxed as grantor trusts. Due to the broad application of section 679, in most cases such trusts will have been created either by non-U.S. grantors or by U.S. grantors who are deceased.

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* The primary authors of this memorandum are Henry Christensen III, Ellen K. Harrison, Donald D. Kozusko and Edward C. Northwood. Anne O'Brien, Carlyn S. McCaffrey, and Ronald D. Aucutt provided helpful comments.

1 Excellent background for the issues addressed in this memorandum is found in four articles prepared by Fellows of ACTEC, copies of which are being sent under separate cover: "Respect for 'Form' as 'Substance' in US Taxation of International Trusts", by Donald D. Kozusko and Stephen K. Vetter, published in the Vanderbilt Journal of Transactional Law, Volume 32(675), 1999, in particular, Section III beginning on page 693; a paper entitled "Thinking Outside the Box: US Federal Income Issues for Trusts and Estates that Own Shares in Foreign Corporations", prepared and presented by M. Read Moore at the Second Annual International Estate Planning Institute held in New York, New York, on March 16, 2006; a paper entitled "PFICs and CFCs: Recent Developments", prepared and presented by Donald Kozusko at the Fourth Annual International Estate Planning Institute held in New York, New York, on May 27-28, 2008; and "Indirect Ownership of CFC and PFIC Shares by US Beneficiaries of Foreign Trusts," by M. Read Moore, published in the Journal of Taxation, Volume 108, No. 2, February 2008.

2 References in this memorandum to "section" or "sections" refer to sections of the Code.

Under the rules of Subchapter J of the Code, U.S. taxpayers have long been subject to tax on the worldwide income of foreign trusts when the income is distributed to them, even though the income is not taxed to the trust itself. Three principles apply to accomplish this end. First, under section 641(b) all trusts, whether domestic or foreign, are taxed in a manner similar to the manner in which individuals are taxed. Since 1997, section 641(b) has included a sentence making clear that a foreign trust will be treated as a nonresident alien individual not present in the U.S. at any time. Second, because the trust is treated as a nonresident alien individual not present in the U.S. at any time, foreign source income and U.S. source capital gains (with some exceptions) will not be taxed to a foreign trust, but will still be part of the income of the trust, computed under sections 641 and 643, and will be taxed to U.S. beneficiaries when distributed to them from the foreign trust. Because of the modification to the distributable net income ("DNI") rules under section 643(a)(6) for foreign trusts , all income collected from any source by the trust, including foreign source income, will be included in the trust's DNI and therefore will be carried out to U.S. beneficiaries as *part of any distribution* to the beneficiary, even though the same income would not have been taxed by the U.S. to the trust itself.

Third, and most importantly for this discussion, sections 665 et seq. of the Code impose a tax (the accumulation distribution tax) on distributions to U.S. beneficiaries from foreign nongrantor trusts that are deemed to come out of undistributed net income ("UNI"). UNI is the trust's DNI for prior years minus income deemed distributed to beneficiaries in prior years.[3] While foreign source income that is accumulated in a foreign nongrantor trust is not taxed currently by the U.S., either to the trust or the beneficiaries, the benefit of deferral is taken away by the accumulation distribution tax. First, the accumulation distribution is taxed as ordinary income regardless of the character of the accumulated income (unless the accumulated income was tax exempt income); most importantly, capital gains that become UNI will be taxable as ordinary income when distributed to U.S. beneficiaries.[4] Second, a U.S. beneficiary who receives UNI is taxed at a rate equal to the average marginal tax rate of the beneficiary for the prior five years, the UNI is allocated to the taxable years in which it was deemed to have been accumulated in the foreign trust and an interest charge is applied on the tax allocated to each such year, to appropriately charge the taxpayer and recompense the Treasury for any deferral in collecting a tax.[5] The interest charge eliminates the benefit of deferring the time for payment of tax on foreign source income accumulated in a foreign nongrantor trust.

However, the operation of the accumulation distribution tax may be undermined by the use of foreign holding companies.[6] If a foreign nongrantor trust invests through or in a foreign holding

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[3] Code §665(a) reduces UNI by the amount of income taxes imposed on the trust but a distribution of UNI carries out taxes attributable to that income and the beneficiary is allowed to credit the accumulation distribution tax by the amount of income tax imposed on the trust that is allocated to such beneficiary. Code §§666(c) and 667(d).

[4] Code §667(a).

[5] Code §§667(b) and 668.

[6] References in this memorandum to "foreign holding companies" refer to corporations organized under the laws of a nation other than the U.S. or a political subdivision of the U.S. As discussed below in more detail, such companies may be either controlled foreign corporations or passive foreign investment companies.

company, the trust will not have any taxable income until either the holding company makes a distribution to the trust or the trust sells the shares of the holding company. If the holding company makes distributions to the foreign trust which the trust in turn distributes currently to the U.S. beneficiaries, then, in our view, it would be appropriate to tax the income accumulated in the holding company in prior years, as PFIC income to the U.S. beneficiaries. But while we believe it appropriate to tax the distribution as PFIC income, unless Treasury adopts a clarifying regulation, at present the distribution from the holding company cannot be taxed as UNI because it constitutes current income, not UNI.[7] If the holding company liquidates into, or makes a distribution to the foreign trust and the trust makes no current distribution to its U.S. beneficiaries, it is not clear whether any of the U.S. beneficiaries would be subject to current tax on the event.

We propose that this potential loophole be closed by adopting a rule that the DNI of a foreign nongrantor trust be calculated by treating income that was accumulated in the foreign holding company owned by the trust as income of the trust when it is distributed by the foreign holding company, and then taxing it through to the U.S. beneficiaries when distributed to them under the rules of Subchapter J. This rule would be consistent with Congressional intent[8] and Treasury's statement in 1992,[9] that the PFIC rules should be harmonized with Subchapter J rules, and that the Subchapter J approach of delaying tax until a U.S. person receives an actual distribution should prevail.

One way to reconcile the rules of Subchapter J with the PFIC tax regime would be to calculate the DNI of the trust by applying the same rules that apply to U.S. taxpayers who own shares of PFICs, which are discussed below. These rules currently do not apply to a foreign nongrantor trust because it is not a U.S. taxpayer. If those rules applied, broadly speaking, the income of the PFIC would enter into the computation of DNI of the trust for the year the income accrued to the holding company in the same fashion as if the foreign trust were a U.S. taxpayer, and be added to the trust's DNI for each year that the trust owned shares of the PFIC, and thus would be part of the trust's UNI. Under such a rule, when the trust received a distribution from the holding company and made a distribution to a U.S. beneficiary in the same year, a portion of that income would be treated as UNI and the accumulation distribution tax would apply to that portion.

Another way to reconcile the rules of Subchapter J with the PFIC tax regime would be to tack the holding period of income accumulated in PFICs owned by foreign trusts to the period in which the UNI is held by the trust itself. Both alternatives are discussed below.

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7 Code §665(b) provides that if the amounts distributed do not exceed the income of the trust for such year, there shall be no accumulation distribution. Code §643(b) defines "income" as fiduciary accounting income.

8 Congress intended, when a U.S. shareholder directly owned shares in a passive foreign investment company, that the PFIC rules would track the Subchapter J accumulation distribution rules, and postpone tax until a U.S. person received an actual distribution, General Explanation of the Tax Reform of 1986 prepared by the Staff of the Joint Committee on Taxation, May 4, 1987 (the "Blue Book"), at p. 1032. The preamble to the PFIC regulations proposed by Treasury in 1992 states: "Pursuant to section 1291, a U.S. person that is a shareholder of a section 1291 fund pays tax and an interest charge on receipt of certain distributions and upon disposition of stock of the section 1291 fund." 1992-1 CB 1124, at 1125.

9 Preamble to proposed Treasury regulations, 1992-1 C.B. 1124, at 1127.

We suggest that these rules apply in lieu of rules that have been proposed to date to treat U.S. beneficiaries of foreign nongrantor trusts as the indirect owners of the shares of PFICs owned by the trust in proportion to their beneficial interests in the trust. These indirect ownership rules, discussed below, are not workable when the beneficiary does not control the trust assets, when different beneficiaries are entitled to income and principal and when the interests of the trust beneficiaries are not fixed, clear and vested, which is the typical case. As a result, these rules have not been effective. Treasury's current indirect ownership rules create problems with both fairness and administrability, including the following:

1. Beneficiaries of foreign trusts usually do not control the distribution of income from a foreign holding company or from the trust and may not even know what investments the trust owns.
2. Certain elections available to U.S. shareholders of PFICs may not be available to a U.S. beneficiary (at least as a practical matter).
3. The exclusion from income allowed to the U.S. shareholder of a PFIC that was previously taxed to such shareholder will not work properly if income is imputed to a U.S. beneficiary and that income is actually received by another person (or retained in the trust).
4. The application of the accumulation distribution tax and the corporate anti-avoidance taxes, discussed below, to the same amounts needs to be coordinated.

These problems can all be avoided by adopting any of the rules we recommend. We do not necessarily favor any one of our recommendations herein over the others, or over any alternative proposal that Treasury may develop. But a workable, fair set of rules must be developed.

If the use of PFICs to undermine the accumulation distribution tax can be curtailed by any of the methods we propose, there would be no need to tax currently changes in ownership of shares of PFICs owned by foreign nongrantor trusts to their U.S. beneficiaries in order to prevent "free" deferral of U.S. tax. Deferral is not "free" and it is not abusive when an appropriate interest charge is imposed in consideration of the deferral of tax payments.[10] The accumulation distribution tax regime should be expanded and the imputation of current tax to indirect ownership of shares of investment companies owned by foreign nongrantor trusts should be limited, we think appropriately, to the rare cases when a U.S. beneficiary of a foreign nongrantor trust actually or in effect controls trust investments. Of course, U.S. grantors of foreign grantor trusts would continue to be subject to the corporate anti-avoidance rules.

Although we acknowledge that Treasury's present approach to the indirect ownership rules, if it were effective, would be likely to expose the income of PFICs to U.S. tax sooner than the rules we propose, we think the present indirect ownership rules are not effective. Any of the rules we propose would likely result in a workable solution by imposing an interest charge on tax attributable to the distribution of income accumulated in PFICs owned by foreign nongrantor trusts.

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[10] See, e.g. Code §1294 allowing a shareholder of a PFIC who has made a QEF election to defer payment of tax.

Moreover, there is little logic to allowing deferral of tax on income accruing directly to a foreign trust under the trust rules, or of allowing deferral of tax on income accruing to a PFIC whose shares are held directly by a U.S. shareholder, until there is a distribution to or a disposition by the U.S. beneficiary/shareholder, and denying such deferral to beneficiaries of foreign trusts that invest in PFICs. There are good nontax reasons for investing through PFICs and the different tax treatment merely traps U.S. beneficiaries who are served by ill advised trustees. In many cases the indirect ownership rules can be avoided by making a check-the-box election for the company to be treated as a flow-through entity. However, a foreign trustee may not be aware of the problem and potential solution.

We are not suggesting abandonment of the indirect ownership rules where a foreign trust owns an interest in a foreign holding company. Our recommendations go to establishing sound taxing rules, not to abandoning indirect ownership rules. Thus, the provisions of section 958(a)(2) and section 1298(a)(3) should be enforced in accordance with their terms, although we believe that a proper application of the "facts and circumstances" test of Treasury regulation § 1.958-1(c)(2) would defer, or make only tentative, an attribution of an interest in a foreign holding company to a U.S. person whose interest in the foreign trust is not clear and vested. What we are suggesting, however, is that the taxing rules of section 951(a) and section 1298(b)(5) be conformed to the principles of Subchapter J.

The corporate anti-avoidance rules

There are two sets of corporate anti-avoidance rules – one for CFCs and one for PFICs.

CFC rules

A foreign corporation is a CFC if "U.S. shareholders" own more than 50% of the total combined voting power or more than 50% of the total value of the stock of the company.[11] For this purpose, a "U.S. shareholder" is a person who owns 10% or more of the total combined voting power of the corporation.[12] If a corporation is a CFC, then each "U.S. shareholder" is required to include in income his or her share of the "subpart F income" of the CFC.[13] A U.S. taxpayer who does not own at least 10% of the voting stock is not a "U.S. shareholder" for purposes of this rule and therefore is not taxed on subpart F income that is not actually distributed to him or her. Subpart F income includes most passive type income. To prevent taxing the same income twice, section 959 provides that a shareholder is not taxed on receipt of a distribution of previously taxed income, and his or her basis in the shares is increased by the income that is taxed to him or her (and reduced by distributions of such previously taxed income) so that any gain realized on the disposition of shares is reduced by undistributed previously taxed income. Upon a disposition of shares, any gain that represents accumulated earnings and profits is taxed as ordinary income.

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[11] Code §957(a).

[12] Code §951(b).

[13] Code §951(a).

For purposes of determining whether a corporation is a CFC and whether a person is a U.S. shareholder, a U.S. person is treated as owning stock owned directly, indirectly or constructively.[14] However, for purposes of imposing tax on a U.S. shareholder, only shares owned directly or indirectly (not constructively) are counted.[15]

Taxing owners of voting shares when U.S. owners who each own at least 10% of the shares collectively own more than 50% of the voting stock makes sense because such persons, acting collectively, can compel the corporation to distribute funds to them to cover the tax attributable to their shares of CFC income. In addition, they can dispose of their shares. In most cases, it does not make sense to treat a U.S. beneficiary of a foreign nongrantor trust as an indirect U.S. shareholder for purposes of the CFC rules because he or she does not have any power to compel the payment of dividends or to force a sale of the stock held by the trust. If such beneficiary directly owned nonvoting shares, he or she would not be treated as a U.S. shareholder for purposes of the CFC rules, and it is inconsistent to treat a trust beneficiary who lacks voting rights less favorably. In fact, the person who owns nonvoting shares should be treated less favorably than a beneficiary of a foreign trust since the person who owns nonvoting shares has the option to sell or dispose of such shares. By contrast, the beneficiary has no recourse to avoid being taxed on income he or she has not received and may never receive.

It is important to recognize that a U.S. person cannot create a foreign trust to defer tax on his or her own, or his or her family's beneficial interest in income earned by a foreign investment company owned by the foreign trust. Section 679 would apply to make the trust a grantor trust. Thus, the concern is limited to trusts created by non-U.S. grantors or U.S. grantors who are no longer living. The beneficiaries of such trusts generally have no control over distributions. This is why sections 665-668 tax the U.S. beneficiary only when he or she receives a distribution from the trust and impose an appropriate interest charge.

A U.S. beneficiary of a foreign nongrantor trust is deemed to own shares of a company owned by a foreign trust in proportion to his or her beneficial interest in the trust.[16] Section 958(a)(2) provides that "stock owned, directly or indirectly, by or for a ... foreign trust or foreign estate ... shall be treated as being owned proportionately by its ... beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person." Treasury regulation §1.958-1(b) provides that for purposes of the indirect ownership rules of section 958(a), stock owned by a foreign trust or foreign estate shall be considered as owned proportionately by its grantors or other persons treated as owners under sections 671 through 679 of any portion of the trust that includes the stock, or by the beneficiaries in the case of foreign nongrantor trusts. Treasury regulation §1.958-1(c)(2) provides that

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14 Code §957(a) provides that for purposes of determining whether a corporation is a CFC, stock is treated as owned by applying both the indirect and constructive ownership rules of Code §958.

15 Code §951(a) provides that income is attributed to a person who owns the shares or is treated as owning the shares indirectly by virtue of Code §958(a). The statute excludes ownership through §958(b)'s constructive ownership rules.

16 Code §958

> The determination of a person's proportionate interest in a foreign trust or foreign estate will be made on the basis of all the facts and circumstances in each case. Generally, in determining a person's proportionate interest in a foreign corporation, the purpose for which the rules of section 958(a) are being applied will be taken into account. Thus, if the rules of section 958(a) are being applied to determine the amount of stock owned for purposes of section 951(a), a person's proportionate interest in a foreign corporation will generally be determined with reference to such person's interest in the income of such corporation.

If the issue is whether the income accruing to the corporation should be taxed to a beneficiary, only the interests of income beneficiaries and not remainder beneficiaries should be considered. The regulation further provides that "If the rules of section 958(a) are being applied to determine the *amount of voting power owned* for purposes of section 951(b) or 957, a person's proportionate interest in a foreign corporation will generally be determined with reference to the amount of voting power in such corporation owned by such person." This portion of the regulation should be construed to mean that a beneficiary who lacks voting power over the shares held by a foreign trust will not be considered to indirectly own the shares for purposes of determining whether he or she is a U.S. shareholder.

For purposes of the constructive ownership rules of section 958(b), Treasury regulation §1.958-2(c)(1)(ii) provides that stock owned by a trust shall be considered to be owned by the persons treated as the owners under sections 671-679 in the case of grantor trusts or, for nongrantor trusts, in proportion to the beneficiaries' actuarial interests in such trust. However, a person who has been attributed constructive ownership who does not have indirect ownership is not a "U.S. shareholder" liable to tax under section 951(a).

Example (3) of Treasury regulation §1.958-1(d) illustrates indirect ownership through a foreign trust. Example (3) is as follows:

> Foreign trust Z was created for the benefit of U.S. persons D, E, and F. Under the terms of the trust instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income may either be accumulated for him or distributed to him in the discretion of the trustee. In 1970, the trust is to terminate and there is to be paid over to each beneficiary the accumulated income applicable to his share and one-third of the corpus. The corpus of trust Z is composed of 90 percent of the one class of stock in foreign corporation S. By the application of this section, each of D, E and F is considered to own 30 percent (1/3 of 90 percent) of the stock in S Corporation.

We think that this example should be narrowly applied. It involved a short-term fixed interest trust with vested remainders; the regulation was adopted in 1966 and by the terms of the example the trust was to terminate in 1970 and all of the assets were required to be distributed to

the named income beneficiaries. In such a case, we believe that the trustee would be violating a fiduciary duty to the beneficiaries by failing to distribute amounts at least sufficient to cover the beneficiary's tax attributable to trust income. If such a fiduciary duty exists, in practical effect the beneficiaries have sufficient indirect control over distributions to justify their being taxed currently on the subpart F income of the investment company under a theory akin to constructive receipt principles. Only in such narrow circumstances is it reasonable and consistent with the assumption underlying the CFC rules that U.S. shareholders effectively control the CFC to tax beneficiaries on a share of CFC income. In addition, because the beneficiaries' interests in the example were vested, there is no risk that the beneficiaries (or their estates if they died prior to the termination of the trust) would not actually receive the income on which they paid tax.[17] Therefore, the CFC rules excluding previously taxed income from tax when distributed (discussed below) would work appropriately.

Note that it is not clear whether the absence of voting rights in D, E and F in Example (3) affects their treatment as "U.S. shareholders". Treasury regulation §1.958-1(c)(2) provides that "If the rules of section 958(a) are being applied to determine the amount of voting power owned for purposes of section 951(b) or 957, a person's proportionate interest in a foreign corporation will generally be determined with reference to the amount of voting power in such corporation owned by such person." If D, E, and F lack voting rights, is it appropriate to treat them as "U.S. shareholders" for purposes of section 951(a)?

Nevertheless, even if D, E and F lack voting rights, as they almost surely do, we believe the right result is reached by the example, as long as the interests are vested.

Section 959 provides a mechanism for avoiding double tax when a shareholder receives previously taxed income from a CFC. Section 959 provides that earnings and profits of a foreign corporation attributable to amounts that are or have been included in the gross income of a U.S. shareholder under section 951(a) shall not, when such amounts are distributed through a chain of ownership described in section 958(a), be included in the gross income of such shareholder or any other U.S. person who acquires from any person any portion of the interest of such U.S. shareholder in such foreign corporation. Section 959 would apply fairly to the facts of Example 3 in Treasury regulation § 1.958-1(d) when the income was later distributed to D, E or F or their estates. But how is that mechanism to apply when a beneficiary of a trust receives a distribution of income previously taxed to another person?

For example, suppose that a foreign trust is established for the life income benefit of H and on his death the trust terminates and its assets are distributed outright in equal shares to A, B and C. Assume further that the CFC's net income over several years includes substantial "foreign personal holding company income" defined in section 954(c) that is not distributed by the CFC and would be properly allocable to principal of the foreign trust were it to be distributed to the foreign trust by the CFC. Taxing that income to H when it is never going to inure to the benefit of H is unreasonable and unfair. That unfairness is not eliminated by allowing A, B and C (or any ultimate

[17] The example does not expressly state that the beneficiaries' interests in the trust are vested, but we believe that to be the fair reading of the facts.

discretionary beneficiaries who receive the trust principal) to exclude from income amounts previously taxed to H when they receive the money, particularly if there is no reason to believe that H would want to benefit A, B or C.

In some cases the application of the section 959 exclusion would be very complicated. For example, assume in the above example that upon H's death, the assets were to be retained in a wholly discretionary trust for the benefit of A, B and C and their descendants. Suppose that the trust made no distributions for five years and then made a distribution to A. Would the DNI/UNI of the foreign trust be calculated by excluding from trust income the income previously taxed to H? If not, then upon a distribution to A, the previously taxed income would be taxed again. If the income is excluded in the calculation of DNI/UNI, then how is the excluded amount apportioned among A, B and C?

Section 961 and Treasury regulation §1.961-1 provide that a U.S. shareholder's basis in his or her shares is increased by the amount the shareholder is required to include in income under section 951(a) and reduced by the amount of distributions of previously taxed income that is excluded from income under section 959. If a U.S. shareholder indirectly owns shares through a trust or estate, Treasury regulation §1.961-1(b)(1) provides that the basis of his or her beneficial interest in the foreign estate or trust is adjusted. According to this regulation, if income is taxable to beneficiaries under section 951(a) but not distributed, the trust may not increase its basis in the shares of the CFC. The adjustment of the basis of a beneficiary's beneficial interest in the foreign trust is ineffective to avoid double tax. Basis in a trust or estate generally is meaningless in the rules governing the taxation of trusts and estates. Basis does not affect the determination of a beneficiary's share of income derived from the trust or estate. Rather, a beneficiary is taxed on his or her share of trust or estate income, and a beneficiary's basis in his or her beneficial interest would not enter into the calculation of trust or estate income.

Our recommendation is that foreign trusts owning shares in corporations that would be classified as CFCs be treated as owning shares in PFICs, and not CFCs, except in the rare and limited circumstance that (1) the U.S. beneficiaries serve as trustees or co-trustees, (2) the U.S. beneficiaries have the right to remove and replace the trustee of the foreign trust with trustees subservient to them, or (3) the interests of the U.S. beneficiaries, in all classes of income, are so fixed, clear and vested that the trustee of the foreign trust would have a fiduciary duty to distribute the income of the foreign investment company currently to the U.S. beneficiaries, and not accumulate it in the corporation.

PFIC rules

A foreign corporation is a PFIC if 75% or more of the gross income of such corporation is passive income or the average percentage of assets held by such corporation which produce passive income or which are held for the production of passive income is at least 50 percent.[18] The PFIC rules were adopted in the Tax Reform Act of 1986 because Congress recognized that while income

[18] Code §1297(a)

accumulated in foreign trusts was being taxed to the U.S. beneficiaries with an appropriate interest charge, income being accumulated in foreign corporations was not being appropriately taxed to the less than 10% U.S. shareholders. Instead, they could effectively dispose of their shares at capital gains tax rates after years of accumulating income in the foreign investment company.[19]

As originally passed in the House bill, the new provisions would have subjected less than 10% shareholders to current tax on accumulated passive income in foreign investment companies. The Senate, noting with approval the operation of the foreign trust rules, which delayed imposition of tax until a beneficiary actually received a distribution, but then imposed tax with an appropriate interest charge to compensate the Treasury for the delay in payment of taxes, amended the House bill to apply to foreign investment companies a regime similar to the Subchapter J regime. With modifications, the Senate approach became law.

A U.S. shareholder of a PFIC is not taxed currently on PFIC income unless certain elections are made. Instead, a regime similar to the accumulation distribution tax applies when a U.S. shareholder receives (or is deemed to receive) an "excess distribution." An excess distribution is (i) a distribution that exceeds 125% of the average distributions received in the prior three years; and (ii) gain realized on a disposition (or gain deemed realized on a disposition) of PFIC shares. Certain nontaxable transfers are treated as generating an excess distribution equal to the excess of fair market value of the shares over basis.[20]

The PFIC rules apply regardless of the percentage of ownership of shares held by U.S. persons. Because control of the PFIC is not important to the application of the PFIC rules, the fact that a beneficiary of a trust does not control the trust investments is not important to the application of the PFIC rules to trust beneficiaries. However, a corporation may be both a CFC and PFIC. In that case, the CFC rules take precedence.[21]

When a U.S. person receives or is treated as receiving an excess distribution, the excess distribution is allocated equally to all prior years in the person's holding period, tax is calculated for each such year and an interest charge is imposed on the tax allocated to each prior year for the number of years between the tax due date for each such year and the date the tax is paid.[22]

A U.S. person may avoid the excess distribution tax regime by making certain elections. One election is the "qualified electing fund" or "QEF" election. Under this election, which is only available if the PFIC agrees to provide the necessary tax information to shareholders, the U.S. shareholder includes in his or her income his or her share of PFIC income as it accrues. If this election is made, the character of the income to the shareholder is the same as the character of the income realized by the PFIC. Capital gain income, for example, retains its character. The

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[19] See Report of the Senate Finance Committee on H.R. 3838, the Tax Reform Act of 1986, Report 99-313, May 29, 1986, at 393 ("Reasons for Change").

[20] Code §1291.

[21] Code §§951(c) and 1297(d).

[22] Code §1291.

distribution of previously taxed income is not taxed again and a U.S. shareholder's basis in the PFIC shares is adjusted for the income taken into account under the QEF election.[23] In addition, a U.S. shareholder may elect to defer the payment of tax on income imputed under a QEF election, but interest accrues on the deferred tax.[24]

A second election is the mark-to-market election, which is available only for publicly traded securities. Under the mark-to-market election, the U.S. shareholder includes in his or her income annual appreciation in the market value of securities and is entitled to a loss if the value declines, to the extent of appreciation previously included in income. As under the QEF election, the basis of the PFIC shares is adjusted for the appreciation or depreciation taken into account under the mark-to-market elections.[25]

Shares of an investment company held by a nonresident alien are not treated as PFIC shares. Only a U.S. person is treated as a PFIC shareholder.[26] Thus, a U.S. person's holding period of PFIC shares does not include the holding period of the shares when they were previously owned by a nonresident alien because the shares were not PFIC shares in the hands of the nonresident alien owner. Similarly, a corporation is not treated as a PFIC with respect to a shareholder for those days included in the shareholder's holding period before the shareholder became a U.S. person.[27] While this rule is correct as a matter of tax policy for shares that are owned by a nonresident alien individual, this rule should not apply to shares owned by a foreign trust, even though a foreign trust is taxed like a nonresident alien individual, because application of this rule to a foreign trust would undermine the application of the accumulation distribution tax rules, as discussed below.

A U.S. person is treated as indirectly owning shares of a PFIC held by a foreign nongrantor trust of which he or she is a beneficiary in proportion to his or her beneficial interest.[28] The definition of indirect ownership is identical to the definition used for a CFC. Proposed Treasury regulation §1.1298-1(b)(8) defines an indirect shareholder as a person who is treated as owning the stock of a corporation that is owned by another person (the actual owner) under this paragraph. In applying this paragraph, the proposed regulation provides that the determination of a person's indirect ownership is made on the basis of all the facts and circumstances in each case; the substance rather than the form of ownership controls, taking into account the purposes of section 1291. Paragraph (8) cross references Treasury regulation §1.958-1(c)(2). Proposed Treasury regulation §1.1291-1(b)(8)(iii)(C) provides that the beneficiaries of an estate or trust that owns stock of a corporation will be deemed to own "a proportionate amount" of such stock.

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23 Code §1293.

24 Code §1294.

25 Code §1296.

26 Treasury regulation §1.1291-9(j)(1), which defines a PFIC, provides "A corporation will not be treated as a PFIC with respect to a shareholder for those days included in the shareholder's holding period when the shareholder, or a person whose holding period of the stock is included in the shareholder's holding period, was not a U.S. person within the meaning of section 7701(a)(30)."

27 Proposed Treasury regulation §1.1291-1(b)(1)(i).

28 Code §1298(a)(3).

Unlike the CFC rules, the proposed regulations do not limit indirect ownership rules to shares held by foreign entities. The application of the indirect ownership rules to shares held by domestic entities seems to be unintended because other PFIC regulations recognize the domestic pass through entity as the shareholder, e.g. for purposes of making a QEF or mark-to-market election.[29] It serves no apparent purpose to impute ownership from a domestic trust to a U.S. beneficiary, since the PFIC tax regime would apply to the U.S. trust itself. In addition, section 1298(a)(1) (B) implies that this should not be the case. Section 1298(a)(1) (B) provides that "except to the extent provided in regulations, [attribution of ownership] shall not apply to treat stock owned (or treated as owned under this subsection) by a United States person as owned by any other person." Because a domestic trust is a U.S. person, ownership of corporate shares held by a domestic trust should not be attributed to any other person, including a beneficiary of such trust. The PFIC regulations should be changed to prevent the application of the indirect ownership rules to PFIC shares held by domestic entities .

When a person is treated as indirectly owning shares owned by an entity, including a trust, a transaction that results in a reduction of his or her indirect ownership of PFIC shares may be treated as a disposition of those shares. Section 1298(b)(5) provides:

> (A) IN GENERAL. – Under regulations, in any case in which a United States person is treated as owning stock in a passive foreign investment company by reason of subsection (a) [providing that beneficiaries are treated as owning proportionately shares owned by a trust] –
>
> > (i) any disposition by the United States person or the person owning such stock which results in the United States person being treated as no longer owning such stock or
> >
> > (ii) any distribution of property in respect of such stock to the person holding such stock,
>
> shall be treated as a disposition by, or distribution to, the United States person which respect to the stock in the passive foreign investment company.

Although there are no regulations implementing section 1298(b)(5), Treasury regulation §1.1291-3(e) does define an "indirect disposition" as any transfer that results in an indirect shareholder's interest being reduced. For example, a U.S. beneficiary of a foreign nongrantor trust would be treated as making an indirect disposition of shares of a PFIC that he or she is treated as indirectly owning if the trust disposes of the PFIC shares either by sale, liquidation or distribution

[29] Treasury regulation §1.1295-1(d)(2)(iii). Treasury regulation §1.1296-1(e)(1) provides that for purposes of the mark-to-market election, only shares owned by a foreign trust or foreign estate are deemed to be indirectly owned by beneficiaries.

to another beneficiary.[30] Such deemed disposition could be treated as generating an excess distribution. If so, what is the U.S. beneficiary's basis in the PFIC shares and what is his or her holding period? Would shifting beneficial interests cause multiple excess distributions to be generated? In thinking about these problems, it must be recognized that the U.S. beneficiary would not necessarily have received distributions to cover any tax imposed by these rules.

Similarly, under section 1298(b)(5), if implemented by regulations, a distribution from the PFIC to the foreign trust could be treated as a distribution to the indirect shareholder/beneficiary. If the distribution is an excess distribution, the PFIC tax regime could be made to apply to the beneficiary.

The issue of whether the excess distribution amounts are properly allocable to the trust's income or principal accounts should affect the determination of which beneficiary is appropriately treated as owning the income and therefore appropriately taxed on such income. For example, if income is payable to A in the trustee's discretion and principal is payable to B, taking into consideration all relevant facts, if anyone is to be imputed income from the trust, dividends should be imputed to A and capital gains or liquidating distributions to B. But under the PFIC regime, only either A or B is treated as indirectly owning the shares. There is no mechanism for allocating fiduciary income to A and principal receipts to B.

The elections available to U.S. shareholders of PFICs mitigate the harsh tax treatment of excess distributions. However, these elections are not, at least as a practical matter, available to U.S. beneficiaries who are treated as indirectly owning the shares held by a foreign trust. Although the QEF and mark-to-market elections may be made by a U.S. beneficiary of a foreign trust who is treated as the indirect shareholder,[31] in most cases the beneficiary does not have a fixed right to any share of the trust and would not want to elect to be taxed on amounts he or she does not, in any common meaning of the term, own. Moreover, when such an election could be made, for example when the trust had a single beneficiary or fixed shares, the rules for dealing with previously taxed income would need to be clarified or modified to make sure that the same income is not taxed more than once.

For example, assume that a beneficiary makes a mark-to-market election. Treasury regulation §1.1296-1(d)(2) provides that the basis of shares in the hands of a foreign partnership or foreign trust is adjusted for amounts taken into income by a partner or beneficiary who has made a mark-to-market election, but only for purposes of determining the subsequent income tax treatment of the U.S. person who is treated as owning such stock. The regulation provides:

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[30] In PLR 200733024, a technical advice memorandum involving disposition of shares in a PFIC by a foreign discretionary trust, the IRS asserted that U.S. beneficiaries should be treated as receiving an excess distribution when the trust disposed of PFIC shares the beneficiaries were treated as indirectly owning even though regulations had not been issued under that statute. The beneficiaries were treated as owning the shares indirectly in proportion to an actuarial allocation of the interests in the trust among the beneficiaries, even though they had no current right to the income and no distributions had ever been made to them. The matter described in the TAM has been settled on other terms.

[31] Treasury regulation §§1.1295-1(d)(2)(iii)(B) and 1.1296-1(h).

> Such increase or decrease in the adjusted basis of the section 1296 stock shall constitute an adjustment to the basis of partnership property only with respect to the partner making the section 1296 election. Corresponding adjustments shall be made to the adjusted basis of the United States person's interest in the foreign entity and in any intermediary entity described in paragraph (e) of this section through which the United States person holds the PFIC stock.

Although paragraph (e) pertains to trusts as well as partnerships, the regulations fail to address how the adjustment to basis will function in the case of a trust. The regulation quoted above does not work appropriately for a trust since there is no mechanism under the trust rules to adjust the taxable amount received by a beneficiary for the adjustment to basis of the shares owned by the trust.

In the case of a QEF election, the regulations provide no guidance at all as to how income that is taxed to a U.S. beneficiary of a foreign trust is to be accounted for when actually distributed to avoid double taxing the income attributable to the corporation.

Coordination of accumulation distribution and PFIC rules

The preamble to the proposed PFIC regulations notes the need to coordinate the accumulation distribution and PFIC tax regimes:

> [T]he regulations do not provide explicit rules for determining the tax consequences to a trust or estate (or a beneficiary thereof) that directly or indirectly owns stock of a section 1291 fund. Until such rules are issued, the shareholder must apply the PFIC rules and Subchapter J in a reasonable manner that triggers or preserves the interest charge.[32]

We believe that adjustments to the accumulation distribution rules are necessary to achieve the result of preserving the interest charge on untaxed income.

A beneficiary of a trust who receives a distribution that represents the current year's income is taxable on his or her share of the trust's DNI.[33] DNI is taxable income from all sources, including (in the case of a foreign trust) capital gains and foreign source income. The character of the income received by the beneficiary in the same year it accrues to the trust is the same as the character of the income to the trust.[34] If a foreign trust's receipt of a distribution from a foreign holding company would be treated as an excess distribution if the shares were held by a U.S. taxpayer, it

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32 Preamble to proposed regulations issued 4/1/92, 1992-1 C.B. 1124, 1127.

33 Code §662(a).

34 Code §662(b).

would be consistent with the trust income tax rules to tax a beneficiary who receives that excess distribution in the same year as subject to the PFIC tax regime.

However, there is no authority clearly applying the above rule. Moreover, an argument could be made that because the holding company shares are not PFIC shares in the hands of a foreign trust, the character of the income to the trust (which flows through to the beneficiary) is not PFIC income. Shares held by a foreign person are not PFIC shares. As noted below, one of our *alternative recommendations* is the adoption of a regulation under section 643(a)(6) stating that income distributed from a PFIC through a foreign trust to a U.S. beneficiary in the *current year* as part of DNI will be treated and taxed to the beneficiary as PFIC income.

In addition, if a foreign nongrantor trust receives an excess distribution in a year (or what would be an excess distribution if made to a U.S. shareholder) and does not make a distribution to a U.S. beneficiary in the same year, the PFIC tax regime cannot apply to the U.S. beneficiary (unless a beneficiary is treated as indirectly owning the PFIC shares). That is because the excess distribution accumulated in the trust would become UNI. The character of income that becomes UNI is not preserved and is taxed as ordinary income to the beneficiary when distributed, subject to an interest charge.[35] However, the interest charge would be based only on the number of years the income was accumulated in the trust and would exclude the number of years the income was accumulated in the holding company.[36] The tax result of not treating a U.S. beneficiary as the indirect owner of PFIC shares will be satisfactory only if the trust accumulation distribution rules are changed to increase the interest charge to cover the period that the income was accumulated in the holding company.

Proposed solutions

We recommend that Treasury adopt one or more regulations that will integrate the rules for taxation of PFICs with the taxation of accumulation distributions from foreign trusts, under the structure of Subchapter J. We believe that the situations in which foreign trusts should be deemed to own CFCs is extremely limited, as discussed above. Alternative solutions for the taxation of PFICs owned by foreign trusts follow. We believe these solutions can be effected by regulations.

We further recommend that all PFIC events that occur at the trust level— that is, a disposition by a foreign trust of an interest in a PFIC or an excess distribution by the PFIC to the foreign trust—should not be taxed to the U.S. beneficiary at the time of the PFIC event, but instead should be taxed only at such time as the U.S. beneficiary actually receives a distribution. Consistent with both the Subchapter J and PFIC rules, the U.S. beneficiary should pay an appropriate tax with appropriate interest charges, reflecting the total period that the income has been accumulated offshore, when he or she receives the distribution.

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35 Code §667(a).

36 Code §668(a)(3) and (4).

1. One way to accomplish the integration of the Subchapter J and PFIC rules is to modify the accumulation distribution rules of Subchapter J so as to treat the excess distribution received by the trust as if the trust were a U.S. taxpayer for the limited purpose of allocating the excess distribution to prior taxable years of the trust and to calculate the UNI of the trust for such prior years. This allocation of excess distributions to UNI would apply to distributions made in the year of the trust's receipt of the excess distribution and in future years but would not require any change in the tax treatment of distributions that had been made to beneficiaries in prior years.

Precise integration for the taxation of the income accumulated in the PFIC to the income accumulated in the foreign trust would be achieved by requiring the PFIC to give to the trustee of the foreign trust (and, ultimately, the U.S. beneficiary) detailed financial information similar to that for a QEF election, and to require the trustee of the foreign trust, upon receiving the excess distribution, to analyze the PFIC's income and to allocate the excess distribution to the appropriate prior years of the trust in computing UNI, as if the PFIC had never existed and the income had been earned and accumulated directly in the trust. If the PFIC did not provide sufficient information to the trustee, the trustee of the foreign trust would be permitted to allocate the excess distribution among prior years on the basis of the annual changes in the net fair market value of the PFIC. Either of these two integration methods would, we believe, operate fairly.

If the information necessary to achieve such an integration is not available, then the trustee would have to allocate the excess distribution without regard to the PFIC's actual history of earnings and appreciation. For example, under this method, if a trust owned shares in a PFIC for ten years and received an excess distribution in the tenth year, the excess distribution would be allocated equally to all prior years and treated as UNI. This produces the same result as treating the foreign trust as a U.S. taxpayer subject to the PFIC tax rules for the sole purpose of calculating DNI and UNI.

A distribution to a beneficiary in the year that the trust receives an excess distribution or any subsequent year that exceeds the DNI and accounting income of the trust for the year of distribution would be an accumulation distribution. Regardless of the method of integration that is used, to protect the application of the accumulation distribution tax in this context, the excess distribution that is allocated to prior years would have to be excluded in computing accounting income of the trust in the year it is received. If the excess distribution were treated as DNI and/or accounting income, the distribution in the year of receipt would not be an accumulation distribution because a distribution that does not exceed the greater of DNI or accounting income is not an accumulation distribution. If the portion of the excess distribution that is allocated to prior years is excluded from the computation of DNI and accounting income, the distribution of the excess distribution would be treated as a distribution of UNI taxable under the accumulation distribution rules. An interest charge would be applied to the tax allocated to each of the prior years in the trust's holding period of the corporation's shares.

We also suggest that the PFIC rules be modified to allow a foreign trust to make a QEF or mark-to-market election even though it is not a U.S. taxpayer. If this election were made, the elections would not accelerate the due date for payment of U.S. tax. Rather, the elections would be used solely for purposes of calculating the DNI of the trust and calculating the interest charge due

on an accumulation distribution. The election would cause income to accrue to the trust as such income was earned by the holding company rather than equally over the holding period of the shares, as is the case under the PFIC tax rules. The mark-to-market election would cause income to accrue to the trust as the investment appreciated.

2. An alternative way to compute a fair amount of tax and interest would be to adopt a "tacking" of the period that income is accumulated in the PFIC to the period the income is accumulated in the foreign trust, but not integrate the PFIC income into UNI unless it is in fact accumulated in the trust after being distributed by the PFIC. Two steps would be needed to adopt this alternative method.

a. First, Treasury could adopt a regulation under section 643(a)(6) stating that any distributions received from a passive foreign investment company that are distributed through to U.S. beneficiaries in the current year as part of DNI shall retain their character as PFIC income and shall be taxed to the U.S. beneficiary as such.

We believe that this may be the result under current law, but recommend adoption of a regulation to remove all doubt. We believe that Treasury has the authority to adopt such a regulation under the provisions of section 643(a)(7). We suggest that Treasury adopt a regulation under section 643 stating that PFIC income will be treated as such when received by a foreign trust (even though it is a foreign person), will constitute part of DNI and will retain its character as PFIC income if distributed currently to U.S. beneficiaries as part of DNI. This is consistent with the treatment in Subchapter J of foreign trusts as modified conduits. The trust itself is taxed as a nonresident alien individual. But every class of income collected by the trust passes through to U.S. beneficiaries with its character maintained, if it is distributed in the current year.

b. In addition, Treasury could adopt a regulation under section 1298(b)(5) that called for tacking the period that income is accumulated in a PFIC to the period that the income is accumulated in the foreign trust, if the PFIC distribution is not distributed currently to the U.S. beneficiaries by the foreign trust.

By this method, Treasury would ensure that an appropriate interest charge was imposed upon the U.S. taxpayer for the full period that the income was accumulated, either in the PFIC or in the trust. If the trustee had full information from the PFIC on the income that had been accumulated in the PFIC, the trustee could provide all of that information to the beneficiary receiving a distribution as part of the trustee's beneficiary statement. If not, the trustee (and the beneficiary) would compute the accumulation distribution tax for the "tacked" period of accumulation in the PFIC by allocating the income equally to the years during which the foreign trust had owned shares in the PFIC, using any of the allocation methods described in the first alternative, so that when the trust later made an accumulation distribution, interest would be charged for the full period that tax was deferred. The resulting tax and interest charge may not be the same in all cases as under the first alternative, but in either case the U.S. beneficiary will not have received a benefit from accumulation of income offshore that is not fairly taxed.

We believe that any of the methods proposed here would achieve a fair result, and do not urge the adoption of one of them over another.

If either of the integration or tacking rules is adopted as proposed above, a regulation under section 1298(b)(5) should be adopted to limit the circumstances in which a beneficiary of a foreign trust is deemed to be taxable under that section to cases (admittedly rare) where a beneficiary voluntarily transfers his or her beneficial interest in a foreign trust that owned PFIC shares. If the U.S. beneficiary voluntarily transfers his or her interest in the foreign trust, he or she presumably will have received consideration for the interest transferred, and have funds to pay the PFIC tax. A regulation might postpone the tax in the case of a donative transfer, but again tack holding periods.

Conclusion

The goal of the PFIC and CFC rules is to prevent U.S. taxpayers from escaping an appropriate tax and interest charge when tax is deferred through the use of foreign corporations. The same result should occur if the interest is held directly or through a foreign trust. The accumulation distribution tax rules under Subchapter J can be modified to accomplish this result. The accumulation distribution rules are equitable because they impose tax on a beneficiary only at the time he or she receives a distribution from the trust. For the same reason, such rules are more administrable. If beneficiaries are treated and taxed as indirect shareholders, complex rules will be necessary to avoid a beneficiary paying tax on income that may ultimately be distributed to someone else and avoid imposing tax on previously taxed income. In addition, the unfairness of imposing tax on income that a beneficiary has no right to receive creates an incentive for taxpayers to try to evade their tax responsibilities.

Our proposals are consistent with the legislative history of the PFIC rules. The 1986 Blue Book explained that:

> The Act provides authority to the Secretary to prescribe regulations that are necessary to carry out the purposes of the Act's provisions and to prevent circumvention of the interest charge. * * * Another instance when regulations may be necessary to carry out the purposes of the Act's provisions is when the ownership attribution rules attributed stock ownership in a PFIC to a U.S. person through an intervening entity and the U.S. person disposes of his interests in the intervening entity. In these cases, the intervening entity may not be a PFIC, so that the U.S. person could technically avoid the imposition of any interest charge. Similarly, if necessary to avoid circumvention of the Act's interest charge, it may be necessary under regulations to treat distributions received by an intervening entity as being received by the U.S. person.[37]

[37] Blue Book, at 1032.

In the case of a trust, a beneficiary generally is not able to transfer his or her beneficial interest and thereby escape the PFIC tax regime. In those rare cases when a beneficiary can (and does) sell his or her beneficial interest in a foreign trust, it may be appropriate to impose the PFIC tax regime to preserve the interest charge. However, the PFIC tax regime should not be imposed on a U.S. beneficiary whose beneficial interest (and therefore indirect ownership) is reduced involuntarily, either by the exercise of fiduciary discretion or pursuant to the terms of the trust instrument.

In conclusion, we submit that our proposals are administrable, are fair, meet the goal of Congress when it adopted the PFIC rules of delaying tax to U.S. beneficiaries until they receive a distribution, and integrate the operation of the PFIC Rules with Subchapter J. We would welcome an opportunity to discuss this memorandum with Treasury staff.

Notice 2013-22

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LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

May 24, 2013

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Recommendations for 2013 - 2014 Guidance Priority List (Notice 2013-22)

Dear Sir/Madam:

The AICPA is pleased to offer our suggestions regarding the 2013 - 2014 Guidance Priority List, which were prepared by the AICPA Tax Division's committees and technical resource panels, and approved by our Tax Executive Committee.

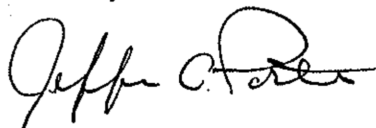
The suggestions are listed under the AICPA working group that developed them, and we have indicated the priority order for our comments under each category of the attached document. For your convenience, contact information for each working group's chair and AICPA staff liaison is listed. Please feel free to contact these individuals directly with your specific questions or concerns.

In addition, the AICPA again encourages the Department of Treasury and the Internal Revenue Service to continue pursuing tax simplification. Although we recognize you must balance competing interests and concerns when drafting guidance, we urge you to consider the following as part of the process:

- Use the simplest approach to accomplish a policy goal;
- Provide safe harbor alternatives;
- Offer clear and consistent definitions;
- Use horizontal drafting (a rule placed in one Internal Revenue Code ("Code") section should apply in all other Code sections) to the greatest extent possible;
- Build on existing business and industry-standard record-keeping practices;
- Provide a balance between simple general rules and more complex detailed rules; and
- Match a rule's complexity to the sophistication of the targeted taxpayers.

We welcome the opportunity to discuss these comments. If you have any questions regarding this submission, please contact me at (304) 522-2553 or jporter@portercpa.com; or Melissa Labant, AICPA Director of Tax Advocacy & Professional Standards at (202) 434-9234, or mlabant@aicpa.org.

Sincerely,



Jeffrey A. Porter, CPA
Chair, Tax Executive Committee

Encl.

AICPA Tax Division
Comments on the
2013 - 2014 Guidance Priority List (Notice 2013-22)
May 24, 2013

Corporations and Shareholders Taxation Technical Resource Panel (Todd Reinstein, Chair, (202) 220-1520, reinstet@pepperlaw.com; or Jason Cha, AICPA Technical Manager, (202) 434-9231, jcha@aicpa.org.) NOTE: Comments are listed in priority order.

Consolidated Returns

1. Provide additional guidance as to the application of section 382(h)(6) in conjunction with Notice 2003-65, 2003-2 C.B. 747, within consolidation.

2. Provide guidance for determining when the Continuity of Business Enterprise (COBE) requirement is satisfied following a section 382 ownership change.

3. Provide additional guidance under Treas. Reg. § 1.1502-36.

    - Provide guidance that would permit a reattribution of losses where a worthless stock deduction is taken on subsidiary stock and the subsidiary ceases to be a member of the group but does not have a separate return year.

    - Regarding the interaction of Treas. Reg. § 1.1502-11(c) and Treas. Reg. § 1.1502-28 (i.e., how does Treas. Reg. § 1.1502-36 apply in a year when there is a disposition at a loss in the same year as a cancellation of debt event subject to Treas. Reg. § 1.1502-28 and Reg. § 1.1502-11(c)).

4. Provide guidance that would permit a worthless stock deduction with respect to a class of subsidiary stock notwithstanding that there is a section 381 transaction with respect to other classes of subsidiary stock.

5. Provide guidance with respect to group continuation and the application of Rev. Rul. 82-152. Specifically, reevaluate the existing group continuation rules under Treas. Reg. § 1.1502-75(d) to eliminate the uncertainty that exists as a result of the expanded application of Rev. Rul. 82-152.

6. Provide guidance with respect to the application of Treas. Reg. § 1.1502-76(b)(1)(ii)(B) to transactions occurring prior to or contemporaneously with the event that results in subsidiary's change in status as a member. Additionally, provide guidance regarding the treatment of discharge of indebtedness income that is recognized on the day the subsidiary becomes a nonmember and is not

excluded from gross income under section 108(a).

7. Provide guidance regarding the treatment of intercompany transactions in determining satisfaction of the gross receipts test for purposes of section 165(g)(3)(B).

8. Provide guidance as to whether an acquiring corporation needs to report on its Schedule UTP, Uncertain Tax Position Statement, a tax position taken on a selling consolidated group's pre-closing consolidated return for which the selling group did not record a reserve and whether the "only once rule" applies to tax positions already reported on Schedule UTP on the selling consolidated group's returns needs to be disclosed on the acquiring consolidated group's post-closing return.

9. Provide guidance that excludes the application of section 351(g) to redemptive transactions between members of a consolidated group where a member redeems its stock through the issuance of non-qualified preferred stock as defined under section 351(g).

10. Provide guidance concerning the application of Rev. Rul. 99-6 involving members of a consolidated group.

11. Provide guidance on circular basis adjustments under Treas. Reg. section 1.1502-11 regarding issues associated with the dispositions of brother-sister subsidiaries within the same consolidated return year.

Corporations and Their Shareholders

1. Guidance under section 382:

    - Provide guidance on identifying five percent shareholders of public companies.

    - Provide guidance under sections 382 and 384, including regulations regarding built-in items under section 382(h)(6).

2. Guidance with respect to section 108:

    - Provide guidance concerning how an election under section 108(i) affects the determination of recognized built-in gain or loss under section 382(h)(6).

    - Provide guidance as to the application of section 108(e)(6) if the subsidiary is insolvent before the contribution of the debt.

    - Provide guidance under section 108 for determining if a publicly traded company is insolvent when the stock is trading above $0.

3. Provide updated guidance regarding transactions involving receipt of no net equity value.

4. Provide guidance on the application of the solely voting stock requirement, meaningless gesture and deemed issuances under section 368(a)(1)(C) in the event of an upstream reorganization where no actual shares are issued and the transferee corporation has multiple both voting and non-voting classes of stock.

5. Finalize regulations under section 368(a)(1)(F).

6. Provide guidance on what constitutes an effective abandonment of stock.

7. Provide guidance as to what represents a "characterization" for purposes of section 385(c)(1) regarding a characterization of an interest as stock or indebtedness.

8. Strongly consider releasing a list(s) of specific common organizational actions that do (or do not) require reporting on Form 8937, Report of Organizational Actions Affecting Basis of Securities, to help taxpayers understand the filing requirement, without the administrative burden and cost that a taxpayer may need to go through to verify if reporting is necessary.

9. Provide guidance as to whether an acquiring corporation needs to report on its schedule UTP a tax position taken on a standalone target corporation's pre-closing return that the target corporation did not record a reserve for in the pre-closing year's returns.

10. Finalize regulations under section 362(e)(2).

11. Provide additional guidance on the following areas in conjunction with Rev. Proc. 2013-3, 2013-1 I.R.B. 113 that would eliminate issuance of private letter rulings:

    - Whether a "distributing" corporation's distribution of the stock of a "controlled" corporation meets the requirements of section 355(a)(1)(A) where, in anticipation of the distribution, the distributing corporation acquires control of the controlled corporation through a recapitalization or issuance of new stock resulting in a "high vote/low vote" structure;

    - Whether either section 355 or section 361 applies to a distribution of a "controlled" corporation's stock or securities in exchange for, and in retirement of, any debt of the distributing corporation if such debt was issued in anticipation of the distribution; and

- Whether a contribution of property and a distribution of property in a so-called "north-south" transaction are respected as separate transactions for federal income tax purposes.

12. Provide guidance on the scope and application of the rescission doctrine as described in Rev. Rul. 80-58, 1980-1 C.B. 181.

13. Provide guidance on how to determine the amount of gain or loss that is recognized if an exchange of excess principal amount (as defined in section 354(a)(2)) occurs.

Employee Benefits Taxation Technical Resource Panel (Chris W. Shankle, Chair, (318) 865-1355, shanklecpa@yahoo.com; or Kristin Esposito, AICPA Technical Manager, (202) 434-9241, kesposito@aicpa.org.) NOTE: Comments are listed in priority order.

Retirement Benefits

1. Finalize the regulations on the suspension/reduction of 401(k) safe harbor contributions.

2. Issue guidance on international tax issues relating to qualified retirement plans.

3. Provide model language for prototype documents to provide for the deferral of unused vacation and leave time.

4. Issue guidance to simplify correction methods under the Employee Plans Compliance Resolution System (EPCRS) as they pertain to correcting Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) testing failures after the 12-month statutory correction period.

   For 401(k) retirement plans, the ADP and ACP tests provide a limit on the amount of certain benefits provided under a plan to highly compensated employees over benefits provided to non-highly compensated employees. A plan annually satisfies these nondiscrimination requirements if the plan passes the ADP or ACP tests; however, if a plan fails these tests for a given plan year, corrective action must be taken within the 12-month statutory correction period following the close of the plan year in which the failure occurred. Any corrective action shall be made in accordance with the EPCRS and specifically a Voluntary Correction Program (VCP) submission to the Internal Revenue Service (IRS or "Service"). Failure to correct within the statutory correction period will result in plan disqualification.

5. Issue guidance to assist plan sponsors in correcting areas of noncompliance relating to Rollovers as Business Start-ups (a/k/a "ROBS").

   Rollovers, as a business start-up, are an arrangement in which a prospective business owner uses their retirement funds to pay for their new business start-up costs in a tax-free transaction. The prospective business owner rolls over their existing retirement funds to the ROBS plan, where the ROBS plan uses the rollover assets to purchase stock of the new business, resulting in the ROBS plan owning the new business.

   It has been our members' experience, that many ROBS plan sponsors are unaware that the plan is a qualified plan with its own set of regulatory requirements. We also think that noncompliant ROBS plans are costly to correct and can result in discrimination, prohibited transactions, plan disqualification and adverse tax consequences to the plan sponsor and plan participants.

Executive Compensation, Health Care and Other Benefits, and Employment Taxes

6. Issue Consolidated Omnibus Budget Reconciliation Act (COBRA)-related guidance, including:

   - Guidance on the applicability of section 162(l) to COBRA premiums.

   - Guidance under section 4980B regarding calculation of the application premium for COBRA continuation coverage.

7. Finalize the regulations on income inclusion under section 409A; proposed regulations were published on December 8, 2008.

8. Issue guidance on the treatment of partnership employees working for a single member limited liability company (SMLLC) or other disregarded entity owned by an upper tier partnership after the SMLLC employment tax reporting rules changed effective in 2009. Is an owner of the upper tier entity treated as a partner or an employee if he or she provides service to the lower tier SMLLC or other disregarded entity?

9. Regulations are needed to implement new section 3121(z) related to foreign employers, as added by section 302 of the Heroes Earnings Assistance and Relief Tax Act of 2008.

10. Issue guidance on the application of section 409A(b) as amended by the Pension Protection Act of 2006, especially guidance on employees transferred from one country to another.

11. Finalize the regulations on cafeteria plans under section 125. Proposed regulations were published on August 6, 2007. Also, regulations are needed under section 4980G on interaction of section 4980G and section 125 with respect to comparable employer contributions to employees' health savings accounts.

12. Provide clarification of the impact of the rebate on the safe harbor definition of compensation associated with the Affordable Care Act mandate which requires insurance companies to give their customers a rebate if they fail to spend 80-85 percent of premium dollars on medical care.

13. Develop a publication on the employer shared responsibility requirements similar to the IRS's Employment Tax Guide, which is written in layman's terms, to assist employers in complying with health care reform.

14. Finalize proposed regulations under section 4980H [Note: See AICPA Comments submitted March 14, 2013.]

15. Finalize proposed regulations under section 1411 on the 3.8 percent Medicare tax on net investment income.

Exempt Organizations Technical Resource Panel (Jeffrey D. Frank, Chair, (317) 656-6921, jdfrank@deloitte.com; or Melissa M. Labant, AICPA Director – Tax Advocacy & Professional Standards, (202) 434-9234, mlabant@aicpa.org.) NOTE: Comments are listed in priority order.

1. Change the extension process for Form 990, Return of Organization Exempt from Income Tax, from two separate three-month extensions to one single six-month extension. A single six-month extension for the Forms 990, 990-EZ, and 990-PF would be beneficial for several reasons.

    - Internal Revenue Code (IRC or "Code") section 6033 describes the annual return and information required of exempt organizations. Exempt organizations who want a six-month extension to file Forms 990, 990-EZ, or 990-PF must file two separate three-month extensions. However, taxpayers who file other types of annual returns, such as the Forms 990-T, 1040, and 1120, only need to submit a single six-month extension. Some people may argue that the Forms 990, 990-EZ, and 990-PF are information returns or reporting forms, not tax forms such as the Form 990-T, 1040, and 1120. Nevertheless, all of these forms have in common an annual filing requirement that involves the gathering of extensive data, both financial and informational. It is logical for all of these forms to have a single six-month extension.

    - A single six-month extension would also simplify the filing requirements for exempt organizations. These organizations are very likely to request both

three-month extensions in order to completely and accurately file their annual returns. Especially with the emphasis on transparency in the new and improved Form 990, many organizations are taking extra time and care to properly disclose all relevant activities. A single six-month extension would reduce the administrative burden on exempt organizations as well as the IRS.

2. Issue final regulations under sections 501(r) and 6033 on additional requirements for tax-exempt hospitals as added by section 9007 of The Patient Protection and Affordable Care Act (PPACA).

3. Affirm that the conclusion and analysis set forth in G.C.M. 39813 represents the current IRS position with respect to the tax treatment of public charities whose exemptions have been retroactively revoked. If such is not the case, provide guidance as to the current position of the IRS. Pursuant to the Pension Protection Act (PPA) of 2006, most tax-exempt organizations were required to file an annual information return (Form 990 or 990-EZ) or a notice (Form 990-N) with the IRS. In addition, the law automatically revokes the tax-exempt status of any organization that does not file required returns or notices for three consecutive years. Although guidance has been issued with respect to reinstatement and retroactive reinstatement, no guidance has been provided with respect to the tax treatment of such retroactively revoked public charities.

4. Please clarify who constitutes a "patient" for purposes of the definition of "patient care." For example, would the following services be considered "patient care," especially when the individual receiving the services is not an inpatient of a hospital at the time the services are rendered: services provided via a telemedicine network; reading of images, laboratory services and pathology services where the technician or physician interpreting the tests does not actually see or "touch" the patient. Such guidance under section 501(r) would reduce uncertainty and support the move toward accountable care organization (ACO) and cost effective health care methods. In addition, absent guidance, costly information technology changes are being made by hospitals which will likely have to be made again when guidance is finally issued.

5. Issue guidance on whether Revenue Ruling 75-435 or General Counsel Memos 37001 (Feb. 10, 1977) or 38327 (Mar. 31, 1980) is the controlling authority on whether contributions from foreign governments to public charities exempt under section 509(a)(1) are subject to the two percent limitation on excess contributions.

6. Similar to the revised public support test on Form 990, Return of Organization Exempt from Income Tax, add a section for supporting organizations to substantiate their type to erase uncertainty by the reader of the Form 990 as well as for the organization to document for its records.

7. Withdraw Temp. Reg. § 1.170A-9T. Issue final regulations defining section 170(b)(1)(A) organizations with one change to the "Definition of support; meaning of general public" under Temp. Reg. § 1.170A-9T(f)(6)(i). Similar to governmental units and organizations described in section 170(b)(1)(A)(vi), provide an exception from the two percent limitation for organizations described in section 170(b)(1)(A)(i)-(iv). There is no reason to limit the support that churches, schools, hospitals, supporting organizations and similar entities provide to other charitable organizations.

8. Issue a revenue procedure allowing all members under a group ruling (including the central organization and the subordinate organizations) to file a single consolidated return rather than the current process which requires a separate return for the central organizations and a consolidated return for all consenting subordinates. The AICPA strongly believes a single consolidated return more accurately reflects the operations of the group.

9. Issue guidance limiting the reporting on Form 990, Schedule R, Parts III and IV of brother-sister related party affiliates of central or subordinate members of a group exemption similar to the exclusion from reporting of tax-exempt members of the group. For example, there may be hundreds of organizations taxable as partnerships or corporations that are affiliated with a particular church whose exempt members are covered by a group ruling and not reportable in Schedule R, Part II. But many of those taxable entities may meet the technical definition of related parties merely because of the centralized structure at some high level in the church and as such are currently reportable on multiple Forms 990 for the various members covered by the group ruling. However, there may be no board overlap or intercompany transactions with those entities beyond their direct owners and their brother-sister affiliates controlled by their direct owners. Issue guidance limiting the reporting to only those related parties directly controlled by the filing organization or with whom the filing organization has engaged in transactions exceeding a fixed dollar amount.

10. We request the IRS provide additional guidance that allows organizations that have had their exempt status revoked for failure to make required annual filings for three years under section 6033(j) the option to request prospective reinstatement and simultaneously but separately request retroactive reinstatement to be determined at a later date. This recommendation allows organizations that qualify to resume operations and solicit the contributions it needs to survive as an organization. It also allows the IRS additional time to properly consider whether reasonable cause exists for the retroactive reinstatement.

Individual Income Taxation Technical Resource Panel (Jonathan Horn, Chair, (212) 744-1447, jmhcpa@verizon.net or John Scheid, AICPA Technical Manager, (202) 434-9268, jscheid@aicpa.org.) NOTE: Comments are listed in priority order.

1. Guidance is needed regarding issues of basis reporting on Form 1099-B. Basis reporting on Form 1099-B began with 2011 tax returns and various issues arose that warrant guidance. We encourage the IRS to request comments from the public to uncover additional issues to ensure that extended guidance addresses all issues. Examples of problems with the basis reporting include the following:

   - How do taxpayers and practitioners properly report the sale of a publicly-traded partnership? Broker-reported basis is not reflective of any return of capital or other changes to taxpayer's original basis. In addition, for royalty trusts, a broker has no information on what amount of depletion has been deducted by the taxpayer. Gain or loss must be split between capital and ordinary.

   - How do taxpayers and practitioners properly report corrections to amounts indicated as "wash sale loss disallowed" where the broker used an inappropriate method of calculating figures reported to the IRS and taxpayer?

   - How should taxpayers and practitioners respond to matching notices where the correct basis, gross proceeds, gain/loss, holding period and tax have been reported by the taxpayer on the return but either the wrong box was checked (A or B) on Form 8949, Sales or Other Dispositions of Capital Assets, or the improper adjustment code was entered on Form 8949 by taxpayer?

2. Guidance is needed on how section 6041, Information at source, applies to owners of rental real estate.

   - P.L. 111-240 (9/27/10), the Small Business Lending Fund Act of 2010, modified section 6041 to add subsection (h) requiring certain landlords to file Form 1099-MISC for payments made for services in excess of $600. The legislative history provided: "Under the provision, recipients of rental income from real estate generally are subject to the same information reporting requirements as taxpayers engaged in a trade or business. In particular, rental income recipients making payments of $600 or more to a service provider (such as a plumber, painter, or accountant) in the course of earning rental income are required to provide an information return (typically Form 1099-MISC) to the IRS and to the service provider." This new provision was effective starting after 2010.

   - P.L. 112-9 (4/14/11), the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, repealed section 6041(h) retroactive to January 1, 2011. Thus, the 1099 reporting obligation for landlords never went into effect.

- Despite repeal of section 6041(h), the 2011 and 2012 1040 Schedule E and instructions included the following new questions (A and B):

SCHEDULE E (Form 1040) Department of the Treasury Internal Revenue Service (99)	**Supplemental Income and Loss** (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.) ▶ Attach to Form 1040, 1040NR, or Form 1041. ▶ See separate instructions.	OMB No. 1545-0074 **2011** Attachment Sequence No. 13
Name(s) shown on return		Your social security number

A Did you make any payments in 2011 that would require you to file Form(s) 1099? (see instructions) ☐ Yes ☐ No
B If "Yes," did you or will you file all required Forms 1099? ☐ Yes ☐ No

These questions contradict the legislative history of P.L. 111-240 (above) and repeal of section 6041(h). With these questions added to Schedule E rather than Schedule C, they imply that landlords who are not in a trade or business may be required to file Form 1099-MISC. The questions raise issues as to the distinction between a real estate rental that qualifies as a trade or business for section 6041 purposes and one that does not.

Clarification is needed under section 6041 as to when an owner of rental real estate is required to file Form 1099-MISC. Also, given the use of the term trade or business and special rules for rental real estate including under section 1402 (self-employment tax), section 469 (passive activity loss limitation) and section 1411 (special tax on net investment income), such guidance should explain how all of these rules apply to owners of rental real estate. In addition, relief should be granted to individuals owning rental real estate who are required to file Form 1099-MISC, but failed to do so for 2011 and 2012 due to the confusion in the law and well as in instructions to Schedule E and Form 1099-MISC.

3. Formal guidance is needed on the filing procedures for Registered Domestic Partners (RDPs) and same-sex couples in states that grant these individuals community property rights, as well as for such couples in other states.

   In 2010, PLR 201021048, CCA 201021049 and CCA 201021050 were issued. These rulings note that due to a state law change, California RDPs should treat income that is community property income for state purposes, as such when they file their federal return.

   Publication 17 for 2012 (page 4) states: "A registered domestic partner in Nevada, Washington, or California (or a person in California who is married to a person of the same sex) generally must report half the combined community income of the individual and his or her domestic partner (or California same-sex spouse). A similar statement is included in the Form 1040, U.S. Individual Income Tax Return, instructions (page 20). Subsequent to April 15, 2011, the IRS posted to its website, a set of questions and answers on various aspects of how registered

domestic partners and same-sex couples in community property states file their income tax returns (http://www.irs.gov/uac/Questions-and-Answers-for-Registered-Domestic-Partners-and-Same-Sex-Spouses-in-Community-Property-States).

This informal guidance raises several issues that need to be addressed in a more detailed and formal manner. These issues include the following issues:

- Not all affected taxpayers were aware of or understood the new guidance. Per CCA 201021050, "for tax years beginning after December 31, 2006, a California registered domestic partner must report one-half of the community income, whether received in the form of compensation for personal services or income from property, on his or her federal income tax return." This CCA goes on to state that for "tax years beginning before June 1, 2010, registered domestic partners may, but are not required to, amend their returns to report income in accordance with this CCA."

  This statement about amending returns seems to imply that the requirement to report community income as such on the federal income tax return is not effective until 2011 tax returns. However, the "June 1, 2010" date appears to be incorrect because in May 2010 when the CCA was issued, 2010 returns could not be amended because they were not yet filed.

  Thus, some who were aware of the guidance or read summaries of it may have believed that the new way of reporting community income did not apply until 2011.

  While the Q&As issued in mid-2011 are helpful, they do not address all issues, were issued after many individuals had already filed their 2010 tax returns, and are not readily found or even searched for by individuals and tax return preparers.

  Guidance is needed in the form of revenue rulings and/or regulations that are published in the Internal Revenue Bulletin and constitute higher level authority than counsel rulings or questions and answers on a website that are not binding authority. This formal guidance should also be highlighted on the IRS websites for the general public and practitioners, as well as in press releases so that more people are aware of the new rules. It should also clearly state what the treatment is in all community property states and for both RDPs and same-sex couples. This guidance should also explain what affected taxpayers should do who did not properly report community income in 2012 and prior years for which the statute of limitations is still open.

- Various questions exist such as regarding the handling of estimated tax payments. The 2012 Annual Report of the IRS National Taxpayer Advocate

provides an overview to several specific issues in need of guidance.[1]

- A procedure for filing amended returns for eligible RDPs and same-sex partners is needed. As noted in the 2010 informal guidance, amended returns can be filed for 2007, 2008 and 2009. Without a procedure in place for handling these returns, taxpayers are at risk of having penalties and interest assessed. For example, where one partner had high income in 2009 and the other partner had much lower income, amended returns would be recommended. On the amended returns, one partner will have a refund which the other's amended return will show tax due. Given the clarification of prior year state property law offered by the 2010 informal guidance, penalties should not be applied. Guidance in this area for returns processing personnel, tax practitioners and taxpayers would be helpful.

In addition to compliance issues for RDPs and same-sex couples in community property states, issues also exist for such couples in non-community property states that warrant guidance. Such guidance should address:

- How RDPs and same-sex couples in non-community property states who jointly own income-producing assets should report each individual's share of the income.

- How the effect of court decisions holding that the Defense of Marriage Act (DOMA) is unconstitutional, affects filing status of all RDPs and same-sex couples.[2]

- How other state law relationships, such as civil unions, are treated for federal tax purposes.[3]

4. Update and finalize the longstanding temporary regulations under section 163(h) (Treas. Regs. §§ 1.163-9T and 1.163-10T) to provide greater clarity and certainty to taxpayers and practitioners.

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[1] National Taxpayer Advocate, 2012 Annual Report to Congress, pages 449-455; available at http://www.taxpayeradvocate.irs.gov/userfiles/file/Full-Report/Status-Updates-Federal-Tax-Questions-Continue-to-Trouble-Domestic-Partners-and-Same-Sex-Spouses.pdf.

[2] See Golinski v. United States Office of Personnel Management, 2012 U.S. Dist. LEXIS 22071 (ND CA), and Gill et al. v. Office of Personnel Management, 699 F.Supp.2d 374 (D.Mass., 2010). A case is pending before the U.S. Supreme Court - Windsor v. U.S, 833 F.Supp.2d 394 (S.D.N.Y. Aug. 19, 2011).

[3] See, for example, the August 30, 2011 letter from IRS Chief Counsel to H&R Block on the treatment of a civil union in Illinois involving an opposite-sex couple. This unofficial guidance provided that the couple could file jointly as husband and wife. The IRS Chief Counsel letter is available at http://law.scu.edu/blog/samesextax/file/IRS%20Civil%20Union%20letter.pdf.

The Tax Reform Act of 1986 made changes to section 163 regarding personal and home mortgage interest. Further changes were made to the home mortgage interest rules by the Revenue Act of 1987. Temporary regulations were issued on these provisions soon after the legislative changes. Several of the regulations were issued prior to the effective date of the change made to section 7805 by the Technical and Miscellaneous Revenue Act of 1988 providing that temporary regulations expire within three years of issuance (effective for regulations issued after November 20, 1988). Thus, temporary regulations issued after enactment of the Tax Reform Act of 1986 and before November 21, 1988, which have not been finalized, remain in their temporary form.

In addition, not all of the regulations are complete or current, such as Treas. Reg. § 1.163-10T on home mortgage interest. Among unsettled issues are the following:

- Section 163(h)(4)(A) does not provide certainty on how to define a qualified residence or a second residence in the context of divorce.

- Must the taxpayer be both responsible for the mortgage and own the underlying property before the interest is deductible? (Or, may the taxpayer satisfy only one of these two requirements?) For example, husband may transfer ownership of the residence to the wife but remain responsible for the mortgage. Is the interest deductible?

- What is the proper method to determine deductible qualified residence interest when there are multiple debts that exceed the debt limit? While CCA 201201017 and IRS Publication 936 provide information on this question, official guidance is needed, such as in regulations.

- Further, guidance is needed regarding whether the $1,000,000 "aggregate" acquisition indebtedness referred to in section 163(h)(3)(B) refers to and applies per taxpayer or per residence. This is particularly important with regard to unmarried taxpayers who jointly own a residence in light of the interpretation presented in CCA 200911007, issued on March 13, 2009 and by the Tax Court in Sophy, 138 TC No. 8 (2012). While these rulings conclude that the mortgage dollar limitations apply per residence rather than per taxpayer/owner, guidance is needed in order to properly apply this conclusion to fact patterns beyond those in the two rulings. For example, assume a brother and sister own a vacation home jointly. In addition, each owns a principal residence with their spouse. If each of the three homes has a mortgage of $1.1 million, how is the section 163(h) limitation applied to each couple on their joint returns? What if either files as married filing separately? What if a same-sex couple in a community property state owns a principal residence and a vacation home as community property with mortgages on each totaling over $1.1 million? There are many other variations of fact

patterns that raise issues of how to apply the mortgage limitations that should be addressed by formal guidance, ideally, by regulations that update and eventually finalize Treas. Reg. § 1.163-10.

5. Update and finalize the longstanding temporary regulations under section 163 on interest tracing and identification of the type of interest generated from a debt, in order to provide greater clarity and certainty to taxpayers and practitioners.

   The interest tracing regulations of § 1.163-8T were issued in 1987 (TD 8145, 7/1/87), soon after enactment of the Tax Reform Act of 1986 which increased the importance of identifying the type of interest generated on any debt. These temporary regulations were issued before the effective date of section 7805(e) which provides that temporary regulations expire after three years.

   In 1989, these regulations were modified by Notice 89-35, 1989-1 CB 675, which made significant changes to how the regulations apply to identify the use of borrowed funds and their operation with respect to debt of passthrough entities. Notice 89-35 supplemented earlier guidance: Notice 88-20, 1988-1 CB 487 and Notice 88-37, 1988-1 CB 522. When a practitioner has a question on interest expense classification under section 163 and turns to the regulations, the practitioner will not readily find the Notices and therefore, can easily apply the law incorrectly.

   The interest tracing regulations have been in temporary form for over 20 years. It would be helpful to have then finalized with incorporation of the changes provided in Notices, 89-35, 88-37 and 88-20, as well as any clarifications provided in court cases.

6. Guidance is needed to clarify the requirements for deductibility of real property taxes under section 164.

   Issues have existed as to what types of real property taxes are deductible under section 164. This provision states that personal property taxes must be ad valorum; there is no such stated requirement for real property taxes. Treas. Reg. § 1.164-4(a) provides that to be deductible, real property taxes must be "levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction." There is no definition of "like rate" in the Code or regulations.

Rev. Rul. 80-121 provides that one characteristic of a deductible real property tax is that it is "measured by the value of real property." PLR 8033022 held that a parcel tax was not deductible under section 164. The ruling explains that "rate" in "like rate" refers to a proportion or ratio. In the ruling, the IRS stated that the parcel tax is "not levied at a like rate within the meaning of the regulations under section 164 of the Code; the tax is a specific tax, not a tax levied according to value, one of the characteristics that a real property tax must have in order to be deductible under section 164(a)(1)."

The 2012 instructions to Schedule A, Publication 530, Tax Information for Homeowners and Tax Topic 503 (updated April 15, 2013) all contain statements that in order to be deductible, real estate taxes must be charged uniformly against all property in the jurisdiction at a like rate.

In April 2012, the IRS released Information Letter 2012-18 (http://www.irs.gov/pub/irs-wd/12-0018.pdf) which states: "there is no statutory or regulatory requirement that a real property tax be an ad valorem tax to be deductible for federal income tax purposes." The letter also notes that the IRS "will recommend appropriate revisions to our forms and publications on this subject."

Issues remain as to when real estate taxes are considered taxes under section 164 rather than assessments for local benefits. In addition, given the language of Rev. Rul. 80-121 and PLR 8033022, official guidance is needed on the application of section 164 to payments labeled as real property taxes at the local level. Such guidance could include a new revenue ruling or regulations under section 164; merely updating the IRS form instructions and publications is insufficient as they are not binding authority for purposes of penalties under sections 6662 and 6694.

7. Guidance is needed relating to the coordination of a tuition payment and the receipt of a distribution from a 529 Plan. Specifically, what is the permitted period of time prior to and after the payment of a qualified expense to make a qualified distribution? For example, if a taxpayer makes a tuition payment in September 2012, but receives the 529 distribution in January 2013, assuming no other tuition payments are made, is the 2013 distribution taxable? Section 529(c)(3) does not address the question. The same question arises if the distribution precedes the payment of qualified education expenses. Guidance is needed on what constitutes a taxable event with regard to the timing of distributions and subsequent payments.

In January 2008, the IRS issued an advance notice of proposed rulemaking (Announcement 2008-17; 2008-9 IRB 512, March 3, 2008) (ANPRM) to curb the possible abuse of section 529 qualified tuition program accounts by creating a general anti-abuse rule and other obstacles to prevent individuals and entities from using the accounts to avoid transfer and other types of taxes. Although a number of organizations commented, there has been no action to date.

8. Guidance is needed on the statutory terms that were introduced by Title XII of the Pension Protection Act of 2006 pertaining to appraisals and individuals performing these appraisals. Proposed regulations (REG-140029-07--Charitable Contributions: Cash and Noncash: Substantiation) were published in August 2008 but have not been issued to date. The AICPA submitted comments on November 5, 2008, requesting further clarification of the terms "generally accepted appraisal standards" and "qualified appraiser."

9. Official guidance is needed on the treatment of Medicare Part B and section 162(l) for self-employed individuals. A change in the treatment of this item was first noted in the 2010 Form 1040 instructions. In addition, Publication 535, Business Expenses, states on page 18: "Medicare premiums you voluntarily pay to obtain insurance that is similar to qualifying private insurance can also be used to figure the deduction. If you previously filed a return without using Medicare premiums to figure the deduction, you can file an amended return to refigure the deduction." This new interpretation should be issued in an official pronouncement, such as a revenue ruling, rather than in form instructions and publications which are not considered binding guidance or "authority" for section 6662 purposes. In addition, "voluntarily pay" and the application to owners of passthrough entities should be explained in official guidance. Finally clarification is needed regarding the treatment of Medicare premiums paid by a self-employed taxpayer's spouse. CCA 201228037 states that Medicare premiums paid for a self-employed taxpayer's spouse may be deducted under section 162(l). However, it also states that "Sole proprietors must pay the Medicare premiums directly." Since Medicare premiums are usually withheld from the covered individual's Social Security payment, the service should explicitly state that they would consider such payments as having come directly from the sole proprietor for purposes of section 162(l).

10. Guidance is needed on how section 6041, Information at source, applies to taxpayers making payments to non-corporate entities which cover both personal and business expenses. An issue that needs to be addressed is whether these individual taxpayers are subject to the Form 1099-MISC reporting requirements for applicable payments made to non-corporate entities. For example, there are certain taxpayers who may allocate tax preparation fees paid to their tax preparer between different schedules such as Schedules A, C and E. The allocation is made as a portion of the tax preparation expense is allocable to their trade or business (Schedules C and E) and the non-trade or business sections of their tax return.

    The instructions for Form 1099-MISC indicate that payments need to be reported when made in the course of your trade or business. In addition, Form 1040, Schedule E, Supplemental Income and Loss, has questions in Part I that ask the taxpayer if they have complied with the Form 1099 reporting requirements.

    We request clarification if taxpayers are required to file Form 1099-MISC in those circumstances when they file Schedule C for a sole proprietorship or Schedule E to report trade or business income that is passed through to them on a Schedule K-1. We feel that this adds more complexity and an increased compliance burden for taxpayers who operate a small business outside of a formal entity structure such as an S corporation, partnership or a limited liability company or for taxpayers who have trade or business activities allocated to them on a Schedule K-1.

11. Guidance is needed on whether the service views tablets (such as iPads) to be listed property under code section 280F or if they may be treated similarly to cellphones under the provisions of Notice 2011-72.

International Taxation Technical Resource Panel (G. Christine Ballard, Chair, (408) 369-2400, christine.ballard@mossadams.com; or Kristin Esposito, AICPA Technical Manager, (202) 434-9241, kesposito@aicpa.org.) NOTE: Comments are listed in priority order.

1. Guidance is needed regarding foreign tax credits, in particular:

    - Provide guidance under section 901(m), including providing exemptions for certain covered asset acquisitions where basis difference is de minimis and where a taxpayer receives a basis step-up for local tax purposes that is comparable to the U.S. tax step-up.

    - Provide guidance on the application of section 904(d)(6), including the interaction of such provision in the context of treaties that already contain their own separate limitation regime for the treaty credit.

- Guidance is needed under section 905(c) regarding taxes paid after a liquidation, stock sale, or section 338 election.

- Finalize guidance under Temp. Reg. § 1.905-3T, -4T and -5T.

- Issue guidance relating to the application of the overall foreign loss rules to certain dispositions involving partnerships.

- More complete guidance is needed regarding the application of Treas. Reg. § 1.865-1(a)(2) and Treas. Reg. § 1.865-2(a)(3) under which losses are allocated to reduce foreign source income if gain on the sale of the property (including stock) would have been taxable by a foreign country and the highest marginal rate of tax imposed on such gains in the foreign country is at least 10 percent.

2. Guidance is needed in the following areas related to inbound transactions:

   - Revise, as appropriate, and finalize the proposed section 163(j) "earnings stripping" regulations, taking into account taxpayer comments and developments since the original issuance of the proposed regulations.

   - Provide guidance on the application of Temp. Treas. Reg. § 1.897-6T and section 1445 to non-recognition transactions involving transfers of United States Real Property Interests (USRPI) to partnerships, and dispositions of interests in partnerships that directly and indirectly hold USRPIs.

   - Provide guidance to explain the application of section 304(b)(6).

   - Provide guidance on the amendment made to section 304(b)(5) by The Education Jobs and Medicaid Assistance Act (P.L. 111-226, August 20, 2010), including guidance on what is considered "subject to tax" for purposes of section 304(b)(5)(B).

3. Guidance is needed in the following areas related to outbound transactions:

   - Finalize the proposed section 987 regulations relating to foreign currency translation gains and losses with respect to branch transactions (taking into account public comments with respect to the proposed regulations). [Note: See AICPA comments to IRS submitted on March 29, 2007.]

   - Finalize existing regulations under section 6038D. [Note: See AICPA comments to IRS submitted on October 25, 2012.]

   - Provide guidance under section 6038D(b)(2)(B) defining instruments and contracts to be treated as specified foreign financial assets.

- Issue updated regulations under section 367(d) reflecting changes to the statute since its original issuance.

- Issue guidance relating to the carryover of tax attributes in section 355 transactions.

- Issue additional guidance under the relevancy rules Treas. Reg. § 301.7701-3(d), including the impact of certain acquisitions of entities that are not relevant and the consequences of certain elections relating to such entities.

- Issue guidance on the treatment of Mexican Land Trusts for purposes of section 6048 expanding the guidance provided in PLR201245003 to all taxpayers.

- Issue guidance that internal restructurings within a U.S. multinational group following a section 338(g) election of a foreign target corporation made by one of the members of the U.S. multinational group is not a transaction described in Notice 2004-20.

4. Guidance is needed related to the following areas related to Subpart F/Deferral:

- Finalize proposed regulations under section 959, regarding exclusions from income of previously taxed earnings, and proposed regulations under section 961, regarding basis adjustments.

- Provide more complete and definitive guidance under the passive foreign investment company (PFIC) regulations. In particular, (1) update the PFIC regulations to take into account the enactment of section 1297(e), which eliminates the overlap of the PFIC and Subpart F regimes under certain circumstances (including the application of section 1297(e) to a PFIC owned by a U.S. partnership that has U.S. partners) (see e.g., PLR 200943004), (2) provide guidance under section 1297(c) regarding the 25 percent ownership look-through rule and its interaction with the section 1297(b)(2)(C) related party income rules, and (3) provide guidance on the application of section 1297(b)(1)'s definition of passive income.

- Provide guidance on section 960(c), including guidance on the application of the provision when there is either a deficit or previously taxed earnings and profits in an upper-tier foreign corporation in the chain of ownership. Additionally, guidance also is requested on the application of this provision when a taxpayer has section 956 investments that pre-date and post-date the effective date of section 960(c).

- Issue regulations pursuant to Notice 2007-13 regarding the substantial assistance rules for foreign base company services income.

- Provide guidance under section 267(a)(3)(B), including guidance regarding the timing of deduction for interest, rental and royalty payments to CFCs that qualify for exclusion under section 954(c)(6) or the same country exception and guidance regarding exceptions for appropriate transactions pursuant to section 267(a)(3)(B)(ii). Also, provide guidance relating to when an item payable to a CFC, and subject to section 267(a)(3)(B), that is included in the gross income of a United States person by reason of section 956 or the payment of an actual dividend (i.e., other than by reason of section 951(a)(1)(A)), will be considered an amount attributable to such item that is includible in the gross income of such United States person.

- Provide additional guidance under section 954(c) relating to the active rent or royalty exception.

- Provide guidance under section 961(c) regarding basis adjustments to the stock of a controlled foreign corporation (CFC) held through partnerships.

- Finalize the proposed section 898 regulations on conforming year-ends of certain foreign corporations to the year-ends of their U.S. shareholders.

- Provide guidance with respect to the Treas. Reg. § 1.954-2(b)(4) substantial assets test relevant to qualification under the same country exception for interest and dividends, as applied to (i) stock in non-CFC foreign corporations; and (ii) banks and insurance companies.

- With respect to section 952(c)(2) subpart F income recapture, provide guidance regarding the application of "rules similar to rules applicable under section 904(f)(5)," and in particular the latter section's incorporation of the disposition rules of section 904(f)(3).

- Redraft Treas. Reg. § 1.6038-2(j)(2) and (3) to conform to the instructions to Form 5471, Information Return of U.S. persons With Respect to Certain Foreign Corporations, clarifying that a U.S. shareholder who qualifies as a Category 4 or Category 5 filer of Form 5471 is not required to file a statement with the U.S. shareholder's own tax return where both of the following conditions are met: (1) ownership in the foreign corporation is solely through application of constructive ownership principles; and (2) the U.S. person through which the U.S. shareholder constructively owns an interest in the foreign corporation files Form 5471 reporting all required information. [Note: See AICPA comments submitted March 26, 2013.]

- Provide a regulatory exception under section 6038 for down-stream attribution causing partnerships, S-corporations, and trusts to be required to file Form 5471 or Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, for constructive ownership of a foreign corporation (or

partnership) created solely for attribution from its partners, shareholders or beneficiaries.

5. Guidance is needed in the following areas related to withholding tax regimes under Chapter 3 and Chapter 4:

   - Continue to align the FATCA regulations with the current withholding regimes under Chapter 3 and Chapter 61.

   - Following the retroactive withdrawal of Treas. Reg. § 1.1441-1(b)(7)(iii) by T.D. 9323, provide guidance on liability of a withholding agent for interest with respect to withholding under section 1445 or section 1446, if the withholding agent does not withhold with respect to a foreign person that has no U.S. tax liability, or that has satisfied its U.S. tax liability.

   - Provide further clarification of Section 871(m) for the applicability of "specified notional principal contract" beyond the scope of Chapter 4 overlays.

   - Provide further guidance on the event of a default (either stand-alone or part of an Expanded Affiliated Group) under IRC 1471-1474.

   - Provide additional guidance regarding sponsored entities ("Sponsored FFIs") under Treas. Reg. 1.1471-5(f)(1)(i)(F).

6. Guidance is needed in the following additional areas:

   - Continue to provide additional guidance relating to Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, for the reporting of foreign bank and financial accounts. [Note: See AICPA comments to FinCEN and IRS submitted on June 27, 2011, AICPA comments to FinCEN and IRS submitted on May 31, 2011, AICPA comments to Treasury, IRS and FinCEN submitted on November 19, 2010, AICPA comments to FinCEN (with copies to Treasury and IRS) submitted on April 30, 2010, as well as AICPA comments to Treasury, IRS and FinCEN submitted on November 16, 2009.]

   - Provide guidance relating to the operation of certain treaty provisions, including the application of reduced or zero-rate tax provisions in treaties with respect to dividends received through hybrid disregarded entities (The Service has issued private letter rulings relating to this issue. See e.g., PLRs 200626009 and 200522006) and the application of certain anti-hybrid provisions (e.g., the treatment of such provisions in connection with the application of the branch profits tax).

- Clarify and relax the double reporting rules under the section 1461 regulations and the treaty-based reporting requirements under section 6114.

- We request the development of, and guidance on, a procedure under which U.S. partnerships may file a composite individual income tax return on behalf of partners who are nonresident aliens (NRA) that have been allocated effectively connected income. Currently, each NRA partner is subject to withholding in excess of the tax that will ultimately result, and must independently file Form 1040NR, U.S. Nonresident Alien Income Tax Return. A composite NRA partner filing, such as has been long and widely used by states that impose state-level income taxes, would enhance both proper taxpayer compliance and the IRS's ability to review and audit compliance, by giving it a single point of contact for questions and other NRA taxpayer contacts. This will reduce the burden and cost of compliance by NRA partners, and the administrative burden and costs on the IRS.

- Clarify and relax the definition of a foreign entity for purposes of section 6038D. Temp. Reg. § 1.6038D-1T(a)(10) defines foreign entities by reference to Treas. Reg. § 1.1471-1(b)(132). We recommend, solely for purposes of section 6038D, that captive insurance companies that have made elections under section 953(d) be treated as U.S. companies without the further requirement of being regulated by a state-based insurance regulator.

- Coordinate and reverse the timing of taxation under Posed Regulation § 1.1411-10. Under the proposed regulations, the section 1411 tax is imposed on Subpart F and PFIC income when income is repatriated rather than when the income is taxed for Chapter 1. There is elective treatment under the proposed regulations to impose section 1411 tax when the income is taxed for Chapter 1. The default ordering under the proposed regulation creates significant taxpayer recordkeeping burdens, basis differences between Chapter 1 and section 1411 and adds an enormous amount of complexity for the average taxpayer. We recommend that the default rule be to impose section 1411 tax at the same time the income is taxed for Chapter 1 with elective treatment to impose section 1411 tax on repatriation.

- Clarification and alignment is requested on the treatment of Subpart F and PFIC income (unless a QEF election is made) for purposes of Chapter 1 and section 1411. IRS and the courts have long held that Subpart F and PFIC inclusions are other income and not dividend income. Proposed Regulation § 1.1411-10 is inconsistent with Notice 2004-70 and Rodriquez, 137 TC 14, 12/7/2011.

- Guidance is requested on whether a distribution from a CFC is eligible for the "ordinary course of a trade of business exception" to the section 1411 tax.

Foreign Related Trust and Estate Tax Issues

7. In conjunction with Item #2 on the trust and estate suggestions, section 1411(e) exempts a non-resident alien (NRA) trust beneficiary from the new Medicare surtax. Guidance is needed to allocate a trust's net investment income included in DNI between U.S. and NRA beneficiaries for proper reporting of current year distributions. We assume that the net investment income included in DNI would be allocated between U.S. and NRA beneficiaries in the same manner as other allocations of income and expense among beneficiaries, whether U.S. or foreign; however, clarity on this would be helpful.

8. Guidance is needed on issues relating to foreign trusts and the HIRE Act. [Note: See AICPA comments to Treasury and IRS on this issue submitted on March 28, 2011.]

9. Further guidance is needed on issues relating to foreign trusts and the Foreign Bank Account Report (FBAR). [Note: See AICPA comments on this issue submitted to FINCEN, Treasury, and IRS on November 19, 2010 and November 16, 2009.]

10. A change in the due date of Form 3520-A, Annual Information Return of Foreign Trust with a U.S. Owner, is requested from March 15 to April 15, to coincide with the due date for calendar year filers of related returns. If a change in the due date is not possible, then an extension or penalty relief is requested for taxpayers who file by April 15. In addition, IRS should consider adding a box to Form 7004, Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns, to permit an extension of time to file Form 3520 in cases where the beneficiary's income tax return (Form 1040 and Form 1040NR) is not going to be extended. [Note: See AICPA comments to IRS on this submitted on June 12, 2008, March 3, 2008, January 31, 2007, and June 17, 2003. This change in the Form 3520A due date is included in proposed legislation, S. 420, introduced 2/28/13 by Senators Enzi and Tester, and H.R. 901, introduced 2/28/13 by Rep. Jenkins, as well as in Rep. Camp's March 12, 2013 House Ways and Means Committee small business tax reform discussion draft and the Senate Finance Committee March 21, 2013 tax reform options paper on simplifying the tax system for families and businesses.]

11. The current tax reporting on Form 1040NR for foreign non-grantor trusts (and foreign grantor trusts with a U.S. owner) is extremely difficult because the IRS form is not designed for fiduciary tax return reporting. IRS instructions direct the preparer to "change the form" for Subchapter J provisions, but attempts to do so result in inconsistent or inadequate changes and lead to return processing errors and confusion. The creation of a new Form 1041NR, which could include information currently reported on Forms 3520 and 3520-A, would eliminate confusion and mistakes in processing returns and would enhance tax compliance

filing requirements. [Note: See AICPA comments to IRS on this submitted on September 22, 2008, March 3, 2008, and January 31, 2007.]

12. Guidance is needed on whether a foreign grantor trust with a U.S. grantor is required to file Form 1041, U.S. Income Tax Return for Estates and Trusts, or Form 1040NR and whether a foreign grantor trust with a foreign grantor and some U.S. income is required to file Form 1041 or Form 1040NR.

13. Guidance is needed on the reporting of and recognition of gain under the expatriation mark-to-market rules in section 877A, including guidance on the interplay of sections 877A and 684, relating to a transfer to a foreign estate or trust.

14. Guidance is needed on how the GST tax applies to grandfathered domestic trusts that become foreign trusts. This issue may be analogous to a GST-grandfathered trust that migrates from one state to another; thus, similar rules and safe harbors should be considered.

15. Guidance is needed regarding several aspects of section 2801.

    - Guidance is needed regarding reporting the receipt of a "covered gift or bequest" and the payment of tax thereon required under section 2801(a). While the IRS has stated in Notice 2009-85, 2009-45 IRB 598, that satisfaction of the reporting and tax obligations for covered gifts or bequests will be deferred pending the issuance of guidance, the longer the delay, the longer the undue burden on those who are required to comply with section 2801(a). This guidance should also include the determination of the reduction of this liability by a credit for the payment of foreign gift or estate taxes on a covered gift or bequest under section 2801(d).

    - Guidance is needed regarding the making of an election by a foreign trust to be treated as a domestic trust under section 2801(e)(4)(B)(iii). In particular, guidance is needed regarding the treatment and reporting of the section 2801 tax for transfers under section 2801(e)(4). Also, neither section 2801(e)(1) nor the legislative history discusses how property can be acquired "indirectly" by gift or by an indirect transfer by a decedent for estate tax purposes. For a covered gift or bequest made to a domestic trust, the section 2801 tax applies in the same manner as if the trust were a U.S. citizen and the tax must be paid by the trust. Under section 2801(e)(4)(B)(iii), an election can be made to treat a foreign trust as a domestic trust for purposes of the transfer tax on covered gifts and bequests. Guidance is needed on whether the foreign trust should withhold the section 2801 tax in the distribution(s) to the beneficiary.

Further, section 2801 does not provide any provisions on how to determine whether a distribution from a foreign trust is "attributable to a covered gift or bequest," where the trust includes other property in addition to the property received in the covered gift or bequest. Guidance is needed on this issue.

16. Guidance is needed as to what qualifies as a "reasonable period of time" for a U.S. grantor or beneficiary of a foreign trust to pay the trust the "fair market value" (FMV) for the "personal use" of trust property under section 643(i)(2). This guidance should also include the determination of the proper FMV measurement and whether "de minimis" amounts can be such a small amount as to make accounting for them unreasonable or administratively impractical. "Safe harbor" guidelines to administer this new law also would be appreciated. For example, a grantor or beneficiary might personally maintain landscaping requirements (at no compensation) for a rental property owned by a foreign trust, but have little or no personal use of the property during the year. [Note: See AICPA comments to IRS, submitted March 28, 2011.]

17. Regulations are needed to enhance guidance in Notice 2009-85 regarding the reporting of tax withholding and payment of these taxes by trustees to the IRS. Such guidance is needed as to the appropriate forms and reporting on applicable tax returns. Guidance on possible "expedited" procedures for successful receipt of a private letter ruling for an expatriate to determine the value of his or her interest in the trust would be appreciated. This guidance should also define "adequate security" for a "tax-deferred agreement" for the covered expatriate's return under section 877A(b).

18. Regulations are needed under section 6677 regarding the failure to file information with respect to certain foreign trusts. The HIRE Act amended section 6677, but guidance is not adequate in Notice 97-34, the only IRS guidance on making a determination on penalties under section 6677. New recently designed letters, as described in IRS memorandum SBSE-20-0709-016, provide determination letters based upon a review of a taxpayer's compliance with section 6677, but taxpayers need regulations to provide them with guidance before the applicable letter is issued.

IRS Practice and Procedures Committee (Kathy Petronchak, Chair, (202) 758-1480, kpetronchak@deloitte.com; or Kristin Esposito, AICPA Technical Manager, (202) 434-9241, kesposito@aicpa.org.) NOTE: Comments are listed in priority order.

1. The Service is phasing in the Modernized e-file (MeF) program to handle the electronic filing of Forms 1040 returns. We recommend that the IRS issue guidance and expand the capability of the MeF program to accept amended returns, claims for refund, and various supporting schedules.

2. In general, a correspondence examination involves an individual or small business taxpayer receiving a letter from the IRS requesting the taxpayer to address a few limited issues about the tax return; often focusing on credit or deduction issues. Unfortunately, many taxpayers (when receiving the letter) either: (a) assume they made a mistake on their return and quickly send in a check to cover the IRS's computation of the underpayment of taxes; or (b) ignore the response deadline set out in the Service's letter, which is often 30 days. If the IRS's letter is ignored, the Service's computers automatically send out the notice of deficiency to the taxpayer.

According to Treasury Inspector General for Tax Administration (TIGTA) Report (February 18, 2011, Reference number 2011-30-016), the IRS has made significant improvements in its handling of correspondence cases. Nevertheless, TIGTA found that the IRS continued to make errors based on a statistical sampling of 62 cases, including circumstances where IRS employees did not always take into account taxpayer correspondence before closure of the case.

With the IRS's increasing reliance on correspondence audits as the primary procedure for examining taxpayers' returns, the AICPA recommends that Treasury and IRS issue additional guidance (in the form of more plain-language publications) for individual and small business taxpayers. We also recommend that a webpage be set up at irs.gov dedicated to correspondence audits. Implementation of these suggestions should contribute to an increase in tax compliance and respect for the tax administration process by taxpayers. [Note: See AICPA testimony provided to the IRS Oversight Board on February 28, 2012.]

3. Section 6662A imposes an accuracy-related penalty on any reportable transaction understatement attributable to a listed transaction or a reportable avoidance transaction for taxable years ending after October 22, 2004. We recommend that Treasury issue regulations under section 6662A which addresses (among other matters): (a) the definition of a "reportable transaction understatement;" (b) coordination of the reportable transaction understatement penalty with the substantial understatement penalty, particularly when multiple years and both penalties are involved; (c) coordination of the reportable transaction understatement penalty with the accuracy-related penalty on underpayments; and (d) application of the penalty (if any) to net operating loss ("NOL") carryback and carryover years.

4. Under section 6662A, if a partnership fails to properly disclose a reportable transaction and the transaction creates a reportable transaction understatement, the partners of the partnership can find themselves liable for a section 6662A penalty with no avenue to challenge the penalty because they did not make the required disclosure under Treas. Reg. § 1.6011-4, even though the partners might never

have been aware of the transaction creating the understatement. Accordingly, we recommend that guidance be issued under section 6662A to address the application of the penalty to partnerships and partners'

5. Treas. Reg. § 1.6011-4(b)(4) addressed the requirement for a statement disclosing participation in transactions with contractual protections. T.D. 9046 amended these regulations to exclude "tax insurance" from the definition of "transactions with contractual protection". We recommend that the IRS clarify in the instructions for Form 8886, Reportable Transaction Disclosure Statement, line 7b that a description for tax result protection (which includes "insurance company and other third party products commonly described as tax result insurance") with respect to the transaction is not required to be included in the description.

6. Given the mandate for tax return preparers to e-file most Forms 1040 and 1041, many more tax return preparers will be required to obtain an EFIN to participate in the e-file system as an electronic return originator (ERO). However, unlike the PTIN rules, a taxpayer with any outstanding account balance (even if the taxpayer disputes the account balance) cannot obtain an EFIN even if that taxpayer is diligent in engaging with the IRS to work through the issues, is a taxpayer that is a reputable tax advisor, and has a history of compliance with the tax laws, and the individual(s) from the taxpayer who will be named as responsible parties on the EFIN application have a PTIN. The inability to obtain an EFIN under these circumstances is unfair, particularly since the statute requires that the practitioner participate in the e-file system. Although the IRS has procedures that allow the preparer to prepare and a taxpayer to file a paper return in these circumstances, the limit on a preparer's ability to obtain an EFIN undermines the e-file mandate. We recommend that the IRS consider coordinating the rules for obtaining an EFIN with the rules for obtaining a PTIN. Such coordination would not only allow PTIN-registered preparers the ability to e-file, but will reduce burden and duplication of effort on the part of the preparer and the IRS. With the current preparer e-file mandate in effect, the AICPA recommends the issuance of immediate guidance to address this matter.

Partnership Taxation Technical Resource Panel (William O'Shea, Chair, (202) 758-1780, woshea@deloitte.com; or Eileen Sherr, AICPA Senior Technical Manager, (202) 434-9256, esherr@aicpa.org.) NOTE: Comments are listed in overall priority order and are additionally segregated into sections designated as Top Priorities and Lower Priorities.

TOP PRIORITIES

1. Expanded guidance is needed under the principles of Revenue Rulings 99-5 and 99-6.

Revenue Ruling 99-5

Guidance related to Revenue Ruling 99-5 is needed in the following areas:

- The amount of the LLC's liabilities that is included in the seller's amount realized on the deemed asset sale that occurs under Rev. Rul. 99-5, Situation 1.

- The treatment of the liabilities owed by the LLC to its single owner upon the formation of the partnership in Rev. Rul. 99-5, Situations 1 and 2 (springing liabilities).

- The treatment of transfers that are not described in Rev. Rul. 99-5 Situations 1 and 2, but which result in the conversion of the single-member LLC to a partnership.

Revenue Ruling 99-6

Guidance related to Revenue Ruling 99-6 is needed in the following areas:

- The amount of the LLC's liabilities that are considered assumed by the buyer (a) as part of the purchase of the selling partner's interest in the LLC and (b) as part of the buying partner's liquidating distribution from the LLC.

- The amount of the LLC's assets that are considered acquired by the buyer (a) from the selling partner, and (b) as part of the buying partner's liquidating distribution from the LLC.

- The deemed extinguishment of any liabilities of the LLC to the acquiring partner that results from the merger of the debtor-creditor relationship which occurs upon the termination of the partnership.

- Application of the section 704(c)(1)(B) and section 737 "mixing bowl" rules to the acquiring partner with respect to the deemed liquidating distributions that occur as part of the Rev. Rul. 99-6 construct.

- Application of the section 751(b) "disproportionate distribution" provisions to the acquiring partner with respect to the deemed liquidating distributions that occur as part of the Rev. Rul. 99-6 construct.

- The treatment of transfers that are not described in Rev. Rul. 99-6, Situations 1 and 2, but which result in the conversion of the partnership to a disregarded LLC.

- Application of Rev. Rul. 99-6 to interest over partnership merger transactions. Such guidance should describe what constitutes a merger or a division under section 708(b)(2). In the preamble to the regulations issued in 2001, the IRS declined to provide a precise definition. Nevertheless, it would be helpful if the IRS provided some examples showing mergers vs. non-mergers. Further, such guidance should address what constitutes a continuation under section 708(b)(1)(A) when one or more historic partner(s) continue in the new partnership.

2. Guidance is requested on the meaning of partners' interest in the partnership in connection with the use of targeted allocations under section 704(b), including under what circumstances the targeted allocations would qualify under the economic effect equivalence test under the regulations. Specifically the guidance should address the following:

   - Guidance is needed to determine the types of circumstances in which a liquidation of a partnership interest that is not in accordance with the partner's capital account balance meet the economic effect equivalence test. For example, many partnerships with target capital account allocation provisions maintain section 704(b) capital accounts, and allocate section 704(b) profits and losses to the capital accounts in a manner that the capital accounts equal the amounts that would be distributed to the partner if the partnership liquidated at book value and distributed its assets to the partners (a hypothetical liquidation approach). However, these agreements may not contain a deficit restoration obligation. Accordingly, under what circumstances do such allocations meet the economic effect equivalence test in the absence of a deficit restoration obligation provided in the partnership agreement? Further, if such agreements contain a qualified income offset provision, would these meet the economic effect equivalence test and thus be considered to be in the safe harbor for economic effect for the year in question (*e.g.*, for purposes of section 514(c)(9)(E))?

   - Guidance is requested with respect to whether the hypothetical liquidation approach is required to determine the manner in which the partners have agreed to share items of income, gain, loss deduction or credit under the "partners' interests in the partnership" (PIP) test in Treas. Reg. § 1.704-1(b)(3), in the event the partnership does not liquidate based on positive section 704(b) capital accounts (*e.g.*, a target allocation agreement or a waterfall distribution agreement). Additionally, in cases where the partnership uses a hypothetical liquidation approach, guidance is needed to address whether the allocation of gross items of income, gain, loss or deduction is required in order to maintain capital account balances that equal the amount partners would receive in a hypothetical liquidation, in the event the partnership agreement provides for the allocation of *net* income or *net* loss. Specifically, if a partnership admits a preferred partner that is entitled to

a preferred return during a year in which the partnership's net income is not at least equal to the preferred return accruing during the tax year, must the partnership allocate gross items of income or gain to the preferred partner to adjust the preferred partner's capital account to the amount he would receive if the partnership liquidated at the end of the year for section 704(b) book value even though the agreement adopts a net income or loss allocation scheme, or can the partnership allocate net income only?

As a simple example, assume that a partnership has two partners, A and B. The AB partnership was formed with A contributing $90 for 90 percent of the common interests in the partnership and B contributing $100 for 100 percent of the preferred interests in the partnership and $10 for 10 percent of the common interests. The preferred interest is perpetual and cumulative preferred paying (or accruing) at a 10 percent annual rate. The partnership agreements adopts a forced allocation schedule that allocates *net* income or loss to the partners in a manner to force the partners ending section 704(b) capital accounts to equal the amounts the partners would receive if the partnership were to sell all of its assets at their section 704(b) book value, pay all of its liabilities (assume none here) and liquidate the partnership pursuant to a cash liquidation waterfall. Assume that in the first year the partnership *net* income of less than $10. Thus, there is not sufficient *net* income to satisfy the perpetual, cumulative preferred return for that tax year. Also, if the partnership were to liquidate at the end of that tax year, some amount of A's capital would be paid to B to satisfy the shortfall in net income. Note however, that the partnership does not expect to liquidate at the end of the first year (and in fact does not liquidate), and the partnership fully expects that over the life of the partnership there will be enough net income to satisfy the preferred return. Under these facts, how is the net income of less than $10 allocated? Does PIP require the partnership to allocate *gross* items of income, gain, loss or deduction to account for the preferred return entitlement, even though the partnership agreement adopts a *net* income allocation scheme? Further, if there is an overall net loss, or not enough gross income to allocate to the preferred return partner, are guaranteed payments implicated?

- Guidance is requested to address whether the special allocation of nonrecourse deductions will be respected where a partnership adopts a targeted allocation provision.

3. Guidance is needed regarding tax credit partnerships. As a result of the Third Circuit opinion in Historic Boardwalk Hall, guidance is needed concerning when tax equity investors will be treated as partners who can share in energy tax credits. IRS should consider updating and expanding Rev. Proc. 2007-65 beyond wind credits to provide guidance on all federal income tax credit partnerships.

4. Guidance is requested regarding the tax treatment to both the partnership and the partner when there is a cancellation of a partner loan. Specifically, guidance is requested on the manner in which the loan is cancelled (e.g., whether the cancellation of the debt occurs at the partnership level or whether the partner can be viewed as assuming the partnership's liability, then cancelling the loan, under an approach similar to the principles applied in Arthur L. Kniffen v. Commissioner, 39 T.C. 553, 561 (1962), acq., 1965-2 C.B. 3. If the cancellation occurs at the partnership level, guidance is requested on the character of the bad debt loss to a partner (e.g., whether the business of the partnership can be attributed to the creditor-partner to prevent a character mismatch under section 166).

5. Guidance is needed to clarify whether the section 752 regulations defining nonrecourse and recourse debt are applicable in determining the classification of partnership indebtedness for purposes of section 1001. The current economic downturn has resulted in an increase in the number of federal tax partnerships that are entering into arrangements with their creditors to work out their indebtedness. Depending on whether the partnership liability is "nonrecourse" or "recourse" for section 1001 purposes, a foreclosure by a creditor on partnership property results in the partnership recognizing (a) the amount realized on the sale or disposition of property subject to nonrecourse debt, or (b) the amount realized plus cancellation of indebtedness (COD) income on the sale or disposition of property subject to recourse debt. None of section 1001, the regulations thereunder, or IRS rulings address the characterization of partnership debt as "recourse" or "nonrecourse" for this purpose. This uncertainty is exacerbated by the prevalence of (a) limited liability companies taxed as partnerships (a situation that was not in existence when the section 1001 regulations were written) which have debts that are recourse to the entity's assets under state law, but for which no member has liability and (b) partnerships that hold multiple properties subject to recourse debts in separate disregarded entities.

6. The AICPA supports the Administration's Fiscal Year 2014 Budget proposal to repeal section 708(b)(1)(B). If that legislation is enacted, the issues below regarding technical terminations would be resolved going forward, and the below guidance projects would not be necessary. However, until that legislation is enacted, the below guidance projects would be helpful. We are pleased that the first item below regarding treatment of unamortized organizational and start-up costs upon a technical termination is now included in the 2012-2013 IRS Priority Guidance Plan as item 9 on the partnership projects, and request that the project be expanded to include the other two related technical termination guidance issues below.

   - Guidance is requested on the treatment of unamortized organizational costs under section 709 and start-up costs under section 195 upon a technical termination. Are such costs written off because the tax entity terminates or are

they treated as a property contribution to the new partnership under section 721 so that amortization continues?

- Guidance is requested on the treatment of partnership level section 481 adjustments. Several unresolved issues include guidance on (1) allocation of the 481 adjustment where there has been a change in ownership, (2) the impact of the 481 adjustment on a section 754 basis adjustment, (3) the treatment of a 481 adjustment on a section 708(b)(1)(B) termination, and (4) the treatment for purposes of 751.

- Guidance is requested in circumstances where partnerships have inadvertently filed a late short period return and associated Schedules K-1 due to a technical termination under section 708(b)(1)(B). It is common for partnerships to be unaware of events that would cause a technical termination until after the due date of the tax return for the short year.

7. Guidance is requested on the treatment of the contribution of the interests in an existing partnership to a newly-formed partnership (whose owners are comprised of all or some of the partners of the existing partnership) such that the existing partnership becomes a disregarded entity held by the newly-formed partnership. Specifically, guidance is requested on whether the existing partnership terminates under section 708(b)(1)(A), or whether the newly-formed partnership is considered to be a continuation of the existing partnership. Such guidance should address the continuity of ownership required to treat the newly-formed partnership as a continuation of the existing partnership (e.g., whether the newly-formed partnership is a continuation of the existing partnership under section 708(a) if less than fifty percent of the partners of the existing partnership continue their interest in the new partnership, or if the continuing partners of the existing partnership hold less than 50 percent of the interests in the newly-formed partnership). Additionally, guidance is requested on the manner in which the federal income tax and employment tax returns for the newly-formed partnership and the existing partnership should be filed in situations where the newly-formed partnership is treated as a continuation of the existing partnership. In particular, guidance should be provided to whether the Form 1065, U.S. Return of Partnership Income, for the newly-formed partnership should be filed with the employer identification number of the existing partnership or whether the newly formed partnership should apply for and use a new employer identification number.

LOWER PRIORITIES

8. Guidance is requested with respect to partnerships that use the special aggregation rule for securities partnerships under Treas. Reg. § 1.704-3(e). Specifically:

- Expanded guidance is requested under Treas. Reg. § 1.704-3(e)(4) to permit the aggregation of assets for certain partnerships that do not qualify for section 704(c) aggregation under the provisions of Treas. Reg. § 1.704-3(e)(3) or under Rev. Proc. 2007-59. Such guidance would expand the requirements to allow a greater number of taxpayers the ability to aggregate in appropriate situations.

- Guidance on the methodology of applying section 743 for partnerships using the special aggregation rule for securities partnerships under Treas. Reg. § 1.704-3(e). Guidance would be expected to include a similar aggregation rule for allocating the section 743 adjustment under section 755 and a methodology for determining when the section 743 adjustment is taken into account.

- Guidance should be issued that identifies certain forward section 704(c) circumstances where aggregation can be used without obtaining a private letter ruling. Such guidance would allow eligible partnerships to aggregate built-in gains and losses from contributed property with built-in gains and losses from revaluations in appropriate circumstances (such as in the case of a merger of eligible partnerships), or provide automatic consent procedures. Permission for such aggregation may currently be obtained only through a Private Letter Ruling request.

9. Guidance is needed to address the revaluation of partnership assets where the assets were either contributed to the partnership or previously revalued by the partnership. This guidance should include (1) how the multiple layers under section 704(c) are maintained; (2) the impact on minimum gain calculations under section 704(b); (3) the impact on nonrecourse debt allocations under section 752; and (4) the treatment of debt obligations including Treas. Reg. § 1.752-7 in a revaluation.

10. Guidance is requested with respect to publicly traded partnerships. Specifically:

    - Guidance is requested granting optional relief from the "single basis in a partnership" rule of Rev. Rul. 84-53 for owners of interests in publicly traded partnerships, similar to the special exception in the holding period rules of Treas. Reg. § 1.1223-3(c)(i) for publicly traded partnerships.

    - Guidance is requested granting relief to publicly traded partnerships to use simplifying assumptions for purposes of calculating section 743 adjustments and section 751(a) amounts upon sale. Such relief would allow the partnership to use the same price for all trades in a particular month to calculate the section 743 adjustments of transferees as opposed to actual purchase price as required in the regulations. Such relief is necessary for ease of administration and due to the lack of precise trading data. Similar

simplifying conventions would be used for calculating the gain on the hypothetical sale of "hot assets" under section 751(a) to transferors.

11. Guidance is requested under section 6063 defining the circumstances in which an originally filed partnership tax return will be considered validly signed by a partner, within the meaning of this statute. Section 6063 and the regulations thereunder require that the partnership tax return be signed "by any of its partners." However, the instructions to Form 1065 appear to narrow the pool of valid signatories by indicating that the return must be signed by a "general partner or LLC member manager." Further, the IRS has indicated in Pub. 3402 and in informal advice that limited partners cannot sign the partnership tax return (GCM 38781; FSA 0556). A valid signature is a prerequisite to the valid filing of an income tax return (Agri-Cal Venture Associates, v. Commissioner, T.C. Memo 2000-271; Burford Oil Co. v Commissioner, 153 F.2d 745 (5th Cir. 1946); Elliott v Commissioner, 113 T.C. 125 (1999)). Because the tax ramifications of failure to timely file a return are significant, the IRS should clarify in one set of guidance the signature requirements for signing a partnership tax return. In particular, such guidance should address if and when a limited partner or non-member manager LLC member can sign the partnership return, what partners are appropriate signatories in a non-member managed LLC, and what partners can sign in situations where the entity is a foreign eligible entity classified as a partnership. Further, in cases where the appropriate partner signatory of a partnership return is itself another entity classified as a partnership, the guidance should address whether an authorized officer of such entity partner can sign the lower-tier partnership return in its capacity as an officer of the partner entity (e.g., if an LLC is the general partner of a partnership, can an authorized officer of the LLC sign the partnership return on behalf of the LLC as general partner of the lower-tier partnership).

12. Guidance is requested to address the constructive ownership rules applicable for section 6038 as they apply particularly to domestic partnerships. Currently, the section 958(b) and section 318(a)(3)(A) constructive ownership rules cause a domestic partnership to be the constructive owner of a controlled foreign corporation (CFC) held by a domestic corporate partner, *regardless of the percentage ownership such corporate partner has in the partnership.* As such, the partnership appears to have a Category 5 filing requirement to file Form 5471 with respect to all CFCs held by such corporate partner. The rules do not make sense where the U.S. partnership is not part of the U.S. corporate partner's affiliated group, and where the U.S. partnership would not have any income inclusions under section 951 with respect to the CFCs held by the corporate partner. Further, the rules do not contain any administrative relief from this filing requirement when, for example, there is more than one U.S. person that has the same filing requirement (compare the administrative relief available for multiple Category 4 filers. Because failure to file a required Form 5471 carries with it punitive results for U.S. partnerships that may not even be aware of the filing

requirement and who may not be able to obtain the information necessary to file such forms from its domestic corporate partners – from monetary penalties to an open statute of limitation – the AICPA is requesting guidance that provides administrative relief.) We applaud the changes to the 2012 Form 5471 that were made in an effort to relieve the partnership from the general filing requirement in circumstances where the partner is appropriately compliant with its Form 5471 filing obligations. Nevertheless, the AICPA requests further guidance be issued that provides that the partnership cannot be subject to penalties for failure to file in all circumstances (e.g., where the partner fails to meet its own filing obligations).

13. The AICPA continues to believe that guidance is needed on the treatment of limited liability company members (and limited partners in light of recent judicial rulings) under section 1402(a)(13). Some taxpayers aggressively avoid classifying LLC income as earnings from self-employment, while others may be overly conservative in this regard. Without guidance, widespread inconsistency will continue to flourish and practitioners trying to do the "right" thing have difficulty retaining clients who prefer an overly aggressive position. While the AICPA continues to believe that the Service should withdraw and re-propose or finalize existing regulations addressing this important issue, our understanding is that such guidance will only be forthcoming following legislative action in this area.

S Corporation Taxation Technical Resource Panel (Chris W. Hesse, Chair, (612) 397-3071, chris.hesse@cliftonlarsonallen.com; or Jason Cha, AICPA Technical Manager, (202) 434-9231, jcha@aicpa.org.) NOTE: Comments are listed in overall priority order and are additionally segregated into sections designated as Top Priorities and Lower Priorities.

TOP PRIORITIES

1. Guidance is needed regarding the inability to utilize certain suspended passive activity losses upon redemption. Section 469(g) generally allows for the utilization of all suspended passive activity losses that have been carried forward when a taxpayer disposes in a taxable transaction of his entire interest in a passive activity. This rule does not apply, however, when the sale of S corporation stock is to a related party described in sections 267(b) and 707(b)(1). When the related party exception applies, the loss is deferred until the party acquiring such stock interest in the passive activity disposes of it to a party that is unrelated to the initial selling taxpayer. In the case of a redemption of S corporation stock, the second disposition can never be achieved because the stock redeemed no longer exists for federal income tax purposes. It is not possible to trace the redeemed stock to a subsequent disposition.

The legislative history to the provision does not appear to contemplate this situation. Although the statute treats redemptions of corporations differently than redemptions of partnership interests with regard to the ability to recognize realized losses on redemption (see section 707(b)(1) allowing for losses on redemption of partnership interests; and see section 267(b) and Revenue Ruling 57-387 for disallowance of loss on redemption of corporate stock), we believe it appropriate that all suspended losses be allowable upon a complete redemption of interests in a pass through entity. Suspended passive losses do not result from a sale or exchange of property between related parties, but rather from true economic losses. The sale transaction solely governs the timing of taking the loss into account. If such losses were not allowed upon a complete redemption in a pass through entity, true economic losses would never be recognized as the provisions of section 469(g) could never be satisfied.

2. We recommend that the guidance from PLRs 200308035 and 201015019 be incorporated into a revenue ruling. Specifically, guidance is requested concerning whether a second class of stock is created by an S corporation's pro rata distributions made to pay: (1) taxes in year one; (2) redemptions in year two; (3) additional taxes in year three for an amendment of its year one tax return; and (4) subsequent distributions to pay additional year one taxes.

   PLR 201017019 provides that there is only one class of stock when an S corporation pays distributions to its shareholders based on the apportionment of taxable income for a given period. The distribution plan discussed in the ruling also provides that if a subsequent audit increases taxable income for a prior period, the corporation may make distributions to shareholders in proportion to their relative shares of taxable income during the prior period. The payment policy described in this ruling appears to relate to distributions on specific dates or events, and there is at least an implication that there may be more than one distribution, subject to different formulae, within a single corporate taxable year.

   Additionally, guidance is needed to confirm that an S corporation can simultaneously make both pro rata distributions according to current stock ownership and other distributions that meet the varying interest rule of Treas. Reg. § 1.1361-1(l)(2)(iv) without creating a second class of stock.

3. Clarification is needed regarding the ordering rule for adjustments to AAA when ordinary and redemption distributions are made in the same year and an ordinary distribution occurs after the redemption distribution. Under Treas. Reg. § 1.1368-2(d)(1)(ii), AAA is adjusted first for ordinary distributions and then for redemptions. The regulations provide an example where the redemption occurs later in the year than the ordinary distribution, but does not provide an example where the redemption occurs prior to the ordinary distribution. Since the redemption distribution is based on the AAA amount as of the date of the redemption, the rule is not clear in the case of a post-redemption ordinary

distribution. The regulation simply says to adjust first for ordinary distributions but does not make a distinction for those ordinary distributions that are before or after redemption. One could interpret the rule either way. Reducing the AAA balance for all ordinary distributions regardless of the timing relative to the redemption provides the best answer in most circumstances. Since a complete redemption is a sale or exchange transaction, the presence of AAA is irrelevant for purposes of determining the shareholder's gain or loss on the redemption. Allocating more AAA to redemptions by ignoring post redemption distributions doesn't benefit the redeemed shareholder while it leaves less AAA for the post redemption distribution to be recovered tax free by the recipient shareholders. We specifically request an example where ordinary distributions are made subsequent to a redemption and how AAA is impacted in that situation. Such guidance could be issued by either modification of the regulation or by revenue ruling.

4. Treasury Reg. § 1.1361-5 should be updated to reflect the addition of clause (ii) (relating to termination of a QSub by reason of the sale of QSub stock) to section 1361(b)(3)(C) made by section 8234 of P.L. 110-28. This can be accomplished in any of three ways: (1) delete the obsolete portion of existing regulation; (2) add a sentence to indicate that the old rules apply only for years before the effective date of the changes; or (3) revise and expand the regulations to indicate that the old rules apply to years before the effective date of the changes and also set forth new rules that apply for years after the effective date of the changes.

LOWER PRIORITIES

5. Guidance is needed as to when, for alternative minimum tax purposes, S corporations will have attributes which will be different for regular tax and alternative minimum tax purposes. For example, does an S corporation have an Accumulated Adjustments Account for alternative minimum tax purposes which would differ by the adjustments of sections 56, 57 and 58 from the Accumulated Adjustments Account for regular tax purposes? Assuming there are Accumulated Adjustment Accounts kept for each type of tax, if distributions in excess of the regular tax and AMT Accumulated Adjustments Accounts are made by an S corporation with accumulated earnings and profits, how much is taxable to the recipient shareholder for regular tax purposes and how much for AMT purposes? As more and more taxpayers become subject to the AMT, it is increasingly important for taxpayers to have guidance on how the regular tax and AMT interface with respect to common transactions.

6. A revenue procedure for the permissible electronic distribution of Schedules K-1 (Form 1120S, U.S. Income Tax Return for an S Corporation) should be issued. (See recently released Revenue Procedure 2012-17 which provides guidance on partnerships that issue electronic Schedules K-1.)

7. Guidance is needed as to whether a state tax refund attributable to the S-portion of an ESBT is allocated to the S-portion.

8. Guidance is needed regarding the temporary shortening of the recognition period under section 1374(d)(7)(B). Specifically, we request that guidance be issued excluding recognized built-in gain that is deferred in 2009, 2010 or 2011 (and beyond, should the provision be further extended) as a result of an income limitation or installment sale and later recognized during the recognition period under section 1374(d)(2)(B) or under the installment sales rules not be subject to tax. In addition, we request clarification as to (1) what happens if a section 444 election is made during the recognition period resulting in a change in the tax year; (2) whether the "7th taxable year" for years beginning in 2009 or 2010 (per American Recovery and Reinvestment Act of 2009) or "5th taxable year" for years beginning in 2011 (per Small Business Jobs Act of 2010), as appropriate, or the "stub-period" months as defined in the regulations determines the temporary end of the recognition period; and (3) whether the temporary rule applies to regulated investment companies and real estate investments trusts.

Tax Methods and Periods Technical Resource Panel (Carol Conjura, Chair, at (202) 533-3040, cconjura@kpmg.com; or Jason Cha, AICPA Technical Manager, (202) 434-9231, jcha@aicpa.org.) NOTE: Comments are listed in priority order.

1. Issue additional guidance on capitalization under section 263:

   - Issue final regulations and industry specific guidance under sections 162(a), 168, and 263(a) regarding the deduction and capitalization of expenditures for tangible assets. [Note: See AICPA comments to IRS submitted on April 17, 2012 and July 16, 2012.]

   - Issue guidance clarifying the safe harbor method to allocate success-based fees under Rev. Proc. 2011-29, including clarification on the allocation of success-based fees between covered and non-covered transactions, milestone payments applied to the payment of success-based fees, and contingent employee compensation.

   - Issue proposed regulations under sections 263(a) and 167 providing guidance on the treatment of capitalized transaction costs, including safe harbor amortization periods, for certain capitalized costs.

   - Release revenue procedure under section 263(a) regarding the capitalization of cable network property.

   - Release revenue procedure under section 263(a) regarding the capitalization of natural gas transmission and distribution property.

2. Issue additional guidance on capitalization under section 263A:

- Issue final regulations under section 263A regarding the inclusion of negative amounts in additional section 263A costs.

- Issue final regulations under sections 263A and 471 regarding sales-based royalties and sales-based vendor allowances.

- Issue proposed regulations under section 263A for resellers (i) updating rules to reflect changes in retail business practices (including those resulting from technological advances and current trends) that have affected the application and administrability of the existing regulations under section 263A to retailers that transact both on-site sales and sales that are not on-site sales from the same sales facility, and (ii) modifying the definitions of on-site sales, a retail customer, a retail sales facility, a dual-function storage facility, and other terms in Treas. Reg. § 1.263A-3(c)(5)(ii) to reflect current business practices of retailers that transact both on-site sales and sales that are not on-site sales from the same sales facility.

- Issue proposed regulations under section 263A: (i) clarifying definition of costs included in and excluded from the simplified service cost production and labor cost formulas, (ii) clarifying sufficient documentation for classification of activities and departments (e.g., sufficiency of interviews with employees), and (iii) updating examples to reflect more common situations such as an IT department.

- Issue regulations under sections 263A and 702 regarding the treatment of excess depletion.

3. Issue additional guidance on changes in method of accounting:

- Issue revised companion revenue procedures authorizing automatic consent for changing accounting methods under the tangibles regulations.

- Modify certain procedures for obtaining automatic and advance consent to change a method of accounting in Rev. Proc. 97-27. [Note: See AICPA comments to IRS submitted on February 15, 2008.]

- Modify the voluntary accounting method change procedures addressing concerns regarding the "issue under consideration" standard for controlled foreign corporations (CFCs). [Note: See AICPA comments submitted to IRS on July 30, 2012.]

- Issue guidance modifying final regulations and Rev. Proc. 2011-14, as modified by Rev. Proc. 2012-39, concerning procedures for changing accounting methods in non-taxable reorganizations under section 381(a).

- Issue guidance regarding changes in method of accounting for section 174 research and experimental expenses.

4. Issue guidance addressing a taxpayer's eligibility for Rev. Proc. 2004-34, as modified by Rev. Proc. 2011-18, in situations where receipts from gift card sales are never included in financial statement income. [Note: See AICPA comments to IRS submitted on July 18, 2012.]

5. Finalize the regulations under section 471 addressing the retail inventory method. [Note: See AICPA comments submitted to IRS on December 13, 2012.]

6. Issue guidance regarding the relevant factors for determining the tax owner of property for section 199 purposes, including clarification that the standard for benefits and burdens under section 199 should be consistent with the standard for benefits and burdens under section 263A in contract manufacturing situations.

7. Issue guidance regarding the time when a business is considered to start for purposes of section 195.

8. Issue guidance on the deductibility of foreclosure and holding costs incurred by banks for other real estate owned (OREO).

9. Issue guidance under section 6655 regarding corporate estimated tax payments.

10. Issue guidance under section 118 specifically relating to the treatment of refundable and transferable credits and incentives as non-shareholder contributions to capital.

11. Release revenue procedure under section 168(k)(4) regarding election to accelerate carryover AMT credits in lieu of claiming bonus depreciation.

12. Issue guidance under section 179(f) regarding qualified real property.

13. Issue guidance regarding the application of Treas. Reg. section 1.267(b)-1(b) to partners and partnerships.

14. Issue guidance under section 453B regarding nonrecognition of gain or loss on the disposition of certain installment obligations.

15. Issue regulations under section 460 regarding the application of the look-back interest rules to certain pass-through entities with tax-exempt owners.

16. Issue regulations under section 460 regarding home construction contracts and rules for certain changes in method of accounting for long-term contracts.

17. Issue regulations under section 472 regarding the carryover of LIFO layers following a section 351 or section 721 transaction.

18. Issue regulations amending Treas. Reg. section 1.472-8 regarding the IPIC method.

Tax Practice Responsibilities Committee (James W. Sansone, Chair, (847) 413-6912, James.Sansone@mcgladrey.com; or Melanie Lauridsen, AICPA Technical Manager, (202) 434-9235, mlauridsen@aicpa.org.) NOTE: Comments are listed in order of priority.

1. Guidance is needed to provide certain core principles for defining "tax shelter" under section 6662(d), including that the term "tax shelter" is intended to apply to an entity, plan or arrangement involving an abusive application of the federal income tax laws, but that the determination of whether a "tax shelter" exists depends upon all pertinent facts and circumstances. The definition is important for purposes of the taxpayer accuracy-related penalties under section 6662 and 6662A, the tax return preparer penalty under section 6694, the section 7525 federal tax practitioner privilege, and the written tax advice rules contained in Circular 230 (Rev. 8-2011).

2. Little general information is available regarding the investigations of practitioners and the processing of cases by the Office of Professional Responsibility (OPR). In addition, regulation of (and limitation) of practitioners' ability to provide service to taxpayers is also delegated to the Return Preparer Office (RPO) and the office of Electronic Tax Administration (ETA). Guidance or information is therefore needed regarding procedures of OPR and other offices that regulate, sanction and limit practitioners. Such guidance could be in the form of a comprehensive "plain English" publication or other statement of a practitioner's rights in the case of a referral to OPR or action to restrict a practitioner's rights or actions by other IRS offices. This might be done in a publication similar to the current IRS Publication 1, Your Rights as a Taxpayer.

   Relatedly, guidance is needed regarding the safeguarding of the **taxpayer's** rights in an OPR investigation of the **preparer**. To illustrate, to gather evidence against the preparer, the IRS examines the tax returns of the preparer's clients. Those taxpayers may be asked to give testimony about the targeted tax preparer's preparation procedures. In an effort to build a case against the targeted tax practitioner, we are concerned that the OPR investigator may inadvertently compromise the taxpayer's rights in the examination. For example, the OPR

investigator may require that the taxpayer accompany the representative to the initial tax interview, contrary to the taxpayer's right to representation as described in IRM 4.10.2.7.5. The IRS may also require, in an affidavit to be completed at the initial interview, that the taxpayer provide answers relating to the tax preparer's procedures. A taxpayer who is under examination at that time may fear reprisal if the affidavit is not completed.

3. Assuming that the proposed amendment of Circular 230 section 10.35 is adopted substantially as proposed, guidance will be needed regarding the criteria that will be used to determine the competence of practitioners subject to Circular 230. Examples of the determination of whether a practitioner demonstrates the required knowledge, skill, thoroughness and preparation are needed by the practitioner community for compliance with this new provision.

4. Additional guidance is needed regarding the imposition of monetary penalties under Circular 230 as amended by section 822 of the American Jobs Creation Act of 2004. [Note: See AICPA comments on Notice 2007-39 regarding this issue, submitted on August 22, 2007.]

5. Guidance, with the opportunity for prior comment, is needed regarding criteria the IRS will use in determining whether to:

   (1) assert a section 6694 preparer penalty;
   (2) refer a matter to OPR, particularly in the case of alleged violations under the section 6694 preparer penalty provisions; and
   (3) sanction or otherwise limit a practitioner in providing tax services by OPR, RPO or ETA.

   Guidance regarding the interpretation of standards to be applied beyond, for example, "assessment of penalties" as an enumerated standard, set forth on page 14 of Publication 3112, to deny a practitioner participation in the e-file program, is essential to provide consistency of application of the standards to limit abuse of discretion by an IRS employee and to adequately inform practitioners of the standards to which they will be expected to adhere.

Trust, Estate and Gift Tax Technical Resource Panel (Frances Schafer, Chair, (202) 521-1511, fwswcs3@comcast.net; or Eileen Sherr, AICPA Senior Technical Manager, (202) 434-9256, esherr@aicpa.org.) NOTE: Items are listed in priority order.

Domestic

1. Final regulations are needed on the portability of the deceased spousal unused exclusion amount under section 2010(c)(4). [Note: See AICPA letter submitted to IRS on September 14, 2012.]

2. Final regulations are needed on the new 3.8 percent tax on unearned income under section 1411(effective January 1, 2013) as it relates to estates and trusts and the Form 1041, including filing requirements, timing of remittances, tax forms and instructions, and any other guidance that will help taxpayers comply with the new law. [Note: See AICPA comments to Treasury and IRS on this issue submitted on May 8, 2013.]

3. A final ruling is needed on the consequences under various estate, gift, and generation-skipping transfer tax provisions of using a family-owned company (private trust company) as the trustee of a trust. [Note: See AICPA pre-release comments on this item submitted on March 29, 2006, and AICPA comments on the proposed revenue ruling, submitted on November 12, 2008.]

4. Regulations under section 6034 should add an administrative exception to the Form 1041-A, U.S. Information Return Trust Accumulation of Charitable Amounts, filing requirement for complex trusts that claim charitable deductions under section 642(c) solely for contributions flowed through to them from partnerships and S corporations. The amendment to these regulations could be done as part of a project to update the section 6034 regulations to reflect the changes made to that section by the Pension Protection Act of 2006. In order to implement this administrative exception as soon as possible, a Notice should be issued stating that regulations will be revised to allow this administrative exception to the Form 1041-A filing requirement for these trusts and that these trusts no longer have to file Form 1041-A. [Note: See AICPA letter submitted to IRS on September 14, 2010 and AICPA letter submitted to Congress on October 19, 2012.]

5. A simplified procedure is needed to obtain an extension of time to elect out of the automatic allocation of the GST exemption to indirect skips and at the end of the estate tax inclusion period, similar to Rev. Proc. 2004-46. Many PLRs have been issued allowing extensions of time to elect out of the automatic rules, but a simplified method for obtaining such extensions without the need for a private letter ruling would benefit taxpayers and the IRS. [Note: See AICPA comments to IRS, submitted June 26, 2007.]

6. Guidance is needed on the ability to split gifts under section 2513 in *Crummey* or similar situations, where the donee spouse has an interest in the trust and others have the ability to withdraw the contributed assets but all the transfers made to the trust during the year may be withdrawn by trust beneficiaries.

   Such guidance is particularly needed in the case of late filing of gift tax returns. Because of the late filing, there is no opportunity to elect out of deemed allocation (i.e., each spouse's GST exemption would be allocated to his or her portion of the transfer) (Treas. Reg. § 26.2632-1(b)(4)(iii), Ex. 5). [Note: See AICPA

comments to IRS, submitted June 26, 2007.]

7. Guidance is needed for marital trusts under section 2056(b)(7) similar to Rev. Rul. 2006-26, regarding plans other than IRAs and defined contribution plans (i.e., defined benefit plans and deferred compensation plans).

8. Guidance is needed regarding the appropriate means and timing of GST allocations to pour over trusts from GRAT terminations. Guidance is also needed under section 2632(c)(5)(A)(i) and examples, addressing the application of the GST exemption automatic allocation rules for indirect skips in a situation in which a trust subject to an estate tax inclusion period (ETIP) terminates upon the expiration of the ETIP, at which time the trust assets are distributed to other trusts that may be GST trusts. [Note: See AICPA comments to IRS, submitted June 26, 2007.]

   We appreciate that the 2012-2013 Priority Guidance Plan includes this suggestion.

9. Clarification is needed in the instructions to Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, with regard to Column C in Part 3 of Schedule A as to the election made under section 2632(c) (electing "in and out" of a deemed allocation.) The instructions state that checking the box in Column C applies only for transfers reported on the return. Confusion can result as the instructions provide that, if a prior election has been made with respect to future transfers, the box in Column C should not be checked and no explanatory statement should be filed with the applicable Form 709. One suggestion would be to have an additional column to check if an election was made in a prior year that affects the GST exemption for a transfer made in the current year.

10. Guidance is needed under section 2632(c), regarding the deemed allocation of GST exemption to certain lifetime transfers to GST trusts. In particular, clarification is requested with regard to the exceptions to the definition of a GST trust contained in section 2632(c)(3)(B)(i)-(vi) as well as the exception in the flush language of this section dealing with gift tax annual exclusions. Six types of GST trusts are defined, but there are many gray areas that we would request additional guidance. Finally, until regulations are issued under section 2632(c)(3)(B)(i)(III), as required by such section, we believe this provision has no effect.

11. It would be helpful to harmonize what is necessary to satisfy the adequate disclosure requirements of sections 301.6501(c)-1(e) and -1(f). At a minimum, section 301.6501(c)-1(e) should contain a safe harbor for appraisal reports as exists in section 301.6501(c)-1(f).

Foreign Related

12. In conjunction with Item #2 above, section 1411(e) exempts a non-resident alien (NRA) trust beneficiary from the new Medicare surtax. Guidance is needed to allocate a trust's net investment income included in DNI between U.S. and NRA beneficiaries for proper reporting of current year distributions. We assume that the net investment income included in DNI would be allocated between U.S. and NRA beneficiaries in the same manner as other allocations of income and expense among beneficiaries, whether U.S. or foreign; however, clarity on this would be helpful. [Note: See AICPA pre-release comments on this item submitted on March 29, 2006, AICPA comments on the proposed revenue ruling, submitted on November 12, 2008, and AICPA comments to Treasury and IRS on this issue submitted on May 8, 2013.]

13. Guidance is needed on issues relating to foreign trusts and the HIRE Act. [Note: See AICPA comments to Treasury and IRS on this issue submitted on March 28, 2011.]

14. Further guidance is needed on issues relating to foreign trusts and the Foreign Bank Account Report (FBAR). [Note: See AICPA comments on this issue submitted to FINCEN, Treasury, and IRS on November 19, 2010 and November 16, 2009.]

15. A change in the due date of Form 3520A is requested from March 15 to April 15, to coincide with the due date for calendar year filers of related returns. If a change in the due date is not possible, then an extension or penalty relief is requested for taxpayers who file by April 15. In addition, IRS should consider adding a box to Form 7004 to permit an extension of time to file Form 3520 in cases where the beneficiary's income tax return (Form 1040 and Form 1040NR) is not going to be extended. [Note: See AICPA comments to IRS on this submitted on June 12, 2008, March 3, 2008, January 31, 2007, and June 17, 2003. This change in the Form 3520A due date is included in proposed legislation, S. 420, introduced 2/28/13 by Senators Enzi and Tester, and H.R. 901, introduced 2/28/13 by Rep. Jenkins, as well as in Rep. Camp's March 12, 2013 House Ways and Means Committee small business tax reform discussion draft and the Senate Finance Committee March 21, 2013 tax reform options paper on simplifying the tax system for families and businesses.]

16. The current tax reporting on Form 1040NR for foreign non-grantor trusts (and foreign grantor trusts with a U.S. owner) is extremely difficult because the IRS form is not designed for fiduciary tax return reporting. IRS instructions direct the preparer to "change the form" for Subchapter J provisions, but attempts to do so result in inconsistent or inadequate changes and lead to return processing errors and confusion. The creation of a new Form 1041NR, which could include information currently reported on Forms 3520 and 3520-A, would eliminate confusion and mistakes in processing returns and would enhance tax compliance

filing requirements. [Note: See AICPA comments to IRS on this submitted on September 22, 2008, March 3, 2008, and January 31, 2007.]

17. Guidance is needed on whether a foreign grantor trust with a U.S. grantor is required to file Form 1041 or Form 1040NR and whether a foreign grantor trust with a foreign grantor and some U.S. income is required to file Form 1041 or Form 1040NR.

18. Guidance is needed on the reporting of and recognition of gain under the expatriation mark-to-market rules in section 877A, including guidance on the interplay of sections 877A and 684, relating to a transfer to a foreign estate or trust.

19. Guidance is needed on how the GST tax applies to grandfathered domestic trusts that become foreign trusts. This issue may be analogous to a GST-grandfathered trust that migrates from one state to another; thus, similar rules and safe harbors should be considered.

20. Guidance is needed regarding several aspects of section 2801:

- Guidance is needed regarding reporting the receipt of a "covered gift or bequest" and the payment of tax thereon required under section 2801(a). While the IRS has stated in Notice 2009-85, 2009-45 IRB 598, that the satisfaction of the reporting and tax obligations for covered gifts or bequests will be deferred pending the issuance of guidance, the longer the delay, the longer the undue burden on those who are required to comply with section 2801(a). This guidance should also include the determination of the reduction of this liability by a credit for the payment of foreign gift or estate taxes on a covered gift or bequest under section 2801(d).

- Guidance is needed regarding the making of an election by a foreign trust to be treated as a domestic trust under section 2801(e)(4)(B)(iii). In particular, guidance is needed regarding the treatment and reporting of the section 2801 tax for transfers "in trust" under section 2801(e)(4). Also, neither section 2801(e)(1) nor the legislative history discusses how property can be acquired "indirectly" by gift or by an indirect transfer by a decedent for estate tax purposes. For a covered gift or bequest made to a domestic trust, the section 2801 tax applies in the same manner as if the trust were a U.S. citizen and the tax must be paid by the trust. Under section 2801(e)(4)(B)(iii), an election can be made to treat a foreign trust as a domestic trust for purposes of the transfer tax on covered gifts and bequests. Guidance is needed on whether the foreign trust should withhold the section 2801 tax in the distribution(s) to the beneficiary.

  Further, section 2801 does not provide any provisions on how to determine

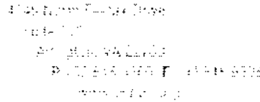
whether a distribution from a foreign trust is "attributable to a covered gift or bequest," where the trust includes other property in addition to the property received in the covered gift or bequest. Guidance is needed on this issue.

21. Guidance is needed as to what qualifies as a "reasonable period of time" for a U.S. grantor or beneficiary of a foreign trust to pay the trust the "fair market value" (FMV) for the "personal use" of trust property under section 643(i)(2). This guidance should also include the determination of the proper FMV measurement and whether "de minimis" amounts can be such a small amount as to make accounting for them unreasonable or administratively impractical. "Safe harbor" guidelines to administer this new law also would be appreciated. For example, a grantor or beneficiary might personally maintain landscaping requirements (at no compensation) for a rental property owned by a foreign trust, but have little or no personal use of the property during the year. [Note: See AICPA comments to IRS, submitted March 28, 2011.]

22. Regulations are needed to enhance guidance in Notice 2009-85 regarding the reporting of tax withholding and payment of these taxes by trustees to the IRS. Such guidance is needed as to the appropriate forms and reporting on applicable tax returns. Guidance on possible "expedited" procedures for successful receipt of a private letter ruling for an expatriate to determine the value of his or her interest in the trust would be appreciated. This guidance should also define "adequate security" for a "tax-deferred agreement" for the covered expatriate's return under section 877A(b).

23. Regulations are needed under section 6677 regarding the failure to file information with respect to certain foreign trusts. The HIRE Act amended section 6677, but guidance is not adequate in Notice 97-34, the only IRS guidance on making a determination on penalties under section 6677. New recently designed letters, as described in IRS memorandum SBSE-20-0709-016, provide determination letters based upon a review of a taxpayer's compliance with section 6677, but taxpayers need regulations to provide them with guidance before the applicable letter is issued.

Notice 2013-22



April 29, 2013

MAY 16 2013
LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

Mr. Joseph Grant
Acting Director, Tax Exempt & Governmental Entities
Internal Revenue Service
1111 Constitution Ave NW
Washington, DC 20224-0002

Re: Comments on Pre-Approved Defined Benefit and 403(b) Plans

Dear Mr. Grant,

The American Society of Pension Professionals and Actuaries ("ASPPA") and the National Tax Sheltered Accounts Association ("NTSAA") are sending this letter to request that the Internal Revenue Service ("IRS") consider various changes to the defined benefit and 403(b) pre-approved plan programs. The issues raised in this letter, and their resolution, are time critical and we thank you in advance for your immediate consideration of our request.

ASPPA is a national organization of more than 11,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA's membership includes the members of NTSAA, a nonprofit organization that became part of ASPPA in order to expand both organizations' strengths in serving the §403(b) marketplace. ASPPA and NTSAA members are retirement professionals of all disciplines including consultants, administrators, actuaries, accountants, and attorneys. ASPPA and NTSAA are particularly focused on the issues faced by small to medium-sized employers. The membership of ASPPA and NTSAA is diverse but united by a common dedication to the employer-based retirement plan system.

Summary

ASPPA and NTSAA recommend that, with respect to the pre-approved defined benefit plan program, the IRS make the following modifications to Rev. Proc. 2011-49:

1. Permit cash balance plans as part of the existing pre-approved defined benefit program for the cycle that began February 1, 2013;
2. Extend the deadline for the submission of mass submitter plans from October 31, 2013 to January 31, 2014; and
3. Expand the master and prototype (M&P) minor modifier program to include volume submitter plans.

ASPPA and NTSAA recommend that, with respect to the pre-approved 403(b) plan program, the IRS make the following modifications to Rev. Proc. 2013-22:

1. Extend the submission deadline from April 30, 2014 to January 31, 2015;
2. Modify the definition of mass submitter by reducing the number of word-for-word adopters from 30 to 10;

3. Confirm that once a mass submitter satisfies the word-for-word threshold for one plan, then there is no threshold for all other plans of the mass submitter; and
4. Expand the prototype minor modifier program to include volume submitter plans.

Discussion

I. Modifications to the Pre-approved Defined Benefit Plan Program

A. Permit Pre-Approved Cash Balance Plans

Rev. Proc. 2011-49 does not permit the submission of hybrid defined benefit plans under the pre-approved plan program. We urge the IRS to modify Rev. Proc. 2011-49 to permit, under the existing pre-approved defined benefit plan program, the inclusion of hybrid plans that are considered cash balance plans. We recommend that cash balance provisions be included as options within a pre-approved defined benefit plan (i.e., we do not envision a separate pre-approved plan program nor separate plan documents or adoption agreements solely to accommodate cash balance plans).

The 2011 Form 5500 filings reflect that there were 8,068 cash balance plans, of which 5,500 were plans with 20 or fewer participants, and we expect this number to increase. Over 70% of these plans were based on documents made available by mass submitters who are among the members of ASPPA's Plan Document Committee. This highlights that: (1) most of the cash balance plans are based on provisions that are consistently and repeatedly used, (2) most of the plans provisions are based on pre-approved defined plans language with the exception of the cash balance specific provisions, which are relatively limited in nature (e.g., the benefit formula and the definition of the present value of the accrued benefit), and (3) most of these plans could fit onto a pre-approved plan if such a plan were available. Interestingly, many of the new cash balance plans (i.e., those that are not conversions of a traditional defined benefit plan) are not subject to IRS user fees (pursuant to the small plan exemption set forth in Code §7528(b)(2)).

ASPPA believes the following represent compelling reasons for why the IRS should permit cash balance plans as part of the pre-approved plan program.

1. The current determination letter process is a labor intensive process for both the IRS and practitioners. In addition, cash balance plans typically require review by some of the highest-grade IRS personnel. Adding cash balance plans to the pre-approved plan program would reduce the need for these reviews.

2. There are only a limited number of differences between the language used for a cash balance plan and a traditional defined benefit plan. These differences are typically contained in a few sections of the plan – they do not permeate the entire plan. Nevertheless, our experience indicates that the overwhelming majority of requested modifications from IRS reviewers relates to language that is identical to language being used in pre-approved defined benefit plans in sections completely unrelated to the cash balance provisions. In other words, the vast majority of issues being raised on IRS review are not unique to cash balance plans. The IRS and practitioners waste countless resources re-hashing issues with plan language that has been utilized and approved countless times.

3. Some at the IRS have expressed concern that pre-approved cash balance or other hybrid plans should not be permitted in the pre-approved plan program because the IRS

has not issued final hybrid plan guidance. We fail to see how this issue would impact the decision on whether to permit pre-approved cash balance plans. The IRS is currently reviewing cash balance plans on an individual basis without having final guidance. The IRS would need to address the same issues regardless of the form of plan (i.e., individually-designed or pre-approved). It seems counterintuitive that exponentially more resources be consumed due to a lack of final guidance. Once guidance is issued, interim amendments may be required regardless of what form of plan an adopting employer is using. Furthermore, sponsors of pre-approved plans would adopt interim amendments on behalf of adopting employers thereby significantly reducing the number of plan document failures due to the failure to timely adopt interim amendments.

4. The IRS can immediately benefit from an announcement that cash balance provisions will be included in pre-approved plans. Once a formal change is made to the revenue procedure to remove the prohibition, plan sponsors can sign Form 8905 and be entitled to the 6-year pre-approved plan cycle. This will result in an immediate decrease in the number of future determination letter requests for individually designed cash balance plans and reduction in the strain on limited IRS resources.

There does not seem to be any policy or practical reason for tying up so many valuable IRS resources on a popular plan design that could readily fit within a pre-approved plan. If the IRS has reservations about specific types of hybrid plan designs, then various reasonable limitations might be considered (e.g., only permitting hybrid plans that are cash balance plans, prohibiting pre-approved plans when there has been a conversion from a traditional defined benefit plan, or requiring a limited Form 5307 filing for the IRS to review specific provisions that may be a concern). We would be happy to discuss alternatives.

This is a critical and time-sensitive issue because waiting until the next 6-year cycle, or creating an entirely new cycle for cash balance plans, merely perpetuates the drain on valuable resources. The gains by permitting pre-approved cash balance plans in the current cycle would even be significant enough to outweigh a delay in the 6-year pre-approved plan cycle for defined benefit plans (it is worth noting that the 6-year cycle for pre-approved plans has a 1 year buffer built into it). The IRS has already had to make cut backs in this area because of resource constraints (e.g., the elimination of the determination letter program for identical adopters of pre-approved plans and the recent announcement that a determination letter program for 403(b) plans will not be established). Significant resources could be freed up if only half (which we believe is conservative) of the existing cash balance plans are removed from the individually designed plan determination letter program.

B. Extend the submission deadline for mass submitter pre-approved defined benefit plans

Mass submitters must submit their defined benefit plans to the IRS by October 31, 2013 (pursuant to Rev. Proc. 2007-44). The LRMs for defined benefit plans were released in April 2013 and we believe an extension of the October 31, 2013 deadline is necessary. Additional time will be needed to review the just released LRMs, update plan language, and distribute the drafts to potential sponsors and provide them with sufficient time to determine whether they want to be word-for-word adopters. The IRS extended the mass submitter submission deadline for the prior 6-year defined benefit cycle (as well as for the prior two defined contribution cycles) and the delay did not materially impact the issuance of opinion and advisory letters. We therefore request

that the IRS extend the mass submitter submission deadline to at least January 31, 2014 to coincide with the submission deadline for all pre-approved defined benefit plans.

C. *Expand the minor modifier program to include mass submitter volume submitter plans*

Rev. Proc. 2011-49 established a minor modifier program for master and prototype (M&P) plans but not for volume submitter plans. There does not appear to be any significant policy reason for this limitation, particularly where the limitation may result in additional plans being submitted to the IRS. Some mass submitters will submit M&P plans solely to utilize the minor modifier program while using the volume submitter program for all other plans. Alternatively, some volume submitter practitioners are willing to pay the high user fee in order to make modifications to a mass submitter volume submitter plan. Once that high user fee is paid, there is no reason for the practitioner to limit its modifications to those that are just "minor" since the user fee was paid for a full review of the plan (i.e., as though it were not based on a mass submitter plan).

We therefore believe that permitting volume submitter minor modifier submissions may reduce the number of M&P plans submitted for review and/or reduce the scope of review that is required to approve volume submitter plans (i.e. volume submitter plans that are based on mass submitter volume submitter plans but are required to be submitted as non-mass submitter plans due to modifications). In either case, expanding the minor modifier program to volume submitter plans will free up additional IRS resources.[1]

II. Modifications to the Pre-approved 403(b) Program

We thank the IRS for issuing Rev. Proc. 2013-22 which establishes a pre-approved 403(b) plan program. The pre-approved program for qualified plans, including the mass submitter program, has been very beneficial to all interested parties in reducing administrative costs and managing resources. The IRS has already spent valuable resources in establishing this new 403(b) program and it would be in the best interests of the IRS, plan sponsors, and adopting employers that it be well received and utilized. Our comments are being made in the spirit of ensuring that the pre-approved 403(b) program will be successful.

A. *Extend the submission deadline to January 31, 2015*

Many pre-approved 403(b) plans will be prepared by document providers who draft documents for other types of retirement plans. The private sector has resource issues just as the IRS does, and creating the various remedial amendment period cycles was intended to provide a better balance of those resources. The IRS has the benefit of establishing deadlines based on its workflow but the private sector is subject to deadlines imposed by the IRS. Currently, those deadlines have converged into what may be considered a "perfect storm."

ASPPA and NTSAA recommend that the IRS extend the 403(b) plan submission deadline from April 30, 2014 to January 31, 2015, for the following reasons.

[1] While it is too late to address for the current pre-approved defined benefit plan cycle, ASPPA will be submitting a separate comment letter recommending that the IRS combine the M&P and volume submitter plan programs into one pre-approved plan program that utilizes the best features of each.

1. In 2013, document providers and sponsors will be working with the IRS to ensure pre-approved defined contribution plans are approved on a timely basis. At the time of the drafting of this letter, most of the mass submitters have not received their first set of comments on the plans that were submitted in April 2012. During this time, however, providers have been working on updating plan document systems that are used to create plans and related documents (such as summary plan descriptions) because these systems and documents must be available fairly soon after IRS approval. As indicated above, providers and sponsors must also be drafting their pre-approved defined benefit plans for submission by October 31 (or for non-mass submitters, by January 31, 2014). In addition, interim amendments may be needed for Hurricane Sandy relief as well as for in-plan Roth transfers pursuant to IRC §402A(c)(4).

2. A submission deadline of April 30, 2014, is simply too short for the establishment of an entirely new program. Providers who intend on being mass submitters of 403(b) plans must draft the plans based on recently issued LRMs, distribute drafts of the plans to potential sponsoring organizations for their review, and then obtain at least 30 (or less based on our recommendation below) word-for-word adopters for submission by the deadline. Working within this time frame is feasible for an existing pre-approved program. With a new program, however, we do not even know how many potential sponsoring organizations there are, and many of the potential sponsoring organizations or volume submitter practitioners have not dealt with IRS pre-approved plans before (i.e., they may not work with 401(a) plans) and will therefore not understand the nuances associated with the types of plans nor the significance of reliance.

3. An extended deadline will enable the IRS and practitioners to analyze and resolve issues with the LRMs that have already been identified and more that may be identified as the drafting process begins.

4. The recommended extension to January 31, 2015, is only a 9 month extension from the current deadline and will allow the program to fit within the established 6-year cycles that apply to pre-approved qualified plans. While our understanding is that 403(b) plans will be reviewed by IRS agents in the IRS National Office, once the program is firmly established that may not always be the case. Having a distinct 6-year cycle for pre-approved 403(b) plans that does not significantly overlap with the 6-year cycles for qualified pre-approved plans will give the IRS more flexibility to address resource demands in the future without making significant modifications to the timing of any of the pre-approved plan programs.

B. Modify the definition of mass submitter

An entity must have 30 word-for-word adopters to qualify as a mass submitter. We request that this threshold be reduced from 30 to 10 word-for-word adopters. We understand the concerns of the IRS that this potentially could result in the submission of more mass submitter documents. It is worth noting that the qualified plan pre-approved mass submitter program initially started with a requirement of 10 word-for-word adopters. While that number was increased to 30 (other than for money purchase pension plans) to ensure that mass submitters had a reasonable number of word-for-word adopters, this was done when IRS user fees were significantly lower than they are today. The current IRS user fees are a deterrent, and in many cases an impediment, to any unnecessary submissions. A mass submitter must have a reasonable number of word-for-word adopters in order to make the submission economically feasible. Equally as important, as indicated above, we do not know how many entities will want to sponsor

a pre-approved 403(b) plan. It is therefore difficult to gauge whether a potential mass submitter will be able to meet the threshold. In some cases this may not be known until very close to the submission deadline. A lower threshold will enable a potential mass submitter to have some reasonable level of assurance that it will qualify as a mass submitter early enough in the process to make appropriate adjustments prior to the submission deadline.

C. Clarifications

Mass submitters must make decisions now regarding the number and types of plans they will submit in order to communicate with potential sponsors and volume submitter practitioners and obtain the requisite number of word-for-word adopters. In order to make these decisions, we request that the IRS clarify the following issues.

Section 11.03 of Rev. Proc. 2013-22 provides that a mass submitter must have at least 30 word-for-word adopting sponsors for each "plan." Section 17.03 provides that once 30 word-for-word adopters have been submitted on one plan then other mass submitter plans may be submitted regardless of the number of word-for-word sponsors. Presumably this means that once a mass submitter has at least one plan that satisfies the requisite threshold, that all other plans submitted by the mass submitter are considered mass submitter plans. This language is similar to the language used in Rev. Proc. 2011-49 regarding pre-approved M&P plans, but we request IRS confirmation of this interpretation as it is critical to know which plans are considered mass submitter plans. For example, it is questionable whether mass submitters will be able to meet a separate threshold for both a retirement income contract under IRC §403(b)(9) (which, pursuant to the revenue procedure, must be a separate plan) and other 403(b) arrangements.

We also request clarification that the retirement income contract is the only type of arrangement that mandates a separate plan. The Revenue Procedure provides, for example, that certain provisions (e.g., IRC §401(m)) language is not needed unless the plan is available for adoption "only as a governmental plan or by a Church or QCCO." It is not clear if this requires a separate plan for these entities or whether a single plan can be made available for all qualifying entities and this language can be made inapplicable in the situation where one of these entities is the adopting employer. Once again, this has a direct impact on the number of plans that must be drafted and therefore requires immediate clarification.

D. Expand the minor modifier program to include mass submitter volume submitter plans

Similar to the request in Part I of this letter for pre-approved defined benefit plans, we request that Rev. Proc. 2013-22 be modified to permit the minor modifier program be made available for pre-approved volume submitter 403(b) plans. In addition to the reasons stated above, there are two additional factors that are unique to the 403(b) program that make this expansion even more critical to the 403(b) pre-approved plan program.

First, there is no determination letter program for 403(b) plans. This makes volume submitter plans significantly more attractive than prototype plans because of the ability to have reliance on unmodified language (i.e., an employer has reliance on unmodified language as long as the plan is "substantially similar" to the pre-approved plan). An employer that modifies a prototype plan loses reliance on the entire plan.

Second, Rev. Proc. §21.04 only permits word-for-word or minor modifier submissions after the submission deadline of April 30, 2014. With qualified plans, we have decades of experience with written plans and the pre-approved plan program. The written plan requirement for 403(b) plans is relatively new and the pre-approved program is new. This means that it will be difficult to determine whether plans drafted today will meet the needs of a provider in the years that follow, especially as employers begin to adopt the plans. This means there is likely to be a need for submissions after the April 30, 2014 submission deadline to accommodate changing business needs.

Mass submitters must be able to address the demands of their clients. It is quite possible that there is current demand for only volume submitter plans. But mass submitters must also submit mass submitter prototype plans to insure there is access to the minor modifier program, for either current or future use. This seems to be an unnecessary use of IRS resources.

Regardless of whether the IRS combines the programs, we believe that expanding the minor modifier program to volume submitter plans is a relatively easy accommodation to make (i.e., it will not require a restructuring of the Rev. Proc.) and is one that will improve the program. There is no downside to making this modification and we believe it will reduce the number of plans submitted for review.

* * *

These comments were primarily authored by Robert Richter, JD, LLM, APM and are submitted on behalf of ASPPA's Plan Document Subcommittee, Elizabeth Hallam, CPC, Chair and the Tax Exempt Governmental Plans Subcommittee, Edie Russo, Chair. We welcome the opportunity to discuss these issues further with you. If you have any questions regarding the matters discussed herein, please contact Craig Hoffman, General Counsel and Director of Regulatory Affairs at (703) 516-9300.

Thank you for your time and consideration.

Sincerely,

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Executive Director/CEO

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Judy A. Miller, MSPA
Chief of Actuarial Issues

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April 29, 2013

Mr. Joseph Grant
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Re: Suggestions for Combining the M&P and Volume Submitter Pre-Approved Plans Programs

Dear Mr. Grant:

The American Society of Pension Professionals and Actuaries ("ASPPA") appreciates the opportunity to provide suggestions for improving the pre-approved plan program (the "Program") by combining the Master & Prototype ("M&P") and Volume Submitter ("VS") components of the Program. As you know, ASPPA has been a strong supporter of the Program and appreciates the on-going efforts by the Internal Revenue Service ("IRS") toward improvements.

ASPPA is a national organization of more than 11,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines including consultants, administrators, actuaries, accountants, and attorneys. ASPPA is particularly focused on the issues faced by small- to medium-sized employers. ASPPA's membership is diverse but united by a common dedication to the employer-based retirement plan system.

ASPPA appreciates on-going IRS efforts to reduce the differences between the M&P and VS programs. Revenue Procedure 2011-49 ("Rev. Proc. 2011-49") provided several helpful changes that minimize the distinctions between these types of plans. However, ASPPA believes that further steps can be taken to combine the two document types which should increase the efficiency in the IRS review of these plans (saving valuable IRS staff time), in particular by eliminating redundant review of nearly identical M&P and VS documents and reducing the number of plans seeking approval letters. Combining the M&P and VS programs will assist the IRS, industry professionals and adopting employers by providing a more streamlined process for submitting, reviewing and adopting pre-approved plans.

In addition to suggesting that the IRS combine the best features of the M&P and VS programs, ASPPA wishes to recommend several other enhancements to the Program, which ASPPA believes will provide greater efficiencies for the IRS, assist practitioners in providing better services and improve the ability of adopting employers to utilize this already extremely-successful program.

Summary

In order to streamline the pre-approved plan procedures, ASPPA recommends that the IRS eliminate the procedural and substantive distinctions between the M&P and VS programs by incorporating the best current features of both programs into a single pre-approved plan program. ASPPA's experience indicates that most employers adopting and maintaining qualified retirement plans only care that the plan is pre-approved by the IRS. The distinctions between M&P and VS are irrelevant to them and, in fact, create confusion as practitioners try to explain the differences. Over the years, the distinctions between the M&P and VS programs have lessened, especially with the ability of VS plans to take the form of a basic plan document and adoption agreement. In fact, most mass submitters who utilize both M&P and VS adoption agreement-style plans, submit virtually identical plans under the Program. This causes redundant and unnecessary review by IRS staff. As a preliminary recommendation, ASPPA suggests eliminating the terms "master and prototype (M&P) plan" and "volume submitter (VS) plan" under the relevant revenue procedures and instead use "Pre-Approved Plan" or a similar term.

Greater efficiencies for the IRS, practitioners and adopting employers could be accomplished by eliminating the procedural and substantive distinctions between the M&P and VS programs. With respect to the substantive distinctions, this could be accomplished by allowing **all** pre-approved plans to include:

- Governmental plan provisions as currently available to VS plans.
- Non-safe harbor hardship withdrawal provisions as currently available to VS plans.
- The ability for participants to make a one-time irrevocable election not to participate in the plan as currently available to VS plans.
- The ability for participants to make employee contributions in all pre-approved defined benefit plans as is currently available for VS defined benefit plans.

With respect to the procedural distinctions, ASPPA recommends:

- Allowing all pre-approved plan sponsors to submit under the "minor modifier" rules as currently available to M&P plans.
- Allowing adopting employers of all pre-approved plans to be able to submit minor modifications using Form 5307 as currently available to VS plans.
- Clarifying the use of "Describe" or "Other" lines (i.e., "blanks or fill-in provisions") in all pre-approved plans and when a change by an employer requires the submission of Form 5300 or Form 5307 for a determination letter.
- Defining a pre-approved "mass submitter" in the same manner as currently defined under the M&P program.
- Allowing all pre-approved plans to take the form of a text- or contract-style document as currently available for VS plans.
- Permitting the "flexible plan" option in all pre-approved plans as currently available for M&P plans.
- Retaining the special rules applicable to "standardized" M&P plans.

- Eliminating the requirement that the VS practitioner (or if expanded pursuant to the first bullet above, the sponsoring organization) be on the power of attorney when a determination letter request is made using Form 5307.

In addition to eliminating the substantive and procedural distinctions between the M&P and VS programs, ASPPA recommends the following enhancements to the Program:

- Permit increased incorporation by reference in pre-approved plan documents.
- Allow ESOP and cash balance provisions in pre-approved plan documents.
- Improve the existing program for approval of separate trust documents.
- Allow the combination of basic, non-deferral profit sharing and money purchase plan provisions into a single adoption agreement.
- Remove the early submission deadline for mass submitter plans.

Discussion

I. Replace the Terms "Master and Prototype (M&P) Plan" and "Volume Submitter (VS) Plan" with the Term "Pre-Approved Plan"

Rev. Proc. 2011-49, consistent with predecessor procedures, provides specific definitions and procedures for "master and prototype (M&P) plans"[1] and "volume submitter (VS) plans." [2] Eliminating the distinctions between M&P and VS plans would allow a much more streamlined revenue procedure. The terms "master and prototype (M&P) plans" and "volume submitter (VS) plans" could be replaced with a more generic term referring to pre-approved plans.

ASPPA recommends eliminating the terms "master and prototype (M&P) plans" and "volume submitter (VS) plans" and substitute a more generic, all encompassing term, such as "Pre-Approved Plans" or something similar. This letter will use the term Pre-Approved Plan to describe the recommended change to the Program.

II. Allow All Pre-Approved Plans to Include Governmental Plan Provisions

Under current procedures, the IRS will not issue approval (i.e., opinion) letters to M&P plans that "would not satisfy the qualification requirements except as governmental plans as described in Code §414(d)."[3] On the other hand, the IRS will approve governmental VS plans (except to the extent they include so-called "DROP" or similar provisions).[4] A significant segment of the qualified plan sponsors utilize the governmental plan provisions of the Code. Providing access to a Pre-Approved Plan document provides efficiencies for the IRS, practitioners and adopting employers.

ASPPA recommends that the IRS allow Pre-Approved Plans to take the form of governmental plans as currently available to VS plans.

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[1] *See* Rev. Proc. 2011-49, Part I.
[2] *See* Rev. Proc. 2011-49, Part II.
[3] *See* Rev. Proc. 2011-49, Section 6.03(10).
[4] *See* Rev. Proc. 2011-49, Section 16.03(10).

III. Permit Non-Safe Harbor Hardship Withdrawal Provisions

Under current procedures, the IRS will not approve M&P "Section 401(k) plans (standardized and nonstandardized) that provide for hardship distributions other than those described in the safe harbor standards in the regulations under §401(k)."[5] (On the other hand, VS plans may allow 401(k) plans to permit non-safe harbor hardship distributions if "these distributions are subject to nondiscriminatory and objective criteria contained in the plan.")[6]

ASPPA recommends allowing a Pre-Approved Plan to include non-safe harbor §401(k) hardship distributions with the condition that these distributions are subject to nondiscriminatory and objective criteria.

IV. Permit One-Time Irrevocable Participant Elections Not to Participate in Any Pre-Approved Plan

During the last Pre-Approved Plan review cycle (i.e., EGTRRA), only VS plans were permitted to include provisions that would permit a plan participant to make a one-time irrevocable election not to participate in the plan. This was a change from the previous IRS position which had permitted these elections in both M&P and VS plans. At this point in the current Pre-Approved Plan review cycle, it is unclear whether there will be a change in the IRS position on this issue.

ASPPA sees no policy reason for prohibiting a one-time irrevocable election provision in any Pre-Approved Plan. The coverage and 401(k) regulations provide protections by requiring that plans treat employees who make a one-time irrevocable election to participate as not benefitting under the plan. There are many reasons why participants choose not to participate and this option should not be precluded simply because the plan sponsor has utilized a particular type of Pre-Approved Plan document.

ASPPA recommends allowing all Pre-Approved Plans to include provisions that would permit an employee to make a one-time irrevocable election not to participate in the plan.

V. Allow Employee Contributions in Pre-Approved Defined Benefit Plans

Under current procedures, the IRS will not approve M&P defined benefit plans "that provide for employee contributions."[7] VS plans are not subject to this restriction and there is no policy reason not to permit employee contributions in a unified Pre-Approved Plan program.

ASPPA recommends allowing all Pre-Approved Plans (defined contribution and defined benefit) to provide for employee contributions.

VI. Allow Pre-Approved Plan Sponsors to Submit under the "Minor Modifier" Rules

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[5] *See* Rev. Proc. 2011-49, Section 6.03(14).

[6] *See* Rev. Proc. 2011-49, Section 16.03(13).

[7] *See* Rev. Proc. 2011-49, Section 6.03(9).

Currently, under the M&P plan program, mass submitters may submit a "minor modification" of an otherwise word-for-word plan, pay a reduced submission fee and receive an opinion letter for the plan. A VS plan sponsor does not have the ability to make a "minor modification" of a VS mass submitter's plan and receive an advisory letter. Any modification to the VS plan would require the submission of a separate VS plan submission for each plan. The number of individual plan submissions for an identical modification would needlessly tie up IRS resources.

ASPPA recommends allowing "minor modification" filing of any mass submitter Pre-Approved Plan, with the reduced submission fees.

VII. Allow All Adopting Employers to Make Minor Modifications to a Pre-Approved Plan and Submit Using Form 5307

Under Rev. Proc. 2011-49, "an employer that **amends** any provision of an approved M&P plan including its adoption agreement ... is considered to have adopted an individually designed plan."[8] (Emphasis added.) The consequence to the employer is that, in order to receive reliance that the form of the plan satisfies the qualification requirements, the employer must submit the plan for a determination letter using Form 5300, which requires an extensive IRS review.

On the other hand, an employer that makes "limited modifications" to an approved VS plan may submit the plan for a determination letter on Form 5307, with its lower submission fee.[9] In this case, the IRS does a limited review of the plan because the focus is only on the modifications and not on the unmodified provisions of the pre-approved plan.

We understand that the IRS may be concerned that expanding the ability to make limited modifications will result in additional Form 5307 filings by adopting employers that want to obtain a determination letter. The concern is that these employers may make modifications to a Pre-Approved Plan solely to obtain a determination letter. We do not believe this will occur. Those practitioners who want to obtain these "protective" type rulings could do so by using a volume submitter plan. Our experience, however, is that practitioners have not been recommending that employers make unnecessary modifications to Pre-Approved Plans. The very high IRS user fee associated with Form 5300 can be a deterrent to modifying an M&P plan where someone is not sure whether a particular modification is absolutely necessary. IRS user fees, however, are only a component of the cost of modifying a Pre-Approved Plan. The practitioner will charge the employer for preparing the submission and addressing any IRS concerns. It is the total cost that is a deterrent and is the primary reason why the Pre-Approved Plans program has been so successful. While there may still be some practitioners who want a "protective" determination letter, the IRS has made great progress in addressing their concerns.

ASPPA recommends that any employer that makes a "minor modification" to any Pre-Approved Plan may submit the plan for a determination letter using Form 5307.

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[8] *See* Rev. Proc. 2011-49, Section 5.02.
[9] *See* Rev. Proc. 2013-6, Part I, Sections 9.01 and 9.02.

VIII. Clarify that the Use of "Describe" or "Other" Lines in a Pre-Approved Plan is not considered a modification to the Pre-Approved Plan

Under current procedures, both M&P and VS plans may include "describe" or "other" lines (referred to as "blanks or fill-in provisions"), provided "the provisions have parameters that preclude the employer from completing the provisions in a manner that could violate the qualification requirements."[10] Generally, insertion of language in the pre-approved "describe" lines is not a modification of the pre-approved language and therefore does not affect automatic reliance on the terms of the plan.

Because of the current rules, many practitioners recommend that any employer that completes any "blank or fill-in provision," even when it can be argued that the provision is within the parameters of the "blank or fill-in provisions," file for an individual determination letter. Generally, this is due to uncertainty on whether the completion of the "blank or fill-in provision" is considered to be a modification to the Pre-Approved Plan.

ASPPA recommends that the IRS clarify that "blank or fill-in provisions" in Pre-Approved Plans which are completed within the "parameters" associated with the "blank or fill-in provisions" are not considered modifications to the Pre-Approved Plan and therefore do not affect an employer's ability to rely on an opinion or advisory letter.

IX. Define a Pre-Approved Plan "Mass Submitter" in the Same Manner as Currently Defined under the M&P Program

Under current procedures, an M&P mass submitter and a VS mass submitter are defined differently. Section 4.08 of Rev. Proc. 2011-49 defines M&P mass submitter as "any person that ... submits opinion letter applications on behalf of at least 30 unaffiliated sponsors, each of which is sponsoring, on a word-for-word identical basis, the same basic plan document. ... An M&P mass submitter will be treated as an M&P mass submitter with respect to all of its M&P plans provided the 30 unaffiliated sponsor requirement is met with respect to at least one basic plan document." A basic plan document may have numerous adoption agreements associated with it.

Section 13.06 of Rev. Proc. 2011-49 defines VS mass submitter as "any person submits advisory letter applications on behalf of at least 30 unaffiliated practitioners each of which is sponsoring, on a word-for-word identical basis, the same specimen plan. A VS mass submitter will be treated as a VS mass submitter with respect to each specimen plan for which the 30 unaffiliated practitioner requirement is separately met." Under Section 13.02 of Rev. Proc. 2011-49, a specimen plan "may consist of a basic plan document and **an** adoption agreement." (Emphasis added.)

One consequence of the differing definitions is that a VS mass submitter using the adoption agreement format must have at least 30 practitioners for each adoption agreement associated with the basic plan document. This means some VS mass submitters who cannot secure 30 practitioners for a particular adoption agreement (such as the less popular money purchase plan adoption agreement) are not able to provide this type of plan to practitioners. This result causes the possible need for

[10] *See* Rev. Proc. 2011-49, Sections 6.03(18) and 16.03(17).

adopting employers to adopt costly individually-designed plans and file such plans for a determination letter.

ASPPA recommends that the definition of a Pre-Approved Plan mass submitter generally follow the current definition of M&P mass submitter, particularly with respect to the adoption agreement and basic plan document requirements.

ASPPA recommends further that the IRS reassess the need to have 30 unaffiliated sponsors (practitioners) associated with a basic plan document or specimen plan to receive mass submitter status. This is particularly difficult for a mass submitter that wishes to sponsor a governmental VS plan, which is required to have a separate basic plan document.

X. Allow All Pre-Approved Plans to Take the Form of a Text- or Contract-Style Document

Under current procedures, an M&P plan must take the form of a basic plan document with one or more adoption agreements.[11] A VS plan may take the form of a basic plan document and an adoption agreement or a single plan that does not use an adoption agreement (i.e., a text- or contract-style document).[12]

ASPPA recommends that a Pre-Approved Plan be able to take either the form of a basic plan document with MULTIPLE adoption agreements or a text- or contract-style format.

XI. Permit the "Flexible Plan" Option for All Pre-Approved Plans

Under current procedures, an M&P mass submitter may submit a "flexible plan" that allows a mass submitter to designate optional provisions that may be included or deleted. A VS mass submitter does not have this ability.

ASPPA recommends that a Pre-Approved Plan mass submitter always have the ability to utilize the "flexible plan" approach.

XII. Retain the Special Rules Applicable to "Standardized" M&P plans

Current procedures apply special restrictive requirements for a "standardized plan."[13] A standardized plan then receives enhanced reliance on its approval letter.[14]

ASPPA recommends the Pre-Approved Plan procedures retain the special restrictive requirements for a "standardized" Pre-Approved Plan with the resulting enhanced reliance on its approval letter.

XIII. Eliminate the Requirement that the VS Practitioner be on the Power of Attorney for Form 5307 Submissions.

[11] *See* Rev. Proc. 2001-49, Sections 4.01 and 4.02.
[12] *See* Rev. Proc. 2011-49, Section 13.02.

[13] *See* Rev. Proc. 2011-49, Section 4.9.
[14] *See* Rev. Proc. 2011-49, Section 19.01.

Current procedures require that an employer requesting a determination letter for a VS plan using Form 5307 allow the VS practitioner to act as an authorized representative of the employer with respect to the request. The employer uses Form 2848 for this purpose. This requirement is unnecessary when an employer authorizes another representative (generally in-house or local counsel) to represent the employer. Generally, the other representative has worked directly with the employer on the plan language that modifies the VS plan (thus, the reason for the need for a determination letter) and answers all inquiries from the IRS relating to the Form 5307 submission. The VS practitioner does not become involved at this level. The need to name the VS practitioner as an authorized representative in addition to another authorized representative is unnecessary and may be a deterrent to some employers filing determination letters on Form 5307. In some cases, the requirement may cause the employer to submit for a determination letter using Form 5300 requiring an extensive IRS review.

ASPPA recommends that the IRS eliminate the requirement that a plan sponsor requesting a determination letter for a VS plan using Form 5307 must allow the VS practitioner to act as an authorized representative of the plan sponsor with respect to the request.

XIX. Additional Enhancements to the Pre-Approved Plan Program

While the major focus of this letter relates to combining the M&P and VS programs into a consolidated Pre-Approved Plan Program, ASPPA has additional recommendations for enhancements to the Pre-Approved Plan Program.

A. Permit More Incorporation by Reference in Plan Documents.

Current procedures contain many restrictions on a pre-approved plan's ability to incorporate statutory and regulatory provisions by reference. Because many statutory and regulatory provisions are quite lengthy and complex, a plan document cannot capture all legal nuances. In many cases, the plan sponsors and practitioners must still consult regulatory and other guidance provided outside of the plan document to properly operate and administer the plan. In addition, any time a regulation or other guidance is subsequently issued that contradicts the provisions of the plan, the plan must be amended to conform to the new guidance.

ASPPA recommends that the IRS permit, but not require, Pre-Approved Plans to incorporate statutory and regulatory provisions by reference, especially provisions required for ADP/ACP testing and Code sections 401(a)(9) and 415.

B. Improve the Existing Separate Trust Approval Process for Use with Pre-Approved Plans

Some corporate trustees (i.e., independent financial institutions) require employers adopting pre-approved plan documents to use custom trust language if the institution is serving as plan trustee. Current IRS procedures require that each mass submitter submit all custom trust documents that an employer may use with its pre-approved plans. This submission requirement results in the same trust document being submitted numerous times by the different mass submitters resulting in duplicate reviews and wasted IRS time.

ASPPA recommends that the IRS adopt procedures that would provide that the trustee is responsible for filing any custom, separate trust with IRS. After approval, any adopting employer could use the trust with any pre-approved document. ASPPA would be pleased to work with the IRS and trustees in working out the details of the program.

C. Allow Combination of Profit Sharing and Money Purchase Plans within the Same Adoption Agreement or Text-Based document.

Under current procedures, Pre-Approved Plan adoption agreements cannot combine profit sharing plan language with money purchase plan language even though the provisions of each plan are very similar.

ASPPA recommends that the IRS allow the combination of basic, non-deferral profit sharing and money purchase plan provisions into a single adoption agreement or text-based document. This could produce a significant cost savings and reduce IRS review time.

D. Remove the Early Submission Deadline for Mass Submitter Filings

Current procedures require mass submitters to submit their defined benefit plans by October 31 of the year in which the submission cycle begins for a particular pre-approved plan. For example, the mass submitter deadline for pre-approved defined benefit plans for the current cycle is October 31, 2013. ASPPA submitted a separate comment letter requesting an extension of this specific deadline. ASPPA believes, however, that it would be beneficial to eliminate entirely the early submission deadline for mass submitter plans.

The mass submitter submission deadline has been extended for every pre-approved plan cycle since the cycles were established. The reasons for the extensions have varied. Regardless of the reasons, the process of releasing formal guidance extending the deadline consumes IRS resources. More importantly, a delayed deadline may be more appropriate for mass submitter plans than for non-mass submitter plans. The reason for the early submission deadline was to provide extra time for IRS reviewers as mass submitter plans go through a two-step review process. In addition, time must be provided to review plans that are based on a mass submitter but are not identical to the mass submitter. However, mass submitters must circulate drafts of their plans to a large number of potential sponsors to ensure the plan is suitable for their use. In many cases, modifications are made to enable these entities to be word-for-word adopters. This process is time-consuming but in the end, benefits the IRS in that the mass majority of entities ultimately end up being word-for-word adopters. Thus, providing additional time to enable mass submitters to adjust their plans to ensure more entities can be word-for-word adopters is beneficial for the Pre-Approved Plan Program.

ASPPA recommends that the IRS eliminate the early submission deadline that is applicable to mass submitters.

These comments were prepared by ASPPA's Plan Documents Committee of the Government Affairs

Committee, Elizabeth Hallam, CPC, Chair, and primarily authored by John Griffin, JD, LLM, APM and Robert Richter, JD, LLM, APM. Please contact Craig Hoffman, General Counsel and Director of Regulatory Affairs at (703) 516-9300 if you have any comments or questions regarding the matters discussed above. Thank you for your consideration of these comments.

Sincerely,

/s/
Brian H. Graff, Esq., APM
Executive Director/CEO

/s/
Judy A. Miller, MSPA
Chief of Actuarial Issues

/s/
Craig P. Hoffman, Esq., APM
General Counsel

/s/
John R. Markley, FSPA, Co-Chair
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LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
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Notice 2013-22

MAY - 2 2013

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April 30, 2013

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: **2013-2014 Guidance Priority List**

Sir/Madam:

This letter is in response to Notice 2013-22 and the Department of Treasury and the Internal Revenue Service's invitation for public comment on recommendations for items that should be included on the 2013-2014 Guidance Priority List. We appreciate the opportunity to provide input to formulate a guidance plan that focuses on guidance items that are important to taxpayers and tax administration.

As a Section 501(c)(3) membership association encompassing more than 350 grantmaking organizations, The Council of Michigan Foundations ("CMF") strongly urges the Department and Service to include in its Guidance Priority List guidance relating to program-related investments ("PRI" or "PRIs"). PRIs are an important, yet underutilized vehicle by which grantmakers may accomplish their charitable purposes. PRIs are underutilized, however, due to minimal guidance regarding qualifying investments and lack of a timely process for approving PRIs.

In 2012, the IRS issued proposed amendments to 26 C.F.R. § 53.4944-3 concerning PRIs. We expressed our comments to the amendments in a letter dated July 16, 2012, a copy of which is attached. We request that the Department and Service consider our letter and recommended course of action for improving the guidance relating to PRIs as part of the 2013-2014 Guidance Priority List.

Additionally, we recommend that further guidance be provided with respect to jeopardizing investments under Section 4944 of the Internal Revenue Code (the "Code"), and offer one other suggestion to allow private foundations to share rulings related to PRIs.

First, we request that the Service issue guidance that a mission-related investment ("MRI") made primarily for charitable purposes is not a jeopardizing investment under Section 4944 of the Code. A "mission-related investment" is a commonly used term among grantmakers and refers to an investment made by a charitable organization to further one or more social objectives. Often, mission-related investments are made primarily for charitable purposes, and as such, are similar to PRIs in that the primary purpose of the investment is to accomplish one or more of the purposes described in Section 170(c)(2)(B). However, MRIs differ from program related investment in that the decision to make the investment is treated primarily as an investment decision rather than a programmatic decision by the foundation. Also, an MRI, whether or not made primarily for charitable reasons, is not treated as a qualifying distribution under Section 4942 of the Code.

Section 4944 of the Code and the regulations thereunder impose taxes on investments made by private foundations which jeopardize charitable purposes. 26 C.F.R. § 53.4944-1 contains care and prudence standards for making a determination as to whether an investment is a jeopardizing one. Guidance is requested to clarify that a mission-related investment made primarily for charitable purposes, or more broadly, any investment, the primary purpose of which is to accomplish one or more of the purposes described in Section 170(c)(2)(B), is not a jeopardizing investment under Section 4944 of the Code.

Finally, as described in the attached letter, we previously requested that the Service amend the regulations to allow rulings relating to PRIs to be relied upon by other parties. While we still urge the Service to give consideration to this suggestion, we offer one other recommendation regarding reliance on PRI rulings.

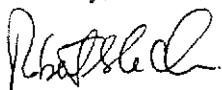
As you know, currently the Code and revenue procedures indicate that a taxpayer may not rely on a letter ruling issued to another taxpayer or use another taxpayer's written determination as precedent. At least with respect to PRIs, this prohibition on reliance is especially frustrating. Often with economic development projects where a project cannot be financed on traditional commercial terms, multiple foundations may make substantially identical PRIs in the same project. We ask that the Service consider a procedure which would allow a ruling or determination issued to one foundation to be shared among, and relied upon by, foundations investing in the same project so long as the investments are made on substantially similar terms.

For example, assume XYZ Foundation applies for a private letter ruling that its investment in an urban investment fund will qualify as a PRI. The fund will make loans to growth-oriented businesses in target urban core areas. The target businesses face obstacles to traditional financing by being above the credit risk threshold for commercial bank loans and below the size and return threshold for other mezzanine financing. The fund's principal purpose in making the loans is charitable, and more specifically, is intended to promote economic development, relieve the underprivileged, eliminate prejudice and discrimination and combat community deterioration. The loans significantly further the accomplishment of XYZ Foundation's exempt activities and would not have been made but for such relationship between the loans and XYZ Foundation's exempt activities. The urban investment fund is organized as a limited partnership and governed by a limited partnership agreement. Each private foundation investor will execute the limited partnership agreement of the fund and participate in the investment on substantially identical terms.

Assume that the Service makes a determination that XYZ Foundation's investment in the urban investment fund constitutes a PRI. We request that this ruling be shared and relied upon by other private foundations that invest in the urban investment fund pursuant to the limited partnership agreement. Alternatively, each private foundation may make a loan to the urban investment fund utilizing template loan documents. Assuming that the Service makes a determination that XYZ Foundation's loan to the urban investment fund constitutes a PRI, we request that this ruling be shared and relied upon by other private foundations that loan to the urban investment fund utilizing the template loan documents.

On behalf of CMF, and our 350 member foundations, we thank you for the opportunity to provide recommendations for guidance on PRIs for inclusion on the 2013-2014 Guidance Priority List. We welcome future dialogue regarding our comments and suggested guidance for PRIs. If we can be of additional assistance, please let me know.

Sincerely,



Robert Collier
President and CEO
Council of Michigan Foundations

cc: Sue Santa, Vice President, Council on Foundations
Ruth Madrigal, Office of Tax Policy, U.S. Department of Treasury
Representative David Camp, Chair Ways and Means Committee
Representative Sander Levin
Senator Debbie Stabenow

Notice 2013-22

APR 5 2013

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March 25, 2013

VIA EMAIL TO: Notice.Comments@irscounsel.treas.gov
Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2013-22

To Whom It May Concern:

CharitablePlanning.com ("CPC") has the following suggestions for IRS to consider as it identifies and prioritizes tax issues to be addressed through published guidance for the fiscal year July 1, 2013 through June 30, 2014.

1. Clarification of the Type II Supporting Organization Regulations

Supporting organizations ("SOs") are described in Section 509(a)(3) of the Internal Revenue Code of 1986, as amended from time to time ("Code"). [Note: All references to "Section" shall be to sections of the Code, unless clearly indicated to the contrary.] Section 509(a)(3) excludes from the definition of "private foundation" those organizations which meet the requirements of Section 509(a)(3)(A), (B), and (C). CPC requests that the Service issue specific guidance regarding the requirements for qualification as an SO under Section 509(a)(3) and the corresponding Treasury Regulations, as follows:

To meet the requirements of Section 509(a)(3)(A), an organization must be organized and operated exclusively to support or benefit one or more "specified" public charities. Section 1.509(a)-4(d)(2)(i) of the Treasury Regulations provides that Type II SOs are permitted to satisfy the "specified public charities" requirement by operating to support or benefit one or more public charities which are designated by class or purpose, rather than by name. However, the Regulations do not make clear the scope and parameters of the permitted charitable class. CPC specifically requests the Service issue guidance clarifying the permitted size and scope of a charitable class of beneficiaries for a Type II SO.

2. **Guidance regarding the ability of an SO's founder to nominate independent trustees**

To meet the requirements of Section 509(a)(3)(C), an organization may not be controlled directly or indirectly by one or more disqualified persons. Section 1.509(a)-4(j)(1) of the Treasury Regulations provides specific examples of circumstances under which an organization will be considered to be controlled by disqualified persons, and notes that indirect control is determined by application of a "facts and circumstances" test. Neither the Code nor the Regulations prohibit an organization's founder from nominating or appointing the organization's independent directors or trustees. In light of the May 6, 2011 ruling by the U.S. Court of Appeals for the D.C. Circuit in *Polm Family Foundation, Inc. v. United States*, CPC urges the IRS to provide specific guidance regarding situations in which an SO's founder can nominate and/or appoint members of the SO's managing board.

3. **Gift/Sale of an Income Interest in a Charitable Gift Annuity to Charity**

An income interest in a charitable gift annuity ("CGA") is a capital asset under Section 1221 of the Code. If the income interest in the CGA were sold, the amount of the gain would be determined under Section 72. To the extent the amount received exceeded the investment in the contract as defined by Section 72(e)(6), it would be included in gross income under Section 72(e)(5)(A).

Section 72, specifically Section 72(e), does not characterize the nature of the gain as ordinary income or capital gain. Although the income interest is a capital asset, some or all of the gain may be characterized as ordinary income if the substitute for ordinary income doctrine applies. *See United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965) and *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958).

In May, 2009 the Service issued Rev. Rul. 2009-13, 2009-21 IRB 1029 and Rev. Rul. 2009-14, 2009-21 IRB 1031, which address the tax consequences of selling and buying preexisting life insurance contracts. The sale of an income interest in a CGA is no different than Situation #2 in Rev. Rul. 2009-13.

A significant number of charities today are requesting that donors gift their income interests in CGAs back to the charity, but the gift annuitants are unsure of the tax consequences. If a hypothetical sale would produce capital gain as set forth in Situation #2, then the gift of the income interest is deductible under Section 170 to the extent of its fair market value (which is the present value of the income interest in the CGA, determined according to actuarial tables). On the other hand, if the gain on a hypothetical sale would produce ordinary income, then the donor's deduction would be limited to his or her investment in the contract.

CPC urges the IRS to issue a Revenue Ruling similar to 2009-13 with respect to a gift of an income interest in a CGA. This would promote sound tax administration by clarifying an uncertain area, in a manner consistent with a very similar asset (that is, life insurance), and

would be easily understandable by taxpayers. The requested guidance can easily be administered on a uniform basis, similar to life insurance. Finally, this will lessen the burdens on taxpayer and the IRS by resolving an issue that otherwise might be the subject of potentially numerous private letter ruling requests.

CPC considers these items of importance to the charitable community, and requests that the Service issue revenue rulings or amend the Treasury Regulations on all topics.

Sincerely yours,

Emanuel J. Kallina, II
Editor-in-Chief
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Emil.Kallina@charitableplanning.com

LEGAL PROCESSING DIVISION
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Notice 2013-22

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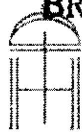

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May 1, 2013

DELIVERED VIA ELECTRONIC MAIL

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224
Notice.Comments@irscounsel.treas.gov

Re: Notice 2013-22: Request to Include an Item on the 2013-2014 Guidance Priority List

To whom it may concern:

We are writing on behalf of the College Savings Foundation[1] in response to the invitation by the Department of the Treasury and the Internal Revenue Service published in Notice 2013-22, 2013-15 I.R.B. 904, for recommendations on items for inclusion on the 2013-2014 Guidance Priority List ("List"). We respectfully request that the List include guidance allowing States to modify their 529 programs to permit account owners up to four changes in investments per calendar year.

Notice 2001-55 states that final regulations under section 529 plans are expected to "permit investments in a § 529 account to be changed annually and upon a change in the designated beneficiary of the account." The IRS further expanded on Notice 2001-55 when it stated in Notice 2009-1 that a 529 plan could permit "a change in the investment strategy selected for a section 529 account twice per calendar year for calendar year 2009."

Notice 2009-1 was very helpful in addressing the short-term uncertainty caused by market volatility during 2008 and in providing American families with greater comfort that they would not be locked into their 529 plan investments. While today's investment climate is somewhat less volatile for families saving for college through 529 college savings plans than it was in 2008, it makes sense to permanently provide more flexibility for families saving for college in both good and bad economic times.

[1] The College Savings Foundation (CSF) is a Washington, D.C.-based not-for-profit organization whose mission is to help American families achieve their education savings goals. A primary focus of CSF is building public awareness of and providing public policy support for 529 plans -- an increasingly vital college savings vehicle. CSF's members include states, investment managers, law firms, accounting and consulting firms, and non-profit agencies that participate in the sponsorship or administration of 529 college savings plans.

Permitting investment changes up to four times per year would provide families with some certainty that they will be able to rebalance their portfolios as needed. Additionally, the sense that 529 plan investments are "locked-in" by the current rule could even discourage some families from beginning to save for college. We need to do all we can to help American families save for college, and providing additional investment flexibility would help achieve that goal.

We appreciate your consideration of this request. If we may provide any additional information or answer any questions, please contact Randy Hardock at rhhardock@davis-harman.com or Barbara Pate at bapate@davis-harman.com. We can also be reached by telephone at (202) 347-2230.

Sincerely,

Randolf H. Hardock

Barbara A. Pate

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Notice 2013-22

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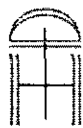

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May 1, 2013

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Internal Revenue Service
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Washington, D.C. 20224
Notice.Comments@irscounsel.treas.gov

Re: Request to Include an Item on the 2013-2014 Guidance Priority List

To whom it may concern:

I am writing on behalf of the National Thoroughbred Racing Association and the American Horse Council in response to the invitation by the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "Service") published in Notice 2013-22, 2013-15 I.R.B. 904, for recommendations on items that should be included on the 2013-2014 Guidance Priority List. For the reasons discussed below and in the attached white paper, we respectfully request that the 2013-2014 Guidance Priority List include guidance changing the definition of "amount wagered" in determining pari-mutuel withholding and reporting.

Background

The current rules that apply to winnings from wagering on horse racing have been in place for many years. However, they do not reflect appropriate or equitable withholding and reporting for the way most wagering is done today.

Section 3402(q)(3)(C)(ii) of the Code requires withholding if the wagering proceeds are more than $5,000 from "a wagering transaction in a parimutuel pool with respect to horse races, dog races, or jai alai if the amount of such proceeds is at least 300 times as large as the amount wagered."

Treasury regulations provide that gambling winnings are reportable on Form W-2G if the amount paid with respect to the wager is $600 or more and the proceeds are at least 300 times the amount of the wager.[1]

[1] *See* Treas. Reg. § 31.3406(g)-2(d)(3); *see also* PLR 7823066 (March 13, 1978).

The withholding requirement came into law in 1976 and, when enacted, applied to proceeds of more than $1,000. The threshold was later increased to $5,000. The reporting requirement was in effect at the time the withholding requirement was enacted in 1976.

The longstanding interpretation of what is considered as the "amount wagered" means that no matter how many combinations a patron bets into a pool in an attempt to have a winning ticket, only the cost of the one winning combination is considered as the amount wagered for withholding and reporting purposes. It does not take into account other wagers involving other combinations placed in that same pool which did not produce any winnings.

For example, in 1978, the Service ruled in PLR 7823066 that:

> We conclude, therefore, that your multiple wager $6 box bet ticket must be considered to be six individual $1 bets and not one $6 bet for purposes of computing the amount to be reported or withheld. Winnings on a $6 box bet must be reported if they are $600 or more and if the winning combination pays off at 300 times the $1 bet; and Federal income tax must be withheld if the winnings amount to more than $1000 after the price of the wager ($1) has been subtracted.

Similarly, the 2013 *Instructions for Forms W-2G and 5754*, in explaining how to treat multiple wagers in the same pari-mutuel pool, restate almost verbatim what was concluded in PLR 7823066.

Problem and Requested Guidance

For a wager to pay 300 to 1 odds or higher, the wager must be on some combination of horses coming in the exact order or coming in first in several races. A wager on a single horse to come in first, second, or third will not pay 300 to 1 or more of the amount of the wager. Most pari-mutuel wagering on horse racing today involves picking a combination of horses to come in the exact order, *e.g.*, an Exacta, Trifecta, Superfecta, or Pick 6. To win, a bettor most often places wagers on numerous combinations in hopes of having the one single combination that pays off. However, as explained above, the total wagers placed on the numerous combinations are not taken into account for purposes of determining the bettor's winnings that are subject to withholding. As a result, a larger amount will be withheld than what should have been withheld if winnings reflected the total amount wagered. Attached to this request for guidance is a white paper describing in more detail the problem, a numerical illustration of the problem, and a description of our request for guidance.

In order to achieve more appropriate withholding and reporting to reflect the way most wagering is done today, we respectfully request that the 2013-2014 Guidance Priority List include guidance providing that for purposes of withholding pursuant to section 3402(q)(3)(C) of the Code, and reporting pursuant to Treas. Reg. § 31.3406(g)-2(d)(3), the "amount wagered"

should include the total amount wagered by the recipient of the winning proceeds into the pari-mutuel pool from which such proceeds are paid.

We appreciate your consideration of this request. If we may provide any additional information or answer any questions, please contact Tad Davis at tadavis@davis-harman.com or by phone at (202) 347-2230.

Sincerely,

Thomas A. Davis

Attachment

Request to Change Definition of "Amount Wagered" In Determining Pari-Mutuel Withholding and Reporting

Problem

The pari-mutuel industry is burdened by an inequitable tax law that requires racetracks and other wagering facilities to withhold federal taxes on winnings over $5,000 if the proceeds are at least 300 times the "amount wagered." (*See* Section 3402(q)(3).)

The 2013 Instructions for Forms W-2G and 5754 state: "For multiple wagers sold on one ticket, such as the $12 box bet on a Big Triple or Trifecta, the wager is considered as six $2 bets and not one $12 bet for purposes of computing the amount to be reported or withheld. Winnings on a $12 box bet must be reported if they are $600 or more, and federal income tax must be withheld if the proceeds total more than $5,000...." (*See also* Private Letter Ruling 7823066.) This means that a bettor who places a $10 bet on 200 different combinations in the Trifecta pool and wins on one of those combinations can only count $10 as the amount wagered even though in fact the person has bet $2,000.

In part, due to current tax laws, U.S. wagering on pari-mutuel horse racing has declined from a high of $15.18 billion in 2003 to $10.87 billion in 2012. The pari-mutuel horse racing industry – representing nearly 1,000 off-track wagering service sites, as well as some 200 racetracks – has lost market share as horseplayers migrate to other forms of gambling entertainment that do not withhold on winnings over $5,000. This migration is not because of a desire to avoid taxes, but because of over-withholding.

Proposed Solution

For purposes of withholding pursuant to Section 3402(q)(3), the "amount wagered" would include the total amount wagered by the recipient of the winning proceeds into the pari-mutuel pool from which such proceeds are paid. For example, if a bettor places 10 bets into a Trifecta pool on 10 different combinations of the three horses that will come in first, second, and third, the cost of all of those bets would be included in the amount wagered for purposes of withholding.

Pari-Mutuel Pools

There is a separate pool for every type of bet that is made on a race. For example, every bet made on a horse to win the race goes into the Win pool, every bet that is made on a horse to finish second goes into the Place pool, and every bet on a horse to finish third goes into the Show pool.

There are separate pools in each race for all Exacta bets (which require picking the horses that finish first and second in the exact order of finish), Trifecta bets (which require picking the first three horses in the exact order of finish), Superfecta bets (which require picking the first four horses in the exact order of finish), and pools for any other types of bets that are available on any given race.

There are also separate pools for bets that are made on horses in different races such as the Pick 3 or the Pick 6, which requires picking the winners in several designated consecutive races. When a person has a winning ticket, that person shares the amount in that particular pool (less the takeout, defined below) with everyone else who has a winning ticket in that pool in proportion to the amount that each winner has bet into that pool.

It is almost impossible for the betting odds from a bet made on a single horse to be 300 to 1 or higher. However, it is quite common for the odds to be over 300 to 1 when picking more than one horse to finish in a particular order, especially when the bet involves more than two horses. Additionally, when people make these types of bets, it is common for them to bet on a number of different combinations to increase their chances of winning.

The Withholding Tax Is Inequitable and Confiscatory

As illustrated by the examples that follow, the definition of the "amount wagered" has a great impact on the determination of whether the winnings are subject to withholding.

Example A

Assume an individual decided to wager a Trifecta (selecting the first-, second-, and third-place finishers in a race, in exact order). To improve his or her chances of winning, the individual selects a group of seven horses in the race and requests a "Trifecta box." By betting a box, the person wins if any three of the seven horses finishes one-two-three (in any order). A seven-horse Trifecta box involves 210 different mathematical combinations. If the person bets $20 on each combination, the total amount wagered is $4,200 ($20 x 210). After the race, the person held a winning ticket that paid $6,100 (which is odds of 305 to 1).

Under the current IRS withholding rules, the racetrack would withhold $1,520 since the rules treat the $20 paid for the **one** winning combination as the **only** amount wagered. The withholding is computed as follows:

$6,100 Proceeds from wager
($20) Amount wagered
$6,080 Winnings
X 25% Automatic withholding
$1,520 Withholding tax

The individual, however, has really only won $1,900 ($6,100 winnings less $4,200 wagered). Consequently, after the withholding tax was taken out, the person was left with a net of only $380, making the withholding rate 80% of the actual winnings.

Example B

The pay-off computations for the winning Trifecta outlined in Example A are changed by defining the "amount wagered" as the actual dollars wagered by that person into the Trifecta pool for that race. The identical wager, in this scenario, results in no withholding as the twin tests of winnings over $5,000 and odds of 300 to 1 or more are not met:

$6,100 Proceeds from wager
$4,200 Amount wagered
$1,900 Winnings (less than the $5,000 threshold)

The person may be able to get back the over-withholding in Example A by claiming the balance of what was bet on the Trifecta as a miscellaneous itemized deduction on his or her tax return when it is filed the following year. But withholding by this procedure takes that money out of the wagering cycle for a long time. Further, if the person is subject to the Alternative Minimum Tax (AMT), as many Americans

are, he or she would not be able to claim the loss against the winnings because miscellaneous itemized deductions are not allowed to be deducted in computing AMT. It is also possible that the bettor would not be able to claim the losses against the winnings if that person does not itemize when filing his/her return but uses the standard deduction, or if the person is subject to limits on the amount of his/her deductions due to income. Not only is this unfair and confiscatory to the person who won, it has serious detrimental ramifications for the racetracks and other waging facilities, as is explained below.

Impact of Withholding

Statistics show that each pari-mutuel dollar returned to the bettor in the form of winnings is re-bet seven times throughout the course of a day. A pari-mutuel dollar wagered on a track on an exotic wager is generally apportioned as follows, with taxes, track operations, purses, and other programs collectively defined as "takeout":

Returned to bettors in the form of winnings	80%
State and local taxes	2%
Track operations	9%
Purses	8%
Other programs	1%
Total	100%

As the figures above illustrate, a diminution in pari-mutuel "churn" (re-betting of a pari-mutuel dollar) by the automatic 25% withholding on winnings of over $5,000 at odds of 300 to 1 or more also impacts the collection of additional tax revenue at the local, state and federal levels, which is paid by each racetrack operator on its net revenues.

Why Is the Racing Industry Seeking this Change Now?

Over the past decade, the number and type of non-pari-mutuel forms of wagering that offer "mega" prizes have grown substantially. Native American casinos, riverboat casinos, lotteries and land-based casinos all offer some form of jackpot-style payout. Horse racing has developed its own wager types that carry the potential to produce large payouts to compete against lotteries or progressive slot machines. Since the introduction of the Trifecta in 1971, followed by wagers such as the Pick 6 (winners of six consecutive races) in the 1990s, horse racing fans have steadily migrated away from simple Win, Place and Show bets to combination or exotic wagers that offer the prospect of large pay-offs.

Exotics are now the most popular form of wagering. For example, bettors wagering on Kentucky Derby day typically pay collectively about $2.5 million in federal withholdings for exotic wagers placed on one race card. A $2 Trifecta bet on the horses that finished first, second, and third in the 2012 Kentucky Derby paid $3,065, but virtually all of those who won the Trifecta bet substantially more than $2 to have a winning ticket.

Every one of horse racing's 1,200+ wagering service sites must calculate, track, withhold, and forward to the IRS any federal tax due on winnings of over $5,000. This process requires the expenditure of thousands of man-hours processing IRS withholdings and producing Forms W-2G. Lotteries avert the IRS withholding by offering tickets that pay less than $5,000 or substantially more than that amount (with relatively few winners and prizes typically paid out as annuities).

Approximately 30 million Americans wager on pari-mutuel horse racing each year. Due to the growing popularity of exotic wagering across all fan groups, virtually any horseplayer may find himself or herself standing in the "IRS line" at a racetrack. Such an experience places an undue burden on horseplayers and is a clear disincentive for them to continue to wager on horse racing.

Nowhere is this more true than at a "racino" – a combination racetrack and casino – where players experience no withholding on casino-style gaming, but when wagering on horse racing in the same facility are subject to automatic withholding if winnings are over the threshold and the odds are at least 300 to 1. In 2012, this bifurcated system was in place at 44 racinos in 12 states, including major racing states such as Florida, New York, Louisiana, and Pennsylvania.

Current Withholding and Reporting Requirements for Various Types of Gambling Winnings

Type of Wagering	**Withholding Requirement**	**Reporting Requirement**
Tournament Poker Winnings	None	Over $5,000
Keno	None	$1,500 or more
Bingo and Slots	None	$1,200 or more
Casino Games (Blackjack, etc.) *	None	None
Pari-Mutuel Wagering	**Over $5,000 and odds of at least 300 to 1**	**$600 or more and odds of at least 300 to 1**
Lotteries and Sweepstakes	Over $5,000	$600 or more and odds of at least 300 to 1

* *While theoretically subject to withholding and reporting, if the proceeds are over $5,000 or $600 and are at least 300 times the amount wagered, in practice there is no withholding or reporting because table game transactions do not result in proceeds that are at least 300 times the amount wagered. See, e.g., IRS PLR 8710006.*

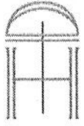
Current regulations should be updated to reflect the current wagering practices in horse racing.

Reporting Requirements Should Be Updated

Current reporting requirements also need to be updated to reflect the realities of pari-mutuel wagering today. As outlined above, the reporting requirements vary by type of wagering. They range from a threshold of $600 for pari-mutuel winnings to a threshold of $5,000 for tournament poker winnings. The reporting requirements for pari-mutuel winnings have been in place for more than 30 years and pre-date the enactment of withholding on pari-mutuel winnings in 1976.

The most recent IRS withholding change in this area took place in October 2007, when the IRS established a reporting threshold of $5,000 and determined that no withholding was required for tournament poker winnings. (*See* Revenue Procedure 2007-57 and IRS News Release IR-2007-173.) A standardized level of reporting and withholding, consistent with the rules established for tournament poker, would bring greater uniformity, simplicity and equity to the tax code for gambling winnings. Additionally, the determination of the "amount wagered" should be the same for pari-mutuel reporting purposes as proposed herein for withholding.

Notice 2013-22



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LEGAL PROCESSING DIVISION
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May 1, 2013

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
1111 Constitution Avenue, NW
Washington, D.C. 20224
Notice.Comments@irscounsel.treas.gov

Re: Recommendations for 2013-2014 Guidance Priority List

To whom it may concern:

We are writing on behalf of the Committee of Annuity Insurers (the "Committee") in response to the invitation by the Department of Treasury and the Internal Revenue Service (the "Service") in Notice 2013-22[1] for public comment on recommendations of items for inclusion on the 2013-2014 Guidance Priority List. The Committee is a coalition of life insurance companies formed in 1981 to participate in the development of federal policy with respect to annuities. The Committee's current 28 member companies represent approximately 80% of the annuity business in the United States. A list of the Committee's member companies is attached.

As explained in more detail below, the Committee respectfully requests that the 2013-2014 Guidance Priority List include the following items:

1. guidance on qualifying longevity annuity contracts ("QLACs");
2. guidance on two matters involving annuities and long-term care insurance contracts;
3. guidance on group trusts under Rev. Rul. 81-100[2] and Rev. Rul. 2011-1;[3]

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[1] 2013-15 I.R.B. 904.

[2] 1981-1 C.B. 326.

[3] 2011-2 I.R.B. 251.

4. guidance under sections 3405 and 6047(d) on the reporting and withholding obligations of life insurance companies in connection with the escheatment of annuity contracts to states;

5. guidance on the circumstances in which annuity payments constitute substantially equal periodic payments ("SEPPs") within the meaning of sections 72(t)(2)(A)(iv) and 72(q)(2)(D);[4] and

6. guidance on two matters relating to the treatment of annuities under section 401(a)(9).

Qualifying Longevity Annuity Contracts (or QLACs)

On February 2, 2012, the Treasury Department and the Service released proposed regulations under section 401(a)(9) relating to the purchase of QLACs under certain types of qualified retirement plans, including individual retirement annuities and accounts ("IRAs").[5] A number of comment letters were filed, including one from the Committee, and a hearing was held on June 1, 2012. The proposed regulations would remove an impediment under section 401(a)(9) that effectively precludes the offering of longevity insurance in these types of arrangements. In removing this impediment, the regulations would facilitate greater access to lifetime income options in retirement arrangements and help Americans better prepare for their retirement. The regulations would affect individuals for whom a QLAC would be purchased under these retirement arrangements, plan sponsors and administrators, IRA trustees and custodians, and insurance companies that issue QLACs. Finalization of the regulations is on the 2012-2013 Guidance Priority List and the Committee requests that this item be carried over to the 2013-2014 Guidance Priority List.

Annuities and Long-Term Care Insurance Contracts

There are several issues on which published guidance is needed to help clarify ambiguities in the federal income tax treatment of transactions involving annuities and qualified long-term care insurance ("QLTCI") contracts. Such transactions are gaining popularity as Americans age and more individuals seek the protections that these insurance products provide. As a result, guidance on these issues would resolve significant issues relevant to many taxpayers and the insurance companies which issue and administer these products. In addition, such guidance would promote sound tax administration by facilitating uniformity in how life insurance companies tax report the relevant transactions and by facilitating better understanding by individual taxpayers and their advisors of the tax consequences of those transactions.

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[4] Unless otherwise indicated, each reference to a "section" means a section of the Internal Revenue Code of 1986, as amended.

[5] 77 Fed. Reg. 5443 (Feb. 3, 2012).

(a) Exchanges Involving Annuities and QLTCI Contracts

The 2011-2012 and the 2012-2013 Guidance Priority Lists included an item regarding guidance on "exchanges under §1035 of annuities for long-term care insurance contracts." The Committee requests that the Treasury Department and the Service carry this item over to the 2013-2014 Guidance Priority List, as there are several issues on this topic for which guidance is still needed. In 2011, the Service issued Notice 2011-68,[6] which requested public comment on, *inter alia*, the treatment of exchanges of annuity contracts for QLTCI contracts. In November 2011, the Committee filed a letter with the Service in response to the Notice. In our letter, we asked for guidance on the following issues involving annuity-for-QLTCI contract exchanges.

- *Partial exchanges of deferred annuities*—Partial exchanges are often the only effective means of exchanging an annuity for a QLTCI contract because the latter type of contract typically requires multiple premium payments over time. Notice 2011-68 was helpful in confirming that a partial exchange of a deferred annuity for a QLTCI contract is entitled to nonrecognition treatment under section 1035, and that the adjusted basis, under section 1031(d), of a QLTCI contract received in a tax-free section 1035 exchange of an annuity generally carries over from the contract being exchanged. The Notice did not, however, address other significant issues that can arise with respect to such partial exchanges. In particular, guidance is needed (a) to confirm how the "investment in the contract" and adjusted basis is apportioned between the deferred annuity and QLTCI contract, and (b) to confirm that Rev. Proc. 2011-38,[7] regarding the partial exchange of an annuity for another annuity, does not apply to partial exchanges involving an annuity-QLTCI combination contract or a stand-alone QLTCI contract.

- *General requirements for tax-free exchanges of annuities for QLTCI contracts*—The regulations under section 1035 elaborate on the requirements that must be met in order for an exchange to receive nonrecognition treatment under that section. The regulations were promulgated in 1956,[8] however, and have not been updated to reflect the 2006 amendments to section 1035 that permit tax-free exchanges involving QLTCI contracts.[9] Thus, questions can and do arise regarding what requirements apply to such exchanges. For example, it is not clear how, if at all, the requirement in the regulations that exchanges "relate to the same insured" applies in an exchange of an annuity for a QLTCI contract.[10] As a result, life insurance companies, policyholders and financial advisors cannot be certain what requirements must be met to assure that

[6] 2011-36 I.R.B. 205.

[7] 2011-30 I.R.B. 66.

[8] T.D. 6211, 1956-2 C.B. 29.

[9] The Pension Protection Act of 2006, Pub. L. No. 109-280, § 844 (2006) ("PPA 2006").

[10] Treas. Reg. section 1.1035-1 (flush language).

such exchanges are tax-free. The regulations need to be updated to reflect these changes in law.

- *Exchanges of payout annuities for QLTCI contracts*—Notice 2011-68 asked several questions about the need for guidance on the partial exchange of the right to some or all of the payments under an immediate annuity contract for a QLTCI contract. In particular, it asked (1) how is such an exchange effected, (2) under what circumstances should it be treated as tax-free under section 1035, and (3) how should the basis and "investment in the contract" be apportioned between the QLTCI contract received in the exchange and the rights retained in the annuity after the exchange? Guidance on these issues is needed because in many cases an exchange of a payout annuity (or a series of partial exchanges involving a payout annuity) may be the most viable method of exchanging an annuity for a QLTCI contract that requires multiple premium payments for long durations, possibly for life.

The Committee continues to believe that each of the foregoing issues needs to be addressed in guidance. As a result, we ask the Treasury Department and the Service to carry over last year's general guidance item to this year's Guidance Priority List, and in doing so ensure that each of the foregoing specific issues is considered as part of the guidance item.

(b) Combination Annuity-QLTCI Contracts

Since 2009-2010, the Guidance Priority List has included an item regarding "guidance on annuity contracts with a long term care insurance feature or rider." While Notice 2011-68 provided helpful guidance on a few outstanding questions, other significant questions remain and need to be addressed through additional guidance. In our November 2011 comment letter on Notice 2011-68, the Committee identified a number of such additional issues needing guidance.

- *Tax-free nature of QLTCI benefits*—By their nature, annuity-QLTCI combination contracts involve certain interactions between the QLTCI and annuity benefits under the contract. For example, a QLTCI rider to a deferred annuity might provide for QLTCI benefits that reduce the annuity's cash value by some amount. Based on the statutory structure and legislative history, the general understanding is that such QLTCI benefits are excludable from gross income in the same manner as other QLTCI benefits, irrespective of their effect on the annuity's cash value. The Service has confirmed this conclusion in two recent private letter rulings.[11] However, there is no published guidance on this point on which all taxpayers can rely.

- *Effect of QLTCI benefits on "investment in the contract"*—Because benefits paid under the QLTCI portion of an annuity-QLTCI combination contract are excludable from gross income in the same manner as other QLTCI benefits irrespective of their effect on the annuity portion of the contract, a question arises whether the payment of such excludable benefits affects the "investment in the contract" of the annuity

[11] PLR 201213016 (Dec. 20, 2011); PLR 200919011 (Feb. 2, 2009).

portion. Although the PPA 2006 did not explicitly address this question, the Service concluded in a 2009 private letter ruling that such rider benefits will reduce the investment in the contract of the annuity portion of the contract.[12] This view is not shared by the Committee. Moreover, the Committee is concerned that some taxpayers may feel compelled to follow the view expressed in the 2009 private letter ruling, while others may adopt a contrary view. In light of this possibility, and given the centrality of this issue to ensuring the proper tax reporting and treatment of payments from an annuity-QLTCI combination contract, published guidance is needed.

Like the section 1035 issues discussed above, the Committee continues to believe that each of the foregoing issues regarding annuity-QLTCI combination contracts needs to be addressed in guidance. As a result, we ask the Treasury Department and the Service to carry over last year's general guidance item to this year's Guidance Priority List, and in doing so ensure that each of the foregoing specific issues is considered as part of the guidance item.

Group Trusts Under Rev. Rul. 81-100 and Rev. Rul. 2011-1

The 2011-2012 and the 2012-2013 Guidance Priority Lists included an item regarding guidance on group trusts under Rev. Rul. 81-100, as modified and updated by Rev. Rul. 2011-1. In 2012, the Service issued Notice 2012-6. This notice addressed some issues that Rev. Rul. 2011-1 identified. It did not, however, address an important issue on which Rev. Rul. 2011-1 requested comments: whether life insurance company separate accounts underlying annuity contracts purchased by qualified plans described in section 401(a) and either held as an investment by a section 501(a) tax-exempt trust or used in lieu of a trust under section 401(f) ("qualified plan separate accounts") should be permitted to invest in group trusts.

Qualified plan separate accounts have long been permitted investors in group trusts, and such investments are widespread. Also, such investments are clearly supported by section 401(f) and the policy underlying Rev. Rul. 81-100. Guidance confirming that life insurance company separate accounts may invest in such a group trust is very important not only to the life insurance companies that issue annuity contracts investing in group trusts, but also to the group trusts that have permitted such investments, as well as all the other qualified plans invested in these group trusts. Accordingly, the Committee asks that this item be carried over to the 2013-2014 Guidance Priority List.

Reporting and Withholding on Unclaimed (or "Escheated") Annuity Benefits

All states require financial institutions, including life insurance companies, to report when personal property has been abandoned or unclaimed after a period of time specified by state law, often three or five years. Before property, including an annuity contract, can be considered abandoned or unclaimed, the insurer must make a diligent effort to try to locate the contract owner. If the insurer is unable to do so, and the contract has remained inactive for the period of time specified by state law, the insurer must report the property to the state where the property is held. The state then claims the property through a process sometimes referred to as

[12] PLR 200919011 (Feb. 2, 2009).

"escheatment," whereby the state takes custody of the property. At that time, the state will take steps to locate or notify the owner and after a period of time specified by state law, the state can liquidate the property and deposit the proceeds into a general fund that can be claimed by rightful owners. In recent years, states and insurers have focused more on the escheatment process. There have always been a number of questions regarding what, if any, reporting and withholding obligations an insurance company has with respect to annuity contracts or proceeds from these contracts in such circumstances, but the issue has assumed a greater importance as the volume of escheated annuity contracts has increased. The Committee requests that the Treasury Department and the Service include guidance on this issue in the 2013-2014 Guidance Priority List.

Annuity Payments as SEPPs

Prior to the issuance of a private letter ruling in 2011, life insurance companies and financial advisors widely believed that annuity payments that satisfy the required minimum distribution ("RMD") rules under Treas. Reg. section 1.401(a)(9)-6 also constitute SEPPs, thereby exempting the annuity payments from the 10% penalty tax that otherwise would apply if the taxpayer is younger than age 59½. This belief was based on Q&A-12 of Notice 89-25,[13] modified by Rev. Rul. 2002-62.[14] In PLR 201120011,[15] however, the Service took the position that the RMD method described in Q&A-12 of Notice 89-25 was superseded by the RMD method described in Rev. Rul. 2002-62.

The significance of the PLR's position is that the RMD method described in Rev. Rul. 2002-62 is limited to contracts with an "account balance," and thus does not encompass annuity payments, which typically are made under a contract without an account balance. Although PLR 201120011 involved the treatment of annuity payments under non-qualified annuities as SEPPs within the meaning of section 72(q)(2)(D), the conclusions and reasoning of the ruling extend to the treatment of annuity payments under annuity contracts used in connection with qualified retirement plans and IRAs as SEPPs within the meaning of section 72(t)(2)(A)(iv). The Service's position that the RMD method of Rev. Rul. 2002-62 excludes annuity payments effectively means that there is no published guidance on when life-contingent annuity payments (or any other form of annuity payments) will constitute SEPPs.

Whether annuity payments constitute SEPPs is a very significant issue for owners (and prospective owners) of annuity contracts, the insurance companies that issue those contracts, and sponsors of employer plans that use commercial annuities to distribute benefits to employees.

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[13] 1989-1 C.B. 662.

[14] 2002-2 C.B. 710.

[15] Feb. 11, 2011.

The Committee requests that the Treasury Department and the Service include guidance on this issue in the 2013-2014 Guidance Priority List.[16]

Treatment of Annuity Payments Under Section 401(a)(9)

As the Treasury Department has recognized in a variety of its actions and policy statements over the last few years, there is a substantial need to encourage and facilitate the use of lifetime income solutions in qualified plans and IRAs. However, the section 401(a)(9) regulations continue to impose barriers to the use of life annuities by plan participants and IRA owners. For the reasons discussed below, the Committee requests that the 2013-2014 Guidance Priority List include guidance on the following two issues, each of which discourages and impedes the use of life annuities by plan participants and IRA owners.

(a) Partial Annuitization

The regulations under section 401(a)(9) set forth different rules for determining the RMD with respect to a retirement plan (including an IRA), depending on whether the interest is in the form of an individual account or an annuity.[17] These rules do not account for the fact that annuity payments that satisfy the annuity rules often exceed the amount that would be required to be distributed under the individual account rules based on the value of the annuity. Stated differently, if an individual takes a portion of his or her interest in a defined contribution plan or an IRA in the form of annuity payments, the RMD with respect to the individual's remaining individual account balance is not reduced to account for any excess annuity payments above what would have been required under the individual account rules. Hence, the individual is forced to take distributions that exceed the RMD that would apply if he or she had not partially annuitized. This result penalizes individuals who partially annuitize their interests in retirement plans, discourages individuals from partially annuitizing their interests in plans, and reduces their financial flexibility.

(b) Increasing Annuity Payments

The regulations under section 401(a)(9) require annuity payments to be non-increasing, subject to certain exceptions.[18] Other than in the case of certain cost of living adjustments, any form of increasing payment under the annuity must meet a minimum income threshold test. This test requires that the total future expected payments, ignoring any increases in the payments, exceed the total value being annuitized.[19] When an older individual (those who are annuitizing

[16] The 2011-2012 and 2012- 2013 Guidance Priority Lists included an item regarding guidance on "exceptions to additional tax under §72(t) on early distributions from retirement plans and IRAs." Guidance under this item has not been issued as of the date of this letter and the scope of this item is unclear.

[17] Treas. Reg. sections 1.401(a)(9)-5 and 1.401(a)(9) - 6.

[18] Treas. Reg. section 1.401(a)(9)-6 Q&A-14(a).

[19] Treas. Reg. section 1.401(a)(9)-6 Q&A-14(c).

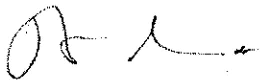
after the required beginning date) decides to annuitize his or her contract, the annuity stream using the contract's payout rates (which typically use different mortality assumptions than the regulations) may not meet the test. This essentially forces these individuals to continue to take withdrawals rather than being able to annuitize. This is true even though the initial annuity payment is *greater* than the amount required to be distributed and subject to income tax under the individual account rules. This problem arises for annuity contracts that increase by a constant percentage each year, *e.g.*, 3% participating annuities, and annuities which allow partial or full commutations. As a result, a number of older individuals who wish to receive the benefit of a life annuity with features that are characterized as increases under the regulations are not able to do so.

The Committee asks that the 2013-2014 Guidance Priority List include guidance on these two issues.

* * * * *

We appreciate this opportunity to offer input on the 2013-14 Guidance Priority List. If you have any questions, or if we can be of any assistance in your consideration of the issues summarized above, please do not hesitate to contact any of the undersigned at 202-347-2230.

Sincerely,



Joseph F. McKeever | Mark E. Griffin | Bryan W. Keene

Counsel to the Committee of Annuity Insurers

Attachment

The Committee of Annuity Insurers
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Suite 1200
1455 Pennsylvania Ave., NW
Washington, D.C. 20004

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Allianz Life Insurance Company, Minneapolis, MN
Allstate Financial, Northbrook, IL
Aviva USA, Des Moines, IA
AXA Equitable Life Insurance Company, New York, NY
Commonwealth Annuity and Life Insurance Co.
(a Goldman Sachs Company), Southborough, MA
Fidelity Investments Life Insurance Company, Boston, MA
Genworth Financial, Richmond, VA
Great American Life Insurance Co., Cincinnati, OH
Guardian Insurance & Annuity Co., Inc, New York, NY
ING North America Insurance Corporation, Atlanta, GA
Jackson National Life Insurance Company, Lansing, MI
John Hancock Life Insurance Company, Boston, MA
Life Insurance Company of the Southwest, Dallas, TX
Lincoln Financial Group, Fort Wayne, IN
MassMutual Financial Group, Springfield, MA
Metropolitan Life Insurance Company, New York, NY
Nationwide Life Insurance Companies, Columbus, OH
New York Life Insurance Company, New York, NY
Northwestern Mutual Life Insurance Company, Milwaukee, WI
Ohio National Financial Services, Cincinnati, OH
Pacific Life Insurance Company, Newport Beach, CA
Protective Life Insurance Company, Birmingham, AL
Prudential Insurance Company of America, Newark, NJ
Symetra Financial, Bellevue, WA
The Transamerica companies, Cedar Rapids, IA
TIAA-CREF, New York, NY
USAA Life Insurance Company, San Antonio, TX

The Committee of Annuity Insurers was formed in 1981 to participate in the development of federal tax and securities law policies with respect to annuities. The member companies of the Committee represent approximately 80% of the annuity business in the United States.

May 1, 2013

Notice 2013-22

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

MAY 2 2013

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

Re: Notice 2013-22 Recommendations for 2013-2014 Guidance Priority List

Ladies and Gentlemen:

We are writing in response to Notice 2013-22, in which the Service invited public comment on items that should be included on the 2013-2014 Guidance Priority List.

Enterprise is a national nonprofit organization that creates opportunity for low- and moderate-income people through affordable housing in diverse, thriving communities. For more than 30 years, Enterprise has introduced neighborhood solutions through public-private partnerships with financial institutions, governments, community organizations and others that share our vision. Enterprise has raised and invested more than $13.9 billion in equity, grants and loans to help build or preserve 300,000 affordable rental and for-sale homes to create vital communities. As a key part of our affordable housing finance work, Enterprise is a leading national syndicator of Low-Income Housing Tax Credits (LIHTC).

Below, we have outlined five guidance issues that we believe impact many transactions and propose solutions that we believe would result in the credit working more efficiently and being more effective. Please note that these are the same items that we submitted last year, but we believe that these issues continue to be important and should be considered in the plan.

Inclusion of Bond Issuance Costs in Eligible Basis: We would like the Internal Revenue Service to reconsider the rule that bond issuance costs, including those associated with construction period bonds, cannot be included in basis.

- TAM 200043015, issued on October 27, 2000, concludes that Bond Issuance Costs cannot be capitalized and included in eligible basis since they are not subject to depreciation, but are amortizable costs. However, while these costs are amortizable, a portion of the amortization would then be capitalized and depreciable under Internal Revenue Code Section 168. Therefore, to the extent these costs would ultimately be depreciable, they would also be includible in eligible basis.
- In many cases, owners use tax-exempt bonds to fund the construction or rehabilitation of the project. In some cases, the bonds are completely paid off at or soon after completion of the project and in other cases, a portion of the bonds are paid off at or near completion of the project, with the balance remaining outstanding for a longer period of time.
- Internal Revenue Code Section 42(d)(1) provides that the eligible basis of a building is its adjusted basis at the close of the first taxable year of the credit period.

- Generally, costs incurred in obtaining a loan are capitalized and amortized over the life of the loan. Internal Revenue Code Section 263A provides that indirect costs allocable to the production of real or tangible property are to be capitalized into the basis of the produced property.
- Such allocable costs would include points and other financing costs associated with a loan used entirely or in part for construction or rehabilitation of the project, as well as interest incurred during the construction or rehabilitation of the project.
- To the extent that these costs are amortizable, the amortization associated with the construction or rehabilitation period would be capitalized under Internal Revenue Code Section 263A.
- In those cases where the bond is a source of construction financing, the points and other costs of the bonds should be treated as an allocable cost and the portion relating to the construction and rehabilitation of the project should be capitalized into the basis of the building, pursuant to Internal Revenue Code Section 263A.

Loss of Low Income Housing Tax Credits upon a Casualty Loss: We would like the Internal Revenue Service to reconsider its position that credits are not allowed for a year to the extent that the building or units are not available for occupancy on December 31st of that year, due to a casualty loss that is not part of a presidentially declared disaster area, even though the owner is in the process of a timely restoration of the damaged units or building.

- Internal Revenue Code Section 42(j)(4) states that there should be no tax credit recapture resulting from a reduction in qualified basis by reason of a casualty loss to the extent that such loss is restored by reconstruction or replacement within a reasonable period established by the Secretary.
- In Revenue Procedure 2007-54, which superseded Revenue Procedure 95-28, the IRS stated that the owner of a building that is beyond the first year of the credit period has suffered a reduction in qualified basis that would cause it to be subject to a recapture or loss of credit will not be subject to recapture or loss of credit if the building's qualified basis is restored within a reasonable period. However, the Revenue Procedure addressed this relief to casualties that resulted from a disaster that caused the President to issue a major disaster declaration since that was the general topic of the Revenue Procedure and it did not address casualty losses that did not result from such disasters.
- In CCA 200134006 and CCA 200913012, the Chief Counsel to the Internal Revenue Service stated that the ability of the owner to claim credits on units while out of service is limited to those casualties resulting from a presidential declared disaster and is not appropriate for a casualty that resulted form some other cause, such as a fire experienced by a specific project, stating that the exception in Revenue Procedure 95-28 was limited to that.
- In the latter case, while recapture does not result if the building or units are restored within a reasonable period of time, if not restored by the end of the year, pursuant to CCA 200134006, no credits are allowed for that year. Although credits would resume for the year in which the project is returned to service, these are credits that the owner would have been entitled to had the casualty not occurred. Credits would be lost for any year in which the

units are not returned to service by the end of the year, regardless of when the casualty occurred, and these credits are not made up later, as in the 11th year, so it is a permanent loss of credits. This result is somewhat punitive to an owner who suffered a loss through no fault of its own, despite acting prudently to restore the unit or building in a reasonable period.

- The distinction provided in CCA 200134006 was based on Revenue Procedure 95-28, which only provided relief in the form of the ability to claim credits during the replacement period if the property was in a location being designated as a major disaster area. However, that distinction is inappropriate. The Revenue Procedure was only dealing with such disaster areas, which is why relief was only given to such an area. In addition, in CCA200134006, it states that "Such an event is quite distinct from the general casualty loss situation confronting property owners." While being in a disaster area can make replacements and restoration more challenging, an owner suffering a casualty loss of any sort has similar challenges.
- We request that the Service consider revising its policy and provide the same treatment for casualty losses that are not located in a presidentially-declared disaster area. In general, tax law provides a time period for replacements to be completed for casualties, even if not located in a disaster area. If restored within that time period, there should be no loss of tax credit, even if the building is not restored until after the end of the year. This was the treatment accorded to casualty losses that occurred in a disaster area. There is no reason why the rule should be different in a disaster area than outside of it. The rules for casualty losses are the same.

Application of the Economic Substance Doctrine: We would like the Internal Revenue Service to issue official guidance that the Economic Substance Doctrine does not apply to tax credit transactions, including the low income housing credit, new markets credit, rehabilitation credit, and the energy credit.

- The Patient Protection and Affordable Care Act and the Health Care and Education Affordability Reconciliation Act codified the common law economic substance doctrine under which federal income tax benefits of a transaction are disallowed if the transaction does not have economic substance or lacks a business purpose, and imposes significant penalties on taxpayers that enter into transactions that lack economic substance.
- The Joint Committee on Taxation description of the economic substance doctrine provides that the doctrine is not intended to disallow tax benefits if the realization of those tax benefits is consistent with the Congressional purpose or plan that the tax benefits are designed to effectuate, such as low income housing, new markets, rehabilitation and energy credit transactions.
- The Joint Committee on Taxation's description is an interpretation and is not part of the Statute. Without formal guidance of the inapplicability of this statute to the programs named above, potential investors will perceive this to be a risk, which can interfere with the effectiveness of the programs.
- We request that the Internal Revenue provide formal guidance that states that the economic substance doctrine provided by The Patient Protection and Affordable Care Act and the Health Care and Education Affordability Reconciliation Act not apply to low income housing, new markets, rehabilitation and energy credit transactions.

Continued qualification of over-income tenants covered by an extended use agreement after a transfer of project: We would like the Internal Revenue Service to issue formal guidance that would state that any household determined to be income qualified at the time of move-in for purpose of the extended use agreement is a qualified household for any subsequent allocation of Internal Revenue Code Section 42 or allowable through the issuance of tax-exempt bonds pursuant to Internal Revenue Code Section 42(h)(4).

- In the Guide for Completing Form 8823 Low-Income Housing Credit Agencies Report of Noncompliance or Building Disposition (Revised October 2009), ("The Guide") the Internal Revenue states that "any household determined to be income qualified at the time of move-in for purposes of the extended use agreement is a qualified low-income household for any subsequent allocation of IRC §42." (p. 4-27)
- This is a reasonable position since these tenants may not be evicted without cause and relocation of the tenants will be very costly and inefficient.
- Rev. Proc. 2003-82 provides a safe harbor that will allow an owner to treat a unit occupied by a tenant whose income exceeds the maximum qualified income as qualified if "The unit has been a low-income unit under §42(i)(3)(B), (C), (D), and (E) from either the date the existing building was acquired by the taxpayer or the date the individuals started occupying the unit, whichever is later, to the beginning of the first taxable year of the building's credit period. Further, the safe harbor provided by the Revenue Procedure provides that in order for the unit to be qualified, "The individuals occupying the units have incomes that are at or below the applicable income limitation under 42(d)(4)(B)(i) on either the date the existing building was acquired by the taxpayer or the date the individuals started occupying the unit, whichever is later."
- The Revenue Procedure does not state that there would be a different result if an extended use agreement were in effect at the time of the transfer. However, since the purpose of the Rev. Proc. was to provide a safe harbor that would allow tenants to qualify in some situations, it presumably was not intended to cover all situations.
- Although The Guide does not have the standing of official guidance from the Office of the Chief Counsel, state agencies and developers rely on it. However, because it is not official guidance, investors and their counsel are reluctant to rely upon it and, in some cases, it forces the owner to relocate tenants that, according to the Service (as stated in The Guide) may not be necessary. This results in additional costs to the owner and displacement of the tenants.
- We request that the Internal Revenue Service issue formal guidance that would be consistent with The Guide.

ENTERPRISE COMMUNITY PARTNERS, INC.
Public Policy Office ▪ 10 G St. NE, Suite 450 ▪ Washington, DC 20002 ▪ 202.842.9190 ▪ www.enterprisecommunity.org

Definition of federally- or state-assisted building for purposes of qualification for exception from ten year rule requirements for the acquisition credit: We would like the Internal Revenue to issue formal guidance on the minimum requirements that a project would need to meet in order to be deemed "a federally- or state-assisted building, which would allow the building to be exempt from the requirement that there be a period of at least ten years between the date the building is being acquired by the taxpayer and the date the building was last placed in service by the previous owner.

- The Housing and Economic Recovery Act of 2008 ("HERA") expanded the exceptions from the ten year rule to include federally- or State-Assisted Buildings. HERA defined a federally-assisted building to be "any building which is substantially assisted, financed, or operated under section 8 of the United States Housing Act of 1937, section 221(d)(3), 221(d)(4), or 236 of the National Housing Act, section 515 of the Housing Act of 1949, or any other housing program administered by the Department of Housing and Urban Development or by the Rural Housing Service of the Department of Agriculture." HERA defined a state-assisted building as a building "which is substantially assisted, financed, or operated under any State law similar in purpose to any of the laws" described under the federal definition.
- While HERA provided a broad list of the programs that qualified a building for the exception, they did not define "substantially assisted".
- Without a definition or guidance of "substantially assisted", taxpayers are unsure whether a buiding qualifies and investors are reluctant to invest in these credits due to the uncertainty.
- We request that the Internal Revenue Service provide guidance as to what would be deemed substantially federally subsidized. Without such guidance, the purpose of creating this exception to the ten year rule will not be achieved.

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We appreciate the opportunity to present our recommendations on items that should be included in the 2012-2013 Priority Guidance Plan. We believe that these changes will improve the use of the tax credits to provide affordable housing that is needed in this country. Thank you in advance for your consideration of these suggestions. If you have any questions about any of the items described above, please feel free to contact Susan Wilson at 410-772-2539 or swilson@enterprisecommunity.com or Peter Lawrence at 202-649-3915 or plawrence@enterprisecommunity.org.

Very truly yours,

B Susan Wilson

B. Susan Wilson
Vice-President
Enterprise Community Investment, Inc.

The ESOP Association

Notice 2013-22

APR 3 2 2013

LEGAL PROCESSING DIVISION
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March 29, 2013

Mr. Robert Gertner
Internal Revenue Service
500 North Capitol Street, N.W.
Washington, D.C. 20226

Mr. Dominic DeMatties
Department of Treasury
1500Pennsylvania Avenue
Washington, D.C. 20226

Re: Exempt Loan Regulations Update: Issues for Consideration

Dear Mr. Gertner and Mr. DeMatties:

I submit these comments to you on behalf of The ESOP Association. (the Association) The comments were developed and written by the Association's Advisory Committee on Legislation and Regulatory Issues. (L&R Committee) The L&R Committee formed a task force about a year ago to provide input to you and your Service colleagues concerning the ESOP exempt loan regulatory project in progress. The task force, chaired by Greg Brown, Katten Muchin Rosenman LLP, is comprised of attorneys and consultants who work extensively with ESOP companies. Members who contributed to these comments are Rebecca Hoffman, Principal Financial; Kim Abello, JPMorgan Chase; Tim Jochim, Kegler Brown Hill & Ritter, P.A.; and Susan Lenczewski, Fafinski Mark & Johnson, P.A, Immediate Past Chair of the L&R Committee.

These comments do not propose specific language changes, but should the Service decide that that would be helpful, please let us know. Also, if the Service would like additional input on any particular comment or have questions to which we might respond, we would be happy to provide follow-up.

We hope that the input in this letter proves valuable to the Service in its considerations.

Let it be clear, the Association is appreciative of the Service's attention to the regulatory regime governing ESOPs.

Issues for Consideration

While there are many issues to be addressed in the ESOP exempt loan regulations, which were promulgated 34 years ago and require technical updates to reflect statutory updates, there are other issues that have arisen in ESOP creation and operation during that time. The items below reflect select issues that have confronted the ESOP community, particularly professional advisors to corporations establishing an ESOP, and ESOP plan sponsors from all disciplines over the years:

Refinancings which extend loan amortization

- Should criteria from Department of Labor Field Assistance Bulletin 2002-3 be reflected in regulations? While arguably many of the issues addressed in the Field Assistance Bulletin are fiduciary duty issues, most of them also involve the exclusive benefit rule applicable under the Internal Revenue Code.

- How should the share release calculation be done for the plan year in which the refinancing occurs (*i.e.*, are shares construed released at the time of refinancing or just the end of the plan year?)

Multiple Loans Outstanding

- Where there are multiple loans outstanding, should the release of shares be calculated separately on a loan-by-loan basis? Should a plan administrator be permitted to aggregate the loans for share release calculations?

Periodic Release v. Plan Year Release

- Current regulations call for a single plan year release on a plan year basis. Should a plan be able to release shares on a periodic basis, such as on a payment date or allocation date (*i.e.*, semi-annual, quarterly, monthly)?

- If so, where a variable rate is used, current regulations provide that the denominator of the release fraction include future interest payments based on the interest rate in effect at the end of the plan year. If a periodic release is permitted, the interest rate used should be the interest rate in effect at the end of the periodic release calculation period.

Allocation Years for Shares Released

- Clarify that contributions made after the end of a plan year but on or before the IRC section 404(a)(6) and 404(a)(9)(B) due dates and used to repay a loan may be used in the numerator of the release fraction. This allows a plan sponsor to co-ordinate the timing of share release and allocation with tax deductions.

Impact of Missed Scheduled Payment on Share Release

- Where one or more loan payments are in arrears, how is this treated for purposes of calculating future interest for a principal and interest method release? Are those payments treated as due the first day of remaining amortization period?

Loan Forgiveness and Release Fraction

- Consider including in regulations language reflecting PLR 9237037 where an ESOP loan is written-down and the share release thereafter is more rapid than if the write-down had not occurred.

Reasonable Interest Rate

- Consider adopting a safe harbor(s) such as the Applicable Federal Rate for a comparable loan period.

Repayment of Loan From Third Party Sales

- Confirm that an ESOP is permitted to repay a loan with the proceeds from the sale of suspense account shares to a third party in a change of control transaction. See, for example, PLRs 9416043, 200514026, 200504040 and 200716027.

- Where a change in control transaction occurs and the loan is repaid partly with employer contributions, address how the release calculation is done. In particular, address whether the release calculation is done by assuming that the loan is fully paid so that the only interest in the denominator is the interest paid for the final year.

Repayment Using Employee Salary Deferrals, After-Tax Contributions and Roth IRA Contributions

- Clarify whether it is permissible to use employee salary deferrals, after-tax contributions or Roth IRA contributions to repay a loan. Should a fair market value rule similar to IRC section 404(k)(2)(B) be required if such contributions are permitted?

Non-terminable Rights

- Add to the non-terminable rights for ESOPs the following items:

  - Accelerated distribution rights under IRC § 409(o)
  - Diversification rights under IRC § 401(a)(28)(B)
  - Independent Appraiser requirements of IRC § 401((a)(28)(C)
  - Voting pass-through rights under IRC § 409(e)

Put Options

- Consider extending rights to alternate payees and legal guardians or conservators of participants, beneficiaries and alternate payees.

- Reflect exceptions in IRC § 409(h)(2)(B) and 409(h)(3).

Readily Tradable on an Established Securities Market

- We would encourage adoption of the rules described in IRS Notice 2011-9.

Subordination Provisions

- Over time, there has been substantial argument among practitioners about the application of the subordination rules of Treas. Reg. § 54.4975-7(h)(12)(v). For example, a loan (presumably including a third party loan to the plan sponsor) provision which prohibits the plan sponsor from redeeming distributed employer securities upon the exercise of a put option, or imposes substantial dollar restrictions thereon, appears to violate the rules. On the other hand, if these redemptions would cause a financial covenant default under a loan or cause plan sponsor insolvency, substantial arguments exist that this is a permissible restriction. Clarification is highly desirable here.

Dividends on Allocated Shares

- Make cross-references to fair market value rules applicable to use of C corporation dividends to repay loans (IRC § 404(k)(2)(B)) or to use of S corporations dividends (IRC § 4975(f)(7)) and address permissible remedies where a plan utilizes dividends to make loan payments and the value of shares released related to the allocated shares is insufficient to meet either fair market value rule. For example, can unallocated shares released which are attributable to dividends on unallocated shares be used to cover the shortfall?

Available Sources for Loan Payment

- Recently, IRS representatives have informally indicated that using contributions from a prior plan year to make loan payments in the current year is impermissible. While this may be the case where the contributions are made prior to the existence of an exempt loan, clarification is needed that contributions made while a loan is outstanding may later be used to make loan payments. This is consistent with the language of Treas. Reg. § 54.4975-7(b)(5), but clarification does appear to be necessary.

Forfeiture Hierarchy

- Consideration should be given as to whether the forfeiture hierarchy provisions of Treas. Reg. § 54.4975-11(d)(4) provide a meaningful protection to participants in light of the administrative complexity involved in complying with these provisions.

Length of Loan

- From time to time we have heard speculation that the longer the loan amortization, the more suspect the loan is for exempt loan purposes. We would discourage adopting any sort of fixed maximum period, as there cases where conservative benefit level projections have caused employers and fiduciaries to agree to amortization periods of 30 years or more. Thus any rules relating to the length of the amortization period should focus on benefit levels provided and other relevant facts and circumstances.

Use of Sale Proceeds From Loan Suspense Account to Repay Exempt Loan

- We would like to clarify that the use of sale proceeds received from a third party to repay an exempt loan does not require a plan termination. Oftentimes such a plan is thereafter merged with another defined contribution plan maintained by the acquiring entity, which preserves the retirement integrity of the plan funds. We see no reason to require a plan termination in this instance.

Exempt Loan Provisions in Plan Documents

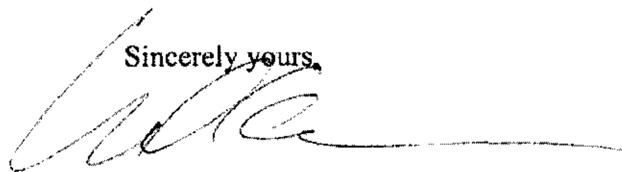
- We would like clarification as to which exempt loan requirements at Treas. Reg. § 54.4975-7 and -11 need to be included in plan documents. Certain provisions in these regulations are explicit regarding inclusion in the plan document, but many others are not. ESOP legal practitioners have received requests from determination letter reviewers insisting that certain language be included in ESOP plan documents to reflect these regulations, but there is little consistency from reviewer to reviewer as to which requirements need to be included. These include ESOPs that do not have (and will probably never have) an exempt loan.

- Language that is frequently requested by determination letter reviewers is the requirement at Treas. Reg. § 54.4975-7(b)(3)(ii), which provides that the interest rate and price of stock to be required with the loan proceeds should not be such "that plan assets might be drained off." If this regulation is to be retained, consider providing an explanation or an example as to the meaning of this requirement.

Please let us know if you or any of your colleagues wish to discuss any of these points made in this communication.

Again, we thank you for considering this communication.

Sincerely yours,



J. Michael Keeling, CAE
President

cc: Greg Brown
Susan Lenczewski

PUBLICATIONS & REGULATIONS BRANCH

Notice 2013-22

MAY - 1 2013

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May 1, 2013

J. Mark Iwry
Senior Advisor to the Secretary and Deputy Assistant Secretary
for Retirement and Health Policy
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Mark J. Mazur
Assistant Secretary for Tax Policy
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Hon. William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Guidance Priority List Recommendations on Retirement Security Issues

Dear Mr. Iwry, Mr. Mazur, and Mr. Wilkins:

The Investment Company Institute[1] is pleased to submit recommendations regarding retirement security issues for projects to be included on the 2013-2014 Guidance Priority List. A separate ICI submission describes our recommendations regarding regulated investment companies.

I. Items from 2012-2013 Guidance Priority List

The 2012-2013 Guidance Priority List included "[g]uidance under §402(c) on distributions that are disbursed to multiple destinations." Consistent with this item, we urge the Service to provide

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $14.96 trillion and serve more than 90 million shareholders.

guidance on partial rollovers of plan distributions containing after-tax employee contributions. A sentence included in the updated model 402(f) notice published in September 2009 created widely-recognized confusion regarding the allocation of after-tax basis and pre-tax amounts in a distribution that is partially rolled over to a plan or IRA. Under the prevailing view of practitioners and service providers, Code section 402(c)(2) provides that in a distribution containing after-tax amounts that is partially rolled over (directly or indirectly), pre-tax amounts are considered rolled-over first. In the view espoused in the model 402(f) notice, however, pre-tax amounts would be considered rolled-over first only in an indirect rollover; in a direct rollover, the amount rolled over would consist of a pro-rata share of basis and pre-tax amounts.

We strongly urge the Service to issue guidance and a revised 402(f) notice confirming that the former view – pre-tax first – is correct. There is no statutory authority that compels the interpretation espoused in the 402(f) notice, and in the interests of sound tax policy, indirect rollovers should not be favored over direct rollovers.[2] At a minimum, if the Service is unwilling to reverse the pro-rata interpretation implied by the 402(f) notice as we suggest, we believe it is imperative to enforce the pro-rata rule for partial rollovers prospectively only. Due to the multitude of past transactions thought to be properly executed under 402(c)(2), anything other than prospective enforcement would cause considerable disruption and challenges.

II. New 2013-2014 Guidance Priority List Items

The Institute requests that the Service add the following retirement security matters to the 2013-2014 Guidance Priority List.

A. In-Plan Roth Conversions

Section 902 of the American Taxpayer Relief Act of 2012 allows 401(k), 403(b) and 457(b) plans that permit employees to make contributions to designated Roth accounts to permit participants to transfer (*i.e.*, convert) non-Roth balances to a designated Roth account within the plan (a taxable event), without regard to whether the participant is eligible for a distribution from the plan. Prior to this change, existing law allowed plans to permit such conversions only upon a *distributable event* (such as separation from service or reaching age 59-1/2). Plans may begin offering the new conversion opportunity in 2013. The Institute recently provided the attached list of issues for guidance and clarification to the Treasury Department. The list is comprised of questions raised by Institute members, including whether plans can restrict conversions to distributable amounts or specific contribution sources; whether participants can specify the source for conversion; confirmation that no special tax reporting rules will apply (*i.e.*, use the same reporting used for conversions of distributable amounts); and whether any special plan amendment deadlines will apply. We request expeditious

[2] A participant desiring to roll over the taxable part of a distribution to another plan or IRA, while receiving the non-taxable portion in cash or rolling it over into a separate vehicle, could do so via an indirect 60-day rollover, but ostensibly could not accomplish the same result via direct rollover under the Service's recent interpretation.

guidance on these issues to enable plans and their service providers to implement the in-plan Roth conversion feature as soon as possible.

B. 403(b) Plan Termination

Pursuant to an item on the 2010-2011 Guidance Priority List, the IRS issued Revenue Ruling 2011-7, providing guidance on 403(b) plan terminations. While this Ruling addressed many open issues, it does not address a significant question regarding plans funded through individually-owned section 403(b)(7) custodial accounts.[3] An effective plan termination depends on the ability to distribute all accumulated benefits within a reasonable period of time. Individual custodial accounts, however, typically do not provide for distribution without the consent of the participant. Therefore, any participant who fails to request a cash distribution or rollover of his or her 403(b) account could jeopardize the effectiveness of the termination for other participants or cause the employer to have to maintain a spun-off plan indefinitely. Guidance for this type of situation is essential.

Revenue Ruling 2011-7 and the regulations under section 403(b) permit the delivery of an individual annuity contract (or a certificate evidencing an interest in a group annuity) as a means of distributing accumulated benefits under a 403(b) plan termination. This ordinarily means that an annuity contract may continue as a tax-deferred vehicle after plan termination. The Ruling does not contemplate distribution of a 403(b)(7) custodial account, however. Given that section 403(b)(7)(A) provides that contributions to a custodial account shall be treated as contributions to an annuity contract, we request equal treatment for 403(b)(7) custodial accounts in connection with a plan termination. Distribution of a custodial account that retains its 403(b) character, like the distributed 403(b) annuity contract, may be the only option for some custodians attempting to carry out terminating distributions without the consent of the participant, particularly where the custodial agreement does not permit involuntary liquidation of the account or unilateral amendment of the agreement for this purpose. Without the ability to distribute the account itself, many custodians are left wondering how to carry out an employer's wishes to terminate a plan while at the same time satisfying legal obligations to the individual account owner.

We also believe that guidance addressing a plan termination involving custodial accounts that do contemplate involuntary liquidation would be appropriate. Some have read Revenue Ruling 2011-7 to require *affirmative* participant consent to a distribution, which would suggest that the presence of a single unresponsive or uncooperative participant could taint and significantly delay a plan termination. To address this misunderstanding, guidance describing an involuntary distribution with an automatic rollover to an IRA after a specified period would be appropriate. Guidance in this regard will facilitate necessary amendments to custodial agreements to permit automatic rollovers to IRAs in connection with plan termination and would allow custodians to rely on an employer's direction that a plan is being terminated. The Institute has strongly urged that this guidance be published as soon as possible,

[3] *See* ICI letter to W. Thomas Reeder, dated March 17, 2009; and ICI letter to W. Thomas Reeder, dated Nov. 12, 2008.

given that some employers have begun the process of terminating their 403(b) plans pursuant to the 2007 final regulations issued under section 403(b).[4]

C. Regulations under §411(a)(11)

We request that the Service finalize the proposed regulations implementing section 1102 of the Pension Protection Act, which instructed the Secretary of the Treasury to modify the regulations under section 411(a)(11) to require disclosure of the consequences of failing to defer receipt of a distribution from a defined contribution plan.[5] We strongly recommend that the Service finalize the requirements as proposed. As we stated in our comment letter,[6] the proposal strikes the right balance by alerting the participant that the plan may have investments, or fee structures, different from those obtainable in an IRA, and alerting the participant that more information is available. This approach will not overwhelm the participant with information that obscures the key information while also assuring the participant has access to information consequential to the decision whether to take or defer a distribution from the plan.

D. Tax Treatment of Escheated Amounts

Finally, we request guidance on the proper tax treatment of escheated amounts from retirement plans and IRAs. In 2004, the Department of Labor ("DOL") issued guidance regarding missing participants in terminating defined contribution plans.[7] The DOL guidance requires that a plan administrator use certain search methods to locate a missing participant, and if all efforts to locate the missing participant fail, then the fiduciary should consider distributing the amounts to a federally insured bank account or escheating them to a state unclaimed property fund. The requested guidance should address certain federal tax implications of escheatment, including (1) whether Form 1099-R reporting is required, (2) whether payors should designate amounts as escheated and, if so, how payors should make such a designation, and (3) whether withholding is required. We have requested this guidance in prior years and we wish to reiterate its importance. We understand that several states have increased their efforts to collect unclaimed property in IRAs and other retirement plans.

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[4] 72 Fed. Reg. 41128 (July 26, 2007). *See* ICI letter to W. Thomas Reeder, dated March 17, 2009; and ICI letter to W. Thomas Reeder, dated Nov. 12, 2008.

[5] 73 Fed. Reg. 59575 (Oct. 9, 2008).

[6] *See* ICI letter to Internal Revenue Service re: proposed regulation (REG-107318-08), dated January 7, 2009.

[7] U.S. Department of Labor, Employee Benefits Security Administration, Field Assistance Bulletin No. 2004-02, dated September 30, 2004.

If we can provide you with any additional information regarding these issues, please do not hesitate to contact David Abbey at 202/326-5920 (david.abbey@ici.org) or Elena Chism at 202/326-5821 (elena.chism@ici.org).

Sincerely,

/s/ David Abbey

David Abbey
Senior Counsel – Pension Regulation

/s/ Elena Barone Chism

Elena Barone Chism
Associate Counsel – Pension Regulation

cc: George H. Bostick

Attachment

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§902 of American Taxpayer Relief Act of 2012
In-plan Roth Conversions
Issues for guidance or clarification

1. **Status of Notice 2010-84.** Any new guidance should confirm the status of Notice 2010-84 – *e.g.*, that it continues to apply or that it is superseded by new guidance.

2. **Limitation to vested assets.** Guidance should confirm that in-plan conversions of non-distributable amounts are limited to vested assets.

3. **Withdrawal restrictions.** Guidance should confirm that following an in-plan conversion of non-distributable amounts, converted assets continue to be subject to the same withdrawal restrictions that applied prior to the conversion.

4. **Permissible limitations on source of in-plan conversions.** Guidance should state whether plan sponsors may elect to limit in-plan conversions to distributable amounts or to specified types of contributions (such as employee elective deferrals only). Also whether plans may allow participants to specify the source for the conversion.

5. **402(f) notice.** Guidance should confirm that adopting the in-plan conversion feature would not require a revised 402(f) notice, and an election to convert amounts not otherwise distributable would not, in itself, trigger the 402(f) notice.

6. **Plan amendments.** Like Notice 2010-84, guidance should state the deadline for adopting plan amendments providing for in-plan conversions of amounts not otherwise distributable (including whether the IRS anticipates issuing model amendment language/LRMs) and any special deadlines for 401(k) safe harbor plans (and should include any other guidance for safe harbor plans, such as any required updates to the safe harbor notice).

7. **Nondiscrimination testing and individual limit refunds.** Guidance should address pre-converted pretax assets required to be refunded due to testing failure and/or individual limit excesses – *i.e.*, whether these amounts can be removed from the Roth conversion source, and the tax consequences of such treatment.

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8. **Indirect rollovers.** Guidance should confirm that in-plan conversions of non-distributable amounts may not be accomplished via indirect rollover, and should confirm that in-plan conversions of distributable amounts may continue to be accomplished via indirect or direct rollover. Also, may a plan limit in-plan Roth conversions to direct rollovers even for amounts otherwise distributable?

9. **Tax reporting and federal income tax withholding.** Guidance should confirm that in-plan conversions of non-distributable amounts are reported the same way as conversions of distributable amounts under current law (*i.e.*, no withholding; report the rollover amount on Form 1099-R box 1, the taxable amount in box 2a, any basis recovery amount in box 5; and enter code "G" in box 7).

10. **Anti-cutback rules.** Guidance should address whether a plan that adopts an in-plan conversion feature can later eliminate the feature without violating the anti-cutback rules.

11. **Examples illustrating tax consequences of subsequent distributions.** Additional examples would be helpful similar to the example provided in Notice 2010-84, Q&A 13, demonstrating the tax consequences of subsequent distributions, including recapture of the 10 percent additional tax under Code §72(t). As you know, ATRA does not permit individuals to defer and spread the taxable income over 2 years, unlike in-plan Roth rollovers made in 2010, so additional examples without the income deferral "wrinkle" would be useful.

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

Notice 2013-22

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By Electronic Delivery

May 1, 2013

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Hon. William J. Wilkins
Chief Counsel
Internal Revenue Service
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Washington, DC 20224

RE: Guidance Priority List Recommendations

Dear Mr. Mazur and Mr. Wilkins:

The Investment Company Institute[1] recommends the following issues affecting regulated investment companies ("RICs") and their shareholders for inclusion on the 2013-2014 Guidance Priority List.[2] As requested in Notice 2013-22, these recommendations have been listed in order of priority. The Institute notes, however, that all of the issues described below are important to the industry; most of these items have been included in prior requests for guidance from the Internal Revenue Service ("IRS") and the Treasury Department, including prior suggestions for the Guidance Priority List.

I. Foreign Tax Recoveries from the European Union under *Santander*

The Institute urges an administrable solution to the U.S. fund industry's anticipated receipt of withholding tax refunds following the European Court of Justice ("ECJ") decision in *Santander*.[3] The requested solution is necessary so that the U.S. government is reimbursed in an administrable manner for foreign tax credits claimed by shareholders in funds taxed as regulated investment companies ("RICs") that subsequently, pursuant to the *Santander* decision, recover the taxes for which the credits were claimed.[4]

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $14.7 trillion and serve more than 90 million shareholders.

[2] A separate submission describes our Guidance Priority List recommendations for retirement security issues.

[3] The *Santander* decision involves joined cases C-338/11 to C-347/11. The decision was rendered in French and translated into the other languages of the European Union ("EU"). The decision can be found online in English and in French.

[4] *See* Institute letter to Erik Corwin dated April 30, 2013.

Specifically, we propose that RICs in this unique situation be required to reduce their foreign tax credits for the year in which the refunds are received pursuant to binding court decisions or final administrative action. The alternative approach – of these RICs entering into closing agreements and writing checks to the government on behalf of their shareholders – imposes significant burdens on RICs, their investors, and the IRS.

The Industry recommends that this issue be given high priority. As soon as reclaims are received, funds will need to make determinations that will affect the value of shareholders' fund shares.

II. Cost Basis Reporting

The Institute urges the IRS and Treasury Department to issue promptly guidance clarifying a number of issues with respect to cost basis reporting, as we have previously requested.[5] Specifically, we ask the IRS and Treasury Department to adopt in final regulations the rules provided in Notice 2011-56[6] regarding changes from a broker's default method of average cost, with the few modifications detailed in our previous letter.

We also urge the IRS and Treasury Department to reconsider its requirement that a shareholder who elects to use the average cost method, revokes such election, or changes from the average cost method (whether the broker default or a shareholder election) must do so in writing. Requiring such elections, revocations, and changes in writing is unnecessarily burdensome and potentially costly for shareholders.[7] The Institute instead proposes that the regulations permit brokers, including RICs, to provide a written confirmation to shareholders of a cost basis method election, revocation, or change, in lieu of a written notification by the shareholder.

The Institute also asks the government to clarify several other issues regarding cost basis reporting. First, the IRS and Treasury Department should clarify that brokers may use any basis method as their default method for mutual fund shares, including first-in, first-out (FIFO), average cost, or any other formulaic method, as clearly intended by Congress. Second, we ask that the government provide that gifted shares will have a carryover holding period, even if the shares were gifted at a loss (*i.e.*, the cost basis of the gifted shares exceeds the fair market value on the date of gift) and the donee subsequently sells the shares at a loss. Third, we ask the IRS and Treasury Department to clarify that, for cost basis reporting purposes, shares acquired by an estate after the decedent's death have a basis equal to the fair market value on the date of acquisition, unless the broker receives other information from an estate representative. Finally, the IRS should (i) clarify whether RIC liquidating

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[5] *See* Institute letter to Emily McMahon and William Wilkins, dated July 28, 2011.

[6] 2011-29 I.R.B. 54.

[7] *See* Institute letter to William Wilkins, dated February 8, 2010. This letter commented on the proposed in-writing requirement for an affirmative average cost election. The proposed regulations did not require a revocation of such an election or a change from average cost to be in writing, so the Institute's letter does not address these rules, which were added to the final regulations.

distributions are subject to cost basis reporting and, (ii) if so, amend Forms 1099-B and 1099-DIV, and the accompanying instructions, to specify that liquidating *distributions* by RICs should be reported on Form 1099-B, so that brokers can properly report cost basis information for such distributions.

III. 2012-2013 Guidance Priority List Items

The Institute requests that the IRS and Treasury Department issue guidance as soon as possible on the following items currently on the 2012-2013 Guidance Priority List.

A. Items Related to RIC Modernization Act of 2010

The Regulated Investment Company Modernization Act of 2010 (the "Act")[8] resolved several issues for which we previously sought regulatory guidance. The industry seeks additional regulatory guidance, however, necessary to properly implement the provisions of the Act.[9]

First, we request guidance clarifying that the bifurcation guidance of Notice 97-64[10] (as modified by Notice 2004-39[11]) continues to apply, to the extent necessary, after the Act's changes to the elective deferral rules for post-October losses. Specifically, a RIC still needs to "bifurcate" its taxable year into two components, to prevent character reclassifications, when a RIC (i) has a pre-November net capital gain, (ii) has a post-October loss in a long-term category (*i.e.*, 15% or 28%) that could change the category of the pre-November net capital gain on a taxable year basis, and (iii) does not have a post-October net capital loss, net long-term loss or net short-term loss that, if deferred, would avoid the reclassification.

Second, we request guidance allowing a RIC to meet the Act's requirement to provide its shareholders with a "written statement" regarding the character of its distributions by posting the information on its website and advising its shareholders, in writing, to consult the website for this information.[12]

B. Distressed Debt

Second, the Institute requests guidance addressing the accrual of interest on distressed debt. Investors have long faced uncertainty regarding how the existing original issue discount and market discount rules should apply to severely distressed, and speculative, debt. In other cases, application of

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[8] Pub. L. No. 111-325, 124 Stat. 3537.

[9] *See* Institute letter to Emily McMahon and William Wilkins, dated June 30, 2011.

[10] 1997-2 C.B. 323.

[11] 2004-1 C.B. 982.

[12] Section 301 of the Act.

these rules creates what many believe to be inappropriate results.[13] These issues have been exacerbated by recent market events.[14]

C. Notional Principal Contracts

Third, the Institute remains very interested in guidance providing simplicity and certainty regarding the taxation of notional principal contracts. The Institute made a number of recommendations in our letters on the regulations proposed in 2004 and 2011.[15] We recommended that marks under the elective mark-to-market method, as well as value payments under the noncontingent swap method, be treated as resulting in capital gain or loss. We also suggested that credit default swaps and certain short-term swaps be excluded from the modified noncontingent swap method and the mark-to-market election. Further, we requested additional guidance regarding the definition of "payment." We also commented on several technical issues. Finally, we suggested that the guidance should be made entirely prospective upon promulgation of final regulations.

D. Prepaid Forward Contracts

Fourth, we urge guidance on prepaid forward contracts.[16] Specifically, the Institute strongly supports prompt and comprehensive guidance regarding the tax treatment of exchange-traded notes ("ETNs"). Although ETNs can provide important investment opportunities, they also take advantage of gaps in the tax law to provide investors with tax deferral (of up to 30 years) and character conversion that is inappropriate. This treatment is far more favorable than the treatment obtained by investors in comparable financial instruments and provides a tax incentive to take on issuer credit risk, rather than invest in products that do not entail this risk. In the absence of legislation, regulations should be issued under Treasury's existing authority under section 1260 and should provide a mark-to-market election. If a comprehensive regulatory approach is not developed under section 1260, guidance should be issued under section 446 to address any ETNs that remain outside the scope of the section 1260 constructive ownership solution.

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[13] *See, e.g.*, Letter of May 15, 1991, from Jere D. McGaffey to Fred T. Goldberg, Jr. (transmitting comments prepared by members of the ABA's Section of Taxation on the application of market discount rules to speculative bonds).

[14] *See, e.g.*, Institute letter to Eric Solomon and Donald Korb, dated July 28, 2008.

[15] *See* Institute letter to Greg Jenner and Donald Korb, dated July 21, 2004, and Institute letter to Emily McMahon and William Wilkins, dated December 15, 2011.

[16] *See* Institute letter to Eric Solomon and Donald Korb, dated May 13, 2008. *See also*, Testimony of William M. Paul on behalf of the Institute, presented on March 5, 2008, before the House of Representatives Ways and Means Subcommittee on Select Revenue Measures.

IV. Other Issues Directly Affecting RICs and Their Shareholders

A. The Application of General Corporate Tax Rules to RICs

The Institute requests that the IRS and Treasury Department address issues arising from the application of the general corporate tax rules to RICs. These rules can be unnecessarily difficult to apply and can result in unintended consequences.

1. Business Continuity Requirement for Tax-Free Mergers

First, the Institute requests guidance clarifying the application of the "business continuity" requirement to RICs under section 368 and Treas. Reg. § 1.368-1(d)(2).[17] This clarification is necessary because it is difficult to discern the intended scope of the business continuity test as applied to RIC reorganizations. As a result, many RICs engaging in merger transactions are compelled to rely on the "asset continuity" test;[18] this test, to the detriment of the RIC's shareholders, can place artificial limits on the ability of a portfolio manager to dispose of portfolio securities acquired from a target RIC and imposes significant compliance burdens on funds. This issue has become increasingly important given recent financial conditions, under which more and more RICs are being merged. The Institute requested guidance on this issue in 2004, at which point the IRS informed us that they wished to gather more information on RIC mergers through the private letter ruling process. The Institute hopes that the IRS and Treasury now have sufficient information to open a project on this issue and requests that they do so.

2. Ownership Tracking Requirements

Second, the Institute asks that a project be opened to amend the regulations under sections 382 and 383 with respect to ownership tracking requirements that apply to participant-directed retirement accounts holding RIC shares and to variable insurance products. Specifically, the regulations should permit a RIC to look through participant-directed retirement accounts and variable insurance product account owners and treat each participant/investor who holds less than five percent of the RIC's shares as part of the RIC's direct public group. The concerns addressed by sections 382 and 383 are not implicated when a RIC's new shareholders are retirement accounts or variable insurance product accounts that cannot benefit from such tax attributes.

This change effectively would prevent a large collection of small investors making independent investment decisions from being treated as a single entity for ownership change purposes. Absent this change, a retirement plan administrator's decision as to which RICs to offer in a plan could significantly affect whether other shareholders in the RIC can benefit from the RIC's capital losses even though the

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[17] *See* Institute letter to William D. Alexander and Lon B. Smith, dated January 15, 2003. *See also* Institute letter to William D. Alexander, dated April 30, 2004.

[18] *See* Treas. Reg. § 1.368-1(d)(3).

retirement plan administrator is neither a beneficial owner of RIC shares nor responsible for allocating investment assets among RICs. Likewise, absent this change, an ownership change could occur if another company buys the insurance company holding the variable insurance product shares. Again, these scenarios should not raise tax policy concerns.

B. RIC Portfolio Investments

The Institute requests guidance on several issues arising from RICs' portfolio investments.

1. Commodity Funds

The Institute strongly urges the IRS and Treasury Department to issue published guidance addressing investment in commodities by RICs through controlled foreign corporations ("CFCs") and commodity-linked notes (""CLNs"). As we have discussed, substantial competitive pressures have arisen since the IRS suspended the private letter rulings ("PLRs") process in this area in 2011.[19] These pressures result from the disruption of settled expectations, the unlevel playing field in the industry, and concerns regarding the IRS's comfort with the legal analysis underpinning the numerous PLRs already issued. These competitive pressures are exacerbated the longer this issue is left unaddressed.

2. PFICs

First, we ask the IRS and Treasury to issue additional guidance regarding passive foreign investment companies ("PFICs"). The preamble to the final PFIC mark-to-market regulations[20] notes in three places that comments received relating to the impact of the PFIC rules on RICs were beyond the scope of that regulations project.[21] We request that a regulations project be opened to address these and other PFIC-related issues faced by the industry.

Specifically, the Institute requests guidance providing (i) that gains from dispositions of former PFIC stock are capital while losses are ordinary to the extent of prior unreversed inclusions; (ii) RICs with automatic consent to terminate a section 1296 election during a non-PFIC year; (iii) that RICs may recognize any change in PFIC status of a foreign corporation for the RIC's taxable year within which the taxable year of the foreign corporation ends; (iv) that the consequences to RICs of applying former Prop. Treas. Reg. § 1.1291-8 will be respected, where relevant, for purposes of section 1296; and (v) that RICs may determine qualified electing fund ("QEF") inclusions using audited financial statements that were prepared using U.S. Generally Accepted Accounting Principles (GAAP) or International Financial Reporting standards, and that all QEF inclusions subject to this election will be treated as ordinary, but retain the capital character of disposition gains and losses.

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[19] *See* Institute letters to Stephen Larson dated August 18, 2011, and September 1, 2011.

[20] T.D. 9123, published on April 29, 2004.

[21] *See* Institute letter, dated November 22, 2002, and Institute letter to Dale Collinson, dated April 24, 2003.

3. RIC Investments in Partnerships with Different Taxable Year-Ends

Second, we request guidance regarding RIC investments in a partnership in which the RICs and the partnership have different tax years; this guidance should allow RICs to take partnership items into income at the end of each month, rather than at year-end. In general, partners must take partnership items into account at the end of the partnership's tax year.[22] If a RIC invests in a partnership with a different tax year, however, this can cause mismatches between the RIC's distributions and the amount of earnings and profits associated with the partnership's income.

4. Taxable Mortgage Pools

Third, we request regulatory guidance to clarify issues relating to excess inclusion income of a real estate investment trust ("REIT") that is a taxable mortgage pool ("TMP") or that has a qualified REIT subsidiary that is a TMP. Although Notice 2006-97[23] addressed a few issues, and responded to some of the Institute's concerns regarding the lack of guidance in this area,[24] many critically important issues remain unresolved. At a minimum, and as requested by the Institute in 2006, guidance should be issued stating that Notice 2006-97 will not be applied until some reasonable period after a practical reporting regime is implemented and the many uncertainties arising from the Notice are resolved.[25]

C. Check-the-Box Election

The Institute asks the IRS and Treasury Department to issue guidance to coordinate the entity classification election under the check-the-box regulations[26] with the RIC election under section 851(b)(1). Specifically, we request that an eligible entity electing to be treated as a RIC will be deemed to have elected to be classified as an association taxable as a corporation, effective as of the first day the entity is treated as a RIC.[27] The regulations already provide such a deemed check-the-box election for entities that elect to be treated as REITs, for certain entities claiming tax-exempt status, and for entities electing to be taxable as S corporations. Amending the regulations to similarly coordinate the RIC election with the check-the-box rules will reduce administrative burdens for affected entities and the IRS and provide certainty as to an entity's status.

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[22] *See* Rev. Rul. 94-40, 1994-1C.B. 274 (for purposes of the required distribution under section 4982, a RIC must take into account its share of partnership items of income, gain, loss, and deduction as they are taken into account by the partnership, regardless of the taxable years of the RIC and the partnership in which the RIC is a partner).

[23] 2006-2 C.B. 904.

[24] *See* Institute letter to Eric Solomon and Donald Korb dated May 12, 2006.

[25] *See* Institute letter to Lon Smith, dated December 29, 2006.

[26] Treas. Regs. § 301.7701-3.

[27] *See* Institute letter to Emily McMahon and William Wilkins, dated June 1, 2011.

V. Section 529 Qualified Tuition Programs

The Institute also urges the IRS and Treasury to address issues regarding section 529 qualified tuition programs ("section 529 plans"). A project to address these issues, which was included on prior Guidance Priority Lists, was deleted from the 2009-2010 list without guidance being issued. Guidance regarding section 529 plans remains necessary to implement fully the Advance Notice of Proposed Rulemaking ("Advance Notice") regarding section 529 plans that the IRS released in 2008. We are pleased that the Advance Notice reflects several comments previously submitted jointly by the Institute and the Securities Industry and Financial Markets Association ("SIFMA").[28] It remains important, for those saving for education through section 529 plans, that the tax treatment of investments in such plans is clear. We urge the IRS to continue its work on this guidance project to address outstanding issues.[29]

VI. Foreign Bank and Financial Account Reporting

Finally, the Institute is pleased that the IRS and the Financial Crimes Enforcement Network ("FinCEN") have finalized rules regarding the reporting of foreign financial accounts on the Report of Foreign Bank and Financial Accounts, Form TD-F 90-22.1 ("FBAR"). We also are pleased that the filing deadline for certain individuals with signature authority has been postponed until June 30, 2014, as the government considers questions and concerns regarding various exceptions to the rules. In light of the many issues raised with respect to the FBAR, we encourage the government to conduct a comprehensive review of the FBAR reporting requirements to eliminate unnecessary filings that do not have the "high degree of usefulness in criminal, tax, regulatory, and counterterrorism matters" required by the Bank Secrecy Act.[30]

Specifically, we request that the IRS and Treasury Department broaden the definition of "authorized service provider" ("ASP"), as originally proposed by the Institute in 2009.[31] Although FinCEN created an ASP reporting exception in the final rules, the exception adopted is narrower than we originally proposed and created new uncertainties. The government also should (1) clarify the scope of FinCEN Notice 2011-1, (2) clarify that FinCEN Notice 2011-2 applies to officers and employees of affiliates to the same extent that FinCEN Notice 2011-1 applies, and (3) make permanent the relief provided to those persons covered by the notices. We also urge that signature authority filings for 2009 and earlier calendar years be forgiven.

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[28] *See* Institute and SIFMA letter to Michael Desmond, dated June 12, 2007.

[29] *See* Institute letter to Richard Hurst, Mary Berman and Monice Rosenbaum, dated May 12, 2008, for comments regarding the Advance Notice.

[30] 31 U.S.C. 5311.

[31] *See* Institute letter to James H. Freis, Jr. and Jamal El-Hindi, dated January 15, 2009.

We will contact your offices shortly to request a meeting to discuss further these issues and their importance to the industry. In the meantime, if we can provide you with any additional information regarding these issues, please contact Keith Lawson (202-326-5832 or lawson@ici.org) or me (202-326-5826 or ryan.lovin@ici.org).

Sincerely,

/s/ Ryan M. Lovin

Ryan M. Lovin
Assistant Counsel – Tax Law

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Notice 2013-22

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Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

APR 30 2013

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

May 1, 2013

Re: IRS Notice 2013-22: 2013-2014 Guidance Priority List

Dear Acting Commissioner Miller:

The Information Reporting Program Advisory Committee[1] (IRPAC) appreciates the opportunity to recommend items that should be included on the 2013-2014 Guidance Priority List in response to Notice 2013-22.

IRPAC recognizes the challenges the IRS faces in developing and implementing new reporting and withholding policies and procedures as a result of the increased focus on using information reporting to help reduce the tax gap. Legislative changes continue to expand information reporting requirements, and payers are being requested to enhance their due diligence efforts when obtaining tax certification documentation from their customers.

Examples of that legislation include the addition of the Foreign Account Tax Compliance Act (FATCA) under sections 1471 through 1474 of the Internal Revenue Code, as amended, as well as the payment card transaction reporting under section 6050W, the Patient Protection and Affordable Care Act reporting under sections 6051, 6055 and 6056, and the cost basis reporting under section 6045. With these additional reporting programs comes an increased responsibility of IRPAC to fulfill its mission to reduce taxpayer burden and improve the overall administration of information reporting.

Considering these recent changes and consistent with our comment last year, we strongly recommend that the Guidance Plan include a new subcategory under "Tax Administration" entitled "Information Reporting" that focuses on the efficient implementation and administration of information reporting, with fair consideration of taxpayers' burdens. This would include an understanding of the lead times needed by the reporting community to implement both new programs and changes to existing programs, and consideration of the data requested in light of the availability and cost associated with producing such data, and the usefulness of the data collection.

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[1] IRPAC was established in 1991 in response to an administrative recommendation in the final Conference Report of the Omnibus Budget Reconciliation Act of 1989. Since its inception, IRPAC has worked closely with the IRS to provide recommendations on a wide range of issues intended to improve the information reporting program and achieve fairness to taxpayers. IRPAC members are drawn from and represent a broad sample of the payer community, including major professional and trade associations, colleges, and universities and state taxing agencies.

IRPAC recommends that the priority items set forth below be added to this proposed new subcategory of the Guidance Priority List:

1. FATCA guidance.
The effective implementation of FATCA is dependent on additional guidance items and forms being issued as soon as possible. IRPAC recommends that the following items related to the implementation of FATCA be included in the Guidance Priority List: (a) issuance of conforming regulations between Chapter 4 and Chapters 3 and 61; (b) issuance of technical corrections to the Chapter 4 final regulations, as well as responding to requests for clarification on matters that remain unclear; (c) issuance of the revised versions of Forms W-8, 8966, 1042 and 1040-S, including their instructions; (d) issuance of the FFI Agreement, including any coordination with existing Qualified Intermediary (QI) agreements; and (e) release of the FATCA Portal registration requirements and final Form 8957 and its instructions.

Both US withholding agents and foreign financial institutions have only a few months remaining to begin applying the initial requirements of the FATCA regulations, and we remind the IRS that the standard timeframe is 18 – 24 months to implement major programming. USWAs and FFIs must also revise account opening documentation, policies and procedures, and communicate those changes both internally and externally. In addition, large financial institutions must budget for changes a year in advance and generally cannot make systems changes in the fourth quarter of the calendar year.

2. Identity theft information reporting.
IRPAC thanks the IRS for issuing proposed regulations that will allow payers to truncate individual taxpayer identification numbers (SSN, ITIN and ATIN) on a permanent basis, and expanded the use to forms provided electronically. However, consistent with our comment letter dated February 14, 2013, payers should be allowed to truncate employer identification numbers (EINs) because of the fact many (if not most) tax reporting systems do not distinguish between the types of taxpayer identification numbers. The truncation of EINs would also have a direct benefit in reducing the volume of fraudulent returns – such as the Form 1099-OID showing a withholding amount just slightly less or equal to the income amount – being created that show withholding amounts being applied by a payer. Legitimate payers who filed a Form 941, 945 or 1042 are becoming concerned the IRS will start issuing withholding underpayment notices because of fraudulent information returns being created using the payer's name and EIN and showing withholding amounts for which the payer has no liability or deposit requirement.

The TIN truncation program should be extended to all existing or newly introduced information returns unless doing so is explicitly excluded as stated in the preamble to the proposed regulations or in the new form's instructions. Since fraudulent returns are most likely the result of theft from the postal mail of Form W-2 information, IRPAC recommends that Counsel support the adoption of H.R.1560 ("SAFE ID Act of 2013") which will amend IRC §6051 and permit the truncation of social security numbers on wage reporting statements.

Finally, the ability to provide all information returns electronically rather than through the U.S. mail where an envelope is marked "Important Tax Document Enclosed" and the due date to mail tax forms is well known would also reduce the possibility of thieves taking those statements and using them to create fraudulent information returns,and tax returns. Please see Priority Item #5 below for additional reasons as to why this program should be expanded.

3. *De minimis* threshold for Form 1099 corrections.
There are substantial costs to processing corrections to information returns, regardless of whether any amount corrected is material. The volume of corrections has increased significantly in recent years because of the expanded information reporting requirements, resulting in significantly increased costs to the IRS, financial institutions and taxpayers. Reclassification of mutual fund distributions and updated cost basis information are common causes of corrected information returns.

Filers would like to be allowed to apply a de minimis threshold so that corrections are not required for net changes of, for example, $50 or less (up or down). If you consider the cost to the financial institution (printing, mailing, reputation, etc.), the taxpayer (filing a corrected tax return) and the IRS (processing and data matching), a de minimis threshold would promote sound tax administration in that it would eliminate costly corrections that result in no material change in tax revenue. This recommendation could be achieved through minor changes to the definitions of an "inconsequential error or omission" in the regulations issued pursuant to IRC §6721 and §6722.

By way of background, last year IRPAC provided a histogram with its 2012-2013 Guidance Priority List letter dated May 1, 2012. The histogram illustrated the impact that such a correction threshold would have. For a given brokerage firm, 5150 accounts held a particular Unit Investment Trust (UIT) in 2009. The Forms 1099-DIV issued to those accounts included income attributable to that UIT. In the first quarter of 2011 (nearly a year after the associated tax returns would have been filed), the trustee's accounting firm discovered an error in the factors that the trustee had supplied to the industry allocating its distributions between dividend and non-dividend distributions. The trustee published amended factors that required corrected Forms 1099-DIV. The chart showed the distribution of those accounts across various dollar correction levels. If corrections were not required for changes of $50.00 or less, nearly 45% of the corrections would have been avoided.

In addition, brokers who are required to issue a Form 1099-B for the sale of securities continue to face significant challenges and customer complaints related to the reporting of wash sales, particularly for de minimis amounts and when all the information must be corrected because a company announces all or part of a dividend distribution is being reclassified to return of capital. While IRPAC recognizes the reporting of wash sales is mandated in IRC §6045(g)(2(B)(ii), the regulations should permit some exceptions to the requirement to file correct Forms 1099-B that are based on a de minimis amount. The confusion and volume of corrections is also being affected by the fact both brokers and taxpayers need more guidance regarding wash sales than currently exists. For example, wash sales resulting from purchases and

dispositions within employee stock purchase plans (ESPP) appear to have a dual tracking requirement for both the cost basis and holding period because of the compensation and gain/loss reporting pursuant to IRC §423 versus the holding period adjustment rules under IRC §1223(3).

4. Guidance concerning the merchant reporting rules under IRC §6050W.
Consistent with a request made by IRPAC last year, IRPAC recommends that the IRS provide additional official guidance to further address open questions related to IRC §6050W. Official guidance is necessary to address open questions regarding the meaning and scope of certain terms in the statute and Treasury Regulations, particularly regarding third party networks. Key terms integral to the meaning of "third party payment network" must be defined in official guidance in order for reporting organizations to reasonably apply the rules. These terms include "central organization," "guarantee," and "substantial number of providers of goods or services." IRPAC's detailed recommendations related to the definition of these terms can be found in its March 28, 2011, comment letter in Appendix D of its 2011 Annual Report.

In addition, guidance is needed to clarify uncertainty between the scope and application of the rules related to "aggregated payees" and "third party payment networks." This is needed, in part, due to apparent overlap of the rules in these areas and because a "third party settlement organization" is not required to report transactions for a payee whose aggregate transactions do not exceed $20,000 or 200 transactions, whereas the aggregated payee rules do not include a *de minimis* rule. Now that the IRS has received the first iteration of Forms 1099-K from payment settlement entities ("PSEs"), it should now be in a better position to understand the challenges facing PSEs and putative PSEs and should issue additional guidance accordingly in advance of the 2013 filing season.

5. Electronic furnishing of tax information forms to payees.
Consistent with a request made by IRPAC last year, IRPAC recommends that the IRS provide guidance that expands the authority of parties responsible for issuing information returns *(e.g.,* payers, withholding agents, business entities, etc.) to electronically furnish payee statements and like documents not permitted under current guidance to be issued electronically to recipients. This would include Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding; Form 8805, Foreign Partner's Information Statement of Section 1446 Withholding Tax; Form 8288, U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests; Schedule K-1 prepared and issued in connection with Form 1120S for S corporation shareholders; and Schedule K-1 prepared and issued in connection with Form 1041 for beneficiaries of certain trusts.

The ability to electronically furnish these additional forms to recipients would create greater procedural uniformity and consistency because the documents listed could be issued in a similar manner to Forms 1099 and W-2, and Schedules K-1 prepared and issued in connection with Form 1065 for partners in partnerships. In addition, foreign customers with bank accounts or who receive bank deposit interest through other types of accounts have expressed concern that not being able to receive a Form 1042-S electronically will expose them to kidnapping for ransom or other bodily injury.

Section 401 of the Job Creation and Worker Assistance Act of 2002 provides that "[a]ny person required to furnish a statement under any section of subpart B of part III of subchapter A of chapter 61 of the Internal Revenue Code of 1986 for any taxable year ending after the date of the enactment of this Act, may electronically furnish such statement (without regard to any first class mailing requirement) to any recipient who has consented to the electronic provision of the statement in a manner similar to the one permitted under regulations issued under section 6051 of such Code or in such other manner as provided by the Secretary."

The IRS has exercised such authority to provide for electronic transmission of payee statements in Notice 2004-10 (regarding, in general, Forms 1099-R and 5498) and in Section 4.6 of IRS Publication 1179 (Rev. Proc. 2011-60) (regarding, in general, most Form 1098 and 1099 series). *Similar to the regulations issued under IRC §6051 (Reg. § 31.6051-1(j)(2)), affirmative consent of the payee is currently required before Form W-2 payee statements can be delivered electronically.*

IRPAC also recommends a change away from an affirmative consent and towards a negative consent in order expand the usage of electronic payee statements, including those that may currently be provided electronically. The response rate to any mail or electronic solicitation is, regrettably, generally ranging only from a few percentage points to the teens. Given the expense incurred to launch such solicitation efforts and the anticipated low response rates, many firms providing payee statements are hesitant to change from mailing paper statements to electronic delivery. As a result, year after year, there are complaints from customers about missing statements and identify thefts resulting from the mailing of paper statements. Firms providing the payee statements spend significant resources to sort and mail the paper statements, and then have to allocate resources to help customers on missing statements and identity thefts. This poses significant burdens both to the businesses providing such statements and the taxpayers receiving such statements.

The above cited legislation clearly grants the IRS broad flexibility in permitting electronic delivery of payee statements. We recommend that the IRS consider new regulations or administrative guidance to allow electronic delivery of payee statements to any person who has established online account access to receive account statements and other communications unless such person affirmatively elects to opt-out of electronic delivery of any or all payee statements (or opt-in to continue to receive paper statements). The IRS may provide for a transition period, such as a period of two years, during which the paper statements must still be provided with a notice informing the recipients of the transition to electronic delivery. This will give the recipients sufficient time and opportunity to opt-out from receiving statements electronically (or opt-in to continue receiving paper statements) should they choose to do so. Further IRPAC believes that permitting issuers to provide information returns electronically creates greater efficiency and security for all parties concerned.

6. IRS forms and publications.

IRPAC reiterates its prior recommendation that the IRS be required to post final information returns, instructions and publications on the IRS web site one year prior to the end of the applicable reporting period. The increasing number and complexity of information returns (for example, Form 1099-B) necessitates payers and software

vendors be able to have final revisions of any forms, instructions and publications available to them at least one year prior to the end of the applicable reporting period. If a final information return cannot be posted by that date, any revisions made thereafter should be optional until the following tax year. Generally, that deadline will be January 1, however, it should be noted that the IRS is creating information returns (such as IRS Form 1097-BTC) that must be mailed to recipients on a quarterly basis, instead of the standard annual basis following the end of a calendar year.

Most financial institutions and other payers do not report to their customers on the official IRS forms because the use of substitute forms and composite statements reduces printing and mailing costs. In addition, payers often include additional information that assists customers in completing their tax returns. IRS Publication 1179 provides guidelines for substitute forms, and in recent years that publication has not been released until December, which is only several weeks before payers start mailing forms for that tax year. Any changes from the prior year cannot be incorporated by that date.

Payers and software vendors must begin their analysis of any changes to forms, instructions and other IRS guidance included in various publications in the first quarter of the applicable tax year to provide sufficient time to make programming changes, test output and communicate changes to taxpayers. Generally, all programming and print formatting changes must be tested and finalized before the final months of the year when information systems are "locked down" and no more changes can be made because of the fact any change to one system can impact many other linked systems.

Revisions to forms, instructions and publications made after January 1 result in significant additional costs and staffing burdens to payers and software vendors. Such delayed revisions also prevent being able to communicate changes to taxpayers who will receive the information for inclusion on their tax returns. Creating a deadline for revisions to or the creation of information returns ensures greater accuracy and efficiency with the tax reporting process.

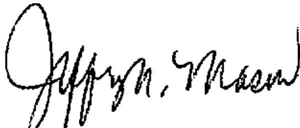
7. Revision of Form 8949 and Schedule D to include unique reporting requirements for contingent payment debt and other instruments. Taxpayers are generally unaware of the fact that a contingent payment debt instrument is not eligible for capital gain/loss treatment, as explained in Reg. §1.1275-4(b)(8). The primary reason for that is the Form 8949 and Schedule D do not have any provisions for reporting these securities separately and in a different manner from the disposition of other types of securities that are eligible for capital gain/loss treatment. Instruments known as currency shares are similarly treated and are also not addressed in the current versions of the applicable returns and schedules. Therefore, the IRS should revise these documents and their instructions accordingly to ensure accurate reporting by taxpayers of contingent payment debt instruments, currency shares or other instruments that are reported on Form 1099-B, but whose gains and losses are not considered capital.

8. Production of Form 2439 not currently filed electronically.
Each year, firms that produce Forms 1099-DIV are frequently required to also produce Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains. Unlike all the forms in the 1099 series, there is no provision to file the Form 2439 with the IRS electronically. This prompts financial services firms to literally pack boxes of paper Forms 2439 for delivery to the IRS. Mandatory paper Forms 2439 do not comport with the IRS' goal of moving to an electronic filing process for all taxpayer forms and returns where it is possible to do so. IRPAC recommends that the Service make a priority of creating electronic filing provisions for the Form 2439 and any other forms that are still filed on paper.

9. Reporting of OID accruals for stripped tax credit bonds. Brokers and other payers have found IRS Notice 2010-28 to be unworkable for reporting the correct amount for stripped tax credit bonds. At the time of the Notice, there were no stripped tax credits trading in the marketplace. That situation has now changed and IRPAC is pleased to see the IRS is seeking comments from the public regarding the effectiveness of the Notice. As part of that process, the IRS may wish to review IRPAC's analysis and recommendations found in its letter of July 26, 2012 (attached) covering these issues. In particular, a model is required for handling situations in which the acquisition cost is not known by the broker and the documented approach of aggregating multiple credits stripped from a single instrument must be eliminated in favor of an approach that considers each stripped credit as a stand alone instrument.

IRPAC thanks the IRS for requesting our recommendations for inclusion of items to include in the 2013-2014 Guidance Priority List. We look forward to working with you in creating a more efficient and sound tax administration system.

Respectfully Submitted,



2013 IRPAC Chair

Attachment: Stripped tax credit bonds analysis

INFORMATION REPORTING PROGRAM ADVISORY COMMITTEE (IRPAC)

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July 26, 2010

Mr. Timothy Jones
Office of Associate Chief Counsel (Financial Institutions and Products)
Re: Notice 2010-28
CC:FIP:B5, Room 3547
1111 Constitution Avenue, NW
Washington, DC 20224

Re: <u>Notice 2010-28-Additional Comments; Stripped Tax Credits and Form 1097-BTC</u>

Dear Mr. Jones:

The Information Reporting Program Advisory Committee (IRPAC)[1] appreciates the opportunity to provide additional comments on Notice 2010-28[2]. This Notice describes regulations that the Treasury Department and the Internal Revenue Service (IRS) expect to issue concerning both stripping transactions for qualified tax credit bonds under section 54A of the Internal Revenue Code and certain income tax accounting matters associated with holding and stripping these bonds. In addition, this Notice describes anticipated related information reporting requirements.

IRPACs comments include discussion and recommendations related to (1) OID computation on stripped tax credits where the purchase cost is unavailable, (2) treatment of stripped components as an aggregated instrument and (3) reporting tax credits on Form 1097-BTC.

STRIPPED TAX CREDITS

<u>Computing Original Issue Discount where Purchase Cost is Unavailable</u>

Original Issue Discount (OID) must be computed and reported for stripped tax credits. This computation requires three elements: the maturity date, the issue price and the issue date. Although a specific tax credit has a maturity date equivalent (allowance date) and a unique CUSIP identifier, there is no distinct issue price or issue date associated with that CUSIP number as there would be for a bond (whether interest bearing or zero coupon). For strips the original issue price is the holder's purchase

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[1] IRPAC was established in 1991 in response to an administrative recommendation in the final Conference Report of the Omnibus Budget Reconciliation Act of 1989. Since its inception, IRPAC has worked closely with the IRS to provide recommendations on a wide range of issues intended to improve the information reporting program and achieve fairness to taxpayers. IRPAC members are drawn from and represent a broad sample of the payer community, including major professional and trade associations, colleges, and universities, and state taxing agencies.

[2] See IRPAC's previous comments dated May 21, 2010.

price and the issue date is the holder's purchase date. Even in the context of traditional bond stripping, this information is not always available such as when securities are transferred to other brokers, or where they are acquired in a bulk acquisition through a delivery versus payment (DVP) account where custody for the beneficial owner is held elsewhere. In the context of stripping tax credits, secondary trading may be even more complex, such as when acquired in some form of collective ownership, such as through a trust or partnership and then distributed for use (apart from in a mutual fund context).

This circumstance will arise repeatedly on security positions transferred in the period before 2013 when fixed income instruments become "covered securities" in the context of the cost basis reporting requirements of section 403 of the Energy Improvement and Extension Act of 2008, Division B of Public Law 110-343. As a result, a method of computing the OID must be available when the custodian of the position having information reporting responsibility is not aware of the purchase price and purchase date for a given position.

The Treasury STRIP Model

The most prominent model for meeting this type of reporting requirement is the computation of OID for Stripped Components of U.S. Treasury and Government-Sponsored Enterprises. For holdings of these instruments, brokers and other middlemen may rely on section II of IRS Publication 1212[3]. This table provides a substitute amount that brokers and other middlemen use to accrue an approximation the OID income. Brokers are permitted, but not required, to compute the OID income specific to a holding and, if the purchase price and purchase date are not available they would then look to Publication 1212 to fulfill the reporting responsibility. Approximately 57% of the outstanding holdings[4] in currently in custody have the tax-lot-specific information required for this calculation, with the balance relying on the amounts published in Publication 1212.[5]

Cost basis reporting mandated for acquisitions after 2012 will, over time, increase the percentage of positions receiving the OID computation specific to the holder's purchase information, but will do nothing to enable brokers and other middlemen to meet the reporting requirement for strips purchased before that time. Moreover, not every relationship is considered under the cost basis requirements that will enable purchase price information sharing. There will be gaps.

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[3] The 2009 version of the Publication 1212 tables are found at http://www.irs.gov/pub/irs-utl/2009p1212_sect_i-iii_2nd.pdf. Section II is displayed on pages 86 and 87.

[4] The statistic is based on a sampling of firms whose data is processed by Wall Street Concepts, a business unit of SunGard Brokerage and Clearance.

[5] Additionally, Publication 1212 provides information for reporting OID income for maturing Treasury Bills and other short term discount obligations. This is another situation in which the custodian may not be in possession of the purchase cost, but is able to rely on the publication to fulfill information reporting obligations.

Recommendation

Section II of IRS Publication 1212 lists ranges of maturity dates and for each establishes the OID income per $1000 to report for an entire year. IRPAC recommends that the publication's structure be modified to accommodate an additional column for annual income on stripped tax credit allowances. The column currently titled "OID per $1000" would be renamed to distinguish it as applicable only to federal strips while the newly added column should be distinctly labeled as applicable to tax credit strips.

Alternately, the Service could publish annually a factor that allowed the amounts from Section II of Publication 1212 to be adjusted for use with stripped tax credits. This approach could also be extended to provide a factor for the interest payments stripped from tax credit bonds and tax credit bond corpuses. For a strip held an entire year the calculation would take the following form:
[Face amount/1000] * [Publication 1212 Amount] * [TC adjustment factor]

With Section II of Publication 1212 limited to 2 pages, we believe these approaches are worthy of consideration as practical and cost effective, particularly in consideration of the fact that cost basis regulations will eventually greatly limit the instances in which the purchase date and purchase price are unavailable. Further, the number of outstanding tax credit bonds for which strippable tax credits are available is limited by specific legislative authorizations. Also consider that within the Build America Bond population a great majority of issuers seem to be opting for the subsidy payments rather than issuing bonds with tax credits[6].

It is important to note that even though the gap will diminish, it will not be fully closed and purchase information will still be missing in some cases. There will need to be some rule for brokers as to what to do if such information is missing or considered unreliable. IRPAC suggests the better process is one of the methods suggested above. Brokers cannot be held accountable for data beyond their ability to acquire it.

Treating stripped components as an aggregated instrument

Notice 2010-28 foresees a broker treating a group of stripped components held in the same account that are derived from a common bond as a single aggregated instrument for the purpose of computing OID income. For a variety of reasons explained above and further below, this approach would be extremely difficult to implement as brokers will not always have access to the aggregated information nor will they have the systems architecture, industry infrastructure and reference data necessary to comply.

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[6] The SIFMA 2010 Municipal Issuance Survey indicates that only $5 billion of a projected $110 of taxable municipal bonds to be issued in 2010 will be tax credit bonds.
http://www.sifma.org/uploadedFiles/Research/ResearchReports/2009/Municipal_MunicipalIssuanceSurvey2010_20091207_SIFMA.pdf

Required information and available processes

The operations of financial services firms rely on a "Security Master" file which is a repository of descriptive information for stocks bonds and other financial instruments. The primary identifier used in these files is the CUSIP number. Descriptive information and features (issue date, maturity date, security type and classification) are stored to ensure proper treatment of the asset for various processes (transfer, valuation, income characterization, timing of payments, information reporting, etc.). Firms do not, however, have the necessary information or processes required to discern that various CUSIP numbers have a common parentage that would facilitate aggregation of the disparate stripped components as a single instrument[7]. Without having determined and stored this information, clearly, processes would need to be built to continuously review investor portfolios to determine if the assets held can or should be considered in aggregate. This process may even need to spread over many different accounts and between different financial institutions, presenting impossible tasks that even the cost basis provisions will not address.

If a collection of assets could be considered in aggregate, the custodian would then have to assign a unique identifier (not an industry recognized CUSIP number) and construct an OID rate schedule to supplement the publicly available amounts published in Publication 1212 in order to make this holding part of its information reporting processes[8]. If the aggregated position were transferred to another institution, the unique security number being used would not be recognizable to the receiving party. The transfer would be facilitated as movement of all the stripped components (identified by their standard CUSIP numbers) via the existing automated account transfer structure (ACATS) with book entry security movements at the industry's depositary, the Depository Trust Company (DTC). There are no universal rules for a firm's maintenance of security numbers apart from the CUSIP process.

Reconciliation with the depository

On a nightly basis, financial service firms reconcile their account positions both internally and externally. In the external reconciliation, firms are ensuring that they are in agreement with the various depositories at which their positions are held for settlement. This process relies on securities having identifiers that are recognized throughout the industry. As described above, for a firm to compute and report OID on an aggregation of stripped assets would require the creation of an identifier unique to the aggregation. The unique identifier would have to be tracked in some sort of shadow account while the actual books and records of the firm continued to

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[7] A CUSIP number's first 6 digits denote the identity of the issuer, but not the specific bond issue, so the structure of the number is not sufficient to reliably detect the existence of a potential aggregation. Also, for active issuers, the six digit prefix does change periodically.

[8] Each credit would be treated as non qualified stated interest payment, a yield would be calculated and a lifetime OID accrual schedule (associated with the unique identifier) would be created. A 12 month slice of the schedule, in the format of Publication 1212 entries, would be used in the process for each calendar year.

reflect the individual stripped components according to their CUSIP identifiers[9]. To do otherwise would cause perpetual mismatches with the depository (DTC breaks, in industry parlance).

With this shadow infrastructure not in existence anywhere, it is doubtful that aggregated reporting would ever become a reality, particularly in light of the limited number of instruments outstanding.

Integration with existing processes

The reportable OID income for an aggregated instrument would have to be merged into standard data streams for information reporting and systems would also have to be modified to ensure that no reportable amounts were computed for the strips individually (when an aggregation exists) as this would lead to double reporting. This is important, not just from the perspective of avoiding overreporting; if there is a single strip in an account, computation of its OID would have to be done according to its standard CUSIP identifier and must not be overlooked because an aggregation was anticipated.

Sales and transfers will create countless variations and combinations

If an aggregation was discernable and identifiable, there is nothing that would require the investor to retain the distinct aggregation for any length of time. For example, the owner of a bond with a term of ten years could strip the bond into its 41 components (corpus and 40 tax credits). Once stripped, they will independently trade in the secondary market, allowing the investor to immediately sell any number of the strips (in varying quantities). The remaining unsold pieces form a new aggregated instrument for which a cost basis must be established and OID accrual must proceed from that date forward (based on a newly constructed custom OID accrual rate schedule). The investor is free, at any time and with any frequency, to sell additional pieces and, in effect, create new aggregations that would require unique identifiers, computations of basis and a new OID accrual schedules. As a result, the number of unique aggregated instruments that an account could theoretically hold over time would be nearly infinite. Each sale transaction would also require allocation of a portion of the basis of the aggregated instrument to the piece sold for the 1099-B (as required beginning in 2013). Further, the investor would be able to reacquire any of the previously sold stripped tax credits through the secondary market, again creating a new aggregation.

It is important to note that anywhere in this process an aggregation, in whole or in part, can be transferred to another institution. Whether brokers offer a stripping process or not, most brokers will be forced to support the transfer of the composites.

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[9] It is worth noting that Notice 2010-28 03(c)(3) and (4) detail the requirements for tax credit issues to be held in book entry form and to have CUSIP numbers assigned for each strippable component. This suggests that there is a desire to have the reported income and tax credits associated with an identifier known, not only to the industry, but to the IRS as well. Aggregating under a single user-defined ID seems contrary to this intent.

If aggregation is not required, each stripped component becomes a unique instrument, identified by an industry recognized CUSIP number that was established by the bond's issuer at the time of the original offering. Although a casual observer might conclude that it is easier to track a single aggregated instrument, that instrument is an exception in every aspect of standard processing and is subject to infinite variations that would require substantial computation for each iteration imaginable.

In conflict with cost basis reporting requirements

If a collection of strips is considered in aggregate for the purpose of OID accrual but individually with regards to cost basis requirements (transfer statements and Forms 1099-B), we are dealing with multiple reporting requirements for a single asset. The accrual of OID is integral to the maintenance of an adjusted cost basis.

In the aggregation scenario, the custodian would establish a unique identifier to track the collection of strips and would have an associated cost basis for the aggregation. If the account were transferred to another financial service firm, the movement of securities through standard industry facilities would reflect the individual stripped components for which individual bases do not exist under the aggregation. Similarly, the sale of a single strip component from the aggregation will eventually require, under the cost basis regulations, that a basis be reported on the 1099-B although none had been established or tracked. Again, the movement of all the components might seem daunting because of the number of securities, but the transfer would actually be handled without incident, and, if no aggregation had been done, would far more readily include an adjusted basis.

Stripping as a transaction unique from the sale or transfer of a stripped component

As the tax credit bond market currently operates, the registrar (or other representative of the issuer) facilitates stripping transactions by accepting the bond and returning the various remaining tax credits (and/or interest payments and bond corpus) to the submitting institution[10]. There is no facility for an owner of the bond to selectively sell or transfer an individual tax credit, interest payment or bond corpus without first having the bond stripped into its component pieces. It is at this point in time that basis can be allocated to all the pieces[11]. Although this may seem more tedious than the aggregated approach, it ensures that the infinite revaluations and reassignments of basis that are possible with aggregation do not take place. This facilitates the accrual of OID routinely on each component, and, in turn, the transfer of these assets with adjusted cost basis.

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[10] This process was described in greater detail in IRPAC's comment letter dated May 21, 2010.

[11] When publishing regulations regarding the handling of fixed income instruments for cost basis reporting, the IRS would be able to provide guidance regarding the method of allocating basis from the original bond to its components. This would ensure a consistent approach to determining the issue price of the strips for purposes of OID computation. There is an implication here that the issuer's agent would be responsible for allocating the basis received on the transfer statement for the bond. This must be clarified in future regulations.

Further, it will allow the product to trade in the secondary market which is a critical component of keeping the product liquid and assuring a market exists to support any sales including initial offerings since the reception, even in initial offering in the market, will rely on ability to later sell if necessary. Aggregation will encumber this process.

This segregation of stripping from the sale of stripped components is not unique. The best model, again, is found in the Treasury market where the ability of an investor to strip a bond is available only via a financial institution. It is explained as follows on the TreasuryDirect website: "STRIPS are not issued or sold directly to investors. STRIPS can be purchased and held only through financial institutions and government securities brokers and dealers."[12]

Recommendation

For investors holding disparate stripped bond components (with common ancestry) in an account, IRPAC recommends that brokers be required to report the accrual of OID income to investors specific to each separate strip. Additionally, brokers should be permitted to report to their investors using an aggregated approach as an alternative. Maintaining the strips as unique assets has numerous benefits:

- The need to track shadow positions for aggregations while keeping the firm's books and records synchronous with the depositories is eliminated;
- The income, tax credits and sales proceeds associated with a particular strip would be reported under the same CUSIP number, providing greater simplicity for the investor and greater audit capability for the IRS;
- By employing existing system architecture, the cost of implementation is minimized while its speed is maximized;
- By reporting OID on each stripped component rather than an aggregation, the relationship between OID reporting and cost basis is maintained;
- With the maintenance of basis simplified, the ability to transfer positions from one firm to another with adjusted cost basis or include basis on the 1099-B when a component is sold is maximized; and
- If the initial basis in a bond is allocated among the various stripped tax credits, interest payments and bond corpus only when stripping takes place, a potentially unending number of customized calculations for OID and basis allocation is eliminated.

[12] Additionally, the Commercial Book Entry System is operated by the Federal Reserve Banks as fiscal agent of the Treasury. See. http://www.treasurydirect.gov/instit/auctfund/held/cbes/cbes.htm

REPORTING TAX CREDITS ON FORM 1097-BTC

New form and reporting requirement

Form 1097-BTC is a new form requiring annual reporting to the IRS and quarterly reporting to beneficial owners of tax credits. Besides the 1097-BTC being an entirely new form, the fact that it requires reporting with greater than annual frequency and that it covers non-cash events make implementation for 2010 (when only annual reporting is required) a huge challenge. Also, since many firm's production of information returns involves substitute statements, the lack of guidance in this regard is an additional impediment.

Recommendations

To ensure a smooth and accurate implementation of this reporting requirement, IRPAC offers the following suggestions:

Consider whether an additional form is necessary

Since the beneficiary of the tax credit allowance will receive a 1099-INT or 1099-OID reflecting the income recognition related to the tax credit, it would seem that an additional box on each of those forms might be sufficient for the annual reporting. With CUSIP level reporting already under consideration for the tax exempt issues reported on a Form 1099-INT and 1099-OID already a CUSIP specific form, this might be a good fit. It would also provide the investor with a more concise view of all the implications of the investment.

Allow flexible means of notification for quarterly requirement

With information reporting systems essentially geared to annual production, the addition of a quarterly requirement is challenging, particularly for noncash activity that is not captured by such systems (nor a monthly statement systems, for that matter). IRPAC recommends that the IRS adopt a flexible approach to allowing firms to notify beneficial owners of their allowance. This would included individual notices (electronic notification permitted), inclusion in monthly statements, etc.

Allow as part of a consolidated payee statement

If a distinct 1097-BTC is deemed to be required, IRPAC recommends that it be permitted as part of a consolidated payee statement along with Forms 1099-DIV/INT/OID/B.

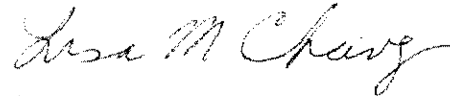
Delay the requirement to allow for development

Regardless of which course is taken, it is too late in the year to design, test and implement this reporting, particularly considering the lack of an official form and guidance regarding substitute statements. IRPAC recommends that the annual

reporting requirement be moved back to 2011 and the quarterly to 2012 (or later if the required guidance is not forthcoming during 2010).

Thank you for the opportunity to provide these additional comments on Notice 2010-28. We are available at your convenience to discuss these comments with you and your staff. If you have any questions, please contact the undersigned.

Sincerely,



Lisa M. Chavez
2010 IRPAC Chair

Notice 2013-22

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April 5, 2013

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Re: *I.R.S. Penalties Under 26 U.S.C. § 6676*

Dear Messrs. Miller, Wilkins, and Mazur, and Ms. McMahon:

I write pursuant to the Department of Treasury ("Department") and Internal Revenue Service's solicitation of public comment on its 2012-2013 Priority Guidance Plan, to supplement my letter of June 1, 2012. That letter (a copy of which is enclosed as Attachment A) addressed the serious constitutional concerns raised by § 6676 of the Internal Revenue Code, which provides for a 20% penalty on "erroneous" refund claims. Specifically, I wish to call your attention to the recent decision by the United States District Court for the District of Columbia (also enclosed as Attachment B), which concluded that the filing of administrative refund claims is protected by the Petition Clause of the First Amendment.

As explained in my previous letter, the First Amendment's Petition Clause has long been held to protect requests by citizens for relief directed to all branches of the Government, including executive branch agencies such as the Department and the IRS. Moreover, under

settled Supreme Court precedents, the Government may not impose financial penalties on citizens for engaging in protected petitioning activity, except in the narrow, exceptional case of "sham" petitions that are both objectively baseless and subjectively motivated by bad faith.

In *Ryan, LLC v. Lew*, No. 12-cv-565 (RLW), --- F. Supp. 2d ---, 2013 WL 1278510 (D.D.C. Mar. 29, 2013), the district court concluded that an administrative claim for refund constitutes First Amendment activity under the Petition Clause because it seeks relief from the Government – namely, a refund of taxes already paid to the U.S. Treasury. *Ryan* involved a constitutional challenge under the Petition Clause and the Due Process Clause to IRS's Circular 230, which prohibits the use of contingency fee arrangements in the preparation and filing of administrative refund claims. In moving to dismiss, the Government asserted broadly that "the Petition Clause does not protect 'a taxpayer's right to file an administrative claim for refund' with the IRS." 2013 WL 1278510, at *12 (quoting the Government's reply brief). But the Court disagreed, concluding that "[i]nsofar as the Internal Revenue Service is an administrative agency established by the Government, the Court believes that the Petition Clause would protect citizens' rights to file claims with the IRS." *Id.*

While the Court's conclusion was technically *dicta*, because Plaintiffs' challenge to Circular 230 was dismissed on other grounds, it rests on the straightforward application of two Supreme Court cases discussed in my June 1, 2012 letter: *Borough of Duryea v. Guarnieri*, 131 S. Ct. 2488 (2011), and *California Motor Transport Co. v. Trucking Unlimited*, 404 U.S. 508 (1972). In *Borough of Duryea*, the Supreme Court "explicitly held that [the] Petition Clause guarantees citizens the ability to seek relief with courts, but it has also made clear that these protections extend to 'other forums established by the government for the resolution of legal disputes.'" *Ryan, LLC*, 2013 WL 1278510, at *12 (quoting 131 S. Ct. at 2494). Indeed, Justice Scalia's separate opinion in *Borough of Duryea* used petitions for tax relief as a paradigmatic example of what the Petition Clause was meant to protect. *See* 131 S. Ct. at 2505 (citing "a letter . . . protesting a tax assessment that he claimed was mistaken" as within "the principal purpose of the Petition Clause").

Likewise, in *California Motor Transport Co.*, the Supreme Court explained that "[t]he same philosophy governs the approach of citizens or groups of them to administrative agencies (which are both creatures of the legislature, and arms of the executive) and to courts, the third branch of Government. Certainly the right to petition extends to all departments of the Government. The right of access to the courts is indeed but one aspect of the right of petition." 404 U.S. at 510.

As things currently stand, the Department and the IRS have not yet issued any formal guidance or regulations limiting the enforcement of § 6676. According to the 2012-2013 Priority Guidance Plan, the Department and IRS are still considering the issue. Absent any limit on the enforcement of § 6676, however, the threat of financial penalties under § 6676 remains, and

creates an ongoing "chilling effect" on the exercise of taxpayers' constitutionally protected right to request refunds of taxes paid through the administrative refund process.

Because these concerns extend beyond ordinary matters of tax administration, and implicate serious constitutional concerns, the Department and IRS should invite public comment on the appropriate scope of any guidance or regulations regarding the implementation of § 6676. In the meantime, I hope that my correspondence is helpful in advancing the Department and the IRS's consideration of these important issues. Of course, I would also be pleased to discuss these matters with you further at any time.

I can be reached at (202) 326-7931.

Sincerely,

Derek T. Ho

Encl.

Attachment A

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June 1, 2012

Via Overnight Delivery

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Re: *I.R.S. Penalties Under 26 U.S.C. § 6676*

Dear Mr. Commissioner, Mr. Wilkins, Ms. McMahon, and Mr. Mazur:

I write in response to the Department of the Treasury's and Internal Revenue Service's updated 2011-2012 Priority Guidance Plan, in which the Department and the IRS announced they are currently considering regulations implementing § 6676 of the Internal Revenue Code. As you know, § 6676 provides for a 20% penalty on taxpayers to the extent they file "excessive" refund claims. I write on behalf of a client that has been assessed penalties under § 6676 to address the serious constitutional concerns raised by the imposition of such penalties. For the reasons set forth below, imposing a penalty on taxpayers for seeking a refund of taxes paid violates taxpayers' First Amendment right to petition the government for redress of grievances, except where the refund claim itself constitutes a "sham." We thus request that the Department and the IRS promulgate regulations or written policies to ensure that § 6676 is not enforced in a manner that violates taxpayers' First Amendment right to petition the government for redress of grievances.

A claim for a tax refund falls squarely within the First Amendment's protection of the "right of individuals to appeal to courts and other forums established by the government for resolution of legal disputes." *Borough of Duryea, Pa. v. Guarnieri*, 131 S. Ct. 2488, 2494 (2011). The Petition Clause forbids imposition of penalties upon the exercise of the right to petition except where the petition constitutes a "sham." To constitute a "sham," a refund claim must be "both (i) objectively baseless in that no reasonable litigant could expect success on the merits and (ii) subjectively motivated by bad faith." *Porous Media Corp. v. Pall Corp.*, 186 F.3d 1077, 1080 n.4 (8th Cir. 1999).[1] Imposition of a penalty under § 6676 violates taxpayers' First Amendment rights with respect to any refund claim that does not amount to a "sham."

Two subsections in particular pose serious constitutional questions. First, § 6676(a) – which provides for a 20% penalty on any unsuccessful refund claim unless the claim is supported by a "reasonable basis" – violates the First Amendment if the "reasonable basis" safe-harbor is more stringent than the "sham" exception to the Petition Clause. Second, § 6676(c) – which appears to authorize a "strict liability" 20% penalty for all unsuccessful refund claims that concern noneconomic substance transactions, no matter how reasonable the basis for the claim – violates the Petition Clause as applied to any non-sham refund claim regarding such a transaction.

These penalty provisions on their face have a substantial chilling effect on the exercise of the right to petition, as taxpayers who seek resolution of a tax dispute regarding a refund will be deterred by the fear that if they are unsuccessful, they will be required to pay a 20% penalty. Accordingly, for the reasons elaborated on below, the Department and IRS should promptly limit the enforcement of § 6676 to avoid a violation of the First Amendment Petition Clause. Specifically, the Department and IRS should promulgate regulations making clear that penalties under § 6676 will be imposed only for refund claims that qualify as "shams," in that they both lack an objectively reasonable basis and are subjectively motivated by bad faith.

I. I.R.C. § 6676

26 U.S.C. § 6676 reads in full:

> (a) Civil penalty.--If a claim for refund or credit with respect to income tax (other than a claim for a refund or credit relating to the earned income credit under section 32) is made for an excessive amount, unless it is shown that the claim for such excessive amount has a reasonable basis, the person making such claim shall

[1] The "sham" exception to the Petition Clause is unrelated to the "sham transaction" doctrine under the tax laws.

> be liable for a penalty in an amount equal to 20 percent of the excessive amount.
>
> (b) Excessive amount.--For purposes of this section, the term "excessive amount" means in the case of any person the amount by which the amount of the claim for refund or credit for any taxable year exceeds the amount of such claim allowable under this title for such taxable year.
>
> (c) Noneconomic substance transactions treated as lacking reasonable basis.--For purposes of this section, any excessive amount which is attributable to any transaction described in section 6662(b)(6) shall not be treated as having a reasonable basis.
>
> (d) Coordination with other penalties.--This section shall not apply to any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under part II of subchapter A of chapter 68.

Congress added § 6676 to the Tax Code as part of the Small Business and Work Opportunity Tax Act of 2007. *See* Pub. L. No. 110-28, § 8247(a), 121 Stat. 112, 190, 204. The original provision consisted only of current subsections (a), (b), and (d). Congress added subsection (c) in 2010 as part of the Health Care and Education Reconciliation Act of 2010 ("HCERA"), which was signed as part of the reconciliation process for the Patient Protection and Affordable Care Act. *See* Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1070.

II. Imposing Penalties Under Section § 6676 Violates the First Amendment's Right to Petition Except Where Refund Claims Amount to a "Sham"

A. The Right to Petition and the "Sham" Exception

The First Amendment provides that "Congress shall make no law . . . abridging . . . the right of the people . . . to petition the Government for a redress of grievances." U.S. Const. amend. I. The Supreme Court's "precedents confirm that the Petition Clause protects the right of individuals to appeal to courts and other forums established by the government for resolution of legal disputes." *Borough of Duryea, Pa.*, 131 S. Ct. at 2494; *see Bill Johnson's Rests., Inc. v. NLRB*, 461 U.S. 731, 741 (1983) ("the right of access to the courts is an aspect of the First Amendment right to petition").

The substantive standards governing the right to petition are established by the *Noerr-Pennington* doctrine. In *Noerr*[2] and *Pennington*,[3] the Supreme Court construed the Sherman Act narrowly in order to avoid infringing the First Amendment right to petition. *See Noerr*, 365 U.S. at 132 n.6, 138. Although initially decided in the antitrust context, "*Noerr-Pennington* was crafted to protect the freedom to petition guaranteed under the First Amendment," *Mercatus Grp., LLC v. Lake Forest Hosp.*, 641 F.3d 834, 846 (7th Cir. 2011), and the doctrine "is today understood as an application of the first amendment's speech and petitioning clauses," *New West, L.P. v. City of Joliet*, 491 F.3d 717, 722 (7th Cir. 2007).

1. Protected Conduct

Courts have recognized that "petition[ing] [of] the Government for a redress of grievances" broadly covers efforts by private parties to seek relief from the Government. U.S. Const. amend. 1. Protected activity includes petitioning the legislature for the passage of laws, *see Noerr*, 365 U.S. 127, petitioning the executive branch for the enforcement of laws, *see Pennington*, 381 U.S. 657, and petitioning courts and administrative agencies for relief under the laws, *see California Motor Transp. Co. v. Trucking Unlimited*, 404 U.S. 508 (1972). "Certainly the right to petition extends to all departments of the Government." *Id.* at 510; *see also American Bus. Ass'n v. Rogoff*, 649 F.3d 734, 738 (D.C. Cir. 2011) ("The right [to petition] extends to [petitioning] all departments of the Government, including administrative agencies and courts.") (internal quotations omitted). Petitions for relief directed to the Department and the IRS thus fall squarely within the conduct protected by the Petition Clause.

2. Prohibited Infringement

Noerr and *Pennington* establish the principle "that when a person petitions the government for redress, the First Amendment prohibits *any sanction* on that action." *Nader v. Democratic Nat'l Comm.*, 567 F.3d 692, 696 (D.C. Cir. 2009) (emphasis added). Individuals that petition the government are therefore protected from a variety of sanctions that might chill their petitioning activity — from direct bans or injunctions of the petition, to more indirect measures, such as an oppressive investigation of petitioners, or statutory and common law liability for bringing the petition.[4] Numerous cases have specifically held that the Petition

[2] *Eastern R.R. Presidents Conference v. Noerr Motor Freight, Inc.*, 365 U.S. 127 (1961).

[3] *United Mine Workers of Am. v. Pennington*, 381 U.S. 657 (1965).

[4] *See Bill Johnson's Rests.*, 461 U.S. at 743 (NLRB may not enjoin the "filing and prosecution of a well-founded lawsuit" as an "unfair labor practice" unless the suit is "based on insubstantial claims"); *White v. Lee*, 227 F.3d 1214, 1228, 1231 (9th Cir. 2000) (eight-month HUD investigation into the activities and beliefs of individuals suspected of engaging in unlawful

Clause protects individuals from being subject to financial liability for petitioning the government. *See, e.g.*, *Sosa v. DirectTV, Inc.*, 437 F.3d 923 (9th Cir. 2006) (*Noerr-Pennington* bars civil RICO claims for petitioning the government); *Porous Media Corp.*, 186 F.3d at 1080 n.4 (*Noerr-Pennington* bars tort claims for petitioning the government); *Video Int'l Prod., Inc. v. Warner-Amex Cable Commc'ns, Inc.*, 858 F.2d 1075, 1084 (5th Cir. 1988) (*Noerr-Pennington* bars tortious interference with contractual relations claims for petitioning the government); *Gorman Towers, Inc. v. Bogoslavsky*, 626 F.2d 607, 614-15 (8th Cir. 1980) (*Noerr-Pennington* bars § 1983 claims for petitioning the government); *Missouri v. National Org. for Women, Inc.*, 620 F.2d 1301, 1318-19 (8th Cir. 1980) (*Noerr-Pennington* bars tortious infliction of economic harm claims for petitioning the government); *Stern v. U.S. Gypsum, Inc.*, 547 F.2d 1329 (7th Cir. 1977) (*Noerr-Pennington* bars § 1985 claims for petitioning the government); *Sierra Club v. Butz*, 349 F. Supp. 934, 938-39 (N.D. Cal. 1972) (*Noerr-Pennington* bars contractual interference claims for petitioning the government).

Section 6676's 20% penalty infringes on the right to petition, because it imposes a financial penalty (similar to tort liability) for petitioning the government over a disputed tax liability. *See also American Commc'ns Ass'n, C.I.O. v. Douds*, 339 U.S. 382, 402 (1950) (noting that "fines" and "taxes" have a "coercive effect upon the exercise of First Amendment rights"). Indeed, it is well-established as a general matter that the imposition of financial sanctions on speech or petitioning activity impermissibly chills that activity, and thus infringes the First Amendment.[5]

3. "Sham Litigation" Exception

The Supreme Court has carved out a very limited exception to the First Amendment's protection for petitioning activity, known as the "sham" exception. The Court has reasoned that "since sham litigation by definition does not involve a bona fide grievance, it does not come within the first amendment right to petition." *See Bill Johnson's Rests.*, 461 U.S. at 743. Thus, "sham" petitions are not protected, but all other petitions are, even where ultimately unsuccessful. A legal claim for relief is considered a sham in only three narrow circumstances.

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discriminatory housing practice by filing state court action to oppose zoning permit "unquestionably chilled" right to petition).

[5] *See, e.g.*, *Arkansas Writers' Project, Inc. v. Ragland*, 481 U.S. 221 (1987) (striking down sales tax selectively imposed on some types of publications but not others); *Minneapolis Star & Tribune Co. v. Minnesota Comm'r of Revenue*, 460 U.S. 575 (1983) (imposition of special tax on media violates First Amendment); *New York Times Co. v. Sullivan*, 376 U.S. 254 (1964) (imposition of damages liability for libel of public official infringes First Amendment absent proof of "actual malice").

First, a lawsuit is a sham if "it is both (i) objectively baseless in that no reasonable litigant could expect success on the merits and (ii) subjectively motivated by bad faith." *Porous Media Corp.*, 186 F.3d at 1080 n.4 (citing *Professional Real Estate Investors, Inc. v. Columbia Pictures Indus., Inc.*, 508 U.S. 49, 61-62 (1993)).[6] The "objectively baseless" standard requires, in essence, that the petition must be legally frivolous. *See City of Columbia v. Omni Outdoor Adver., Inc.*, 499 U.S. 365, 380 (1991) (noting that "frivolous objections to the license application of a competitor" are a "classic" example of sham litigation). This stringent test is designed to differentiate the use of governmental processes to commit wrongdoing (sham) from a genuine effort to influence government and obtain a favorable outcome (not sham). *See City of Columbia*, 499 U.S. at 381-82; *Mark Aero, Inc. v. Trans World Airlines, Inc.*, 580 F.2d 288, 296-98 (8th Cir. 1978).

Under this two-prong test, the Supreme Court has specifically held that if the petition has an objective basis, it cannot be a sham, regardless of the petitioner's motivation. *See Professional Real Estate Investors*, 508 U.S. at 60-61. Moreover, even if the petition is objectively baseless, the petition is not a "sham" unless the petitioner filed it in bad faith. *See id.* As several federal courts have noted, the requirement of subjective bad faith exists deliberately to "overprotect[] baseless petitions" so as to create the "breathing room" necessary to safeguard the First Amendment right to petition. *Sosa*, 437 F.3d at 934; *see BE & K Constr. Co. v. NLRB*, 536 U.S. 516, 531 (2002); *cf. New York Times*, 376 U.S. at 283-84 (only permitting the punishment of false statements made with "actual malice").

Second, "a series of lawsuits brought pursuant to a policy of starting legal proceedings without regard to the merits and for an unlawful purpose" constitutes a "sham." *Sosa*, 437 F.3d at 938 (internal quotation marks omitted); *Kottle v. Northwest Kidney Ctrs.*, 146 F.3d 1056, 1060 (9th Cir. 1998). This applies even if any one of the lawsuits "has merit — some may turn out to, just as a matter of chance —" so long as they are brought pursuant to the said policy. *Kottle*, 146 F.3d at 1060. Where the purpose of serial litigation is not to resolve bona fide legal disputes, but to harass, it is not protected.

Third, litigation may be a sham where it involves knowing fraud "that deprives [the] litigation of its legitimacy." *Baltimore Scrap Corp. v. David J. Joseph Co.*, 237 F.3d 394, 399-

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[6] The original test, set forth in the antitrust context, is as follows: first, "the lawsuit must be objectively baseless in the sense that no reasonable litigant could realistically expect success on the merits"; second, focusing on "the litigant's subjective motivation," the lawsuit must "conceal[] an attempt to interfere directly with the business relationships of a competitor through the use of the governmental process — as opposed to the outcome of that process — as an anticompetitive weapon." *Professional Real Estate Investors*, 508 U.S. at 60-61 (internal quotation marks, citation, and alterations omitted).

402 (4th Cir. 2001); *Liberty Lake Invs., Inc. v. Magnuson*, 12 F.3d 155, 159 (9th Cir. 1993) (where there is "proof that a party's knowing fraud upon, or its intentional misrepresentations to, the court deprive the litigation of its legitimacy"); *United States v. Philip Morris USA Inc.*, 566 F.3d 1095, 1124 (D.C. Cir. 2009) ("Where statements are deliberately false or misleading, *Noerr-Pennington* does not apply."); *see generally California Motor Transp.*, 404 U.S. at 513 ("Misrepresentations, condoned in the political arena, are not immunized when used in the adjudicatory process."). This is a limited exception, requiring fraud that affects the outcome of the litigation. *See, e.g., Cheminor Drugs, Ltd. v. Ethyl Corp.*, 168 F.3d 119, 123 (3d Cir. 1999) ("While we do not condone misrepresentations in a judicial setting, neither will we deprive litigants of immunity derived from the First Amendment's right to petition the government if the alleged misrepresentations do not affect the core of the litigant's" case).

In short, unless a petition falls within one of these three "sham" categories, it is protected by the First Amendment's Petition Clause, and may not be sanctioned, even if it is ultimately unsuccessful.

B. Penalties for Non-Sham Refund Claims Violate the Right to Petition

1. Refund Claims Are Constitutionally Protected Petitioning Activity

A claim for refund under § 6676 qualifies as protected First Amendment activity because it seeks relief from the Government – namely, a refund of taxes already paid to the U.S. Treasury. The Department's regulations confirm that a "claim for refund" constitutes a request for Government action: "The claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof. The statement of the grounds and facts must be verified by a written declaration that it is made under the penalties of perjury." Treas. Reg. § 301.6402-2(b)(1) (2012).

A claim for refund to the IRS is also protected because it is an incident to litigation over disputed tax liability. A refund claim is a prerequisite to – and therefore "incidental to" – a formal judicial lawsuit seeking a refund, which itself is also protected by the Petition Clause. *See Ziegler v. United States*, No. 83 C 8184, 1984 WL 2804, at *5 (N.D. Ill. Apr. 16, 1984) (finding that a taxpayer's "appearance before this court seeking a refund of the penalty already paid is a clear exercise of their First Amendment right [to petition]"). "[C]onduct incidental to a petition is protected by *Noerr-Pennington* if the petition itself is protected." *Freeman v. Lasky, Haas & Cohler*, 410 F.3d 1180, 1184 (9th Cir. 2005) (internal quotation marks omitted).[7] Courts

[7] In the litigation context, for example, such conduct includes preparation for litigation, discovery during litigation, and settlement negotiations to end litigation. *See, e.g., Baltimore Scrap Corp.*, 237 F.3d at 4013 (funding litigation is protected conduct); *United Mine Workers of Am., Dist. 12 v. Illinois State Bar Ass'n*, 389 U.S. 217, 222 (1967) (hiring attorneys for others is

have extended the doctrine in this way in order to provide the "breathing space" necessary for the right to petition. *Sosa*, 437 F.3d at 933.

2. Imposing a 20% Penalty on Unsuccessful Refund Claims Violates the First Amendment Unless the Claim Meets the Sham Litigation Standard

Under settled Petition Clause jurisprudence, the Government may not impose monetary penalties on constitutionally protected petitioning activity. Imposing a 20% penalty on an unsuccessful refund claim unquestionably chills legitimate petitioning activity. Therefore, § 6676 is unconstitutional to the extent such penalties are imposed on refund claims that do not qualify as a "sham."

The imposition of a penalty under § 6676 would violate the Petition Clause in at least two circumstances. First, § 6676(a) imposes a penalty for refund claims brought without a "reasonable basis," but it is not clear that the standard for claims lacking a "reasonable basis" matches the standard for "sham" petitioning activity that is unprotected by the First Amendment. For purposes of I.R.C. § 6662, for example, the Department has provided that "[r]easonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim." *Id.* § 1.6662-3(b)(3). If the Department were to interpret "reasonable basis" under § 6676 in the same fashion, it would lead to the imposition of unconstitutional penalties on refund claims that are protected by the First Amendment because they do not constitute "sham" petitions. A "colorable" or "arguable" refund claim cannot be penalized, because it is not objectively baseless, even leaving aside the issue of subjective bad faith.

Second, imposing a penalty under § 6676(c) on all unsuccessful refund claims that concern noneconomic substance transactions would violate the Petition Clause as applied to any non-sham refund claim. The potential for § 6676(c) to violate the Petition Clause is plain on the face of the statute. Pursuant to Congress's "clarification" of the economic substance doctrine in the HCERA, effective 2010, in order to establish that a transaction has economic substance, the taxpayer must demonstrate: (1) that the transaction objectively "changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position;" *and* (2) that the taxpayer subjectively had "a substantial purpose (apart from Federal income tax effects) for entering into such transaction." 26 U.S.C. § 7701(o)(1)(A)-(B). This requirement is conjunctive. Thus, even if a taxpayer enters into a transaction with a good-faith non-tax business

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protected conduct); *McGuire Oil Co. v. Mapco, Inc.*, 958 F.2d 1552, 1560 (11th Cir. 1992) (threats of litigation are protected conduct); *Freeman*, 410 F.3d at 1184 (discovery communications are protected conduct).

purpose, the transaction could still be held to lack economic substance if it was deemed not to objectively change the taxpayer's economic position. And the transaction likewise could be held to lack economic substance even though it did objectively change the taxpayer's economic position, if the taxpayer were held not to have had a subjective, non-tax business purpose. Moreover, as discussed above, § 6676(c) appears to provide for strict liability: the taxpayer is charged with the 20% penalty even if he or she had a reasonable basis to believe that the transaction had economic substance.

Under the Petition Clause, as interpreted by *Noerr-Pennington*, the Government may not impose a penalty on a refund claim unless "no reasonable litigant could expect success on the merits" *and* the suit was subjectively filed in bad faith. *Porous Media*, 186 F.3d at 1080 n.4. Thus, if the taxpayer had a non-frivolous argument that the transaction had economic substance, the refund claim could not constitute sham litigation, even if the taxpayer lost. Moreover, even a refund claim that was objectively baseless would not constitute a sham unless it was *also* subjectively motivated by bad faith. Yet § 6676(c) appears to impose a penalty regardless of whether a reasonable litigant might have had an objective basis to expect success, and regardless of whether the suit was brought in bad faith. Accordingly, § 6676(c)'s penalty provision is unconstitutional as applied to any refund claim that is not a "sham."

III. The Department and the IRS Should Promulgate Regulations Limiting Enforcement of § 6676 to Sham Refund Claims, So As Not To Violate the First Amendment's Petition Clause

Under the doctrine of constitutional avoidance, the Department and the IRS should act promptly to limit the application of § 6676 to avoid infringement on taxpayers' First Amendment right to petition. Specifically, the Department and the IRS should take two actions to avoid imposing penalties under § 6676 that would violate the First Amendment Petition Clause. First, the Department should promulgate regulations interpreting the "reasonable basis" standard in § 6676(a) to be consistent with the *Noerr-Pennington* "sham" petition standard, such that a refund claim cannot be penalized unless it is both objectively baseless (*i.e.*, legally frivolous) and motivated by an improper motive other than a genuine desire to obtain relief from the Government. Courts have repeatedly invoked the doctrine of constitutional avoidance to preserve the statute in question but narrow it in order to avoid impinging on the right to petition.[8] The Department and the IRS likewise have the responsibility to avoid interpreting and applying

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[8] *See Whelan v. Abell*, 48 F.3d 1247, 1254 (D.C. Cir. 1995) (noting that the Court has used "the filter of *Noerr-Pennington* . . . to justify narrow constructions of federal law"); *see, e.g., BE & K Constr.*, 536 U.S. at 535-36 (construing NLRA to avoid right to petition problem); *Stern*, 547 F.2d at 1344 (construing § 1985 to avoid right to petition problem); *Manistee Town Ctr. v. City of Glendale*, 227 F.3d 1090, 1093 (9th Cir. 2000) (construing § 1983 to avoid right to petition problem).

§ 6676(a) in a way that violates the U.S. Constitution. *See, e.g., Edward J. DeBartolo Corp. v. Florida Gulf Coast Bldg. & Constr. Trades Council*, 485 U.S. 568, 574-76 (1988) (rejecting agency interpretation that created serious doubts about the validity of the statute).

Similarly, to save § 6676(c) from constitutional infirmity, the Department and IRS should, through formal regulations or otherwise, make clear that it will not impose any penalty except with respect to petitions that satisfy the "sham" exception to the Petition Clause. Although § 6676(c) on its face appears unambiguously to create a "strict liability" rule, the Department and the IRS have an independent responsibility to act within constitutional limits, even if that means declining to enforce a federal statute to its full extent. *See United States v. Navarro-Vargas*, 408 F.3d 1184, 1203 (9th Cir. 2005) ("[I]f the president or the attorney general determines that a law is either unwise or unconstitutional, he may decline to enforce the law and will do so systematically and, often, publicly."); *Baltimore Gas & Elec. Co. v. F.E.R.C.*, 252 F.3d 456, 459 (D.C. Cir. 2001) (noting that the executive branch has "the prerogative to decline to enforce a law, or to enforce a law in a particular way"). Thus, just as the Supreme Court created a judicial safe-harbor from Sherman Act liability for constitutionally protected petitioning activity in *Noerr* and *Pennington*, the Department and the IRS should recognize a safe-harbor from the imposition of penalties under § 6676(c) for refund claims that are protected by the Petition Clause.

Taxpayers with objectively reasonable, good-faith disputes about the proper application of the Tax Code have reason to fear that if they submit or litigate a refund claim that is ultimately unsuccessful, they will face hefty penalties under § 6676 merely for seeking resolution of their legal dispute. Section 6676 on its face therefore dramatically threatens rights that have "long been recognized as a cornerstone of democratic government itself." *Mercatus Grp.*, 641 F.3d at 846. Given the severe chilling effect created by the threat of substantial penalties on petitioning activity, it is imperative that the Department and the IRS act promptly to make clear that § 6676 will not be applied to infringe on these core constitutional rights. Given the gravity of the constitutional concerns regarding § 6676, we would welcome the opportunity to discuss these issues with you further. I can be reached at (202) 326-7931.

Sincerely,

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Attachment B

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United States District Court,
District of Columbia.

RYAN, LLC, et al., Plaintiffs,
v.
Jacob LEW, U.S. Secretary of
the Treasury, et al., Defendants.

Civil Action No. 12–cv–565
(RLW). | March 29, 2013.

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Opinion

MEMORANDUM OPINION

ROBERT L. WILKINS, District Judge.

*1 Plaintiffs Ryan, LLC, G. Brint Ryan, and Gerald Lee Ridgely (collectively, "Plaintiffs") bring this action against Jacob Lew, in his official capacity as the U.S. Secretary of the Treasury, [1] and against Douglas H. Shulman, in his official capacity as the Commissioner of the Internal Revenue Service ("IRS") (collectively, the "Government"). Plaintiffs challenge certain provisions of Title 31, Section 10 of the Code of Federal Regulations—commonly known as "Circular 230"—that generally limit the use of contingent fee arrangements in connection with the preparation and filing of refund claims with the IRS. *See* 31 C.F .R. § 10.27. More specifically, Plaintiffs mount three distinct attacks against Circular 230:(1) Ryan, LLC and Mr. Ryan argue that Circular 230 violates their rights under the Petition Clause of the First Amendment (Count I); (2) Mr. Ryan argues that Circular 230 violates his Fifth Amendment Due Process Rights (Count II); and (3) Mr. Ridgely brings suit under the Administrative Procedure Act ("APA"), 5 U.S.C. §§ 701, *et seq.*, arguing that the IRS exceeded its statutory authority in promulgating Circular 230 (Count III). Plaintiffs seek a declaratory judgment that Circular 230's restrictions of contingent fee arrangements in the context of "ordinary refund claims" is unconstitutional and exceeds the scope of the IRS's authorizing statute, and they seek a permanent injunction barring the enforcement of Circular 230's restrictions on the use of contingent fee arrangements for "ordinary refund claims."

This matter is presently before the Court on the Government's Motion to Dismiss Counts I and II. (Dkt. No. 10). The parties previously appeared before the Court for a hearing on the Government's Motion on November 19, 2012, at which time the Court alerted the parties to its concerns as to whether Ryan, LLC and Mr. Ryan possess standing to pursue their constitutional claims. At the conclusion of the hearing, the parties sought leave to submit supplemental briefs on the standing issue, which the parties have now done. (*See* Dkt. Nos. 21, 22, 23). Upon careful consideration of the parties' respective briefs and supplemental briefs, the presentation of counsel during the hearing on November 19, 2012, and the entire record in this action, the Court concludes, for the reasons set forth herein, that Mr. Ryan lacks standing to pursue his Due Process Clause claim and that Count II will therefore be **DISMISSED** for lack of jurisdiction. The Court also concludes that both Ryan, LLC's and Mr. Ryan's Petition Clause claims under Count I will be **DISMISSED** pursuant to Rule 12(b)(6) for failure to state a claim. Accordingly, the Government's Motion to Dismiss Counts I and II is **GRANTED IN PART** and **DENIED AS MOOT IN PART.**

BACKGROUND

A. Factual Summary

Circular 230 prescribes rules governing the practice of attorneys, certified public accountants, enrolled agents, enrolled actuaries, and appraisers before the IRS. (Dkt. No. 1 ("Compl.") at ¶ 34). Circular 230 was promulgated by the IRS under authority granted to it by statute. (*Id.* ¶ 35 (citing 31 U.S.C. § 330)). Circular 230 is divided into five subparts that establish: (i) rules governing the authority to practice before the IRS; (ii) duties and restrictions relating to practice before the IRS; (iii) rules applicable to disciplinary proceedings; (iv) rules applicable to disqualification of appraisers; and (v) general miscellaneous provisions. (*Id.* ¶ 36). Simply stated, Circular 230 delineates who may practice before the IRS, the standards and restrictions such persons must follow, and the sanctions imposed for violations of such standards and restrictions. *See* 31 C.F.R. §§ 10.1–10.93.

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*2 Beginning in 1994, Circular 230 restricted the use of contingent fee arrangements for preparing original income tax returns; however, the regulations allowed the use of contingent fee arrangements for the preparation and filing of amended returns and/or refund claims, so long as the practitioner "reasonably anticipate[d] at the time the fee arrangement [was] entered into that the [amended] return [or refund claim] will receive substantive review by the IRS." (Compl. at ¶ 38 (quoting *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service,* 59 Fed.Reg. 31,523, 31,525 (June 20, 1994))). In promulgating these regulations, the IRS explained that "Treasury continues to believe that a rule restricting contingent fees for preparing tax returns supports voluntary compliance with the tax laws by discouraging return positions that exploit the audit selection process." (*Id.* (quoting 59 Fed.Reg. at 31,525)).

In September 2007, however, the IRS promulgated a final rule that amended Circular 230's regulations and expanded the limitations on the use of contingent fee arrangements. *See Regulations Governing Practice Before the Internal Revenue Service,* 72 Fed.Reg. 54,540 (Sept. 26, 2007). In response to public comments, the IRS explained that "[t]he Treasury Department and the IRS continue to believe that a rule restricting contingent fees for preparing tax returns supports voluntary compliance with the Federal tax laws by discouraging return positions that exploit the audit selection process." (Compl. at ¶ 39 (quoting 71 Fed.Reg. 6,421, 6,423–24 (Feb. 8, 2006)). Circular 230 now provides that, in most circumstances, "a practitioner may not charge a contingent fee for services rendered in connection with any matter before the [IRS]." 31 C.F.R. § 10.27(b)(1). However, Circular 230 does allow for some exceptions to this limitation, "for services rendered in connection with the Service's examination of, or challenge to: (i)[a]n original tax return; or (ii) [a]n amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return." *Id.* § 10.27(b)(2). Additionally, a practitioner may properly charge a contingent fee "for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the [IRS]," or "for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code." *Id.* § 10.27(b)(3), (4).

The term "contingent fee" is defined as "any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the [IRS] or is sustained either by the [IRS] or in litigation," and also includes "a fee that is based on a percentage of the refund reported on a return, that is based on a percentage of the taxes saved or that otherwise depends on the specific result attained." *Id.* § 10.27(c)(1). The regulations define "[m]atter before the Internal Revenue Service" as:

> *3 [T]ax planning and advice, preparing or filing or assisting in preparing or filing returns or claims for refund or credit, and all matters connected with a presentation to the [IRS] or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the [IRS]. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the [IRS], rendering written advice with respect to any entity, transaction, plan or arrangement, and representing a client at conferences, hearings, and meetings.

Id. § 10.27(c)(2). As relevant here, Circular 230 proscribes the use of contingent fee arrangements for what the Plaintiffs term "ordinary refund claims," *i.e.,* claims for refund filed after taxpayers have filed their original tax return, but before the IRS initiates an audit of the return(s). (Compl. at ¶ 2).[2] It is precisely this restriction—Circular 230's application to "ordinary refund claims"—that Plaintiffs challenge herein.

Ryan, LLC, a leading global tax services firm, alleges that "[a]n integral part" of its business "has historically been the representation of clients on a contingent fee basis in the preparing and filing of 'Ordinary Refund Claims.' " (*Id.* ¶ 20). Ryan, LLC asserts that the "ordinary refund claims" it has prepared and filed on behalf of its clients "typically have not involved complex legal issues, or in many cases, any legal disputes at all. Instead, these refund claims have usually been extremely fact intensive inquiries that required an enormous outlay of time, energy, and resources." (*Id.* ¶ 22). According to Plaintiffs, Ryan, LLC's efforts in "[c]ompiling, organizing, preparing, and analyzing the volumes of data necessary to establish the validity of such claims results in substantial

expenses being incurred upfront, in the preparation of the claim." (*Id.*). Given this, Ryan, LLC alleges that its "clients have preferred the use of contingent fee arrangements when pursuing Ordinary Refund Claims." (*Id.*). Ryan, LLC alleges that it "has lost clients and substantial revenue due to the Circular 230 prohibition on the use of contingent fee arrangement for services rendered in connection with the preparation and filing of 'Ordinary Refund Claims.' " (*Id.* ¶¶ 8, 49–51). Through this suit, Ryan, LLC asserts that Circular 230's restrictions infringe upon the "First Amendment right to petition the Government for a redress of grievances," through the filing of "ordinary refund claims." (*Id.* ¶¶ 1, 54–60).

Plaintiff G. Brint Ryan ("Mr.Ryan") is the founder and chairman of Ryan, LLC. For his part, he asserts that, because of Circular 230's prohibition on the use of contingent fee arrangements, he "is unable to retain a practitioner on a contingent fee basis to prepare and file an Ordinary Refund Claim on his behalf." (*Id.* ¶ 24). Elsewhere in the Complaint, however, Mr. Ryan avers that, while unable to obtain representation on a contingent fee basis, he has nevertheless "filed an Ordinary Refund Claim since the effective date of the 2007 revisions to Circular 230." (*Id.* ¶ 25). Along with Ryan, LLC, Mr. Ryan alleges that Circular 230 violates his rights under the Petition Clause of the First Amendment, and he also claims that Circular 230 violates his Fifth Amendment due process rights by depriving him of the ability "to obtain a refund for an overpayment of tax." (*Id.* ¶¶ 1, 9, 54–60, 61–66).[3]

B. Procedural History

*4 Plaintiffs filed their Complaint in this matter on April 11, 2012. (*See generally* Compl.). On July 23, 2012, the Government filed its Motion to Dismiss Counts I and II, seeking the dismissal of Plaintiffs' constitutional claims under Federal Rule of Civil Procedure 12(b)(6) on the grounds that they fail to state plausible claims under either the Petition Clause or the Due Process Clause. (*See* Dkt. No. 10–1). The parties subsequently stipulated to a briefing schedule, and the Court set a hearing on the Government's Motion for November 19, 2012. (*See* Dkt. No. 11; Minute Entry, Aug. 1, 2012). In the course of preparing for that hearing, however, the Court developed some concerns as to whether Ryan, LLC and/or Mr. Ryan had standing to pursue their constitutional claims. The Court raised these concerns with the parties during the hearing on November 19th, setting forth in detail its doubts about Plaintiffs' ability to establish standing. (*See* Dkt. No. 20 (Transcript)). At the conclusion of the hearing, the parties asked to submit supplemental briefing, which the Court allowed. (Dkt. No. 19). The parties have since filed their supplemental briefs on the issue of standing, and this matter is now ripe for decision.[4]

ANALYSIS

A. Legal Standards Governing Article III Standing

"Article III of the Constitution strictly limits the federal judicial power to resolving 'Cases' and 'Controversies.' " *Dominguez v. UAL Corp.,* 666 F.3d 1359, 1361 (D.C.Cir.2012) (quoting U.S. CONST. art. III, § 2). As the Supreme Court very recently reiterated, "no principle is more fundamental to the judiciary's proper role in our system of government than the constitutional limitation of federal-court jurisdiction to actual cases or controversies." *Clapper v. Amnesty Int'l USA,* ––– U.S. ––––, 133 S.Ct. 1138, 1146 (2013) (quoting *DaimlerChrysler Corp. v. Cuno,* 547 U.S. 332, 341 (2006)). Of course, standing is "an essential and unchanging part of the case-or-controversy requirement of Article III." *Lujan v. Defenders of Wildlife,* 504 U.S. 555, 560 (1992). Ensuring that a plaintiff has standing to sue is thus a necessary "predicate to any exercise of [the Court's] jurisdiction." *Fla. Audubon Soc'y v. Bentsen,* 94 F.3d 658, 663 (D.C.Cir.1996) (en banc). "The question of standing involves both constitutional limitations on federal court jurisdiction and prudential limitations on its exercise." *Bennett v. Spear,* 520 U.S. 154, 162 (1997) (internal quotation omitted); *see also Info. Handling Servs. v. Def. Automated Printing Servs.,* 338 F.3d 1024, 1028 (D.C.Cir.2003).

First, to satisfy the "irreducible constitutional minimum of standing" under Article III, a plaintiff must demonstrate: (1) that it has suffered an "injury in fact"—an actual or imminent invasion of a legally-protected, concrete, and particularized interest; (2) a causal connection between the alleged injury and the defendant's conduct at issue; and (3) that it is "likely," not "speculative," that the injury "will be redressed by a favorable decision." *Defenders of Wildlife,* 504 U.S. at 560–61. "This triad ... constitutes the core of Article III's case-or-controversy requirement, and the party invoking federal jurisdiction bears the burden of establishing its existence." *Steel Co. v. Citizens for a Better Env't,* 523 U.S. 83, 103–04 (1998). In addition, a party must be able to demonstrate prudential standing, by showing that its grievance "arguably fall[s] within the zone of interests protected or regulated by the statutory provision or constitutional guarantee invoked in the suit." *Nuclear Energy Inst., Inc. v. EPA,* 373 F.3d 1251,

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1266 (D.C.Cir.2004) (quoting *Bennett,* 520 U.S. at 162)). In this Circuit, prudential standing, like Article III standing, is jurisdictional. *See Steffan v. Perry,* 41 F.3d 677, 697 (D.C.Cir.1994); *Animal Legal Defense Fund, Inc. v. Espy,* 29 F.3d 720, 723 n. 2 (D.C.Cir.1994).

***5** If either Article III or prudential standing "is lacking, then 'the dispute is not a proper case or controversy, [and] the courts have no business deciding it, or expounding the law in the course of doing so.' " *Dominguez,* 666 F.2d at 1361 (quoting *DaimlerChrysler Corp.,* 547 U.S. at 341) (alteration in original). It also bears emphasis that, "[w]hen there is doubt about a party's constitutional standing, the court must resolve the doubt, *sua sponte* if need be." *Lee's Summit v. Surface Transp. Bd.,* 231 F.3d 39, 41 (D.C.Cir.2000); *see also Catholic Social Serv. v. Shalala,* 12 F.3d 1123, 1125 n. 2 (D.C.Cir.1994) ("Because standing is a jurisdictional doctrine, the district court [is], of course, obliged to consider the issue *sua sponte.*"). Indeed, where the Court has doubts about a party's standing, it is reversible error to bypass standing and to proceed to the merits of the case, even "where the merits question may be easily answered." *Dominguez,* 666 F.3d at 1362.[5]

At the pleadings stage, "the standing inquiry requires careful judicial examination of a complaint's allegations to ascertain whether the particular plaintiff is entitled to an adjudication of the particular claims asserted." *Allen v. Wright,* 468 U.S. 737, 752 (1984). While the Court "must assume that the plaintiff states a valid legal claim and must accept the factual allegations in the complaint as true," *Holistic Candlers & Consumers Ass'n v. FDA,* 664 F.3d 940, 943 (D.C.Cir.2012), a plaintiff's factual allegations "will bear closer scrutiny" in resolving issues of standing, "than in resolving a 12(b)(6) motion for failure to state a claim." *Grand Lodge of the Fraternal Order of Police v. Ashcroft,* 185 F.Supp.2d 9, 13–14 (D.D.C.2001) (quoting 5A CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1350 (2d ed.1987)).

Finally, the Court is mindful of admonitions from both the Supreme Court and our Court of Appeals that the standing inquiry is "especially rigorous when reaching the merits of the dispute would force [a court] to decide whether an action taken by one of the other two branches of the Federal Government was unconstitutional," as Plaintiffs' claims would require here. *Clapper,* 133 S.Ct. at 1147; *see also Alaska Legislative Council v. Babbitt,* 181 F.3d 1333, 1337 (D.C.Cir.1999); *Cheneweth v. Clinton,* 181 F.3d 112, 115 (D.C.Cir.1999).

With these standards firmly in mind, the Court turns to consider whether Plaintiffs possess standing to maintain their constitutional claims in this action.

B. Ryan, LLC Has Standing To Pursue Its Petition Clause Claim (Count I)

Beginning with Plaintiffs' claim under the Petition Clause of the First Amendment, the Court first examines whether Ryan, LLC possesses standing to pursue this claim. As an initial matter, there appears to be no legitimate dispute that Ryan, LLC satisfies the requirements of constitutional standing under Article III. According to the allegations of the Complaint, it has suffered the loss of "a significant number of clients and several million dollars in revenue" as a result of Circular 230's prohibition on the use of contingent fee arrangements for Ordinary Refund Claims. (Compl. at ¶ 23). The nature of this claimed injury suffices to satisfy the first prong of Article III standing. *See, e.g., Lepelletier v. FDIC,* 164 F.3d 37, 42–43 (D.C.Cir.1999) ("[T]he denial of a business opportunity satisfies the injury requirement."). Moreover, Ryan, LLC credibly alleges that its revenue and clientele losses are fairly traceable to Circular 230's prohibition on the use of contingency fee arrangements, and that its claimed injury is likely to be redressed by a favorable decision from the Court. (Compl. at ¶¶ 23, 49–51). Thus, Ryan, LLC meets the necessary requirements to establish Article III standing.

***6** However, the parties quarrel over whether Ryan, LLC satisfies the prudential standing requirements to pursue its Petition Clause Claim. For its part, Ryan, LLC effectively concedes that its particular injuries—which are economic in nature—do not fall within the zone of interests protected by the First Amendment's Petition Clause. Instead, Ryan, LLC seeks to invoke third-party standing (sometimes referred to as *jus tertii* standing) on behalf of its clients. (Dkt. No. 21 ("Pls.' Supp. Mem.") at 2 ("Ryan, LLC satisfies the ... prudential standing requirements to assert its Petition Clause claim on behalf of its clients and taxpayers.")). On this point, our Court of Appeals has recognized "three prudential considerations to be weighed when determining whether an individual may assert the rights of others: (1) 'the litigant must have suffered an 'injury in fact,' ... (2) 'the litigant must have a close relation to the third party,' and (3) 'there must exist some hindrance to the third party's ability to protect his or her own interests.' " *Lepelletier,* 164 F.3d at 43 (quoting *Powers v. Ohio,* 499

U.S. 400, 411 (1991)). The Government does not challenge Ryan, LLC's ability to satisfy the first of these elements, but takes issue with the latter two, arguing that Ryan, LLC cannot establish a sufficiently close relationship with its clients, and that there is no hindrance that precludes Ryan, LLC's clients from seeking to vindicate their own Petition Clause rights.

The Court need not dwell long on the first of these arguments. As the D.C. Circuit has explained, the "close relation" criterion of third-party standing is intended to ensure that there is "an identity of interests between the parties such that the plaintiff will act as an effective advocate of the third party's interests." *Lepelletier,* 164 F.3d at 44. This standard is met here. Ryan, LLC is interested in setting aside Circular 230's contingent fee prohibition so that it can resume contingent compensation agreements with its clients and can benefit from the renewed business opportunities and increased revenues that will result. According to Ryan, LLC, its clients' interest in upending Circular 230 is to reduce the initial outlay of cost in pursuing "ordinary refund claims" by enabling them to "shar[e] the expenses associated with the preparation and filing of these claims" through contingency fee payments. (Pls.' Supp. Mem. at 18). While not identical, Ryan, LLC's interests are certainly closely aligned with those of its clients (and potential clients), and both seek the same result—the elimination of Circular 230's contingent fee restrictions so they can enter into "mutually advantageous" contingent fee arrangements. *See Lepelletier,* 164 F.3d at 45 (explaining that "*jus tertii* standing does not require a perfect match").

The Government's second argument, however, requires a closer look. As a general rule, "[a] plaintiff may assert the rights of a third party only when there is some hindrance to the third party's ability to protect his or her own interests." *Rumber v. District of Columbia,* 595 F.3d 1298, 1301 (D.C.Cir.2010); *Am. Immigration Lawyers Ass'n v. Reno,* 199 F.3d 1352, 1362 (D.C.Cir.2000). Ryan, LLC does not even attempt to argue that any such impediment, or "hindrance," exists here. It makes no suggestion that its individual taxpayer clients—whose First Amendment Petition Clause rights Ryan, LLC ostensibly seeks to vindicate—are somehow precluded from pursuing these claims in their own right.

*7 Instead, Ryan, LLC contends that, because it asserts a First Amendment violation, "it is not necessary for the Court to find that those third parties would be hindered from bringing this action on their own behalf." (Pls.' Supp. Mem. at 15). In so arguing, Ryan, LLC correctly points out that the Supreme Court has seen fit to relax the "hindrance" component of third-party standing in the free speech context, such that "where the claim is that a statute is overly broad in violation of the First Amendment, the Court has allowed a party to assert the rights of another without regard to the ability of the other to assert his own claims." *Sec'y of State of Md. v. Joseph H. Munson Co., Inc.,* 467 U.S. 947, 957 (1984). There, the Supreme Court reasoned:

> Even where a First Amendment challenge could be brought by one actually engaged in protected activity, there is a possibility that, rather than risk punishment for his conduct in challenging the statute, he will refrain from engaging further in the protected activity. Society as a whole then would be the loser. Thus, when there is a danger of chilling free speech, the concern that constitutional adjudication be avoided whenever possible may be outweighed by society's interest in having the statute challenged. "Litigants, therefore, are permitted to challenge a statute not because their own rights of free expression are violated, but because of a judicial prediction or assumption that the statute's very existence may cause others not before the court to refrain from constitutionally protected speech or expression." *Broadrick v. Oklahoma,* 413 U.S. 601, 612 (1973).

Id. at 956–57; *see also Kowalski v. Tesmer,* 543 U.S. 125, 130 (2004) ("Within the context of the First Amendment ... the Court has enunciated other concerns that justify a lessening of prudential limitations on standing."). Ryan, LLC urges the Court to adopt this relaxed approach in evaluating its Petition Clause claim. While unable to cite to any case in which this leniency was specifically applied to a First Amendment Petition Clause claim—rather than a claim under the Speech Clause, *see, e.g., Munson,* 467 U.S. at 956–59; *Reese Brothers, Inc. v. U.S. Postal Service,* 531 F.Supp.2d 64, 69–70 (D.D.C.2008)—Ryan, LLC insists that, "given the fundamental and inseparable nature of the various First Amendment rights, the relaxed standing requirements apply to claims involving all First Amendment rights." (Dkt. No. 23 ("Pls.' Supp. Reply") at 5). The Government, on the other hand, argues that the doctrine should be constrained to First Amendment cases involving "pure speech," and should not extend to the Plaintiffs' challenge under the Petition Clause here, particularly given the lack of any allegation that "taxpayers will not bring their own claims under the Petition Clause ... [or] that the statue [sic] has had a chilling effect on constitutionally protected speech." (Defs.' Supp. Opp'n at 15). On balance, Ryan, LLC has the better of this argument.

***8** To begin with, the Supreme Court has described the right to petition as "intimately connected" with the First Amendment's other concomitant rights:

> [T]he rights to assemble peaceably and to petition for a redress of grievances are among the most precious of the liberties safeguarded by the Bill of Rights. These rights, moreover, are intimately connected, both in origin and in purpose, with the other First Amendment rights of free speech and free press. All these, though not identical, are inseparable.

United Mine Workers v. Ill. State Bar Ass'n, 389 U.S. 217, 222 (1967) (internal quotation and citations omitted); *see also McDonald v. Smith,* 472 U.S. 479, 485 (1985) ("The Petition Clause ... was inspired by the same ideals of liberty and democracy that gave us the freedoms to speak, publish, and assemble. These First Amendment rights are inseparable...."). In this Court's view, therefore, it reasonably follows that the more forgiving approach to prudential standing requirements developed in the Speech Clause context should logically extend to claims under the Petition Clause. Indeed, this result seems particularly appropriate given the Government's acknowledgement that "the right to petition and the right to free speech ... are related and are generally subject to the same constitutional analysis." (Dkt. No. 10–1 ("Defs.' Mem.") at 7 (citing *Wayte v. United States,* 470 U.S. 598, 610 n. 11)). The Court also notes that at least one leading constitutional treatise makes no distinction on this issue as between the various First Amendment guarantees. 1 RONALD D. ROTUNDA & JOHN E. NOWAK, TREATISE ON CONSTITUTIONAL LAW: SUBSTANCE AND PROCEDURE § 2.13(f)(iii)(2), at 368 (5th ed. 2012) ("In the First Amendment area, prudential barriers are lower.").

Along with these general parallels, the Court finds the Plaintiffs' allegations in this case plausibly establish a danger of "chilled speech" sufficient to place this particular case within the contours of *Munson.* Taking the Complaint's allegations as true, as the Court must, Ryan, LLC asserts that it has "lost clients and substantial revenue" due to Circular 230's revisions, which means that clients who may have formerly filed "ordinary refund claims" are no longer doing so, given their inability to compensate Ryan, LLC on a contingent basis. *Munson,* 467 U.S. at 956–57 (finding relaxation of the hindrance requirement appropriate where "the statute's very existence may cause others not before the court to refrain from constitutionally protected speech or expression"). The fact that Ryan, LLC's clients may not be exercising their right to pursue refund claims, as Plaintiffs allege, at least raises the specter of chilled speech. Given all this, the Court finds that Ryan, LLC possesses standing to pursue its Petition Clause claim on behalf of its third-party taxpayer clients.

Insofar as Ryan, LLC has standing to pursue its Petition Clause claim, the Court need not (and does not) decide whether Mr. Ryan would independently have standing to pursue a Petition Clause claim as well. It is well settled that, to proceed to the merits of a claim, the Court "need only find one party with standing." *Americans for Safe Access v. DEA,* 706 F.3d 438, 443 (D.C.Cir.2013); *see also Comcast Corp. v. FCC,* 579 F.3d 1, 6 (D.C.Cir.2009) ("[I]f one party has standing in an action, a court need not reach the issue of the standing of other parties when it makes no difference to the merits of the case.").

C. Mr. Ryan Lacks Standing To Pursue His Due Process Claim (Count II)

***9** Turning to Count II of the Complaint, Mr. Ryan asserts that Circular 230's prohibition on the use of contingent fee compensation in connection with "ordinary refund claims" violates his rights under the Due Process Clause of the Fifth Amendment, which guarantees that "[n]o person shall ... be deprived of life, liberty, or property, without due process of law." U.S. CONST. amend. V. Both the Supreme Court and our Circuit have made clear that "[t]he first inquiry in every due process challenge is whether the plaintiff has been deprived of a protected interest in 'liberty' or 'property.' " *GE v. Jackson,* 610 F.3d 110, 117 (D.C.Cir.2010) (quoting *Am. Mfrs. Mut. Ins. Co. v. Sullivan,* 526 U.S. 40, 59 (1999)); *Lepelletier,* 164 F.3d at 45 ("When presented with a due process challenge, a court must determine, first, whether there has been a deprivation of a property interest, and, if so, what process is due.") (internal citation omitted). Thus, to ensure that Mr. Ryan meets Article III's injury-in-fact prong as to this claim, the Court must satisfy itself that the allegations of the Complaint plausibly establish that he was deprived of a protected property interest under the Due Process Clause. On balance, the Court concludes that Mr. Ryan fails to make such a showing.

In reaching this conclusion, the Court begins with the allegations of the Complaint. Plaintiffs allege that Circular 230 infringes on Mr. Ryan's "due process right *to obtain a refund of taxes paid.*" (Compl. at ¶ 1) (emphasis added).

Elsewhere in the Complaint, Mr. Ryan invokes his "*statutory right to obtain a refund for an overpayment of tax* pursuant to [Internal Revenue Code] §§ 6402(a) and 6511(a)." (*Id.* ¶ 63) (emphasis added). Based on these allegations, and Plaintiffs' repeated adherence to this theory in their briefs, the Court construes Mr. Ryan's claimed injury as the deprivation of his property right to *file refund claims with the IRS.* (*See* Dkt. No. 13 ("Pls.' Opp'n") at 13 (describing the basis of Mr. Ryan's due process claim as the deprivation of his "protected property interest in filing refund claims"); Pls.' Supp. Mem. at 18 (identifying the applicable injury as an "impair[ment] of the statutory rights of taxpayers, including Mr. Ryan, to file refund claims"); Dkt. No. 23 ("Pls.' Supp. Reply") at 9 ("Mr. Ryan has properly alleged a deprivation of a protected property interests in the statutory right to file refund claims for the overpayment of taxes.")). In this respect, the Court emphasizes that Plaintiffs do not contend that Circular 230 categorically bars taxpayers from filing "ordinary refund claims" altogether. Nor could they. Notwithstanding Circular 230's revised regulations, taxpayers still have the ability to file "ordinary refund claims" with the IRS—they can continue to file such claims on their own, without practitioner representation, and they can even continue to file such claims with the assistance of tax practitioners, so long as they are compensated on a non-contingent basis. All that Circular 230 prohibits is a taxpayer's ability to compensate a tax practitioner for preparing or filing an "ordinary refund claim with "a fee that is based on a percentage of the refund reported on a return, that is based on a percentage of the taxes saved or that otherwise depends on the specific result attained." 31 C.F.R. § 10.27(c)(1).

***10** Seemingly recognizing this, the constitutional deprivation Plaintiffs allege is more nuanced. In essence, they assert that, because "ordinary refund claims" are complex and require a substantial outlay of time and effort, taxpayers cannot effectively pursue refund claims on their own; for all intents and purposes, Plaintiffs suggest, taxpayers need practitioner assistance to file such claims. In turn, because some taxpayers may be unable to afford to pay a tax practitioner through anything but a contingent fee arrangement, Plaintiffs contend that Circular 230's prohibition on contingent fee compensation precludes some taxpayers from filing refund claims with the IRS altogether. (*See* Pls.' Supp. Mem. at 17–18) ("[B]ecause of the complexities of the tax laws and the cost-prohibitive nature of preparing and filing Ordinary Refund Claims, the use of contingent fee arrangements ... reflects, in plain, practical terms, a means for taxpayers, such as Mr. Ryan, to pursue these often costly refund claims by sharing the expenses associated with the preparation and filing of these claims."). Assuming without deciding that these circumstances amount to a constitutional due process violation—i.e., that the right to file a refund claim with the IRS is a protected property interest, and that Circular 230 unconstitutionally infringes upon that right—Mr. Ryan fails to allege an injury consistent with this theory. Stated another way, despite the supposedly "complex" and "costly" nature of "ordinary refund claims," Mr. Ryan does not assert that his inability to retain a practitioner on a contingent fee basis has deprived him of the right or ability to pursue such a claim. In fact, the plain allegations of the Complaint confirm precisely the opposite —Mr. Ryan "*has filed an Ordinary Refund Claim* since the effective date of the 2007 revisions to Circular 230." (Compl. at ¶ 25) (emphasis added).

While the Court can perceive that some "taxpayers" could potentially fall victim to the type of injury articulated by Plaintiffs, Mr. Ryan is not plainly one of them. This is because Plaintiffs assert that Circular 230 infringes upon taxpayers' due process right to *file refund claims,* but Mr. Ryan simply fails to establish that he has been injured in this manner. At most, he pleads that he has been "unable to retain a practitioner on a contingent fee basis to prepare and file an Ordinary Refund Claim on his behalf." (Compl. at ¶¶ 5, 52). However, the ability to hire a practitioner on a contingent fee basis is *not* the protected property interest that Mr. Ryan seeks to vindicate—indeed, Plaintiffs expressly disclaim any such approach. (Dkt. No. 17 ("Pls.' Surreply") at 1 ("Plaintiffs are not asserting a constitutional right to hire an attorney on a contingent fee basis."); Pls.' Supp. Reply at 7 ("Mr. Ryan has never asserted an inability to hire a practitioner as a basis for his constitutional claims.")). Given all this, Mr. Ryan's claimed injury, when measured against Plaintiffs' due process theory, is the type of "conjectural or hypothetical" injury too speculative to satisfy Article III's requirements. *See, e.g., Dominguez,* 666 F .3d at 1362–64; *Rodearmel v. Clinton,* 666 F.Supp.2d 123, 131 (D .D.C.2009) (three judge court) (dismissing due process claim alleging deprivation of continued employment because, although plaintiff alleged intolerable working conditions that might eventually result in his forced resignation, he remained an employee at the time of suit, and therefore his allegations demonstrated "speculative" injury, at best, and not the "actual or imminent" injury necessary to establish Article III standing).

***11** Seeking to avoid this outcome, Plaintiffs argue that the Court's concern "is really a question of whether the

Circular 230 prohibition *sufficiently* impairs Mr. Ryan's right to file Ordinary Refund Claims" that "goes to the merits of Mr. Ryan's Due Process Clause claim and ... should not be considered for purposes of determining standing." (Pls.' Supp. Mem. at 18). But the Court is not passing on the merits of Mr. Ryan's claim. Quite conversely, the Court assumes, as stated, that Mr. Ryan would prevail under Plaintiffs' theory on the merits—i.e., that the right to file refund claims is protected under the Due Process Clause, and that Circular 230 unconstitutionally infringes on such right. (*See* Compl. at ¶¶ 61–66). Despite these assumptions, Mr. Ryan's claim runs aground because his allegations fail to establish that he has suffered any cognizable injury consistent with this theory. He does not allege that Circular 230 has rendered him unable to file or obtain a refund with the IRS. (*Id.* ¶ 63). In fact, he alleges precisely the opposite-that he has remained able to file refund claims despite Circular 230's restrictions on contingent fee compensation. (*Id.* ¶ 25). Far from a simply a matter of degree or a question as to whether Mr. Ryan's rights were "sufficiently" impaired, as Plaintiffs seem to suggest, this distinction goes to the very heart of the property interest that Mr. Ryan alleges was infringed.

In sum, because Mr. Ryan fails to allege a sufficiently concrete and particularized injury that comports with his constitutional due process theory, the Court finds that he lacks Article III standing to pursue this claim. Accordingly, Count II of Plaintiffs' Complaint is hereby dismissed for want of jurisdiction.

D. The Merits of Plaintiffs' Petition Clause Claim

1. *Standard of Review on Motion to Dismiss*

The Government moves to dismiss Plaintiffs' Petition Clause claim pursuant to Rule 12(b)(6). FED.R.CIV.P. 12(b)(6). "To survive a motion to dismiss [under Rule 12(b)(6)], a complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.' " *Ashcroft v. Iqbal,* 556 U.S. 662, 678 (2009) (quoting *Bell Atl. Corp. v. Twombly,* 550 U.S. 544, 570 (2007)). In considering a Rule 12(b)(6) motion, the Court must construe a complaint "liberally in the plaintiffs' favor," and must "grant plaintiffs the benefit of all inferences that can be derived from the facts alleged." *Stokes v. Cross,* 327 F.3d 1210, 1215 (D.C.Cir.2003). However, the Court need not accept inferences that are "unsupported by the facts set out in the complaint," nor "legal conclusions cast in the form of factual allegations." *Kowal v. MCI Commc'ns Corp.,* 16 F.3d 1271, 1276 (D.C.Cir.1994). Finally, in evaluating a Rule 12(b)(6) motion to dismiss, the Court properly considers "the facts alleged in the complaint, documents attached thereto or incorporated therein, and matters of which it may take judicial notice." *Stewart v. Nat'l Educ. Ass'n,* 471 F.3d 169, 173 (D.C.Cir.2006).

2. *Plaintiffs Fail To State A Claim Under The Petition Clause*

***12** The First Amendment to the Constitution guarantees "the right of the people ... to petition the Government for a redress of grievances." U.S. CONST. amend. I. While infrequently litigated, the Supreme Court has recognized the right to petition as "one of 'the most precious of the liberties safeguarded by the Bill of Rights.' " *BE & K Constr. Co. v. NLRB,* 536 U.S. 516, 524 (2003) (quoting *United Mine Workers,* 389 U.S. at 222). Recently, the Supreme Court expressly reaffirmed that "the right of access to courts for redress of wrongs is an aspect of the First Amendment right to petition the government." *Borough of Duryea v.. Guarnieri,* ––– U.S. ––––, 131 S.Ct. 2488, 2494 (2011) (quoting *Sure–Tan, Inc. v. NLRB,* 467 U.S. 883, 896–97 (1984)).

Through Count I of their Complaint, Plaintiffs allege that, in prohibiting the use of contingent fee arrangements to prepare and file "ordinary refund claims," Circular 230 unconstitutionally impinges on their First Amendment petition rights. (*See* Compl. at ¶¶ 1, 54–60). In opposing the Government's Motion, Plaintiffs insist that they have stated a viable claim under the Petition Clause and contend that:

> [They] have sufficiently alleged that, given the technical complexities of the tax laws, the requirements imposed by the IRS on the content of refund claims and the enormous amount of time and effort necessary to prepare a proper refund claim, the prohibition on the use of contingent fee arrangements impairs and, in some cases, may extinguish, the ability of taxpayers to effectively petition the IRS for a refund of taxes that have been overpaid.

(Pls.' Opp'n at 8). Ultimately, even accepting as true the well-pleaded allegations of Plaintiffs' Complaint, the Court concludes that Plaintiffs fail to state a plausible claim for relief under the First Amendment's Petition Clause.

In pressing for the dismissal of Plaintiffs' claim, the Government first argues that the Petition Clause does not protect "a taxpayer's right to file an administrative claim for refund" with the IRS. (Defs.' Reply at 7). The Court finds this proposition dubious. Not only has the Supreme Court explicitly held that Petition Clause guarantees citizens the ability to seek relief with courts, but it has also made clear that these protections extend to "other forums established by the government for the resolution of legal disputes." *Borough of Duryea,* 131 S.Ct. at 2494. The Court has also explained that "[t]he same philosophy governs the approach of citizens or groups of them to administrative agencies (which are both creatures of the legislature, and arms of the executive) and to courts, the third branch of Government." *Cal. Motor Transport Co. v. Trucking Unlimited,* 404 U.S. 508, 510 (1972) ("Certainly the right to petition extends to all departments of the Government. The right of access to the courts is indeed but one aspect of the right of petition."). Insofar as the Internal Revenue Service is an administrative agency established by the Government, the Court believes that the Petition Clause would protect citizens' rights to file claims with the IRS, as Plaintiffs suggest. On balance, however, the Court need not directly pass on this issue because, even assuming that the right to file a refund claim with the IRS does fall within the ambit of the Petition Clause's protections, Plaintiffs fail to allege any constitutionally cognizable violation or impingement of such a right.

***13** To be sure, "the protections afforded by the First Amendment ... are not absolute." *Virginia v. Black,* 538 U.S. 343, 358 (2003); *see also Real Estate Bar Ass'n for Mass., Inc. v. Nat'l Real Estate Info. Servs.,* 608 F.3d 110, 124 n. 8 (1st Cir.2011) ("The First Amendment protects an individual's right to petition ... but that right is not absolute."); *Mangold v. Analytic Servs., Inc.,* 77 F.3d 1442, 1458 (4th Cir.1996) (similar); *Wright v. DeArmond,* 977 F.2d 339, 347 (7th Cir.1992) (similar); *U.S. Postal Serv. v. Hustler Magazine, Inc.,* 630 F.Supp. 867, 872 (D.D.C.1986) ("While the right to petition Government is among the most precious of the liberties safeguarded by the Bill of Rights, we recognize that this right, like many rights, is not absolute but can be subject to reasonable limitations ."). In the Government's view, therefore, Circular 230's impact on taxpayers' ability to file refund claims with the IRS, if any, falls well within the permissible bounds of the Government's ability to regulate potential First Amendment conduct. Under the revised regulations of Circular 230, taxpayers remain free to file "ordinary refund claims" with the IRS. (*See* Compl. at ¶¶ 23, 25, 47). Taxpayers remain free to retain a tax practitioner to assist them in the preparation and filing of such claims. (*See id .*). And taxpayers also remain free to compensate tax practitioners for such claims. The only limitation that Circular 230's revised regulations place on taxpayers is this: if taxpayers choose to file an "ordinary refund claim," and if taxpayers choose to retain a tax practitioner to assist them in the preparation and filing of such a claim, then they cannot compensate the practitioner on a contingency fee basis. The Court agrees that this minor limitation on proceedings before the IRS does not run afoul of the Petition Clause.

The Government compares the Plaintiffs' claim in this case to an issue presented in *United States v. Harriss,* 347 U.S. 612 (1954), which involved a challenge to the Federal Regulation of Lobbying Act on First Amendment grounds. The *Harriss* Court held, in relevant part, that a statute requiring lobbyists to register with Congress and to make specific disclosures did not violate the plaintiff's First Amendment petition rights; rather, those discrete regulations, which simply allowed Congress to "know who is being hired, who is putting up the money, and how much" so that it could "maintain the integrity of a basic governmental process," were found to be permissible under the First Amendment. *Id.* at 625. Relatedly, says the Government, Circular 230 does not categorically prohibit taxpayers from pursuing claims with the IRS, even with representation. It simply limits the compensation structure in connection with any such representation, "to discourage tax return positions that exploit the audit selection process." (Defs.' Mem. at 3; *see also* Compl. at ¶¶ 38–39). While certainly not on all fours with this case, the Court agrees that some reasonable parallels can be drawn from the *Harriss* decision. Both cases involve discrete, limited restrictions on a party's ability to petition the government, and in both cases those restrictions were driven by the same essential objective: "to maintain the integrity of a basic governmental process." *Harriss,* 347 U.S. at 625.

***14** Plaintiffs, on the other hand, rely heavily on the Montana Supreme Court's decision in *Montana Auto Ass'n v. Greely,* 632 P.2d 300 (Mont.1981). But that decision does not dictate a different result. There, the Montana Supreme Court struck down as unconstitutional portions of a state ballot initiative that amended Montana's Lobbying Act. More specifically, the court—through a single paragraph of analysis—voided provisions that completely prohibited the compensation of lobbyists through contingent fee arrangements because the provisions did not distinguish between contingent arrangements that were

"properly motivated," as against those that were "improperly motivated." *Id.* at 393. As the Government rightly points out, the restrictions invalidated in *Greely* are plainly distinguishable from the challenged provisions of Circular 230, which do not impose a blanket prohibition on contingent fee arrangements in proceedings before the IRS. Rather, the applicable regulations permit the use of contingency fees in proceedings where the Service "first take[s] an initial action such as challenging a taxpayer position, commencing an examination, or making an assessment of penalties or interest." (Defs.' Mem. at 2–3; *see also* Compl. at ¶ 40). Thus, Circular 230 prohibits contingent compensation only in certain circumstances—as relevant here, in connection with "ordinary refund claims." Moreover, the Government adopted the revised regulations "to discourage tax return positions that exploit the audit selection process," (Defs.' Mem. at 3), which reflects an effort on the Government's part to separate "properly motivated" contingent arrangements from those that are "improperly motivated," which was precisely the concern identified in *Greely*. Thus, the Court finds the Plaintiffs' reliance on that decision unavailing, and to the extent its holding is not distinguishable from the instant matter, the Court disagrees with its (cursory) analysis for the reasons stated herein.

Accordingly, because the Court finds that Plaintiffs fail to state a cognizable claim for relief under the Petition Clause of the First Amendment, Count I of Plaintiffs' Complaint will be dismissed under Rule 12(b)(6).

CONCLUSION

For the foregoing reasons, the Court concludes that Mr. Ryan lacks Article III standing to pursue his claim under the Due Process Claim and therefore **DISMISSES** Count II of Plaintiffs' Complaint for lack of jurisdiction. In addition, the Court find that Plaintiffs fail to state a claim under the Petition Clause and therefore **DISMISSES** Count I pursuant to Federal Rule 12(b)(6). Accordingly, the Government's Motion to Dismiss Counts I and II is **GRANTED IN PART** and **DENIED AS MOOT IN PART.** Count III of Plaintiffs' Complaint, however, brought by Mr. Ridgely pursuant to the APA, shall proceed. An appropriate Order accompanies this Memorandum Opinion.

Footnotes

1 Plaintiffs originally brought suit against Timothy Geithner, but upon his confirmation, Secretary Lew was automatically substituted as the named defendant. FED.R.CIV.P. 25(d).

2 The Government takes issue with Plaintiffs' use of the term "ordinary refund claim," as "not descriptive of the regulatory prohibition." (*See* Dkt. No. 22 ("Defs.' Supp. Opp'n") at 1 n .1). The Court understands the Government's argument, but, for purposes of this opinion, the particular label used by Plaintiffs makes no meaningful difference.

3 Inasmuch as Mr. Ridgely's claim under the APA (Count III) is not the subject of the Government's Motion, the Court, in the interest of judicial economy, foregoes a detailed discussion of the allegations underpinning his claim.

4 Plaintiffs requested a hearing on the Government's Motion, but the Court, in its discretion, does not believe that the presentation of oral argument would be of assistance to the Court, and finds this matter suitable for decision on the papers. *See* LCvR 7(f), 78.1. Accordingly, the Court denies Plaintiffs' Motion for an Oral Argument (Dkt. No. 24).

5 The Court expresses no view on the merits of the Plaintiffs' claims. Instead, the Court heeds its duty "not to decide the questions on the merits for or against the plaintiff" and "assume[s] that on the merits the plaintiffs would be successful in their claims." *City of Waukesha v. EPA,* 320 F.3d 228, 235 (D.C .Cir.2003) (citing *Warth v. Seldin,* 422 U.S. 490, 502 (1975)).

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Notice 2013-22

From: Peggi Collins <peggi@pcollinslaw.com>
Sent: Wednesday, February 26, 2014 1:14 PM
To: Notice Comments
Subject: Notice 2013-22

FEB 27 2014
LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

As a practicing real estate and tax attorney, it is my opinion that the tax code needs to be completely over-hauled and simplified.

As for the IRS, itself, I am shocked and appalled at its interference with free speech and it's targeting of groups opposed to the current administration.

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LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

Notice 2013-22

MAY - 1 2013

Marc J. Gerson
Member
(202) 626-1475
mgerson@milchev.com

May 1, 2013

VIA HAND DELIVERY
VIA ELECTRONIC MAIL

Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Recommendation for 2013-2014 Guidance Priority List

To Whom It May Concern:

On behalf of American Express Company and pursuant to Notice 2013-22, 2013-15 I.R.B. 1, Miller & Chevalier Chartered respectfully requests that guidance pursuant to Section 4261(e)(3)(C) of the Internal Revenue Code as described below be included on the 2013-2014 Guidance Priority List.

Requested Guidance Pursuant to Section 4261(e)(3)(C)

Guidance is requested under Section 4261(e)(3)(C) regarding the application of the Section 4261(a) domestic air transportation excise tax to the purchase of mileage awards ("Section 4261(e)(3)(C) Guidance"). Specifically, such guidance should provide a reasonable safe harbor method (or methods) that may be used at the time mileage awards are purchased to determine the proper allocation between the amounts paid for mileage awards (i) to be used for "taxable transportation" (as defined in Section 4262) and, therefore, subject to the excise tax, and (ii) those not to be used for taxable transportation and, therefore, exempt from the excise tax (including mileage awards for international and foreign travel, merchandise, hotel stays, car rentals and other rewards, as well as expired mileage awards).

Appropriateness of Inclusion of Section 4261(e)(3)(C) Guidance on the 2013-2014 Guidance Priority List

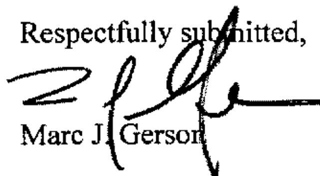
Pursuant to the Notice, the Treasury Department and the Internal Revenue Service (the "Service") consider the following in reviewing recommendations and selecting projects for inclusion on the 2013-2014 Guidance Priority list: (i) whether the recommended guidance resolves significant issues relevant to many taxpayers; (ii) whether the recommended guidance

promotes sound tax administration; (iii) whether the recommended guidance can be drafted in a manner that will enable taxpayers to easily understand and apply the guidance; (iv) whether the recommended guidance involves regulations that are outmoded, ineffective, insufficient, or excessively burdensome and that should be modified, streamlined, expanded or repealed; (iv) whether the Service can administer the recommended guidance on a uniform basis; and (v) whether the recommended guidance reduces controversy and lessens the burden on taxpayers or the Service.

It is respectfully submitted that Section 4261(e)(3)(C) Guidance satisfies each of the criteria enumerated above. The application of the Section 4261(a) excise tax to the purchase of mileage awards impacts the wide number of purchasers of mileage awards (including credit card companies, hotels, automobile rental companies and others), as well as the airline company sellers of such awards. Section 4261(e)(3)(C) specifically authorizes rules to exclude from tax amounts attributable to mileage awards depending upon how such mileage awards are used. Since that provision was enacted in 1997, taxpayers have been in need of guidance to determine the appropriate amount of tax applicable to purchased mileage awards. To date, the scope of Section 4261(e)(3) has been the subject of lengthy and controversial examinations. *See, e.g.*, IRS Air Transportation Excise Tax - Audit Technique Guide. Section 4261(e)(3)(C) Guidance would help to resolve significant issues for a large number of taxpayers and promote sound tax administration by providing understandable rules which would apply the tax in a fair and equitable manner and to which both taxpayers and Service examiners could refer, thereby minimizing the likelihood of controversies and the burden on both taxpayers and the Service that they entail. It would also provide a consistency in approach, which for now may be lacking as taxpayers, in good faith, attempt to address this issue, albeit on an individualized basis. Finally, Section 4261(e)(3)(C) Guidance that may be used as the time mileage awards are purchased would reduce the need for the submission of refund claims by purchasers of mileage awards and avoid other problems that arise if an exemption from tax is based on an "after the fact" determination, such as where mileage awards are ultimately used for something other than taxable transportation or have expired after the applicable statute of limitations has run.

Thank you in advance for your consideration of this request.

Respectfully submitted,



Marc J. Gerson

cc: Lisa Zarlenga
Christopher Kelley
Treasury Department Office of Tax Policy
Curt Wilson
Frank Boland
Stephanie Bland
Michael Beker
Internal Revenue Service

Notice 2013-22
SEP 4 2013
LEGAL PROCESSING DIVISION
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MAYER • BROWN

August 23, 2013

Office of Information and Regulatory Affairs
Office of Management and Budget
Attention: Desk Officer for Treasury
New Executive Office Building
Room 10235
Washington, D.C. 20503

Re: OMB Number: 1545-1572; title: Notice 97-66, Certain Payments Made Pursuant to a Securities Lending Transaction; Notice 2010-46, Prevention of Over-Withholding and U.S. Tax Avoidance With Respect to certain Substitute Dividend Payments

Ladies and Gentlemen:

On July 25, 2013, the Department of the Treasury published the *Submission for OMB Review; Comment Request* in Volume 78, No. 143, of the Federal Register. This Comment Request asks for comments regarding the burden estimate, or any other aspect of the information collection, including suggestion for reducing the burden with respect to, *inter alia*, the above-referenced matter. This letter responds to that request. Specifically, the introduction of the rule contained in Section 871(m)(2)(A) of the Internal Revenue Code of 1986, as amended (the "Code") by Section 541 of the Hiring Incentives to Restore Employment Act (the "HIRE Act"), Pub. L. No. 111-1247, 125 Stat. 71 (2010) has created substantial uncertainty and unnecessarily burdensome information collection requirements for financial market participants engaged in securities lending transactions involving U.S. stocks from the United Kingdom. Specifically, we request that the United States Department of the Treasury and the Internal Revenue Service (the "IRS") (i) clarify, as described below, that a lender in a series of Security Lending Transactions, within the meaning of Notice 2010-46, bears the burden of the U.S. federal income tax withheld and (ii) provide a credit forward mechanisms for chains of notional principal contracts ("NPCs" or "swaps") that operates in a parallel fashion to the credit forward mechanisms for chains of securities lending transactions.

It is our experience that there is a significant volume of stock lending involving U.S. stocks undertaken by U.K. financial market participants. The existence of such market in London is extremely beneficial for U.S. companies as it creates substantial liquidity for U.S. stocks. The change requested below is not expected to have any significant U.S. federal income tax consequences. The IRS, by making requested clarifications, will be solving an ambiguity between the U.S. and U.K. tax systems and thereby increasing the ability of U.K. financial market participants to continue to provide liquidity on U.S. stocks.

I. Clarification that a Stock Borrower Relying on Upstream Withholding Is a Withholding Agent

A. Legal Background on the Taxation of Dividend Equivalents Paid to Non-U.S. Persons in Securities Lending Transactions

The United States imposes a flat 30% withholding tax on U.S.-source dividend payments paid to a foreign person not in connection with the conduct of a U.S. trade or business by such foreign person. Code §§ 861, 871 and 881. Dividends paid by U.S. corporations generally are treated as U.S.-source income and, thus, are subject to the U.S. withholding tax. Code § 861(a)(2); Treas. Reg. § 1.861-3. Substitute dividend payments made by a stock borrower with respect to stock of a U.S. corporation in a stock lending transaction follow the source rule for the stock itself. Code § 861(m)(2)(A). Accordingly, such substitute dividend payments are considered U.S.-source income. Treas. Reg. §§ 1.861-3(a)(6); 1.871-7(b)(2); 1.881-2(b)(2). A substitute dividend payment is a payment made to a lender of a security in a securities lending transaction or a sale-repurchase transaction of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction. *Id.* The statutory withholding tax rate of 30% may be reduced by the terms of an applicable income tax treaty. Code § 894.

Notice 2010-46 provides rules that allow taxpayers to structure securities lending transactions that avoid excessive or cascading taxation. In the absence of such rules, each borrower of the same stock would be required to withhold U.S. tax. For example if a foreign person (FP-1) lent a U.S. stock to another foreign person (FP-2), withholding would be required on the actual dividend payment to FP-2 and on the substitute dividend payment that FP-2 makes to FP-1. Thus, U.S. withholding tax would be imposed twice on the same economic income. Code § 871(m)(6) provides a legislate mandate to the IRS to promulgate certain rules that will prevent cascading withholding in securities lending transactions.

The anti-cascading rules effectively break down into three new regimes. First, dealers may enter into agreements with the IRS, in which they promise to ensure proper withholding is made, are exempted from withholding (the "Qualified Securities Lender" or "QSL" rules). Second, parties to securities lending transactions that obtain certifications that there has been prior withholding in the chain (referred as a "series") are exempted from withholding. Last, in circumstances where the amount passed through reflects proper withholding, no further withholding is required. The issue posed by the interaction of the United States and United Kingdom rules concern the second regime, referred to as the "credit forward of prior withholding" rules.

B. Documentation Rules for The Credit Forward of Prior Withholding

If party to a securities lending transaction is not a QSL, the IRS follows the mandate provided by Code § 871(m)(6) by providing relief from over-withholding "with a document-based system." Under the document-based system, the amount that a securities borrower must

withhold is equal to the excess of the amount of withholding that the lender would be subject to if it held the stock directly minus the amount that was actually withheld on a prior dividend or substitute dividend within the same series. The IRS will not provide refunds for withholding if a prior person in the chain (series) bore a higher withholding tax. For example, assume that a taxpayer that is subject to a 15% withholding tax lends stock to a person subject to 30% withholding tax. The borrower holds the stock over the dividend record date and the issuer (or its agent) withholds 30% of the amount of the dividend. The borrower then makes a substitute dividend payment to the stock lender. Although the stock borrower is not required to make any additional withholding on the substitute dividend payment to the lender, no refund is available to the parties.

Notice 2010-46 prescribes a four-party documentation substantiation test to determine if there has been prior withholding in a series:

(1) The lender receives a substitute dividend net of U.S. withholding taxes;

(2) The lender receives a written statement from the immediately prior withholding agent setting out the amount of such taxes (proof that the stock has been on-sold is not evidence of prior withholding);

(3) The borrower identifies the person who withheld such tax and the recipient of the payment against which such tax was withheld; and

(4) The lender does not know or have reason to know that the written statement is unreliable.

The fourth prong is reinforced by an anti-abuse rule. If a withholding agent or Qualified Securities Lender "knows or has reason to know" that a securities lending transaction has a principal purpose of reducing or eliminating withholding tax, it must withhold notwithstanding compliance with the documentation requirements. Taxpayers who rely on the credit-forward system must report that they relied on prior withholding on line 8 of a IRS Form 1042-S and on line 66 of Form 1042. The reporting must show the maximum amount that would have been subject to withholding and the amount of the prior credit.

C. Interaction of the United States and United Kingdom Income Tax Rules

When a United Kingdom corporation is the lender in a series of securities lending transactions, the U.K. lender is treated as though it received the full amount of the dividend equivalent (referred to as a "manufactured overseas dividend" or "MOD"), unreduced by the amount of U.S. withholding tax imposed on the dividend. The U.K. stock lender then has the ability to claim a foreign tax credit for the amount of United States tax imposed on the payment of the dividend or dividend equivalent, provided that the U.K. stock lender has received the dividend equivalent from a withholding agent that has an obligation to withhold. A difficulty arises, however, for the U.K. stock lender to claim a foreign tax credit on the MOD when the withholding took place "upstream," that is, using the example above, the withholding was undertaken by the stock issuer (or a subsequent stock borrower) against the dividend (or dividend

equivalent) payable to the borrower, not by the borrower on the payment of the MOD to the stock lender.

The difficulty arises because Notice 2010-46 is not entirely clear that a withholding obligation remains when there has been upstream withholding. While we understand that the Notice should be read to reduce or eliminate the amount to be remitted to the IRS, without having an effect on the substantive withholding requirement, it can also be read to reduce or eliminate withholding on substitute dividend payments to the extent of any prior amounts withheld. While the distinction does not have any significant U.S. federal income tax consequences, it is significant from a U.K. tax perspective in that a reduction to the substantive withholding requirement does not permit the stock lender to claim its full U.K. foreign tax credit, while a change to the amount required to be remitted does permit the claiming of the full credit. This is because the U.K. rules would permit the stock lender to claim a U.K. foreign tax credit only if the stock borrower is treated as a withholding agent with an obligation to withhold. For U.K. tax purposes, the upstream withheld taxes are creditable if the taxes can be said to have been charged on, or in respect of, the payment to the stock lender, even if the withholding agent has no requirement to account to the IRS for the amount of withheld taxes. If the stock borrower is not treated as a withholding agent with an obligation to withhold (i.e., if Notice 2010-46 has reduced or eliminated the substantive withholding requirement), the U.K. lender will not be entitled to claim all or a portion of its foreign tax credit. On the other hand, if Notice 2010-46 retains the substantive withholding requirement but merely eliminates the requirement that tax be remitted, the stock borrower will continue to be treated as a withholding agent with an obligation to withhold and the U.K. lender will be entitled to claim its full foreign tax credit.

Economically, it is clear that the U.K. stock lender has borne the impact of the upstream withheld taxes. The U.K. stock lender must treat itself as though it receive the full amount of the dividend. Its cash receipts, however, reflect the imposition of the U.S. tax on the dividend equivalent. (Indeed, if the stock borrower was subject to a higher rate of tax than would have applied to the U.K. stock lender, the U.K. stock lender would bear the impact of such higher withholding tax rate.)

D. The Stock Borrower Is a U.S. Federal Income Tax Withholding Agent

Generally, any person that meets the definition of a withholding agent is required to withhold the applicable withholding tax and deposit it with the U.S. Department of the Treasury. Treas. Reg. § 1.1461-1(a). The term "withholding agent" means any person, whether U.S. or foreign, that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding (e.g., U.S. source dividends). Treas. Reg. 1.1441-7(a)(1). The applicable regulations do not require that the withholding agent otherwise be subject to U.S. jurisdiction. The rules specifically contemplate that more than one person can be a withholding agent with respect to a single payment: "When several persons qualify as withholding agents with respect to a single payment, only one tax is required to be withheld and deposited." Id.

The fact that a borrower of stock in a stock lending transaction is a withholding agent even when it has no obligation to remit any tax to the Department of Treasury because there has

been upstream withholding is borne out by the language used in Notice 2010-46. Notice 2010-46, Section II(B)(i), which promulgates the rules for the credit forward of prior withholding, refers to persons who may claim a credit for upstream withholding as "withholding agents:"

> **[W]ithholding agents** may relieve excessive tax on substitute dividends by reducing withholding on a substitute dividend payment that the **withholding agent** is obligated to make by an amount not to exceed the amount that has been previously withheld within the same series of Securities Lending Transactions, but only to the extent that there is sufficient evidence that tax was actually withheld on a prior dividend and/or substitute dividend paid to the **withholding agent** or a prior withholding agent within the same such series.

Emphasis added. Similarly, the instructions to Form 1042 (Oct. 31, 2012) refer to a person who claims a credit for upstream withholding on dividend equivalents as an "other withholding agent." See instructions for Line 66.

E. Documentation Change Requested

The challenge experienced by U.K. stock lenders in order to claim a U.K. tax credit for the amount of U.S. taxes withheld "upstream" in a series of Securities Lending Transactions involving a U.S. stock could be alleviated if the U.S. rules were explicit that (i) the borrower of the stock is a withholding agent with an obligation to withhold on the dividend equivalent to the stock lender and remit the amount withheld to the IRS, (ii) only the obligation to remit the amount of the tax is excused by the upstream withholding, not the obligation to withhold and (iii) the lender of the U.S. stock is considered to have borne the U.S. tax on the substitute dividend received, even in instances in which the requirement to remit such tax has been satisfied through the mechanism of the credit forward upstream withholding. It would be helpful if these statements could be added to any regulations ultimately issued to implement the rules contained in Notice 2010-46 and in the instructions to the Form 1042-S.

II. Request for a Parallel Withholding Tax Remittance Credit for Chains of NPCs

A. Legal Background on Chains of NPCs

Code § 871(m)(2)(B) treats dividend equivalents paid on "specified notional principal contracts" as U.S.-source dividends to the extent that the dividend equivalent is paid with respect to a U.S. stock.[1] In those instances in which withholding is required on dividend equivalents paid on specified notional principal contracts, there is no mechanism to avoid cascading withholding when the specified notional principal contract has been hedged with the stock referenced in the NPC, a securities lending transaction and/or another securities lending transaction. This inability to credit forward the U.S. federal income withholding that has occurred upstream acts as a substantial impediment for non-U.S. financial institutions to offer

[1] The IRS is currently engaged in considering what types of NPCs and other derivatives should be included within rules applicable to specified notional principal contracts. See T.D. 9572 (Aug. 16, 2012); REG-120282-10 (January 23, 2012). This comment letter does not address what transactions should be within such rules.

swap exposures over U.S. equities to their clients. As a result, the liquidity and attractiveness of U.S. capital markets is hurt.

For example, assume that foreign person (FP1) desires to obtain an unfunded total return exposure to a U.S. stock or a basket of U.S. stocks. Assume further that FP1 enters into a specified notional principal contract with a non-U.S. bank (FB) to obtain such exposure. The transaction is not effectively connected to conduct of a U.S. trade or business of either FP1 or FB. FP1 is the "long party" within the meaning of Code § 871(m)(4)(A). FB is the "short party" within the meaning of Code § 871(m)(4)(B). FB hedges its financial exposure on the specified notional principal contract by purchasing the U.S. stocks referenced in the swap.

Under current federal income tax rules, the issuer of the stock (or its agent) must withhold U.S. federal income tax on the dividends paid on the stock held by FB as a hedge of its obligations under the specified notional principal contract with FP1. Code § 881(a)(1) (imposition of tax); Code § 1441(a)(1) (withholding tax liability on payer of income). Under Code § 871(m)(2)(B), FB must withhold on the dividend equivalent paid or credited to FP1 under the swap. FB is not entitled to a withholding tax credit for the tax that it suffered on the hedge position. As a result, two withholding taxes have been imposed on the same economic income.

The proposed regulations promulgated under Code § 871(m) offered a limited solution to this double taxation of the same income. Specifically, Proposed Treasury Regulation § 1.871-16(e)(2) provided that a NPC between related parties that otherwise would be treated as a specified notional principal contract would not be so treated if:

(1) The swap is between related parties;

(2) Each of the related parties entered into the swap "in the ordinary course of their business as a dealer in securities or commodities derivatives; and

(3) The swap between the related parties hedges a swap entered into with an unrelated party.

If these requirements are met and the related party swap is not treated as a specified notional principal contract, there would not be any withholding on the related party swap. See Treas. Reg. § 1.863-7(b).

B. Extension of Credit Forward Rules for Specified Notional Principal Contracts

Code § 871(m)(6) authorizes the IRS to promulgate rules to prevent cascading withholding taxes "in the case of any chain of dividend equivalents, one or more of which is subject to tax . . . ." The grant of authority to prevent cascading U.S. withholding taxes is not limited to securities lending transactions. Accordingly, the IRS has the authority to prevent cascading withholding taxes on chains of NPCs that include specified notional principal contracts.

The promulgation of a rule that prevents cascading of withholding on specified notional principal contracts can be addressed independently of the determination of what transactions should be subject to the rules promulgated for specified notional principal contracts. The prevention of cascading withholding is a current issue and can be addressed without impeding the existing effort to determine when swaps (and other financial instruments) should be treated as generating U.S.-source income treated as dividend income for transactions on which dividend equivalents are paid on or after January 1, 2014 (or such later date as may be specified by the IRS). See Treas. Reg. § 1.871-16T(b). Accordingly, the existing regulation project under Code § 871(m) should not be an impediment to the promulgation of an anti-cascading rule.

C. Substance of the Rule for the Prevention of Cascading Withholding Taxes on Specified Notional Principal Contracts

There is a clear path in securities lending transactions to determine whether there is a chain of such transactions. When a person borrows a share of stock, that share can be traced. If the borrowed share of stock is on-lent, a rule following specific identification of the borrowed share of stock allows the borrower to determine whether a chain of securities lending transactions has occurred.

With swaps, there is no ability to trace a particular security inasmuch as swaps are bilateral contractual arrangements and not the passing of a physical security. Accordingly, a method other than one that follows a physical security is needed to ensure that a chain of NPC transactions exists. We recommend that the IRS employ the hedge identification rules contained in Treasury Regulation § 1.1221-2. Under such a rule, a swap would be considered to be in a chain of swaps only to the extent that:

(1) The notional indices of the two NPCs were identical;

(2) The NPCs were designated as hedges of each other, that is, the total return on one position was matched by the total return on the other transaction;

(3) For this purpose, the holding of the physical stock position by a short party would be treated as a specified notional principal contract; and

(4) The other requirements necessary for a credit forward of withholding taxes were satisfied if the transaction constituted a chain of securities lending transaction, that is, the taxes were actually withheld, evidence of withholding is provided and there are no circumstances known that the transactions were undertaken to avoid the withholding taxes.

Very truly yours,

MAYER BROWN LLP

By: Mark Leeds

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Additional Submission Pursuant to Notice 2013-22
Internal Revenue Service
Attn: CC:PA:LPD:PR (Notie 2013-22)
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Notice 2013-22

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April 29, 2013

BY E-MAIL

Internal Revenue Service
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1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: <u>2013-2014 Treasury/IRS Guidance Priority List</u>

Dear Sir or Madam:

The purpose of this letter is to propose guidance for inclusion on the 2013-2014 Treasury/IRS Guidance Priority List. We recommend that the list include guidance about the standards for recognizing organizations engaged in the publication of information that is useful to the individual and beneficial to the community, including general news, as exempt under Section 501(c)(3). In this letter, we refer to such organizations as "nonprofit news organizations."

As background, in 2011 the Federal Communications Commission (the "FCC") issued a report, *The Information Needs of Communities: The Changing Media Landscape in a Broadband Age,* which documents the substantial decrease in accountability reporting by commercial news organizations. For example, the FCC report points to a study conducted by the Pew Center for Excellence in Journalism which found that in 2009 the *Baltimore Sun* produced 32 percent fewer investigative stories than it did in 1999 and 73 percent fewer stories than in 1991.[1] It explains that financial pressures are forcing commercial news organizations to reduce coverage of investigative pieces involving lengthy documents and records searches or stories requiring a reporter to develop comprehensive knowledge of a particular subject matter. This cut-back affects coverage of issues that Americans care about – such as schools, health care, the environment, and local public affairs – and that offer substantial public benefit and civic value. The FCC report also describes the serious consequences that result from communities losing

[1] S. Waldman and the Working Group on Information Needs of Communities, *The Information Needs of Communities: the Changing Media Landscape in a Broadband Age*, 123 (July 2011).

information that can improve government responsiveness and accountability. It explains that nonprofit news organizations can help to fill the gap in coverage and notes that uncertainty about the standards required for nonprofit news organizations to obtain tax exemption under Section 501(c)(3) is a significant barrier to this evolution.

The FCC report recommended that tax and journalism experts study the tax exemption requirements for nonprofit news organizations more carefully, and the Council on Foundations convened a working group of such experts. The group released its findings in a report issued earlier this year, *The IRS and Nonprofit Media: Toward Creating a More Informed Public*. The report is available online at http://www.cof.org/files/Bamboo/home/documents/Nonprofit-Media-Full-Report-03042013.pdf.

The working group report confirms that many nonprofit news organizations have experienced lengthy delays and even rejections of their applications for exemption. It concludes that the Internal Revenue Service ("IRS") approach for evaluating whether an organization primarily engaged in publishing qualifies for tax exemption under Section 501(c)(3), namely Revenue Ruling 67-4,[2] needs to be modernized. The working group report notes that Revenue Ruling 67-4 was issued decades before the advent of the digital era. That ruling establishes four criteria for analyzing the tax-exempt status of nonprofit news organizations, whether: (1) the content of the publication is educational, (2) the preparation of material follows methods generally accepted as "educational" in character, (3) the distribution of the materials is necessary or valuable in achieving the organization's educational and scientific purposes, and (4) the manner in which the distribution is accomplished is distinguishable from ordinary commercial practices. The fourth criterion, in particular, does not reflect dramatic changes in the manner of dissemination of information by all news organizations, nonprofit and for-profit alike.

This request for guidance is consistent with the recommendations of the working group report, and the discussion below explains how such guidance meets the factors that Treasury/IRS considers in choosing to add an item to the priority list.

1. The guidance will resolve significant issues relevant to many taxpayers.

The Section 501(c)(3) status of nonprofit news organizations is of great importance to the millions of Americans who seek information about the events shaping their lives. According to the FCC report, "communities and citizens are seriously harmed – including financially – if there is not a critical mass of full-time professional journalists watching over the key institutions – such as state and local government, local schools, state and local courts, police, environmental

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[2] Revenue Ruling 67-4, 1967-1 CB 121.

planning, land use, transportation, and public health."[3] Nonprofit news organizations offer an additional source of information on these topics just as the for-profit news sector is cutting back. These stories help Americans gain useful and beneficial information that allows them to make more-informed decisions.

Moreover, investigative reporting benefits residents of communities whether or not they are readers of a particular paper. For example, the working group report points to an in-depth series in the *Raleigh News & Observer* on the quality of the city's parole system that helped take criminals off the streets in the Raleigh-Durham area, thereby improving safety for all residents, regardless of whether they were readers of the paper.[4] Nonprofit news organizations, often with philanthropic support from foundations, are the hope of the future for this type of reporting.

Section 501(c)(3) status is critical for nonprofit news organizations, in part because their ability to provide or expand accountability coverage on subjects such as local government, schools, and healthcare often hinges on philanthropic support from funders that require such exemption as a prerequisite for providing support. These organizations also want to structure their activities in a manner consistent with the requirements for Section 501(c)(3), but lack guidance about how to do so. In this regard, the working group report notes that the operator of the *Oshkosh Community News Network*, a Section 501(c)(3) nonprofit news organization, shut down the organization in part because of uncertainty regarding the tax laws.[5] Updated guidance will help these organizations gain important information about how to structure their activities in order to ensure continued qualification as a Section 501(c)(3) organization.

Finally, private foundations are investing in nonprofit news organizations, with one report estimating contributions of nearly $128 million to news and information projects since 2005.[6] The guidance will facilitate and streamline the grant-making programs of these foundations and help ensure their investments are advancing charitable and educational purposes.

2. The guidance will promote sound tax administration.

As noted above and in the working group report, nonprofit news organizations have experienced substantial delays associated with the processing of their applications for exemption under Section 501(c)(3). Recently, the IRS centralized a group of applications submitted by nonprofit

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3 S. Waldman and the Working Group on Information Needs of Communities, *The Information Needs of Communities: the Changing Media Landscape in a Broadband Age*, 263 (July 2011).

4 *See* S. Waldman and the Working Group on Information Needs of Communities, *The Information Needs of Communities: the Changing Media Landscape in a Broadband Age*, 18 (July 2011).

5 Council on Foundations, *The IRS and Nonprofit Media: Toward Creating a More Informed Public*, 12 (2013).

6 J. Schaffer, *New Media Makers: A Toolkit for Innovators in Community Media and Grantmaking* 2 (2009).

news organizations as it attempted to understand, analyze, and apply the rules for exemption to these organizations and needed to ensure consistent treatment. Providing updated guidance about how nonprofit news organizations advance Section 501(c)(3) purposes will facilitate the IRS's processing of applications for exemption, as well as nonprofit news organizations' compliance with the law.

3. The guidance can be drafted in a manner that will enable taxpayers to easily understand and apply the guidance.

The guidance can be drafted in a form such as a revenue procedure that provides background on the rules for evaluating the Section 501(c)(3) status of nonprofit news organizations, outlines the various factors the IRS will consider in evaluating whether a nonprofit news organization is advancing charitable and educational purposes, and identifies the factors that are not relevant in such a determination. The IRS has issued similar types of revenue procedures in the past to help give guidance about how a particular sector or industry advances tax-exempt purposes. For example, Revenue Procedure 96-32 provides a safe harbor for organizations providing low-income housing to qualify as Section 501(c)(3) organizations, and this has proved to be an invaluable tool for low-income housing organizations seeking to apply for exemption, and for IRS agents processing such applications.

4. The guidance involves regulations that are outmoded, ineffective, insufficient, or excessively burdensome and that should be modified, streamlined, expanded, or repealed.

As noted above and in the working group report, the IRS is relying on outdated standards for evaluating whether nonprofit news organizations are furthering charitable and educational purposes. For example, Revenue Ruling 67-4 evaluates whether an organization's manner of distribution of a publication is distinguishable from ordinary commercial publishing practices. However, since the publication of Revenue Ruling 67-4, advances in the development of technology and devices that facilitate the low-cost dissemination of information have made the distribution of free or low-cost content to the public an ordinary practice by Section 501(c)(3) organizations and commercial publishers alike.

5. The Service can administer the guidance on a uniform basis.

The IRS has faced challenges with applying the rules for tax exemption under Section 501(c)(3) on a uniform basis to nonprofit news organizations, in part because the current outdated guidance does not reflect changes in the manner of dissemination of useful and beneficial public information. Updated guidance will enable the IRS to administer the tax laws on a more uniform basis.

6. The guidance will reduce controversy and lessen the burden on taxpayers and the Service.

As noted above, the guidance will have a substantial positive impact on the American public, nonprofit news organizations, private foundations, and the IRS. It will enable new nonprofit news organizations to move forward to meet the information and accountability needs of their communities. It will provide certainty to philanthropy funders. It will provide clear standards for the IRS to apply. And it will avoid litigation that will inevitably result if the IRS does not address the need for updated guidance in this area.

* * *

We appreciate your consideration of this request. We believe the time is right and the time is now for the IRS to issue updated guidance. Every month more commercial newspapers close their doors or reduce new coverage to the detriment of their communities. Nonprofit news organizations can and will emerge to help address this problem, but they need Section 501(c)(3) status to do so. Updated guidance is essential to allow that to happen.

Sincerely,

Celia Roady

cc: The Honorable Mark Mazur
Assistant Secretary for Tax Policy
Department of the Treasury

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

Notice 2013-22

MAY - 2 2013

May 1, 2013

Internal Revenue Service
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Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Notice 2013-22, 2013-2014 Guidance Priority List

Dear Ladies and Gentlemen:

The LIHTC Working Group was established to provide a platform for low-income housing tax credit ("LIHTC") industry participants to work together to resolve technical and administrative LIHTC program issues. On behalf of the members of the LIHTC Working Group, we would like to recommend the following issues in priority order for addition to the Guidance Priority List for 2013-2014.

1. We are requesting guidance as it relates to the exception under Internal Revenue Code ("IRC") Section 42(d)(6) for any federally or state assisted building. IRC Section 42(d)(6) does not currently define "federally or state assisted" building.

2. We are requesting guidance under IRC Section 42(j), which provides for recapture of LIHTCs, in relation to tax credit recapture for projects that have received Section 1602 subawards under the American Recovery and Reinvestment Act of 2009 ("Section 1602"). Treasury has expressed its intentions to issue separate recapture procedures for Section 1602 fund subawards; however, no procedures have yet been issued.

3. We are requesting guidance under IRC Section 142 on whether a low-income housing project that has lost its rural designation is held harmless at the highest national non-metro median income that the project achieved if its income limit was originally determined using the national non-metro median income afforded to rural projects under IRC Section 42(i)(8).

4. We are requesting guidance regarding the application of IRC Section 42 requirements as they conflict with the requirements of other affordable housing governmental assistance programs. In certain circumstances, the construction of affordable housing projects requires additional financing from other governmental assistance programs. The funds provided by these assistance programs may include restrictions that conflict with program guidance under IRC Section 42. Guidance is needed on whether IRC Section 42 projects

can be held harmless by virtue of complying with other affordable housing governmental assistance program requirements.

5. We are requesting guidance on the documented legislative intent included in the technical explanation prepared by the Joint Committee on Taxation explaining revenue provisions of the Health Care and Education Affordability Reconciliation Act of 2010, footnote 344 ("Footnote 344"). Footnote 344 clarified that the codification of the economic substance doctrine is not intended to disallow tax credits in a transaction that achieves the basic purpose or plan for which the tax credits were intended by Congress. In addition, we request that Treasury provide guidance as to the applicability of Footnote 344 to Section 1602.

The LIHTC Working Group has submitted previous comment letters to the Internal Revenue Service and the Department of the Treasury requesting guidance on the above-mentioned issues. A copy of these comment letters, as listed in Appendix A, can be reviewed at www.lihtcworkinggroup.com. Please contact us if you would like us to resubmit our comment letters in Appendix A for your review.

We appreciate the opportunity to comment on the 2013-2014 Guidance Priority List. The furtherance of these issues will help the LIHTC program better provide affordable housing in our communities by providing clarification and lessening the risks in the LIHTC program compliance. Thank you in advance for your time and careful consideration of these issues. Please do not hesitate to contact us if you have any questions regarding our comments or if we can be of further assistance.

THE LIHTC WORKING GROUP

Very truly yours,

NOVOGRADAC & COMPANY LLP

by

Stacey Stewart

Appendix A – LIHTC Working Group Comment Letters

1. LIHTC Working Group Letter Regarding Definition of "Substantially Assisted, Financed, or Operated" in the Housing and Economic Recovery Act of 2008 (original letter: March 11, 2009; reissued: July 14, 2010).

2. LIHTC Working Group Letter Regarding Recapture Rules Surrounding Section 1602 of the American Recovery and Reinvestment Act of 2009 (original letter: July 30, 2009; reissued: August 2, 2010).

3. LIHTC Working Group Letter on Rural Designation Uncertainty (January 30, 2013).

4. LIHTC Working Group Letter on Conflicting Affordable Housing Program Requirements (February 27, 2013).

5. LIHTC Working Group Letter Seeking Guidance Related to Codification of Economic Substance and Low-Income Housing Tax Credits (October 27, 2010).

Notice 2013-22

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MAY 3 2013

From:	Blake Major <bmajor@nabl.org>
Sent:	Friday, May 03, 2013 11:22 AM
To:	"Notice.Comments@irscounsel.treas.gov."@ewhserver582.edgewebhosting.net
Subject:	NABL Priority Guidance List 2013-14
Attachments:	NABL Priority Guidance 2013-14.pdf

I believe I had submitted this on Tuesday, April 30, 2013, however I did not receive a confirmation email. I am re-submitting this in the event that I did not properly submit it the first time. Thank you.

The National Association of Bond Lawyers ("NABL") respectfully suggests the following items for inclusion in the 2013-2014 Guidance Priority List. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986.

1. Guidance on the definition of "issue price" under Section 148.

2. Guidance regarding reissuance, including the application of the reissuance rules to multi-modal private placements.

3. Guidance concerning application of the private business use tests to "accountable care organizations" and other arrangements entered into under the Patient Protection and Affordable Care Act.

4. Update to the management and service contract safe harbors in Revenue Procedure 97-13.
5. Reviewing, revising and finalizing proposed regulations concerning (a) public approval under Section 147(f), (b) allocation and accounting of proceeds and projects under Section 141, and (c) yield computation in connection with certain qualified hedges under Section 148 and related matters.

These items are suggested as priority items. These items are not listed in any specific order of priority. Nor by suggesting them do we mean to withdraw any other items we suggested for any prior list.

The list of suggested items was compiled by a NABL task force. If you have any questions concerning them, please contact Michael Larsen (Chair of the NABL Tax Law Committee) at (843) 727-6311 or MikeLarsen@parkerpoe.com.

Blake Major
Governmental Affairs Representative
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Washington, D.C. 20005

April 30, 2013

Internal Revenue Service
Attn: CC:PA:LPD:PR
(Notice 2012-25)
Room 5203
P. O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

RE: 2013-2014 Guidance Priority List

Ladies and Gentlemen:

The National Association of Bond Lawyers ("NABL") respectfully suggests the following items for inclusion in the 2013-2014 Guidance Priority List. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986.

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Sincerely,

Scott R. Lilienthal

Notice 2013-22

400 North Columbus Street
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May 1, 2013

MAY 2 2013

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

Internal Revenue Service
Attn: CC:PA:LPD:PR
(Notice 2013-22)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2013-22 Recommendations for 2013-2014 Guidance Priority List

Thank you for this opportunity to submit recommendations for the 2013-2014 Guidance Priority List on behalf of the National Affordable Housing Management Association (NAHMA). NAHMA members manage and provide quality affordable housing to more than two million Americans with very low to moderate incomes. Presidents and executives of property management companies, owners of affordable rental housing, public agencies and national organizations involved in affordable housing, and providers of supplies and services to the affordable housing industry make up the membership of NAHMA. In addition, NAHMA serves as the national voice in Washington for 19 regional, state and local affordable housing management associations (AHMAs) nationwide. NAHMA's comments will focus on two important matters related to the Section 42 Low Income Housing Tax Credit (LIHTC) program, namely the utility allowance submetering rule and treatment of casualty losses.

Utility Allowances (UA) Submetering

On August 7, 2012, the Internal Revenue Service (IRS) – Treasury Department issued the "Utility Allowances Submetering Notice of Proposed Rulemaking and Notice of Public Hearing" [REG–136491–09], RIN 1545–BI91. NAHMA respectfully requests that IRS-Treasury add finalization of this rule, with certain changes, to its 2013-2014 Guidance Priority List.

Before releasing the final rule, NAHMA strongly urges IRS-Treasury to revise its interpretation of State housing agencies' authority to disapprove UA estimation methods permitted under current policies. Under the section, "Summary of Comments on Notice 2009-44 and Explanation of Provisions," the August 7 Notice states:

> *"A commentator asked whether State housing agencies are allowed to disapprove of certain methods for determining utility allowances listed in § 1.42–10(b)(4)(ii). Existing rules address the role of the State housing agencies in determining utility allowances. Thus, depending on the particular method under §1.42-10(b)(4)(ii), State housing*

agencies may require certain information before a method can be used, or they may disapprove of a method."

NAHMA stands by the position articulated by nine national organizations which represent property owners and managers, developers and lenders who participate in the LIHTC program. The joint industry comments, submitted on October 4, 2012, stated:

> *"We disagree with the general implication of this language that State housing agencies may arbitrarily choose to disapprove any method described in the regulation...."*
>
> ...
>
> *"As written, the language in the August 7, 2012, proposed rule would give State housing agencies authority to ignore the intent of the existing regulation, which is to recognize accurate estimates that encourage energy efficiency and are based on reliable methods that are easily verifiable. We are concerned that agencies may impose less accurate methods for calculating utility allowances on an arbitrary basis. We recommend that the IRS direct State housing agencies to review the data and information provided by project sponsors and make a determination based on the facts of the individual project submission. Applicants for LIHTC credits should be encouraged to engage with the State housing agency to determine what, if any, issues or concerns the approving agency may have."*

NAHMA urges IRS-Treasury to issue a final rule that reaffirms LIHTC property owners' options for selecting an appropriate UA estimation method available under current IRS policies.

Section 42 Low Income Housing Tax Credit Buildings Damaged by Casualty Events

NAHMA respectfully requests that IRS-Treasury include harmonization of casualty loss policies for LIHTC properties on its 2013-2014 Guidance Priority List.

Under current policies, casualties are treated differently depending on whether they are the result of a presidentially declared disaster. As described in Revenue Procedure 2007-54, a taxpayer can continue to claim the credits for casualty events in presidentially declared disaster areas. Low Income Housing Tax Credits will not be subject to recapture or loss of credit if the building's qualified basis is restored within a reasonable restoration period—which may not exceed 24 months after the end of the calendar year in which the president issued a major disaster declaration for the area where the building is located. However, properties that suffer casualty losses outside of these declared disaster areas operate under different terms. Internal Revenue Code 42(j)(4)(E) provides relief from recapture of previously earned credits if the building is restored by reconstruction or replacement within a reasonable time. However, it does not provide authority for claiming the credit during the time that the building is being restored.

As stated by the IRS, the credit is determined at the close of the taxable year under IRC §42(c)(1). Credit is determined on a monthly basis only for the first year of the credit period under IRC §42(f)(2)(A), and for additions to qualified basis under IRC §42(f)(3)(B).Otherwise, there is no authority to disallowing credits on a monthly basis. Owners of buildings in presidentially declared disaster areas will not lose credits if the building is not placed back in service by the end of the year. However, owners of buildings not in a declared disaster area will lose credits for the year if their units are not back online by December 31. This means an owner could have a unit that was in compliance

for the entire year, but have a fire in December that is not restored by December 31, and the owner would not be eligible to take credits for the entire year. If this is not done on December31, then credits cannot be claimed for the entire year, no matter if the units were in compliance every other day of the calendar year.

NAHMA urges IRS-Treasury to apply the same casualty loss policies across the board. Properties should be able to continue to take the credits during the restoration period, regardless of whether or not the property is in a presidentially declared disaster area. It is reasonable, however, for IRS to establish criteria for owners to demonstrate they took prompt action to begin the restoration process following the casualty event when the loss occurs outside of a presidentially declared disaster area.

Conclusion

Thank you again for the opportunity to offer these recommendations for the Guidance Priority List.

Sincerely,

Kris Cook, CAE
Executive Director

Notice 2013-22

JUL 3 2 2013

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

National Association of Water Companies

MOVING WATER FORWARD

Michael Deane
Executive Director

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July 19, 2013

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Mark J. Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Subject: Request for priority guidance under Notice 2013-22

Ladies and gentlemen:

This is to request that the Treasury Department and IRS provide guidance as described below on the rules related to remedial actions for tax-exempt bonds under section 1.141-12 of the Treasury Regulations. We also request that you include this issue in the 2013-2014 Guidance Priority List.

The remedial action requirements apply when an issuer of outstanding tax-exempt bonds takes an action that causes the bonds to no longer satisfy the private activity bond restrictions under section 141 of the Code. For example, a city or county may arrange for a private-sector business to assume the ownership or management of public facilities that were financed with tax-exempt bonds and that are used to provide services to residents. Such arrangements – often termed public-private partnerships (PPPs) – let public bodies tap into the expertise, experience, and efficiency of the private sector. Where the public facilities were financed with tax-exempt debt previously issued by the public body, Treasury regulations require that one of three remedial actions be taken in connection with the transfer of the facilities to the private sector to avoid triggering tax on the bond interest for the holders of those bonds.

In a letter last year (attached) to then-Acting Assistant Secretary of the Treasury for Tax Policy Emily McMahon, we outlined reasons why the existing remedial alternatives are inadequate. In particular, we

explained that the first alternative—defeasance—is impractical and extremely costly in the current interest-rate environment. To defease bonds bearing an interest rate of, for example, five percent, requires capital outlays far exceeding the face amount of the bonds. A second alternative – a deemed reissuance of the bonds – requires the state to apply its annual volume cap to the reissuance in the case of water and wastewater treatment facilities. This requirement makes the deemed reissuance impractical. The third alternative is for the public body to agree to use the proceeds from the disposition of the public facilities for governmental purposes (i.e., for purposes that do not cause the bonds to be considered private activity bonds). The precise application of this rule to long-term concession arrangements is unclear in the regulations.

We believe the IRS and Treasury have multiple options for modifying one or more of the remedial action rules to reduce hindrances to public-private partnerships due to outstanding tax-exempt bonds. Perhaps the simplest approach would be for the IRS and Treasury to clarify that an issuer's expenditure of lease payments, or ongoing payments under a concession arrangement, for governmental purposes satisfies the remedial action rules for alternative uses of disposition proceeds. This change would clarify that leases and concession arrangements are eligible for the same remedial action relief as outright sales of facilities. Under the existing regulations, the issuer must reasonably expect to expend the disposition proceeds for governmental purposes within two years of the disposition. Where the issuer receives the proceeds from a lease or concession arrangement over time, rather than up front, the policy behind the existing requirement should logically be considered as satisfied if the issuer were required to expend those proceeds within a time certain following their receipt. We are not aware of a policy basis for a different result.

An alternative approach for the IRS and Treasury to take would be to waive the defeasance requirement where the concessionaire does not receive the benefit of the tax-exempt bonds through an assumption of the debt service. A third approach would be for the IRS and Treasury to waive the requirement that the state allocate volume cap to the bonds at the time of the concession arrangement.

As you know, the President has proposed removing the issuances of tax-exempt bonds for water infrastructure from state private activity bond volume caps. That proposal reflects a policy decision to promote PPPs for development of water infrastructure. The President's budget contains a number of other proposals that would foster PPPs. Any regulatory adjustments by the IRS and Treasury that remove hindrances to the use of such partnerships in cases where there is outstanding tax-exempt debt would be fully consistent with the President's proposals.

Under current economic conditions it is clear that the defeasance requirement imposes a major burden on issuers that desire to take advantage of public-private partnerships. That burden, together with the administration policy favoring expanded use of such partnerships, should satisfy the requirements of

Notice 2013-22 for inclusion of this issue on the 2013-2014 Guidance Priority List. We are confident the IRS and Treasury can eliminate or reduce the burden through clarifications in the regulatory requirements for remedial actions.

We appreciate your attention to this matter. Please let us know if you have any questions about this.

Sincerely,

Michael Deane

cc: Vicky Tsilas, Advisor, Office of Tax Legislative Counsel

Notice 2013-22

APR 30 2013

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

April 19, 2013

Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

VIA EMAIL: Notice.Comments@irscounsel.treas.gov

Re: Recommendations for 2013-2014 Guidance Priority List (Notice 2013-22)
Transportation of Persons by Air: Taxability of Aircraft Management Fees Under I.RC. § 4261

Dear Sir and/or Madam:

This letter is submitted by the National Business Aviation Association ("NBAA") and the National Air Transportation Association ("NATA") in response to the invitation published in Notice 2013-22 for recommendation of items for inclusion on the 2013-2014 Guidance Priority List. NBAA represents more than 9,000 member companies and is the leading organization for companies that own or operate general aviation aircraft to make their businesses more efficient, productive and successful. NATA is the leading organization representing over 2,000 owners and operators of aviation service businesses such as fixed base operators, charter providers, maintenance and repair organizations, and aircraft management companies.

For the reasons discussed below, we respectfully request that the Internal Revenue Service ("Service") issue clear and precise guidance to determine if an aircraft management company providing certain services to an aircraft owner is providing taxable air transportation under I.R.C. § 4261.

While this letter outlines our request at a high level we have previously provided officials in the Service's Office of Associate Chief Counsel (Passthroughs and Special Industries) with additional details as to possible guidance. We look forward to discussing our previous submissions in more detail as part of the priority guidance process.

Existing Guidance on Taxability of Aircraft Management Fees

For over 60 years there has been a recognized lack of clear and precise guidance as to the applicability of the Federal Excise Tax ("FET") on air transportation to aircraft management companies and their customers. For example, in Rev. Rul. 58-215, 1958-1, C.B. 439, the IRS determined that "since the corporation owns the aircraft, has exclusive control over the aircraft's personnel, pays the operating expenses of the aircraft, and maintains liability and risk insurance and the airline operates the aircraft as an agent for the corporation," the airline company was not providing taxable transportation and thus the corporation's payments to the airline company were not subject to FET.

However, the Service also issued an outlier ruling, Rev. Rul. 74-123, 1974-1 C.B. 31, where a government agency was required to pay FET for fees the agency paid to a charter company for transporting government personnel both on aircraft owned by the charter company and on government-owned-aircraft. At the request of the Service we previously provided a detailed explanation contrasting the facts and conclusions in Rev. Rul. 74-123 with a typical aircraft management arrangement.

The publication of the Excise Tax- Air Transportation Audit Technique Guide ("ATG") in 2008 created further confusion as it described aircraft management arrangements in ways that are inconsistent with

how the industry functions. Publication of the ATG generated increased audit activity but did not provide the aircraft management industry with clear and precise guidance as to FET applicability.

Finally, the Chief Counsel Advice ("CCA") memorandum (Number: 201210026, released March 9, 2012) ignored this conflicting guidance and took the approach that virtually all amounts paid by an aircraft owner to a management company are subject to FET. Since the publication of the CCA, NBAA and NATA have observed that virtually any business aviation company engaged in providing aircraft management services is subject to audit. The expense incurred by the Service to undertake these audits, and by the taxpayer to defend the audits, is significant and clearly not the best use of resources by either party.

Requirement for Clear and Precise Guidance

Management companies are typically small and mid-sized companies that may manage one or two aircraft each and do not have significant financial resources. FET is a collected tax causing the management companies to be secondarily liable for the tax. With the enforcement position currently being taken by the Service, management companies are often found liable for FET not only on payments by current customers but also on payments by previous customers. With the lack of clear and precise guidance on this issue, aircraft management companies have not typically collected FET from owners conducting non-commercial flights for themselves on their own aircraft. These owners may no longer own aircraft or may not even exist, making it impossible for management companies to collect retroactive taxes. Management companies simply cannot continue as going concerns with the retroactive tax liabilities being imposed by the Service during audits.

In *Central Illinois Public Service Co. v. United States*, 435 U.S. 21 (1978)—which involved the scope of an employer's secondary liability for allegedly failing to withhold and deposit employment taxes on an employee's "wages"—the Supreme Court explained that when a taxpayer (the employer in that case) acts as the Government's tax collector, its collection and deposit obligations must be clear at the time the taxpayer is required to collect the tax. Thus, a person in a secondary liability position is protected by the Central Illinois principle from liability for failing to collect the tax from the person primarily liable for the tax when it lacks a contemporaneous "precise and not speculative" notice of its duty to collect the tax.

In the context of FET, aircraft management companies have not been provided with guidance that is clear as to their requirements for serving as the government's deputy tax collector. Aircraft management companies are left to try and make sense of conflicting IRS rulings and have no explanation as to how the Service actually determines FET applicability.

Apply Common Law Principles of Leasing to Determine if Aircraft Owner has Transferred Possession, Command and Control of Aircraft to Management Company

In general, to provide taxable air transportation, a person must provide both the aircraft and the pilot services for the flight. In order to provide the aircraft, the person must have possession, command and control of the aircraft. It is possible to have possession, command and control of the aircraft by owning the aircraft or by leasing it from another person.

Based on several meetings with the Service on this issue, we understand that they agree that a clear standard is needed to determine when taxable air transportation is provided. Since obtaining possession, command and control of the aircraft is necessary to provide taxable air transportation, focusing on this element in developing a test seems to be logical.

Under common law principles, an aircraft owner has the exclusive right to possession, command, and control of its aircraft. Furthermore, under common law principles, a lease of an aircraft can be by means of an actual lease or a constructive lease. Common law principles apply to determine, on a flight by flight basis, whether the owner has transferred possession, command, and control of its aircraft to another

person under a constructive lease, or whether such other person is merely performing services with respect to the aircraft, *e.g.,* pursuant to an aircraft management agreement. *Petit Jean Air Service, Inc. v. United States,* 33 A.F.T.R.2d 74-1526 (E.D. Ark. 1974, *appeal not recommended,* AOD 1975-33 (Mar. 27, 1974) (constructive lease found based on intent of the parties).

Using these common law principles and existing case law to determine whether an aircraft has in fact been actually or constructively leased to an aircraft management company will provide a clear test to determine whether the management company has obtained possession, command and control of the aircraft. Most aircraft management arrangements are simply service arrangements and the aircraft is not actually or constructively leased to the management company.

We have previously submitted an explanation regarding this constructive leasing standard to the Service's Office of Associate Chief Counsel (Passthroughs and Special Industries) and look forward to discussing the concept further.

Requested Guidance

Accordingly, we respectfully request that the Service provide guidance that creates a clear standard, consistent with applicable law, to determine when taxable air transportation is being provided. In our opinion, the constructive leasing standard discussed above may serve as a good starting point for such guidance.

We would appreciate the opportunity to discuss this issue with appropriate officials from the Service and Department of the Treasury.

Thank you in advance for your consideration of this request.

Sincerely,

Ed Bolen
President and CEO
National Business Aviation Association

Thomas L. Hendricks
President and CEO
National Air Transportation Association

cc: Lisa Zarlenga, Tax Legislative Counsel, U.S. Department of the Treasury
Curt Wilson, Associate Chief Counsel, Passthroughs and Special Industries, IRS

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATION
BRANCH

Notice 2013-22

APR 22 2013

April 19, 2013

Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

VIA EMAIL: Notice.Comments@irscounsel.treas.gov

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In *Central Illinois Public Service Co. v. United States*, 435 U.S. 21 (1978)—which involved the scope of an employer's secondary liability for allegedly failing to withhold and deposit employment taxes on an employee's "wages"—the Supreme Court explained that when a taxpayer (the employer in that case) acts as the Government's tax collector, its collection and deposit obligations must be clear at the time the taxpayer is required to collect the tax. Thus, a person in a secondary liability position is protected by the Central Illinois principle from liability for failing to collect the tax from the person primarily liable for the tax when it lacks a contemporaneous "precise and not speculative" notice of its duty to collect the tax.

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Based on several meetings with the Service on this issue, we understand that they agree that a clear standard is needed to determine when taxable air transportation is provided. Since obtaining possession, command and control of the aircraft is necessary to provide taxable air transportation, focusing on this element in developing a test seems to be logical.

Under common law principles, an aircraft owner has the exclusive right to possession, command, and control of its aircraft. Furthermore, under common law principles, a lease of an aircraft can be by means of an actual lease or a constructive lease. Common law principles apply to determine, on a flight by flight basis, whether the owner has transferred possession, command, and control of its aircraft to another

person under a constructive lease, or whether such other person is merely performing services with respect to the aircraft, *e.g.*, pursuant to an aircraft management agreement. *Petit Jean Air Service, Inc. v. United States,* 33 A.F.T.R.2d 74-1526 (E.D. Ark. 1974, *appeal not recommended,* AOD 1975-33 (Mar. 27, 1974) (constructive lease found based on intent of the parties).

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We have previously submitted an explanation regarding this constructive leasing standard to the Service's Office of Associate Chief Counsel (Passthroughs and Special Industries) and look forward to discussing the concept further.

Requested Guidance

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We would appreciate the opportunity to discuss this issue with appropriate officials from the Service and Department of the Treasury.

Thank you in advance for your consideration of this request.

Sincerely,

Ed Bolen
President and CEO
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cc: Lisa Zarlenga, Tax Legislative Counsel, U.S. Department of the Treasury
Curt Wilson, Associate Chief Counsel, Passthroughs and Special Industries, IRS

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

Notice 2013-22

MAY - 2 2013

May 1, 2013

Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224
VIA EMAIL: Notice.Comments@irscounsel.treas.gov

Re: Recommendation for 2013-2014 Guidance Priority List (Notice 2013-22)
Tax Treatment of Charitable Flights on Business Aircraft

Dear Sir and/or Madam:

This letter is submitted by the National Business Aviation Association ("NBAA") in response to the invitation published in Notice 2013-22 for recommendation of items for inclusion on the 2013-2014 Guidance Priority List. NBAA represents more than 9,000 member companies and is the leading organization for companies that own or operate general aviation aircraft to make their businesses more efficient, productive and successful.

For the reasons discussed below, we respectfully request that the Service amend the listed property regulations to correct the lack of co-ordination with the regulations regarding the tax consequences of the use of a business aircraft for charitable purposes.

Business Aircraft Are Frequently Used for Charitable Purposes

Owners and operators of business aircraft regularly contribute the use of their business airplanes for charitable purposes, often in support of national safety and relief efforts. NBAA maintains a Humanitarian Emergency Response Operator (HERO) database in which volunteers enroll to indicate their willingness to participate in emergency response operations. NBAA also works with a number of charitable organizations, such as Aerobridge, SkyHope, Veterans Airlift Command and Corporate Angel Network, which arrange important charitable flights every day of the year.

According to the General Aviation Manufacturers Association, in a recent year, business aircraft conducted more than 15,000 flights for humanitarian purposes. Examples include airlifting more than 1500 athletes and coaches from all over the country to the Special Olympics, arranging free travel on business aircraft to help cancer patients get the best possible treatment for their particular type of cancer anywhere in the world and the contribution of relief flights in the days and months following Hurricane Katrina. Countless business aircraft flew medical and food supplies and relief workers to the hurricane-stricken areas and transported hurricane victims to safe grounds in new communities throughout the U.S. The same volunteer spirit again was demonstrated in 2010 when the earthquake devastated Haiti and during recent disasters in Mississippi, Louisiana and Missouri.

In recognition of general aviation's outstanding humanitarian efforts in the aftermath of the Haiti earthquake, the United States House of Representatives and Senate adopted Concurrent Resolution S. Con. Res. 61 (April 27, 2010), which recognizes the many contributions of the general aviation community to the Haitian relief effort and "encourages the continued generosity of general aviation pilots and operators in the ongoing humanitarian relief efforts in Haiti."

National Business Aviation Association 1299 Pennsylvania Ave. NW, Suite 550 Washington, DC 20004 (202) 783-9000 www.nbaa.org

Charitable Use of Business Aircraft Is Effectively Penalized Due to Unintended Regulatory Glitch

Despite this encouragement and well-deserved Congressional recognition, there is a lack of co-ordination between (i) the income tax regulations limiting charitable deductions of out-of-pocket expenses incurred in providing services to charitable organizations and (ii) the regulations regarding non-business use of listed property. This lack of co-ordination is an unintended regulatory glitch that in effect results in the imposition of a tax *penalty* on a business for using its business aircraft for charitable purposes.

Out-of-Pocket Expense Deduction for Charitable Flights

Under Treas. Reg. § 1.170A-1(g), no deduction is allowed for the value of services contributed to a charitable organization. This Regulation limits the charitable deduction to certain "out-of-pocket transportation expenses" incurred for charitable purposes. Expenditures incurred for operation, maintenance and repair can qualify as charitable deductions only if they are out-of-pocket expenses that are directly attributable to the use of the aircraft on a charitable flight. *Orr v. United States*, 343 F.2d 553, 557 (5th Cir. 1965) (charitable deduction is not allowed for "payments which the taxpayer would have made for non-charitable reasons"); Rev. Rul. 58-279, 1958-1 C.B. 145, *modified*, Rev. Rul. 84-61, 1984-1 C.B. 39 (charitable deduction allowed for "out-of-pocket expenses directly attributable to the performance of such volunteer services"). Examples of costs that could be "directly attributable" to a charitable flight include the cost of fuel and oil for the flight, out-of-pocket pilot fees incurred solely for the flight, rental charges for an aircraft used only for the flight, and extra liability insurance incurred only for the flight. In other words, this is a "but for" test: the expenditure is deductible only if it would not have been incurred but for the charitable flight that caused the expenditure. *See Orr*, 343 F.2d at 555; Rev. Rul. 58-279; Priv. Ltr. Rul. 92-43-043 (July 29, 1992). Charitable deductions are not permitted for a proportionate share of fixed costs that would have been incurred whether or not the charitable flight had occurred. *Orr*, 343 F.2d at 556-8; Rev. Rul. 58-279. Examples of such fixed costs include depreciation, insurance, general maintenance and repairs. *Orr*, 343 F.2d at 556-8; *Mitchell v. Comm'r*, 42 T.C. 953, 973-4 (1964), *acq.* 1965-2 C.B. 6 (no charitable deduction for depreciation); Rev. Rul. 58-279. Similarly, pilot salaries and aircraft rents that do not vary with the number of flights would appear to be fixed costs that would not be "directly attributable" to a charitable flight. Accordingly, taxpayers generally cannot take a charitable deduction for fixed aircraft operating and maintenance costs attributable to charitable flights.

Charitable Flights Are Treated as Non-Business Under Listed Property Regulations

Under the "listed property" regulations in Treas. Reg. § 1.274-5T(b)(6)(i)(B), fixed and variable expenses can be deducted only to the extent of the applicable "business use percentage." The business use percentage is determined based on business miles divided by total miles, and does not provide for the treatment of charitable miles as business miles. *Orr* and the other authorities cited herein indicate that charitable flights are non-business and therefore fixed expenses attributable to charitable flights are non-deductible. *See Orr v. United States*, 226 F. Supp. 809 (M.D. Ala. 1963), *aff'd*, 343 F.2d 553 (5th Cir. 1965) (all fixed expenses attributable to charitable use of the aircraft disallowed). *See also Davidson v. Comm'r*, 82 T.C. 434, 440 (1984) ("[c]haritable uses are personal").

Regulatory Glitch Effectively Results in Unintended Tax Penalty for Charitable Use of Business Aircraft

Since fixed expenses often comprise most of the costs of owning and operating an aircraft, the lack of co-ordination between (i) the "out-of-pocket transportation expense" rule of Treas. Reg. § 1.170A-1(g) and (ii) the "business use percentage" rules in Treas. Reg. § 1.274-5T(b)(6)(i)(B), means that a charitable flight can result in a substantial disallowance of fixed expenses that might otherwise be deductible. For example, if a company aircraft is used 100% for business flights, then all of its fixed costs, including depreciation, ordinarily would be deductible. However, if the same aircraft is used 90% for business flights

and 10% for charitable flights, then 10% of the fixed costs would be nondeductible. In other words, charitable flights can result in the disallowance of otherwise deductible business expenses because no charitable deduction is allowed for fixed costs attributable to charitable flights, and there is no provision in the law allowing the deduction of such costs as business expenses (assuming the primary purpose of the flight was for charitable rather than business purposes).

Instead of rewarding companies that conduct charitable flights with a tax benefit, this rule imposes an additional tax liability on such companies. We believe that neither Congress nor Treasury could possibly have intended to effectively impose a tax *penalty* on flights for charitable purposes. In addition, this rule is contrary to the Congressional policy behind the enactment of the charitable contribution deduction. It also is contrary to the Congressional policy to encourage investment by businesses in capital goods, most recently a 100% bonus depreciation deduction in the year the asset is placed in service. Depending on the amount of charitable use in the initial year, doing a good deed and responding to Congressional incentives could cost the owner the significant value of lost depreciation deductions.

Recommended Amendment to Regulations To Remedy Regulatory Glitch

An appropriate remedy would be to amend the business use rules in Treas. Reg. § 1.274-5T(b)(6) to provide that costs to operate and maintain an aircraft are to be allocated only among non-charitable flights, and that costs qualifying for an out-of-pocket charitable contribution deduction are excluded from the total costs allocated between business and personal flights. In other words, the out-of-pocket costs of charitable flights would not be taken into account in allocating costs between business and personal flights and the charitable flights would be disregarded in determining the business and personal percentage of the flights.

Accordingly, we recommend that Treas. Reg. § 1.274-5T(b)(6)(i) be amended by adding a new subparagraph (C), to read as follows:

> (C) Special Rule for Listed Property Used for Charitable Purposes. Notwithstanding subparagraphs (A) and (B):
>
> (i) expenditures that are deductible under Section 1.170-1(g) with respect to the use of an item of listed property shall not be treated as expenditures with respect to such item of listed property for purposes of subparagraph (A); and
>
> (ii) the use of an item of listed property for which any expenditures are deductible under Section 1.170-1(g) shall not be taken into account for purposes of determining the business/investment use or total use of such listed property during the taxable period.

This solution is consistent with the purposes behind both (i) the limitation on deduction of out-of-pocket expenses incurred in providing services to charities and (ii) the limitation on deduction of non-business expenses under the listed property rules. Under the out-of-pocket expense limitation, only the variable expenses resulting from the operation of the charitable flight are deductible as charitable contributions. Since the remaining expenses (including 100% of the fixed costs) do not result from the charitable flight and would have been incurred whether or not the charitable flight had been conducted, they are allocated proportionately between the business and non-business flights (excluding the charitable flights).

For example, suppose that 80% of the flight miles of an aircraft are for business flights, 10% are for charitable flights and 10% are for personal flights. Under the suggested regulatory structure, the "out-of-pocket" costs attributable to the charitable flights would be deductible as a charitable contribution. The

out-of-pocket costs would then be subtracted from the total operating costs, and the remaining operating costs (including 100% of the fixed costs) would be allocated 8/9ths to the business flights and 1/9th to the personal flights.

We would appreciate the opportunity to discuss this issue with you and others from Treasury. Please contact me at (203) 783-9451 or sobrien@nbaa.org if you have any questions or if you would like any additional information.

Thank you in advance for your consideration of this request.

Sincerely,

Scott O'Brien
Senior Manager, Finance & Tax Policy

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

Notice 2013-22

MAY

May 1, 2013

Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224
VIA EMAIL: Notice.Comments@irscounsel.treas.gov

Re: Recommendations for 2013-2014 Guidance Priority List (Notice 2013-22)
Treatment of Leasing Activity Under I.R.C. § 280F(b)

Dear Sir and/or Madam:

This letter is submitted by the National Business Aviation Association ("NBAA") in response to the invitation published in Notice 2013-22 for recommendation of items for inclusion on the 2013-2014 Guidance Priority List. NBAA represents more than 9,000 member companies and is the leading organization for companies that own or operate general aviation aircraft to make their businesses more efficient, productive and successful.

For the reasons discussed below, we respectfully request that the Internal Revenue Service ("Service") review the treatment in TAM 200945037[1] of leasing aircraft to 5-percent owners and related parties under the depreciation limitation in I.R.C. § 280F(b) and provide administrative guidance as described below.

In addition to this letter, we are including an explanation of why Treasury and the IRS are not barred from implementing a "look-through" approach with regard the treatment of leasing activity under I.R.C. § 280F(b) (Enclosure 1), and a description of why businesses lease aircraft (Enclosure 2).

Background Regarding Depreciation Class Lives and Recovery Periods of Aircraft

Revenue Procedure 87-56[2] sets forth the class lives of property that are necessary to compute the depreciation allowances available under I.R.C. § 168. The revenue procedure specifies class lives and recovery periods for MACRS property subject to depreciation under the general depreciation system ("GDS") provided in I.R.C. § 168(a) or the alternative depreciation system ("ADS") provided in I.R.C. § 168(g).

An aircraft may fall into one of two asset classes within Rev. Proc. 87-56. Asset class 00.21 generally includes aircraft other than those used in commercial or contract carrying of passengers or freight. Aircraft placed into asset class 00.21 are assigned a GDS recovery period of 5 years, and an ADS recovery period of 6 years. Asset class 45.0 generally includes all other aircraft (i.e., those aircraft used in commercial or contract carrying of passengers or freight). Aircraft placed into asset class 45.0 are assigned a GDS recovery period of 7 years, and an ADS recovery period of 12 years.

The determination of the appropriate class life is based on the "primary" use of the aircraft.[3] The primary use may be determined in any reasonable manner.[4] In the case of leased aircraft, that determination is made based on the lessee's use of the aircraft.[5] If the primary use of the aircraft changes in a year after

[1] July 29, 2009.
[2] 1987-2 C.B. 674,
[3] Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b).
[4] Treas. Reg. § 1.168(i)-4(d)(2).
[5] Treas. Reg. § 1.167(a)-11(e)(3)(iii).

the year in which it was initially placed in service, the depreciation deductions must be recalculated prospectively based on the new primary use.[6]

I.R.C. § 280F Requires the Alternative Depreciation System If Qualified Business Use of the Aircraft Does Not Exceed 50-Percent

I.R.C. § 280F(b)(1) provides that if any listed property is not predominantly used in a qualified business use for any taxable year, the deduction allowed under I.R.C. § 168 with respect to the property for such taxable year and any subsequent taxable year shall be determined under I.R.C. § 168(g) (i.e., the ADS rules). I.R.C. § 280F(b)(3) provides that property shall be treated as predominantly used in a qualified business use for any taxable year if the business use percentage for such taxable year exceeds 50 percent.

I.R.C. § 280F(d)(6)(A) defines the "business use percentage" to mean the percentage of the use of any listed property during any taxable year which is a qualified business use. Subparagraph (B) states that, except as provided in subparagraph (C), the term "qualified business use" means any use in a trade or business of the taxpayer. However, subparagraph (C) provides that qualified business use shall not include—

(i) leasing property to any 5-percent owner or related person;

(ii) use of property provided as compensation for the performance of services by a 5-percent owner or related person; or

(iii) the use of listed property is provided as compensation for the performance of services by any other person unless an amount is included in income (and withheld upon) with respect to that person.

If the listed property involved is an airplane, the above-mentioned business use by 5-percent owners and related persons is qualified business use if at least 25-percent of the total use of the aircraft during the taxable year consists of other types of qualified business use. The flush language of Treas. Reg. § 1.280F-6(d)(2)(ii)(A) provides that the exclusion of leasing listed property to any 5-percent owner or related person shall apply only to the extent that the use of the listed property is by an individual who is a 5-percent owner or a related party with respect to the owner or lessee of the property.

As explained in the legislative history to § 280F, the purpose of ACRS was to encourage investment in new equipment "rather than to subsidize the purchase of personal property that is used incidentally or occasionally in the taxpayer's business. Therefore, Congress decided not to allow the incentive portion of tax benefits for property whose predominant use is personal or investment-related, rather than in the conduct of a trade or business."[7]

As explained in TAM 200945037, "[t]he exceptions under section 280F(d)(6)(C) were designed to prevent a taxpayer from disguising excessive personal use by business owners and their employees by structuring the use as a lease or a compensation arrangement."[8]

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[6] Treas. Reg. § 1.168(i)-4(d).
[7] *See General Explanation of the Revenue Provisions of the Deficit reduction Act of 1984*, P.L. 98-369, Pages 559-560; *see also* TAM 200945037 (Nov. 6, 2009).
[8] TAM 200945037.

Issue: Whether Use of Property Leased to a 5-Percent Owner or Related Party Is Deemed 0-Percent Qualified Business Use

Under the above rules, the activity of leasing to a 5-percent owner or related party is not qualified business use. This raises the issue of whether (a) the flights conducted by the lessee should be deemed 0-percent qualified business use, or (b) the lessee's business flights should be treated as qualified business use.

Technical Advice Memorandum 200945037

TAM 200945037 specifically addresses this issue. The TAM explains that the taxpayer argued that in a lease of an aircraft to a 5-percent owner or related party, qualified business use should be determined based on the lessee's use of the property. The TAM notes that qualified business use does not exclude such leasing to the extent that the individual passengers are not 5-percent owners or related parties. However, without discussing the merits of the taxpayer's argument in the case of flights on which the passengers are 5-percent owners or related parties, the TAM concludes that such flights are deemed 0-percent qualified business use irrespective of the nature of lessee's actual use of the aircraft.

The Problem with the Holding in TAM 200945037

The problem with the holding in TAM 200945037 is that it is irrational to treat all flights on a leased aircraft as nonbusiness flights, and the holding in the TAM is not compelled by the language of the statute.

As noted above, while accelerated depreciation is intended to encourage the purchase of assets, § 280F(b) was adopted because the benefits of accelerated depreciation were not intended to be provided for listed property on which there is excessive personal use. For purposes of this test, qualified business use does not include the activity of leasing to a 5-percent owner or related party, because leasing merely disguises the real extent of the business and personal use by the lessee.

Interpreting § 280F(b)(6)(C) as treating all flights on an aircraft leased to a 5-percent owner or related party (when passengers are 5-percent owners or related parties) as personal flights for purposes of the predominant business use test in § 280F(b) fails to accomplish the purpose of making accelerated depreciation available to purchasers of assets when there is no excessive personal use of the asset. Taxpayers often place an aircraft in one entity and lease it to a related entity for legitimate non-tax business reasons (e.g., FAA compliance, limiting liability exposure, stakeholders' parameters, flexibility, and efficiency in management). By effectively overstating the extent of personal use in applying the predominant business use test, the TAM inappropriately denies the benefits of accelerated depreciation to purchasers of assets. In this regard, note that Congress' desire to encourage investment in business assets in the current economic environment is underscored by the extensions of bonus depreciation in recent years.

Furthermore, the specific reason for excluding leasing from qualified business use in § 280F(d)(6)(C) is that leasing would *disguise* the actual business use by the lessee. The rationale for this provision makes sense. If an owner of listed property leases it to a related party who uses the property for less than 50-percent qualified business use, then treating the leasing activity as 100-percent business would fail to accurately measure the percentage of business use. However, it does not follow that the business use percentage of such leased property should be deemed to be 0-percent. Since leasing disguises the real percentage of business use, the obvious solution is to lift the disguise as required by the statute and measure the qualified business use percentage based on the lessee's percentage of business use.

For example, based on the TAM, if two employees (who are not 5-percent owners or related parties of the employer) travel on an aircraft leased by the employer from a related party on the business of their employer, such use is qualified business use. However, if the same two employees traveling on the leased aircraft for the same business purpose happen to be 5-percent owners of the employer, such use would not be qualified business use for purposes of § 280F. Conversely, if the aircraft is owned by the employer (and not leased from a related party) the business use of the two employees (whether they are 5-percent owners or not) is qualified business use for purposes of § 280F. As can be seen by this example, it is arbitrary to distinguish what is qualified business use simply by who is on board (i.e., 5-percent owners or not) and whether the aircraft is leased from a related party or not. The business use of the leased aircraft is the same in any variations of the example described above and, thus should be treated the same for purposes of § 280F.

This conclusion that the qualified business use percentage of property leased to a 5-percent owner or related party should be determined based on the lessee's use of the property is consistent with the general rule discussed above that the depreciation life and method for leased property is determined based on the lessee's use of the property.[9]

The language of § 280F(d)(6)(C) does not compel the conclusion that all leasing to a 5-percent owner or related party (when the passengers are 5-percent owners or related parties) must be treated as 0-percent qualified business use. The statute is efficiently written to only exclude the activity of "leasing" from qualified business use. The statute does not go further in explaining how to measure qualified business use on the flights of a leased aircraft, but the statute should not have to do that. The appropriate test is already set forth in the statute for distinguishing business use from personal use.

Requested Guidance

Accordingly, we respectfully request that the Service provide guidance clarifying that business use of an aircraft by a lessee, who is a 5-percent owner or related party of the lessor of the aircraft, is qualified business use for purposes of I.R.C. § 280F.

We would appreciate the opportunity to discuss this issue with the IRS and Treasury. Please contact me at (202) 783-9451 or sobrien@nbaa.org if you have any questions or if you would like any additional information.

Thank you in advance for your consideration of this request.

Sincerely,

Scott O'Brien
Senior Manager, Finance & Tax Policy

Enclosures: 2

[9] Treas. Reg. § 1.167(a)-11(e)(3)(iii).

Enclosure 1

NBAA

NBAA Explanation of Why Treasury and the IRS Are Not Barred From Implementing a "Look-Through" Approach With Regard to the Treatment of Leasing Activity under I.R.C. § 280F(b)

As detailed in the legislative history, one of the original purposes of enacting § 280F, as part of the Tax Reform Act of 1984, was to curtail the use of listed property (such as aircraft) by business owners for excessive personal purposes rather than for "qualified business use." The penalty for excessive personal use of aircraft, along with all other types of listed property, is the requirement that the aircraft owner use the longer recovery periods and slower depreciation methods of § 168(g), the alternative depreciation system ("ADS"), with regard to such property.

To such end, § 280F(d)(6)(C)(i)(I) provides that the term "qualified business use" shall not include leasing property to any 5-percent owner or related person. The statute does not explain how to measure qualified business use on the flights of a leased aircraft.

However, the flush language of Regulation § 1.280F-6(d)(2)(ii)(A) provides that § 280F(d)(6)(C)(i)(I) applies only to the extent that the use of the listed property is by an individual who is a related party or a 5-percent owner with respect to the owner or lessee of the property. The IRS noted in TAM 200945037 that the flush language in the regulations was a necessary clarification to the statutory language, for without such clarification all use of an aircraft under a lease to a 5-percent owner or related person would be excluded from "qualified business use."

During previous meetings and conference calls with Treasury and IRS National Office personnel, it has been indicated that the statutory language bars the Government from implementing such a "look-through" approach and that the only "fix" possible would be to change the statutory language to allow for a look-through rule. Yet, pursuant to § 7805(a), Treasury, and thus, the IRS, do possess the power to prescribe rules (through numerous formats, such as regulations, rulings, etc.) guiding taxpayers how to apply statutory rules. As a matter of fact, Treasury and the IRS have already done just that with regard to § 280F(d)(6)(C). As noted above, Treasury and the IRS have already clarified § 280F(d)(6)(C) once by issuing regulations as noted in TAM 200945037. The existence of the flush language in the regulations supports the proposition that the Treasury and the IRS have the ability to further interpret the statutory language of § 280F(d)(6)(C) to allow for a "look-through" approach in implementing the goals of Congress with regard to the enactment of § 280F.

Interpreting § 280F(b)(6)(C) as treating all flights on aircraft leased to a 5-percent owner or related party (when passengers are 5-percent owners or related parties) as personal flights for purposes of the qualified business use test is overbroad and in direct conflict with one of the original purposes of enacting § 280F. Such interpretation can result in a penalty when there is no personal use of the aircraft and thus fails to accomplish the purpose of curtailing excessive personal use. Such result also frustrates the purpose of Congress to make accelerated depreciation available to purchasers of assets when there is no excessive personal use of the asset. In order to more appropriately achieve Congress' purposes in enacting § 280F, the actual use of the asset by the lessee must be taken into consideration to determine the qualified business use. In other words, one must "look-through" to the actual use of the aircraft by the lessee to determine the true qualified business use percentage of the aircraft.

Accordingly, based on the legitimate non-tax business reasons described in the supporting materials submitted, we respectfully request that Treasury and the IRS provide guidance clarifying that the business use of an aircraft by a lessee, who is a 5-percent owner or related party of the lessor (or owner) of the aircraft, is qualified business use for purposes of § 280F.

Enclosure 2

NBAA

NBAA Explanation of Why Businesses Lease Aircraft
RE: Treatment of Leasing Activity under I.R.C. § 280F(b)

Taxpayers often place an aircraft in one entity and lease it to one or more other entities for legitimate non-tax reasons.

FAA Compliance:

Leasing is a common method used by aircraft owners to comply with FAA rules. FAA operational rules make leasing necessary for certain types of aircraft uses. The general aviation rules in Part 91 of the FAA Regulations ("FAR") generally permits aircraft operations that involve no compensation or hire. Therefore, in order for an aircraft owner limited by the rules of FAR Part 91 to provide use of the aircraft, even to related parties, in compliance with the rules, leasing is necessary. Leasing an aircraft allows the lessee to operate the aircraft for the lessee's own use, generally also under the rules of FAR Part 91.

Aircraft owners may also lease to avoid the FAR Part 91 issue of the "flight department company." This term refers to a company that is set up solely for the purpose of owning and operating aircraft to provide air transportation. The FAA takes the position that a "flight department company" cannot operate an aircraft under FAR Part 91 because the carriage of persons would not be "incidental to" the business of that company. Nevertheless, a separate entity is permitted to own an aircraft and lease it to another company that operates the aircraft under FAR Part 91.

Leasing is also a common method to place an aircraft in commercial operations. An aircraft owner may lease an aircraft to a certificated air carrier in order that the aircraft may be used to provide transportation of passengers or property for compensation or hire. For business aircraft, such operations are generally conducted under FAR Part 135, which generally applies to air charter operations. In that case, the lessee must hold an air carrier certificate that authorizes the operator to conduct aircraft charter operations under FAR Part 135. In addition, the aircraft must meet the outfitting, equipment, and maintenance requirements of that Part.

The FAA also has complex citizenship rules for aircraft registration that may prevent a limited partnership or other entity from registering an aircraft with the FAA Aircraft Registry. In such instances, it is common practice for a separate company to register the aircraft with the FAA and lease it to such an entity for its business use.

Limiting Liability Exposure:

Generally under common law, each person who owns, operates, pilots, or maintains an aircraft is responsible for damages arising from that person's negligence or willful misconduct with respect to the aircraft. An aircraft owner may also be strictly liable for damages arising out of aircraft ownership under a products liability theory or a particular state statute. Leasing the aircraft allows aircraft ownership liability to be borne by the company that owns the aircraft and aircraft operational liability to be borne by the company responsible for the pilots and operating the aircraft for its particular flights.

Likewise, the owners of a business frequently place ownership of an aircraft in a separate entity that leases the aircraft to the business to protect the aircraft from liability exposure arising from other operations of the business.

Stakeholder's Parameters:

The owners of a company may have differing purposes or concerns with regard to an aircraft used for company business travel. In such instances, it is common for the aircraft to be owned in a separate company with an overlapping but not identical ownership to the main business. This structure enables

the owners who have direct business use of the aircraft to proportionately bear the capital and other costs of aircraft ownership.

In some instances, aircraft owners must structure ownership of the aircraft to meet the requirements of their lenders. A commercial lender for a business may limit the types of assets that a particular company may own, including requiring that an aircraft be owned in a separate company. This separate ownership may be required to strengthen the lender's security rights in and to the aircraft and to facilitate any potential future repossession by the lender. Where multiple lenders are involved in a business, separation of asset ownership may also be required. In these circumstances, leasing allows a company to use the aircraft for its own business purposes while complying with the lender's financing requirements.

Similarly, in certain highly regulated industries (e.g., public utilities, banks, insurance companies), industry regulations may discourage direct ownership of an aircraft. In such cases, it may be necessary to place ownership of an aircraft in a separate entity that leases the aircraft to comply with the regulations.

State Tax Flexibility:

Many aircraft owners use a leasing structure for state sales tax reasons. A leasing structure can allow state sales tax to be paid by its user(s) on lease payments instead of by its owner immediately upon its purchase.

Johnson Regina

Notice 2013-22

MAY 2 2013
LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

From: Brad Elphick <Brad.Elphick@novoco.com>
Sent: Wednesday, May 01, 2013 5:25 PM
To: Notice Comments
Cc: Handleman Paul F; Ibanez, Robert
Subject: Notice 2013-22
Attachments: NMTC Working Group Guidance Priority List Letter (05-01-13).pdf

On behalf of the members of the New Markets Tax Credit ("NMTC") Working Group, we submit the attached comments, considerations, and recommendations regarding existing NMTC rules and regulations, which we believe will increase the effectiveness and efficiency of the NMTC Program.

We appreciate the opportunity to submit our suggestions for issues that should be included on the 2013-2014 Guidance Priority List. We believe that further guidance on these issues is essential to sustain and increase the impact of the NMTC Program on low-income communities. With further guidance, we believe that the NMTC can be an even more effective tool in restoring economic growth throughout the country. We commend the Department of Treasury and IRS for its continuing efforts to improve and clarify tax guidance for the NMTC program in order to ensure its continuing success. Thank you in advance for your time and consideration.

Brad Elphick, CPA
Novogradac & Company LLP
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NOVOGRADAC & COMPANY LLP
CERTIFIED PUBLIC ACCOUNTANTS

May 1, 2013

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2013-22 Public Comment Invited on Recommendations for 2013-2014 Guidance Priority List

Dear Ladies and Gentlemen:

On behalf of the members of the New Markets Tax Credit ("NMTC") Working Group, we submit the following comments, considerations, and recommendations regarding existing NMTC rules and regulations, which we believe will increase the effectiveness and efficiency of the NMTC Program. The members of the NMTC Working Group are participants in the NMTC industry who work together to help resolve technical NMTC Program issues and provide recommendations to make the NMTC Program even more efficient in delivering benefits to qualified businesses located in low-income communities around the country. Our group includes over 50 organizations that are allocatees, nonprofit and for-profit community development entities ("CDEs"), consultants, investors, accountants and lawyers.

We appreciate the opportunity to comment on ways to further enhance the good being done by the NMTC Program, and we also appreciate the level of commitment, dedication and outreach that has been shown and continues to be shown by the CDFI Fund, the Internal Revenue Service ("IRS") and the Treasury's Office of Tax Policy in implementing and managing the NMTC Program. The CDFI Fund, IRS and Treasury have proven to be capable managers of the NMTC Program. This is evidenced by the tremendous success the NMTC Program has enjoyed since its inception in 2000. Low-income communities across the country have benefitted from targeted investments of more than $26 billion. We applaud the various offices within Treasury that have worked with all those involved in these transactions to ensure that those dollars get into highly distressed communities as efficiently as possible.

Since the program's inception, the knowledge, understanding and experience among participants in the NMTC Program has been continuously rising, as has the demand and competition for the NMTC among participants in the NMTC Program, including investors, lenders, CDEs and qualified businesses. The interaction of these and other factors has led to ever greater efficiencies and effectiveness of the NMTC Program in delivering much needed subsidy to qualified businesses.[1] These factors have also helped direct a greater portion of the NMTC Program to the nation's most distressed low-income communities and to qualified businesses generating even greater community impacts.

[1] See "Reports Indicate that NMTC Program Improves with Age," Novogradac Journal of Tax Credits, July 2011, Volume II, Issue VII.

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We commend the IRS for requesting items to be included on its annual Guidance Priority List. We believe that one of the most effective ways to further improve the efficiency of the NMTC Program requires a statutory change – that is to make the credit permanent or, at a minimum, provide a long-term extension. The current trend Congress has exhibited of granting a short-term extension creates uncertainty in the industry. Uncertainty in any aspect, especially as it relates to the future of funding for the NMTC Program, limits the number of investors and potential CDEs willing to participate, and also limits the level of long-term investment that existing investors and CDEs are willing to make. Willingness by investors to participate in the NMTC Program would also be greatly enhanced if a long-term or permanent extension of the NMTC included a provision that would allow the NMTC to offset the alternative minimum tax (AMT).[2] A long-term extension of the NMTC with an AMT offset provision would put the NMTC Program on par with Low-Income Housing Tax Credits, Historic Tax Credits and certain Renewable Energy Tax Credits, and would increase the demand by investors for the NMTC. An increase in demand by investors would lead to an even greater amount of subsidy reaching qualified businesses. Additionally, if the NMTC Program were made permanent or received a long-term extension, CDEs and other NMTC Program participants would dedicate more resources to the NMTC Program and generate even greater efficiencies. Due to the economic downturn, the financing of qualified businesses has become increasingly complicated, requiring industry participants to become progressively more creative in transaction structuring while simultaneously ensuring that as much subsidy from the NMTCs as possible reaches qualified active low-income community businesses ("QALICBs").

We believe that the following comments, considerations, and recommendations regarding existing NMTC rules and regulations, if pursued and adopted, will increase the effectiveness and efficiency of the NMTC Program. That said, we believe one regulatory change rises above all others in its potential to positively impact the NMTC Program – the manner in which tax credit recapture is determined. By imposing the risk of full recapture, plus interest and penalties, for the full term of the investment for all potential causes of recapture, the NMTC Program has created a level of compliance analysis and transaction structuring unrivaled by other tax credit programs. A reduction in tax credit recapture risk during the term of the investment would lower overall transaction costs and help facilitate the financing of specific types of businesses that tax credit investors are reluctant to make currently.

The following comments, considerations, and recommendations specifically relate to regulatory changes. Because many of the proposed revisions to the regulations clarify policies that many industry participants have thought were already implicit in the regulations, we believe it would be helpful if the proposed changes, at the option of the taxpayer, could be relied on for periods prior to their effective date. Otherwise, CDEs will receive no additional comfort that transactions structured before the effective date will be allowed to rely on any of the clarifications and guidance provided in the proposed regulations.

For your convenience, the recommendations have been prioritized in Exhibit A and are what we believe to be the order of highest priority. However, we agree that each recommendation should be considered to generate and sustain the greatest possible community impact. Our comments reflect the work of over 50 member organizations participating on numerous conference calls and countless drafting sessions over several years. We trust you will find our comments useful and instructive. Many of our comments have been previously submitted in response to other requests for public comment. All of the NMTC Working Group's comments regarding these issues, as well as many others, can be found on our website at www.nmtcworkinggroup.com. We would be happy to meet with you to discuss our comments in further detail.

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[2] For further discussion of AMT implications, see §2.16 of Novogradac & Company New Markets Tax Credit Handbook, 2011.

We appreciate the opportunity to submit our suggestions for issues that should be included on the 2013-2014 Guidance Priority List. We believe that further guidance on these issues is essential to sustain and increase the impact of the NMTC Program on low-income communities. With further guidance, we believe that the NMTC can be an even more effective tool in restoring economic growth throughout the country. We commend the Department of Treasury and IRS for its continuing efforts to improve and clarify tax guidance for the NMTC program in order to ensure its continuing success. Thank you in advance for your time and consideration.

Please do not hesitate to contact us if you have any questions regarding our comments or if we can be of further assistance.

Yours very truly,
Novogradac and Company LLP

by

Brad Elphick

cc: Paul Handleman
Robert Ibanez

Exhibit A
NMTC Working Group
2013-2014 Guidance Priority List

Regulatory Changes

1. **Provide proportionate recapture to provide a reduction in tax credit recapture risk during the term of the investment**

When trying to determine what changes can be made to improve the NMTC Program, many suggestions can be made about individual aspects of the Program's regulations. Depending on what outcome is desired, certain changes can be made to achieve that outcome. While we agree that changes need to be made in order to encourage more investments in non-real estate qualified active low-income community businesses ("QALICBs"), we do not believe that any changes will cause a substantial increase in investments made until a single component of the program is changed that affects all investments – "tax credit recapture". By having full recapture risk, plus interest penalties, for the full term of the investment, the NMTC Program has a level of compliance and transaction structuring unrivaled by other tax credit programs. This level of structuring and underwriting ensures that the goals of the NMTC Program are ultimately achieved but at a cost that is incorporated into the overall price of the NMTC and the types of investments that investors are willing to make. A reduction in tax credit recapture risk during the term of the investment would certainly lower the discount of the NMTC applied by investors and broaden the types of investments that tax credit investors are willing to make, including non-real estate QALICBs.

Currently, if $1 of an investor's qualified equity investment is redeemed during the seven year compliance period, many believe full recapture is triggered. It does not matter if this redemption occurs in year one or year six, the result is the same – 100 percent of the new markets tax credits must be recaptured (plus interest) by both the investor who purchased the qualified equity investment from the CDE and by all subsequent holders of that investment, to the extent of the NMTCs allowed and used by each investor.[3] In many other tax credit programs, the level of recapture risk decreases over time. The recapture risk for NMTCs does not decline during the seven year compliance period. With the low-income housing tax credit ("LIHTC"), only the accelerated portion, on a downward sliding scale, is recaptured. If recapture occurs before year 12, only 1/3 of the previously claimed LIHTC is recaptured. During years 12, 13, 14 and 15, 4/15, 3/15, 2/15 and 1/15, respectively, is subject to recapture. The impact of total recapture of the NMTC is amplified because the investor must also pay interest on the underpayment of tax for each prior taxable year, beginning on the due date of the tax return for such prior taxable year.[4]

Recapture risk is a greater concern for investors in CDEs where the investors' qualified equity investment ("QEIs") will be used for non-real estate investments in a QALICB that is an operating business. Operating businesses typically don't need investments with a 7 year term or longer. These operating businesses typically have a need for a much shorter term investment. Also, investments in operating businesses may require some control features as opposed to real estate investments that do not generally require control. The risk to the investor is related to the reinvestment and reasonable expectations requirements of the NMTC Program. If an investment is made with a term shorter than seven years, the CDE must be able to reinvest the proceeds of the qualified low-income community investment ("QLICI") within 12 months in order for them to be considered continuously invested for purposes of the substantially all requirement. If they are unable to reinvest all or a portion of the QLICI(s) and fall below the 85% substantially all requirement, recapture may be triggered. In practice, investors have

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3 IRC §45D(g)(1); Treas. Reg. §1.45D-1(e)(1).
4 IRC §45D(g)(2).

generally favored the simplicity and security of seven-year NMTC investments rather than taking the inherent recapture risks involved with a reinvestment scenario. Prior to the addition of a limited right to cure an investment, investors generally avoided the shorter-term investments solely because of the recapture risk. Today, investors also focus on economic considerations in deciding to invest in shorter-term investments. These considerations include drag on yield when liquidated monies are in temporary investments (i.e., awaiting reinvestment) and the uncertainty on what economic yield might be available on such reinvestment.

Whether recapture is triggered by redemption or failure of the substantially all test, the risk is that a $1 mistake can cause total recapture. If the goal is to promote changes to the program to encourage more investments in operating businesses, we believe changes to the calculation of the amount of recapture triggered by these recapture events needs to be changed to a less draconian approach. We recommend a proportionate calculation rather than total recapture. For example, if $10 of the investor's QEI is redeemed in year 6, only those credits associated with the redeemed amount and previously claimed are subject to recapture plus interest penalties.

Example:
ABC makes a $1 million investment in CDE that in turn invests in XYZ business. ABC receives $50,000 in annual credits in 2011, 2012 and 2013. ABC reduces its tax liability by $50,000 in 2011, 2012 and 2013. In 2014, CDE redeems $100,000, or 10%, of ABC's QEI.

Based upon our recommendation to make recapture proportionate to the amount that caused recapture, ABC would recapture 10% of all credits it received. Therefore, ABC must report recapture tax of $15,000 with interest accruing from 2011 (on $5,000), 2012 (on $5,000) and 2013 (on $5,000).

Using the same set of facts, if a CDE fails the substantially all requirement by $100,000, or 10% of ABC's QEI, the result would be the same.

Without substantive changes to reduce the recapture risk of NMTC transactions, we believe that any changes made to other parts of the regulations will achieve limited results and will not cause investors and CDEs to significantly increase the amount of investments made with non-real estate operating business QALICBs.

Without substantive changes to reduce the recapture risk of NMTC transactions, we believe that any changes made to other parts of the regulations will achieve limited results and will not cause investors and CDEs to significantly increase the amount of investments made with non-real estate operating business QALICBs. We recommend that the CDFI Fund not deviate from the current statutory mandate of priority points.

2. Redemption Safe Harbor for Partnership CDEs

In a letter dated April 24, 2006, we submitted comments and suggested language for the Treasury Regulation on redemption (Treasury Regulation § 1.45D-1(e)(3)) regarding the timing of distributions and distributions made for prior years' accumulated profits. The NMTC Working Group requests that the suggested language offered in our previous letter be further considered. We still believe that our suggested changes will lessen the unnecessary administrative burden for CDEs as well as the undue risk of recapture faced by investors in CDEs. By lessening the administrative burden to CDEs, more of the NMTC subsidy can be

made available to qualified businesses. Similarly, by lessening the undue risk of recapture to investors, more equity capital can be raised and invested in qualified businesses. We commend the Department of Treasury for its efforts in proposing changes to the regulations. However, we still request that our recommendations be considered as an alternative to the proposed changes in the regulations. For your convenience, we are resubmitting our comments below from our previous letter with certain changes made to incorporate the proposed changes in the Regulations. We have also provided the additional follow-up clarifications to this sample language that were sent in the letter dated March 13, 2009 for your consideration in Exhibit C.

Final Regulation Section 1.45D-1(e)(3)(iii) provides a safe-harbor for CDEs that are considered a partnership for Federal tax purposes. The Regulation specifically states:

> ". . . a pro rata cash distribution by the CDE to its partners based on each partner's capital interest in the CDE during the taxable year will not be treated as a redemption for purposes of paragraph (e)(2)(iii) of this section if the distribution does not exceed the CDE's operating income for the taxable year."

a. Timing of distributions

The Final Regulation then defines Operating Income.[5] However, the Final Regulation implies that the distribution must be made in the same taxable year to which the Operating Income is attributed. By requiring the distribution to be made in the same year, CDEs are required to estimate Operating Income before the end of the taxable year rather than rely on its books and records which are typically closed and adjusted after year end. Even with the changes in the proposed regulations that allow distribution of the current taxable year's Operating Income and the prior taxable year's undistributed Operating Income this remains an issue for the CDE.

For example, the books and records of a calendar year CDE may not be closed and adjusted until January 15. Additionally, the tax returns will not be completed in most cases until sometime in March. As a result, the only way a CDE can distribute its Operating Income before the end of the taxable year is if the CDE estimates its Operating Income for the given year. If the CDE miscalculates its estimate of Operating Income and distributes cash in excess of Operating Income, then investors in the CDE could potentially suffer recapture.

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[5] For purposes of calculating operating income, Reg. 1.45D-1(e)(3)(iii) defines operating income as:

(A) The CDE's taxable income as determined under section 703, except that—
   (1) The items described in section 703(a)(1) shall be aggregated with the non-separately stated tax items of the partnership; and
   (2) Any gain resulting from the sale of a capital asset under section 1221(a) or section 1231 property shall not be included in taxable income;
(B) Tax-exempt income under section 103;
(C) Deductions under section 165, but only to the extent the losses were realized from qualified low-income community investments under paragraph (d)(1) of this section;
(D) Deductions under sections 167 and 168, including the additional first-year depreciation under section 168(k), and any other depreciation and amortization deductions under the IRC;
(E) Start-up expenditures amortized under section 195; and
(F) Organizational expenses amortized under section 709.

In order for the CDE to accurately determine Operating Income as defined in the Regulation, the CDE must wait until after year-end to calculate Operating Income. There are several examples throughout the Internal Revenue Code ("IRC") that allow an entity to treat a distribution as having been made in a given taxable year if it makes the distribution within a certain amount of time after the end of a given taxable year. For example, IRC Section 855 allows a regulated investment company to treat a distribution as having been made in a given taxable year if it declares the dividend prior to the due date for the filing of the tax return, including any extensions, and distributes the dividend within 12 months after the taxable year.[6] IRC Section 857(b)(9) allows a real estate investment trust to treat a distribution as having been made on December 31 of a given taxable year if the distribution is made by January 31 of the following taxable year.[7]

We recommend that the Regulation be clarified to allow CDEs, solely for purposes of determining if a recapture event has occurred, to treat distributions made by the due date (including extensions) of a CDE's federal income tax return to be treated as made in the prior taxable year. We have provided sample language for your consideration attached as Exhibit B.

b. Distributions made for prior year(s)

In a given taxable year, a CDE may not want to or may not be able to distribute all of its Operating Income to its investors. The Regulation currently does not allow the CDE that is taxed as a partnership for federal tax purposes to carry this undistributed Operating Income forward to future years. The Proposed Regulation allows a CDE to distribute undistributed

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[6] IRC Section 855(a) provides the following rule for distributions after close of taxable year:

(a) General rule.

For purposes of this chapter, if a regulated investment company—

(1) declares a dividend prior to the time prescribed by law for the filing of its return for a taxable year (including the period of any extension of time granted for filing such return), and
(2) distributes the amount of such dividend to shareholders in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration,

the amount so declared and distributed shall, to the extent the company elects in such return in accordance with regulations prescribed by the Secretary, be considered as having been paid during such taxable year, except as provided in subsections (b) , (c) and (d) .

[7] IRC Section 857(b)(9) allows dividends to be paid in the following year but deemed paid in the year they were declared:

(9) Time certain dividends taken into account.

For purposes of this title, any dividend declared by a real estate investment trust in October, November, or December of any calendar year and payable to shareholders of record on a specified date in such a month shall be deemed—

(A) to have been received by each shareholder on December 31 of such calendar year, and
(B) to have been paid by such trust on December 31 of such calendar year (or, if earlier, as provided in section 858).

The preceding sentence shall apply only if such dividend is actually paid by the company during January of the following calendar year.

operating income from the prior taxable year only. If, however, the CDE is taxed as a corporation, it is permitted to make distributions out of accumulated earnings and profits. It seems inequitable that corporations may make distributions out of accumulated earnings and profits from all prior taxable years but entities taxed as partnerships are only permitted to make distributions out of current year Operating Income and undistributed Operating Income from the prior taxable year.

There are numerous examples of the inequities of this rule. For example, a CDE makes a three year loan that requires a balloon payment at the end of year 3 for the amount of principal and accrued interest. The CDE has accrued the interest income over the three years but has not received any current cash payments of interest. At the end of year 3, the CDE receives cash for the repayment of the loan it made and corresponding accrued interest. However, because the taxable year in which the loan was repaid will only reflect the interest income for that year in its Operating Income calculation as the Regulation is currently interpreted, about two-thirds of the cash will be trapped at the CDE, unable to be distributed. With a carry-forward of undistributed Operating Income from prior years, the CDE would be able to distribute cash received when accrued interest is paid.

Another example relates to a CDE that decides to hold its interest income received in the earlier years of its NMTC investment period in a reserve account, to hedge against future potential loan losses or unanticipated operating expenses. As the CDE's operations stabilize, the CDE may be in a position to release some of these prior earnings and provide a return to its investors. However, under the current and proposed regulations, the CDE would be unable to pay distributions to its partners for its undistributed Operating Income, except for amounts related to the current and immediate prior year.

In an effort to create symmetry between the rules for corporations and partnerships as it relates to the Regulation, we ask that a CDE be allowed to make distributions from Operating Income in the same manner that a C corporation can make a distribution from earnings and profits. IRC Section 316 defines a dividend as being a distribution out of accumulated earnings and profits or from current earnings and profits without regard to the accumulated earnings and profits at the time the distribution was made.[8] We ask that entities taxed as partnerships be allowed to make distributions from Operating Income in the same manner. By creating this symmetry between corporations and partnerships, the burden on partnership CDEs to avoid redemption when distributing Operating Income without jeopardizing the NMTCs will be alleviated. We have provided sample language for your consideration.

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[8] IRC Section 316(a) defines a dividend for purpose of distributions by a C corporation as follows:
(a) General rule.
For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

1. out of its earnings and profits accumulated after February 28, 1913, or
2. out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

If the proposed regulations are not changed to incorporate our previous comments regarding the inclusion of all prior taxable years' undistributed Operating Income and the timing of when distributions can be made, we recommend that the regulations clarify the calculation of how distributions are applied to undistributed Operating Income. It is currently unclear as to which year's Operating Income would be deemed to be distributed first. For example, a CDE has $100 of Operating Income for the current taxable year and $100 of undistributed Operating Income for the prior taxable year for a total of $200 that could be distributed based upon the safe harbor provision in the proposed regulations. If the CDE has $120 of cash that it intends to distribute pro rata to its partners, would the $120 distribution be applied first to the prior year's undistributed Operating Income of $100 with the remaining $20 applied to the current year's Operating Income, thereby leaving $80 of undistributed current taxable year Operating Income (which would be available for distribution in the following taxable year)? Or, would the $120 distribution first be applied to the entire current taxable year's Operating Income and next only $20 attributable to the undistributed Operating Income from the prior taxable year (thus leaving $80 of prior year Operating Income not available for distribution and no amount of current year Operating Income available for distribution in the following taxable year)? We believe that the CDE should be allowed to use the former approach using a first-in first-out (FIFO) methodology. Otherwise, $80 of undistributed Operating Income will be unavailable to the CDE for distribution during the next taxable year.

c. Catch-up period

We recommend that CDEs be allowed to apply these rules retroactively to allow them to "catch-up" their distributions. Without guidance on this issue, many CDEs chose not to make distributions due to the severe risk of recapture. If this guidance had existed, they would have made distributions in prior taxable years. If our recommendation to allow CDEs to distribute the cumulative amount of all prior taxable years' undistributed Operating Income is not incorporated into the final changes, we recommend that guidance be provided to allow CDEs with undistributed Operating Income from any prior taxable year to distribute their undistributed Operating Income. For all taxable years following the year in which the guidance is finalized, the CDE would only be able to distribute the sum of the current taxable year Operating Income and the undistributed Operating Income from the prior taxable year as provided in the Proposed Regulation. For example, a CDE began generating $100 of Operating Income beginning taxable year 2006 and $100 every year thereafter through 2009 for a total of $400 of Operating Income. However, to date, the CDE hadn't distributed its Operating Income each year due to the lack of guidance in the regulations. If the proposed regulations are finalized March 15, 2009, the CDE would then be able to "catch-up" its distributions by distributing the entire $400 during 2009. In 2010 and each year thereafter, under the safe harbor provision, the CDE would be able to distribute the sum of its current taxable year's Operating Income and prior taxable year undistributed Operating Income.

d. Definition of Operating Income – capital gains

We commend Treasury for adopting our comments related to the inclusion of tax-exempt income and the CDE's allocable share of depreciation and amortization in the calculation of Operating Income. However, the inclusion of capital gains was not addressed in the proposed regulations. Some CDEs are making venture capital investments in qualified businesses. A goal of the NMTC program is for CDEs to provide equity capital (the most patient form of capital) to businesses located in distressed communities. If these

investments are redeemed or otherwise sold, the CDE must reinvest the lesser of the proceeds received or the original cost basis. Amounts received in excess of the original cost basis do not need to be reinvested. However, the definition of Operating Income excludes capital gains. As such, while profits do not need to be reinvested by the CDE they cannot be distributed to investors without risking a recapture event. We recommend that capital gains be included in Operating Income.

Additional Comments Regarding the Proposed Redemption Regulations

e. Special exceptions

The amendment to the Regulations to allow distributions in a succeeding year of undistributed operating income from a prior year is useful given the difficulty of determining the actual operating income before year-end. The amendment does not address, however, the situations in which a CDE receives QLICI loan interest payments or equity distributions sufficient to make projected distributions which exceed the operating income safe harbor due to unanticipated losses incurred by the CDE or the QALICB.

> Example #1: CDE makes loans to a QALICB. The QALICB defaults on its interest payments due to the CDE, and, as a result of this default, the CDE may incur additional expenses (or may be uncertain as to its ability to accrue the interest income). The CDE has a loan loss reserve set aside equal to 5% of the QEI, and uses the funds in the loan loss reserve to make distributions pro rata in accordance with the financial projections at closing. The distributions are in the amounts required for the Investment Fund (a) to pay interest due with respect to a Leverage Loan (or the economic return on an equity investment) made to the Investment Fund to fund a portion of the QEI and (b) to pay the Investment Fund's projected operating expenses.

> Example #2: CDE makes a loan and an equity investment in a QALICB. The equity investment generates unanticipated losses which are not funded by the CDE. The unanticipated losses may be funded by project reserves, QALICB affiliate contributions or loans, or third party financing. The CDE receives the projected cash flow from the QLICI loan (or equity investment) and makes distributions pro rata to its members in accordance with the financial projections provided at closing. The distributions are in the amounts required for the Investment Fund (a) to pay interest due with respect to a Leverage Loan (or the economic return on an equity investment) made to the Investment Fund to fund a portion of the QEI and (b) to pay the Investment Fund's projected operating expenses.

The legislative history and the Final Treasury Regulations state that there is a recapture event if the investment is redeemed or "otherwise cashed out." The distributions described above in Examples #1 and #2 do not constitute a "cashing out" of the QEI since they are funded by loan loss reserve funds set aside for use in the event of defaults on QLICI loan payments or QLICI loan interest payments (or a return on an equity investment). The distributions are in amounts required to pay Leverage Loan debt service (or the economic return on an equity investment) and operating expenses of the Investment Fund.

The request is to modify the safe harbor (i) to define "operating income" to include QLICI loan interest payments without regard to whether the income should be accrued for federal

income tax purposes up to the amount of the loan loss reserve held by the CDE and (ii) to add back the tax deductions incurred by the qualified active low-income community business or the CDE that do not reduce the CDE's operating cash flow. We have provided sample language for your consideration attached with this comment letter.

f. Allocation among multiple QEIs

In the event that multiple qualified low-income community investments ("QLICIs"), are made into the same qualified active low-income community business ("QALICB") (e.g. installments of historic tax credit equity or advances of a construction loan), there is uncertainty as to how payments of or for capital, equity or principal received by the CDE should be attributed to those QLICIs. Under Treasury Regulation Section 1.45D-1(e)(2)(ii) there is a recapture event with respect to a QEI if "the proceeds of the investment cease to be used in a manner that satisfies the substantially all requirement." It is not clear under this Regulation how the "proceeds of the investment" are defined. This is particularly relevant where (i) multiple QLICIs are made to a single borrower over a period of time, and (ii) these QLICIs are funded from multiple QEIs. In this situation, it is not clear whether the borrower would be deemed to have repaid the QLICI made with the first QEI, the last QEI or repaid QLICIs made proportionally from each QEI.

Similar uncertainty exists under Section 1.45D-1(e)(2)(iii) where multiple QEIs are made into one CDE over a period of time. In this case, there is uncertainty as to how distributions from the CDE which constitute a return of capital will be attributed among those QEIs for purposes of the redemption test for QEIs. For example, consider the case where multiple QEIs have funded a single QLICI. Cash is paid to the CDE by the borrower and that cash is distributed to the investor as a return of capital. Which QEI has been redeemed? This is particularly relevant where the first of a series of QEIs has reached its seventh anniversary but later QEIs have not.

We believe in both cases CDEs should be permitted to elect to use any reasonable method to treat proceeds from a repaid QLICI as applicable to the QEIs made into that CDE. Further, the Regulation should state that the use of a FIFO method, a LIFO method or a pro-rata allocation method should be allowed if consistently applied.

g. C Corporation filing consolidated return

If a CDE is taxed as a C corporation and is included in a consolidated return, then it will likely make cash payments to its parent, the qualified equity investment ("QEI") holder, to fund the CDE's portion of the consolidated group of corporations' income tax liability. Under Regulation 1.45D-1(e)(3)(i), a C corporation's distributions to its parent are limited to earnings and profits. Earnings and profits are reduced by federal income taxes. If a C corporation CDE distributed all its earnings and profits to its parent, and made a payment to its parent for its allocable share of income taxes, there is concern that the payment to the parent would be treated as a distribution in excess of earnings and profits. We have suggested language to clarify that this is not the result.

3. Non-Real Estate Businesses

In a letter dated September 8, 2011, to the Internal Revenue Service in response to a request for comments on the notice of proposed NMTC regulations issued June 7, 2011, the NMTC Working Group provided comments on (i) whether the definition of a "non-real estate

QALICB" is sufficient for CDEs and investors to rely on and (ii) whether the "more than 50% gross income" requirement and activity limitation are the appropriate ways to define a non-real estate QALICB. For your convenience, we have provided the body of those comments below, because we believe the changes we recommended in 2011 are still applicable today.

Generally, the definition is sufficient. However, it is not uncommon for non-real estate investments to have a portion of the proceeds used for the development of real estate in conjunction with other operating business uses. The following sentence in the proposed definition may present issues regarding certain uses of QLICI proceeds:

> "The purpose of the capital or equity investment in, or loan to, the non-real estate qualified active low-income community business **must not be connected to** the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate." (emphasis added)

It is unclear what "must not be connected to" means. For example, does a non-real estate QALICB, "whose predominant business activity does not include the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate," fail to be a non-real estate QALICB if it has a small portion of "enhancement" expenditures for its existing building? We believe this limitation is not appropriate or consistent with the overall purpose of this definition, and that the language regarding the purpose of the investment should be removed, so that the definition solely relies on the 50% gross income requirement of the business activity.

4. Working Capital

Treasury Regulation § 1.45D-1(d)(4)(i)(E)(2) provides that working capital includes any proceeds that will be expended for construction of real property within 12 months after the date the investment or loan is made. While this provision takes into account the timing difference in which investment or loan proceeds are made to a construction project and then expended, it doesn't allow for a reasonable amount of time for the funds to be expended based upon the length of typical construction timelines. Historically, the construction period for NMTC projects is rarely 12 months or less. We believe that the regulation should be modified to 24 months to allow for a more reasonable construction period. We recommend that the regulation be amended with a provision such as the following to Treasury Regulation § 1.45D-1(d)(4)(i)(E)(2):

> (2) Construction of real property. For purposes of paragraph (d)(4)(i)(E)(1)(i) of this section, the proceeds of a capital or equity investment or loan by a CDE that will be expended for construction of real property within **24** months after the date the investment or loan is made are treated as a reasonable amount of working capital.

Further regulatory clarification around the "non-qualified financial property" limitation, particularly in regard to what is (and is not) "reasonable working capital," would be very helpful. Aside from extending the safe harbor period for QLICI and non-QLICI funds held for construction (which we understand is under consideration by the IRS), more basic guidance is needed. Neither the IRC nor the regulations (under Section 45D or elsewhere) provide any definition of "working capital," much less "reasonable working capital." The analysis and structuring that are currently required to deal with these issues leads to higher transaction costs, and it creates a serious impediment to many kinds of financing, particularly for operating

businesses, which typically need to retain and manage funds in a wide range of amounts for a wide variety of purposes. With no guidance to help define reasonable working capital, investors and CDEs are often unwilling to take the risk of having to simply guess whether a particular amount of capital held for a particular type of business fits within this limitation.

5. Aggregation of QEIs

Treasury Regulation §1.45D-1(c)(6) provides, "A CDE may treat any qualified equity investments issued on the same day as one qualified equity investment. If a CDE aggregates equity investments under this paragraph (c)(6), the rules in this section shall be construed in a manner consistent with that treatment." Under this provision, a CDE can receive multiple investments on the same day and treat them as a single QEI. However, if a CDE receives a single investment, it cannot elect to treat that single investment as more than one QEI.

It is not uncommon for a CDE to receive a QEI intended for a particular QLICI, but then for unexpected reasons, the CDE is unable to close the QLICI that the QEI was originally intended for. The CDE must then identify and close other QLICIs, the amounts of which may not correspond to the original QEI amount. This subjects the CDE and its investors to compliance risks associated with multiple QLICIs, the failure of any of which could result in recapture of NMTCs for the entire QEI.

We believe CDEs should be permitted to make an election to designate a single investment made on a particular date as one or more QEIs made on that date, so long as such election is made on or before the "substantially all" testing date selected for such QEIs (within the initial 12-month investment period). On the other hand, a CDE could accomplish exactly the same result if, instead of designating the initial investment as a single $1,000,000 QEI, it received 10 separate wire transfers of $100,000 each and registered 10 QEIs on the same date.[9] The only difference is that this latter approach represents a substantial reporting and administrative burden for the CDE and CDFI Fund. If the designation must be made within the limited period described above, this would give CDEs flexibility in getting their funds invested initially, without affecting compliance measurements over the long term.

In addition to the above, when for unexpected reasons the CDE is unable to close the QLICI that the QEI was originally intended for it is also not uncommon for an Allocatee to want to move a QEI from one sub-CDE to another sub-CDE. However, Allocatees are concerned that if the one sub-CDE seeks to transfer its QEI to the other sub-CDE with the same investor in each sub-CDE, the IRS would treat the transfer as a redemption triggering recapture of the tax credits associated with the QEI in the transferring sub-CDE.

For example, Sub-CDE 1 received a QEI of $10,000,000. Sub-CDE 1 is a subsidiary of Allocatee ABC. Sub-CDE 1 was created to be used solely for debt QLICIs. Sub-CDE 2 is another subsidiary of Allocatee ABC and is used solely for equity QLICIs. For internal bookkeeping purposes, the Allocatee will not do both equity and debt QLICIs out of the same subsidiary CDE. The initial QEI in Sub-CDE 1 was for the purpose of funding a debt QLICI for a particular transaction. However, the transaction has failed to close and Allocatee ABC would like to use the proceeds of the QEI for equity QLICIs that are available to be funded through Sub-CDE 2. By moving the QEI from Sub-CDE 1 to Sub-CDE 2, Allocatee ABC is not seeking to re-start the 12-month substantially-all test. If Allocatee ABC cannot transfer the QEI from Sub-CDE 1 to Sub-CDE 2, then recapture may result if a replacement

[9] We note that some CDEs may even opt to segregate the QEIs into even smaller denominations, such as 100 QEIs at $10,000 each, to further minimize recapture risk.

debt QLICI cannot be identified in time to satisfy the substantially-all requirement, and $10,000,000 of NMTC-advantaged money will not reach low-income communities.

We believe CDEs should be permitted to transfer QEIs from one subsidiary CDE to another subsidiary CDE without triggering a redemption either to avoid a violation of the substantially-all requirement or for administrative purposes, provided that the 12-month period for satisfying the substantially-all requirement does not expire as to the transferred QEI(s).

6. De Minimis Rule

Under Treasury Regulation §1.45D-1(d)(5)(iii)(B), a qualified business for a CDE excludes several types of business. The regulation specifically provides:

> (B) Certain other trades or businesses. The term qualified business does not include any trade or business consisting of the operations of any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

In IRC Section 1400N, certain tax benefits, including an expansion of available new markets tax credits, were made available to investments made to Gulf Opportunity Zone (GO Zone) properties. In Section 1400N(p)(3)(A)(i), "qualified Gulf Opportunity Zone Property" specifically excluded "any property used in connection with any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises" and such property was not eligible for GO Zone tax benefits. Although applicable only for purposes of Section 1400N(p)(3)(A)(i), in Internal Revenue Bulletin 2006-33, Notice 2006-77, the IRS provided the following guidance: "a taxpayer's trade or business that has less than 10% of its total gross receipts derived from massages, tanning services, or a hot tub facility is not treated as, respectively, a massage parlor, suntan facility, or a hot tub facility." For purposes of this guidance, "only gross receipts from the taxpayer's trade or business activity that includes the massages, tanning services, or hot tub facility are taken into account."

We recommend that Treasury Regulation §1.45D-1(d)(5)(iii)(B) be revised to incorporate the following language:

> (B) Certain other trades or businesses. The term qualified business does not include any trade or business, (i) **from which more than 10 percent of its total gross receipts are derived from,** the operations of any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or (ii) consisting of any store the principal business of which is the sale of alcoholic beverages for consumption off premises. **In determining whether this 10 percent test is satisfied, only gross receipts from the taxpayer's trade or business activity that includes operations of any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, are taken into account.**

We note that this is consistent with the Internal Revenue Bulletin 2006-33, Notice 2006-77, in which the IRS provided similar guidance for properties considered in the GO Zone. We recommend that the additional language mentioned above be added to the Treasury Regulation

§1.45D-1(d)(5)(iii)(B) and be applicable to all new markets tax credit properties (not just GO Zone properties).

7. Tenant Excluded Businesses

Treasury Regulation § 1.45D-1(d)(5)(ii) provides that "a CDE's investment in or loan to a business engaged in the rental of real property is not a qualified low-income community investment under paragraph (d)(1)(i) of this section to the extent a lessee of the real property is described in paragraph (d)(5)(iii)(B) of this section." This provision takes the approach of disqualifying a CDE's investment as a QLICI "to the extent a lessee . . .is" one of the prohibited businesses listed in paragraph (d)(5)(iii)(B).

First, this approach attempts to connect a specific quantity (a portion of the QLICI) to the existence of a business operation that is not in any way quantified. It is unclear whether a lessee must be engaged exclusively (or primarily) in a prohibited business, or whether the lessee's engagement in any such business activity triggers this provision.

We recommend that the regulations clarify that, in order to disqualify a QLICI, the lessee must be "exclusively or primarily engaged in one of the prohibited businesses listed in paragraph (d)(5)(iii)(B)." It would present a considerable burden on CDEs and investors if incidental activities by lessees could trigger disqualification.

An example of such incidental activities would be a hotel that includes a day spa that offers massage services and includes a sun tanning booth. The primary business of the hotel is to provide lodging and convention facilities as evidenced by the amount of square footage dedicated to these purposes and the income generated from these activities. The massage services and sun tanning booth generate an extremely small portion of the hotel's overall income. It is not entirely clear if the massage services and sun tanning booth disqualify the hotel project from being able to receive a QLICI.

It is also unclear how to determine how much of the QLICI would be disqualified if, and to what extent, a lessee is engaged in any such business. This might be done based upon the proportion of square footage of the space of the "offending" lessee bears to the total rentable space in the property. Another approach could be based upon the proportion that the amount of the lessee's space devoted to the prohibited activity bears to the total rentable space in the property. Or it might be done according to the proportion of the costs spent on the lessee's space (or portion of that space devoted to the prohibited activity), relative to the total cost of the project. Or it could be done on the basis of the amount of income generated by the lessee's space (or portion of that space devoted to the prohibited activity), relative to the total income generated by the project.

We recommend that the regulations provide guidance on how to quantify the lessee's activity. We believe the square footage of the lessee's space relative to other rentable space in the project would be the most reasonable approach. Square footage is readily determinable in real estate businesses and would not be subject to nearly as much uncertainty or manipulation as attempting to apportion costs or income between the lessee's space or operations and the project as a whole. However, we also believe that a taxpayer should be able to select any other method that is reasonable.

Another concern about how the regulations are currently written is how the current approach by-passes the entire QALICB analysis, and in so doing, has the effect (presumably unintended)

of by-passing the "reasonable expectation" safe harbor. As the regulations are written, the reasonable expectation safe harbor applies only to a CDE's expectation about QALICB status. But a tenant's engagement in a prohibited business impacts QLICI status directly, without reference to QALICB status. We recommend that the regulation be amended with a provision such as the following:

> For purposes of this paragraph (d)(5)(ii), a QLICI will not be disqualified if the CDE reasonably expects, at the time it makes the capital or equity investment or loan to a business engaged in the rental of real property, that lessees will not be engaged in the businesses described in paragraph (d)(5)(iii)(B) of this section.

8. Definition of Control

In several comment letters submitted over the years, the NMTC Working Group has recommended changes be made to the CDFI Fund's related party test definition and measurement in order to encourage CDEs to make majority equity investments in qualified active low-income community businesses ("QALICBs"). The CDFI Fund made changes consistent with the NMTC Working Group's recommendations that would allow a CDE to make majority equity interest investments without violating its allocation agreement so long as it had committed to investing substantially all of its proceeds in entities that were considered unrelated before it invested. This change was a significant step and one that the industry applauds the CDFI Fund for making.

However, it is unlikely that many CDEs will make majority interest equity investments because of an issue related to the reasonable expectations test defined in Treasury Regulation §1.45D-1(d)(6). The Regulations provide that if a CDE:

> "...reasonably expects, at the time the CDE makes the capital or equity investment in, or loan to, the entity, that the entity will satisfy the requirements to be a qualified active low-income community business [for the term of the investment...]"

then the QALICB will continue to be deemed a QALICB even if it falls out of compliance at a later time. This provision permits a CDE to avoid suffering a recapture event if the QALICB ceases to qualify as a QALICB during the recapture period for reasons that are outside the control of the CDE.

However, the Regulations further require that if the CDE has or obtains control of the QALICB, it generally must ensure that the entity remains a QALICB for the entire 7-year compliance period and cannot rely on its reasonable expectation at the time the investment is made to avoid a recapture event.

Investors do not want to be subject to strict liability for recapture merely because they acquire a majority equity interest in the QALICB if they do not also have management or voting rights that would allow them to control QALICB status. As a result of the broad definition of "control" under the reasonable expectation test, investors in the current market are unlikely to allow the CDE to acquire a majority equity interest in a QALICB.

If a CDE cannot rely on the reasonable expectation test, investors perceive the compliance risk as too great and most are unwilling to enter into such a transaction. This outcome is

unfortunate since equity investments are generally the most patient form of capital and would also reduce the burden of ensuring that the subsidy can remain at the QALICB.

The current definition of control in Treasury Regulation §1.45D-1(d)(6)(ii)(B) states (emphasis added):

> "Control means, with respect to an entity, **direct or indirect ownership (based on value)** or control (based on voting or management rights) of more than 50 percent of the entity. For purposes of the preceding sentence, the term management rights means the power to influence the management policies or investment decisions of the entity."

The problem for equity investors is the imputation of control based on "direct or indirect ownership (based on value)". Currently there is no clear guidance on how to calculate direct or indirect ownership "based on value". It is unclear to us how value is determined and how it is relevant to whether or not the CDE is controlling the QALICB. We believe that the concept of control should be based solely on the CDE's ability to control the QALICB's status as a QALICB through voting or management rights.

It would also be helpful to clarify the meaning of "control" given the variety of possible equity structures and documentation used in New Markets transactions. The potential for confusion is compounded by the fact that the CDFI Fund has adopted its own definitions regarding "control" in the NMTC arena -- definitions that do not necessarily work well for this purpose.

We believe that the only type of control based on voting or management rights that should be of concern in the context of the reasonable expectation test is control based on rights that enable the CDE to either (i) cause the QALICB to take actions that result in the QALICB failing to remain a QALICB, or (ii) allow the CDE to override or block actions by the QALICB when the authority to take such actions is necessary to enable the entity to remain a QALICB. The ability to exercise management or voting control on other issues would not seem to bear on whether the CDE should be allowed to rely on its own reasonable expectation of compliance as a safe harbor.

We note that there are some areas where a CDE's actions could indirectly affect compliance decisions by the QALICB, and one important example would be the right to remove a general partner of a partnership, the managing member of an LLC, or a majority of the directors of a corporation. Removal rights are commonly required by investors in scenarios in which a CDE is making equity investments in a QALICB. We believe that the existence of such rights in the CDE to remove **for cause** a managing member, general partner, or other party or parties with management control should not, by itself, be deemed to confer voting or management control on the CDE. Where removal is limited to "for cause" events (i.e., failure of the general partner, managing member, or majority of directors to comply with their obligations under the organizational documents), the threat of removal would not represent a mechanism for influencing management decisions that is tantamount to direct management control. Moreover, removal provisions typically contemplate the appointment of a substitute managing member, general partner, or directors, rather than entitling the CDE to manage the QALICB itself. In such a case, so long as the CDE does not actually "control" the substitute management, then the CDE could still satisfy the control test as we have recommended it be changed herein.

Accordingly, we recommend that the definition of "Control" contained in Treasury regulations be updated to remove the reference to a value based test and clarify voting and management

rights that should be considered. Specifically, we recommend the following change to Treasury Regulation §1.45D-1(d)(6)(ii)(B):

> "Control means, with respect to an entity, ~~direct or indirect ownership (based on value) or~~ control ~~(based on voting or management rights) of more than 50 percent of the entity based on~~ **of voting or management rights that enable the CDE to either (i) cause the QALICB to take actions that result in the QALICB failing to remain a QALICB, or (ii) to override or block actions by the QALICB that are necessary to enable the entity to remain a QALICB.**
>
> **(a) The existence of rights in the CDE to remove for cause a managing member of a limited liability company, a general partner of a limited partnership, or majority of directors of a corporation by substituting a new managing member, general partner, or majority of directors with control would not, by itself, be deemed to give the CDE 'control' for purposes of this provision."**

If these changes are adopted, it is likely that equity transactions could be structured in a manner that would attract investors by successfully addressing the issue of control and providing CDE's with the ability to rely on the reasonable expectations test. Without such a change, it is likely that investors will continue to sit on the sidelines when it comes to investing in CDEs that intend to make equity investments and will continue to effectively prevent the most patient form of capital, equity investments, from being made to QALICBs.

9. Reinvestment Rule for Equity Investments

Many CDEs have made and many more would like to make QLICIs in the form of equity, as opposed to debt. However, the Regulation does not define when an amount received by a CDE from a QALICB with respect to an equity investment is payment of, or for, capital or equity. The Regulation does specify that if the amount is determined to be a return <u>of</u> capital rather than a return <u>on</u> capital, then it must be reinvested within 12 months from the date of receipt in order to be treated as continuously invested. Without guidance on determining whether a distribution received with respect to a QLICI must be reinvested in another QLICI, CDEs often choose not to receive any distributions with respect to their equity investments in QALICBs in order to avoid any possibility of failing the reinvestment and substantially all requirements. Since CDEs generally have operating expense funding needs, CDEs are forced to either fund cash reserves or split their QLICI into a debt portion, with current pay interest, and an equity portion. These solutions add administrative complexities and transaction costs that reduce the efficiency of the NMTC program.

We believe there should be symmetry between the rules for determining if a cash distribution received by a CDE from a QALICB on its equity investment in the QALICB must be reinvested with the rules for determining if a cash distribution received by an investor in a CDE is a redemption. We believe that symmetry is necessary since the issue in both cases is the return of a capital investment versus return on a capital investment. For redemption purposes, the determination of whether capital has been redeemed is made in order to determine if a recapture event has occurred. If one dollar of capital has been redeemed, recapture is deemed to have occurred. For QLICI reinvestment purposes, the determination between a return of capital versus a return on capital is made in order to determine whether the CDE is meeting the substantially all requirement. If capital has been received from an equity investment in a

QALICB and not reinvested within twelve months, then the dollar amount treated as meeting the substantially all requirement is reduced by one. While the reason for making the determinations is different, we believe the underlying principles of return "on" investment versus return "of" investment are the same for both, and the method for determining which occurred should similarly be the same. We believe that this can be achieved by providing a cross reference in (d)(2)(i) to (e)(3). Just as distributions that are made by a CDE are not considered redemptions if they either don't exceed accumulated earnings and profits or operating income, a QALICB would be allowed to make distributions in a similar manner without the distributions being deemed a return of capital for reinvestment determination purposes.

> Example: CDE A makes an equity investment in a partnership. The investment is a qualified low-income community investment in a qualified active low-income community business. The qualified business makes a distribution to CDE A. The distribution will not be considered a return of capital for reinvestment consideration if either the distribution does not exceed the partnership's operating income (as defined in the regulations pursuant to Reg. 1.45D-1(e)(3)) for the taxable year) or the distribution and all prior distributions do not exceed the partnership's cumulative operating income for all years. (Note: This example assumes that the suggested language from our recommendations regarding the Redemption regulations will be incorporated.)

10. Reasonable Expectations

We believe the added language that is designed to protect CDEs who make QLICIs in other CDEs leaves uncertainty regarding whose reasonable expectation about the QALICB's status can be relied upon. The proposed revisions make it clear that, if a CDE (the "first CDE") makes a QLICI in another CDE (the "second CDE"), and then the second CDE makes a loan to a QALICB, the first CDE can rely on the reasonable expectation test. However, the wording of the revised regulation at least suggests that it is the first CDE that must have that reasonable expectation.

One of the advantages of enabling CDEs to invest in other CDEs is that it enables the first CDE to support and expand the activities and operations of the second CDE. Naturally, the second CDE will be operating in those markets and dealing with those QALICBs with which it is most familiar and will have the primary contact with prospective QALICBs. Accordingly, the second CDE will generally be responsible to the first CDE for determining that the QALICBs to whom the second CDE lends meet and are expected to meet the necessary qualifications.

However, if it is the first CDE that must have a reasonable expectation of continued QALICB status, then it seems that the first CDE would have to perform much of the qualification underwriting and analysis on QALICB status. This underwriting and analysis is probably more efficiently performed by the second CDE and would likely be done by the second CDE anyway as part of its efforts to screen eligible loans. This effectively requires both CDEs to do the same underwriting, which is unnecessarily duplicative, inefficient, and costly.

It should be clear that the first CDE can rely on the reasonable expectation test if either the first CDE or the second CDE has a reasonable expectation of ongoing QALICB status.

11. Economic Substance Doctrine

In the Health Care and Education Affordability Reconciliation Act of 2010 (the "Act"), the economic substance doctrine was codified in Section 7701(o) of the IRC of 1986, as amended effective for transactions entered into after March 30, 2010. In a technical explanation prepared by the Joint Committee on Taxation ("JCT") explaining revenue provisions of the Act, footnote 344[10] clarified that the codification of the economic substance doctrine is not intended to disallow tax benefits in a transaction that achieves the basic purpose or plan for which the tax benefit was designed by Congress. The NMTC community, as well as other tax credit communities, applaud the explanatory guidance provided by this footnote since it recognizes and is consistent with Congress' legislative intent in codifying the economic substance doctrine as well as Congress' legislative intent in enacting tax credits that provide incentives for investment in affordable rental housing, historic properties, underserved economic areas, and renewable energy resources.

We request that Treasury provide guidance that it will follow the documented legislative intent included in footnote 344. While we believe that case law and historical Treasury guidance is generally consistent with the interpretation provided in footnote 344, we also believe that industry participants and practitioners can more readily rely on written guidance from Treasury expressing Treasury's agreement with the explanatory statements provided in footnote 344. Such guidance from Treasury would receive greater deference by a court interpreting the economic substance statute than the JCT explanatory footnote.

12. Partnership Allocations (IRC section 704(b))

It is currently unclear as to how a partnership allocates NMTCs among its partners. Internal Revenue Code ("IRC") §45D and §704(b) provide no specific reference on how the NMTC should be allocated among partners in a partnership. The NMTC is a unique credit that doesn't generate a readily identifiable expense similar to other credits like the low-income housing tax credit, which subsidizes construction costs that generate depreciation expense. In the absence of current specific guidelines, we believe that NMTCs should be allocated among the partners in a partnership in a manner that is most consistent with the existing §704(b) partnership allocation regulations. Therefore, the NMTC should be allocated in the same manner as the NMTC basis reduction which in turn should be allocated in the manner agreed to by the partners of the partnership and that is consistent with the partnership allocation safe harbor rules under existing Treasury Regulations. Guidance on this issue would be very helpful, particularly to CDEs seeking to make venture capital investments.

13. Program Related Investments and NMTC Transactions

We recommend changes to the Regulations related to Program Related Investments that will decrease transaction costs discussed in detail below. In a letter to Ms. Emily S. McMahon, Acting Assistant Secretary (Tax Policy), dated April 10, 2012, the NMTC Working Group made recommendations regarding guidance under §4944 Treasury Regulation § 53.4944-3 and on Program Related Investments. We have provided our comments below to recommend new language be added to the regulations for §4944 to provide a safe harbor for investments in NMTC transactions.

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[10] Joint Committee on Taxation Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010, " as Amended, in Combination with the "Patient Protection and Affordable Care Act", JCX-18-10, March 21, 2010, page 152.

We request that Treasury provide a program-related investments safe harbor for private foundations that make loans to or equity investments in an entity that makes a qualified equity investment, as defined in §45D(b)(1). For purposes of determining the amount of NMTC allowable under IRC § 45D, the amount of the QEI made by a limited liability company ("LLC") classified as a partnership includes cash from a nonrecourse[11] or recourse[12] loan to the LLC that the LLC invests as equity in a qualified community development entity. It has been our experience that private foundations are generally hesitant to make a loan to or equity investment in an entity that will use the proceeds to make a QEI because under the regulations related to program-related investments under Treasury Regulation § 53.4944-3, it is unclear if such an investment would meet the requirements. We believe that the intent of the NMTC Program to provide below-market rate investments to qualified businesses in low-income communities meets the intent of the exceptions provided for program-related investments that don't jeopardize the carrying out of exempt purposes of a private foundation as described in Treasury Regulation § 53.4944-3. Therefore, we recommend that the following safe harbor be added to Treasury Regulation § 53.4944-3(a)(2)(i):

> **(A) A loan to or equity investment in an entity that makes a qualified equity investment in accordance with section 45D(b)(1) shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B).**

We also recommend a similar safe harbor be added to Treasury Regulation § 53.4944-3(a)(2)(iii):

> **(A) A loan to or an equity investment in an entity that makes a qualified equity investment in accordance with section 45D(b)(1) shall be deemed to <u>not</u> have as a significant purpose the production of income or the appreciation of property.**

We believe that such guidance will give private foundations the comfort necessary to make direct investments in an entity that will use the investment to make a QEI. Without such guidance, private foundations are likely to avoid NMTC transactions or incur additional structuring costs to make the investment, diluting the overall benefit that can be passed on to qualified businesses located in low-income communities.

> Example (11). X is a business enterprise that operates in a low-income community and is considered a qualified active low-income community business as defined in section 45D(d)(2). Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to Z, an investment fund created to make qualified equity investments in accordance with section 45D in A, a qualified community development entity (CDE) as defined in section 45D(c). The loan made by Y to Z bears an interest rate below the market rate for commercial loans of comparable risk. Y's primary purpose for making the loan to Z is to encourage the economic development of low-income communities and/or serve low-income persons and low-income communities through Z's investment in a CDE, an investment that will generate new markets tax credits as defined in section 45D. The loan from Y to Z has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have

[11] Revenue Ruling 2003-20.
[12] Revenue Ruling 2010-17.

been made but for such relationship between the loan, its use by Z to make a qualified equity investment in A, A's use of substantially all of the proceeds from Z to make qualified low-income community investments, and Y's exempt activities. Accordingly, the loan is a program-related investment even though Y may earn income from the investment in an amount comparable to or higher than earnings from conventional portfolio investments.

Below is example one from the § 53.4944-3 regulations for comparison to our example above:

Example (1). X is a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. Y's primary purpose for making the loan is to encourage the economic development of such minority groups. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment even though Y may earn income from the investment in an amount comparable to or higher than earnings from conventional portfolio investments.

14. Investments Prior to Receipt of Allocation Agreement

Under Treasury Regulation § 1.45D-1(c)(3), subject to specified conditions, an investor may make an equity investment in a CDE prior to the CDE's receipt of its executed allocation agreement, and such investment is treated as a qualified equity investment as of the effective date of the allocation agreement. It is unclear, however, how this provision applies to subsidiary CDEs that must receive a sub-allocation in order for the investment to constitute a valid qualified equity investment.

Many (if not most) QEIs are made through subsidiary CDEs, and commonly, the parties to the allocation agreement will include, in addition to the CDE that received the allocation award, one or more subsidiary allocatees. Under CDFI Fund procedures, the fact that an allocation agreement has been executed by a subsidiary CDE is not, by itself, sufficient to effect a sub-allocation to such subsidiary CDE (the sub-allocation must be logged into the CDFI Fund's system), and an investment cannot be a QEI unless and until the subsidiary CDE has received a valid sub-allocation.

We believe this can be addressed by a minor modification to Treasury Regulation § 1.45D-1(c)(3)(iv) so that it reads as follows:

(iv) Initial investment date. If an equity investment is designated as a qualified equity investment in accordance with paragraph (c)(3)(ii) of this section, the investment is treated as initially made **(A)** on the effective date of the allocation agreement between the CDE and the Secretary**, or (B) in the case of an investment in a CDE receiving a sub-allocation, the date (on or following the effective date of such allocation agreement) on which such sub-allocation is effective for purposes of such allocation agreement.**

In addition, we note that it would be appropriate for Treasury Regulation § 1.45D-1(c)(3) to make clear that the entity receiving the equity investment prior to the execution of the allocation agreement must be a CDE at the time the equity investment is received. Currently, Treasury Regulation § 1.45D-1(c)(3) does not explicitly provide that the entity receiving the equity investment must be a CDE when the equity investment is received.

15. Equity Investments in Other CDEs

Treasury Regulation §1.45D-1(c)(4)(i)(B) provides that the term qualified equity investment does not include "Any equity investment by a CDE in another CDE, if the CDE making the investment has received an allocation under section 45D(f)(2)." We believe this provision can inhibit investments in other CDEs in ways that were not intended by this provision.

Some allocatees obtain their allocations in their parent companies, though they will generally utilize their allocations by making sub-allocations to one or more subsidiary CDEs. At the same time, the parent company that received an allocation may have non-NMTC investment activities unrelated to those they undertake using their NMTC allocation.

We believe the intent of the above regulation is to preclude one investment from generating NMTCs twice (once when a QEI is made in the first CDE, and then a second time if the first CDE makes an equity investment in a second CDE with an allocation who designates that investment as a QEI). That concern, as well as our concern described above, can still be addressed if the above regulation is modified to read, "Any equity investment by a CDE **(the "primary CDE")** in another CDE **(the "second CDE")**, if the **primary** CDE making the investment has received an allocation under section 45D(f)(2) **and is using funds from any QEI to make the equity investment in the second CDE.**"

As an alternative, the regulation could be changed to exclude investments from a CDE with an allocation into another CDE only after the primary CDE has issued a QEI. That would allow a parent CDE who has sub-allocated all of its allocation to subsidiary CDEs to make equity investments since it won't be issuing QEIs. This alternative can be enacted by modifying the above regulation to read, "Any equity investment by a CDE **(the "primary CDE")** in another CDE **(the "second CDE")**, if the **primary** CDE making the investment has received an allocation under section 45D(f)(2) **and has issued one or more QEIs for the full amount of its allocation.**"

16. Safe Harbor for Investments in Other CDEs

When a CDE makes a QLICI in the form of a loan or equity investment in a QALICB, it is permitted to claim the benefit of the "reasonable expectation" safe harbor with respect to the continued qualification of the recipient as a QALICB over the seven-year compliance period. However, when a CDE makes a QLICI in the form of a loan or equity investment in another CDE, there is no safe harbor with respect to CDE status, so as to protect that loan or investment as a QLICI should the recipient CDE cease to be a CDE during the compliance period.

Thus, the loss by the recipient CDE of its CDE status at any time during the compliance period would mean that the loan or investment would cease to constitute a QLICI. There are many scenarios in which there are no practical ways for this to be cured -- the proceeds of the loan or investment will have, in turn, been used to make loans or investments in QALICBs (as required by the regulations) and will not easily be recoverable from the non-qualifying intermediary CDE.

This has significantly impeded the use of NMTCs to invest in other CDEs. Generally, only the strongest and most sophisticated CDFIs have been able to raise capital under this program since only those institutions can provide enough comfort to investors that they will remain CDEs (or will be able to repay the investments should that status change) throughout the compliance period.

We believe that there should be a "reasonable expectation" safe harbor applicable to CDE status (presumably in Treasury Regulation § 1.45D-1(d)(1)(iv)) similar to that provided for QALICBs, which might read as follows:

> For purposes of paragraph (d)(1)(iv) of this section, a CDE (the "second CDE") receiving a loan or equity investment from a CDE (the "primary CDE") is treated as a CDE for the duration of the primary CDE's investment in the entity if the primary CDE reasonably expects, at the time the primary CDE makes the capital or equity investment in, or loan to, the second CDE, that the second CDE will satisfy the requirements to be a qualified community development entity throughout the entire period of the investment or loan.

17. Nonqualified Financial Property – Hedges

The NMTC program is designed to stimulate capital investment in low-income communities. The GAO Report to Congressional Committees regarding the New Markets Tax Credit Program dated January 30, 2004 stated that "[a]ccess to credit and investment capital is essential for creating and retaining jobs, developing affordable housing, revitalizing neighborhoods, and promoting the development of small businesses."

Based on the purpose of the NMTC program to incentivize economic development in low-income communities, we believe that hedges entered into in the ordinary course of the QALICB's trade or business to manage risks of operations should not constitute nonqualified financial property. For example, an ethanol plant routinely enters into options, futures contracts and forward contracts in connection with the purchase of corn and natural gas required for the production of ethanol and in connection with the sale of ethanol. Another example is a food manufacturing facility which may use hedges to minimize the impact of price fluctuations of the core ingredients.

In order to address this concern, Treasury Regulation Section 1.45D-1(d)(4)(i)(E)(1) should be clarified by adding the following exclusion to the definition of nonqualified financial property: (iii) option contracts, futures contracts, forward contracts and similar property that a taxpayer acquires in the normal course of the taxpayer's trade or business primarily to manage risk of price changes with respect to ordinary property that is held or to be held by the taxpayer as the applicable terms are defined pursuant to Treasury Regulation Sections 1.1221-2(c) and (d).

Treasury Regulation Sections 1.122-2(c) and (d) provide definitions for "normal course", "ordinary property" and "managing risk" in connection with defining hedging transactions that do not result in capital assets.

We believe this clarification will enhance the efficiency and the impact of the NMTC program by eliminating uncertainty regarding the proper treatment of such hedging transactions and allowing borrowers to use standard market practices in managing operational risks.

18. Trade or Businesses Involving Intangibles

Treasury Regulation § 1.45D-1(d)(5)(iii)(A) provides that a "qualified business does not include any trade or business consisting predominantly of the development or holding of intangibles for sale or license." We request Treasury provide clarification, possibly through the use of examples or by referencing a specific section elsewhere in the Internal Revenue Code, that clarifies the meaning of "developing or holding intangibles for sale or license." Further clarification is needed to avoid any confusion about the type of intangibles referenced in this exclusion. Specifically, is there a difference between intangibles created as a result of the nature of the business?

We believe the key to the interpretation and application of this exclusion lies in the words "development or holding of intangibles for sale or license." While the businesses of many companies involve intangibles, the above exclusion is intended to apply only to businesses that create the intangibles internally and then grant to their customers (though either sale or license) the right to use those intangibles. The exclusion should not apply where the intangibles arise out of contracts or transactions between the business and its customers.

We note that there are regulations under Section 367 of the Code, involving situations where a person is transferring or licensing an intangible to a foreign person, which draw a distinction between an "operating intangible" which is an integral part of a business, versus an intangible that is typically transferred for consideration and dependent on use by the transferee. A similar approach may be called for here.

In any case, we believe it would be helpful to clarify Treasury Regulation §1.45D-1(d)(5)(iii) through examples in the Regulations that illustrate the distinction made above. For example, assume a business enters into service contracts with its customers to provide cleaning services for commercial buildings, pursuant to which the customers agree to make fixed payments over the terms of the contracts. Although the service contracts may be intangible assets in the hands of the business, they are created by the transactions between the business and its customer that are integral to the nature of the business. It is not created by the business and then sold or licensed to others. We believe this would be a situation where the business would not be disqualified.

In contrast, assume instead that the business is primarily involved in developing a brand name, associated trademarks, and a set of operating procedures for "XYZ Commercial Cleaners", which it then sells or licenses to third party operators of cleaning companies under agreements that entitle such operators to use the brand name, trademarks, and operating procedures so developed. The business receives fees for granting such rights, which might be based in whole or in part on the sales of the cleaning companies. We believe this may be a situation where the business would be disqualified, because the intangible assets (in the form of trade names, trademarks, and other intellectual property) are first created by the business and then transferred to others for consideration.

Without further clarification of the meaning within the regulation regarding intangibles, industry participants may be reluctant to invest in transactions involving businesses that have intangibles, regardless of the nature of the intangibles or how they are involved in the business.

19. Control as Impacted by Enforcement

Treasury Regulation § 1.45D-1(d)(6) contain the "reasonable expectation" safe harbor for QALICB status and goes on to provide that this safe harbor is not available if and when the CDE obtains "control" of the qualified business. Treasury Regulation § 1.45D-1(d)(6)(ii)(C) provides an exception which protects a CDE's ability to rely on the reasonable expectation safe harbor where the CDE obtains control due to financial difficulties of the QALICB.

One of the requirements for this exception is that the CDE must dispose of the entire amount of the investment or loan and reinvest the amount received in such disposition in a qualified low-income community investment within a 12-month period following acquisition of control. We believe that this does not provide CDEs with an adequate time period to deal with troubled investments.

For example, in the context of a real estate loan, it is common for lenders to acquire properties through foreclosure and hold them for a period of time prior to disposition. This enables the lender to recover as much of its loan as possible, by (i) avoiding the "distress sale" atmosphere of a foreclosure sale, (ii) enabling the lender to take steps to repair or improve the property prior to sale, and/or (iii) enabling the lender to sell the property at a time and manner of the lender's choosing.

CDEs that face troubled loans need the flexibility to recover the most value for their investments. A CDE that forecloses on a real estate loan could acquire the property through an entity that it forms, and in which the CDE would own all, or nearly all, of the equity interests. Although the CDE's equity interests could still constitute a QLICI, the CDE would "control" the entity because of its ownership. The requirement that the CDE *both* dispose of the property and re-invest the proceeds within 12 months is a severe constraint on the CDE's ability to maximize its recovery. The regulations generally allow CDEs 12 months to reinvest, which recognizes the difficulty a CDE can face in finding, negotiating, and closing replacement QLICIs of the proper size and on acceptable terms.

However, under Treasury Regulation § 1.45D-1(d)(6)(ii)(C)(3)(ii), the CDE is penalized if it controls the property or the business for any significant period of time, because every day it continues to control the property or business reduces the time it has to dispose of it, if it wishes to continue to rely on the reasonable expectation safe harbor. We believe it should be sufficient if the CDE disposes of the investment within 12 months from when it acquires control. Once it does so, reinvestment would be governed by the general 12-month reinvestment period, during which there would be no question of "control" anyway because the CDE will be holding cash for re-investment in other QLICIs. We recommend that the regulation be amended with a provision such as the following to Treasury Regulation § 1.45D-1(d)(6)(ii)(C)(3)(ii):

> The CDE sells or causes to be redeemed the entire amount of the investment or loan described in paragraph (d)(6)(ii)(C)(1) of this section **within a 12-month period** from the date on which it first acquired control and, by the end of the 12-month period applicable to reinvestment of the proceeds of such sale or redemption under paragraph (d)(2) of this section, reinvests the amount received in respect of the sale or redemption in a qualified low-income community investment under paragraph (d)(1) of this section . For this purpose, the amount treated as continuously invested in a qualified low-income community investments is determined under paragraphs (d)(2)(i) and (ii) of this section.

20. Non-Qualified Financial Property – Entity Ownership

Many businesses choose to own divisions of the company as separate legal entities, for liability or other reasons. Under the existing "nonqualified financial property" restrictions, shares of stock and membership or partnership interests are included in the definition. We recommend excluding these items from the definition where the entities are under common control.

As such, Treasury Regulation Section 1.45D-1(d)(4)(i)(E) should be further supplemented by adding the following exclusion: **(iv) shares of stock in wholly owned subsidiaries of the entity or partnership interests in partnerships which are under common control.**

This clarification will be particularly beneficial to investments in operating businesses.

21. Portions of the Business Requirements

The "portions of the business" provisions of the regulations (Treasury Regulation §1.45D-1(d)(4)(iii)) have become a very useful tool in structuring investments. In order to make use of these provisions, (i) a "complete and separate set of books and records" must be maintained with respect to the applicable portion of the business, and (ii) the proceeds of the CDE's loan or investment are treated as a QLICI only to the extent that such proceeds are used in such portion of the business.

The regulations currently do not provide any definition of "complete and separate set of books and records." Presumably, one of the intended benefits of making this test available is to encourage companies with varied and complex operations to locate businesses in low-income communities, without requiring that they set up and maintain separate legal entities. In addition to the costs of formation and organization that having to use separate entities would entail, companies are also often required to conform to complex, inter-company accounting rules that are both expensive and burdensome.

We believe that the purposes of the program and of the "portions of the business" regulations are met if the separate books and records are sufficient in content and detail to enable the company to demonstrate that the portion of the business would meet the tests constituting a QALICB if the business had been separately incorporated. We suggest that Treasury Regulation § 1.45D-1(d)(4)(iii)(A) be modified to add the following clarification:

> For purposes of this paragraph (d)(4)(iii), the books and records required to be maintained with respect to a trade or business that is treated as a portion of a business hereunder will be deemed sufficiently complete and separate if they are sufficient to demonstrate that such trade or business would meet the requirements of subparagraphs (d)(4) and (d)(5) hereof if such trade or business had been separately incorporated.

To go a step further than this and require that the books and records must be equivalent in all respects to that which the company would be required to maintain if the portion of the business had been separately incorporated, would defeat one of the main benefits of using this approach.

It is also not clear when the proceeds of a CDE's loan or investment are deemed to be (or not to be) used in the trade or business that constitutes the portion of the business. In particular, (i) a company might advance funds for the benefit of such trade or business (e.g., the development of a new store in a low-income community) prior to the date when the CDE's loan or investment closes, or (ii) a company might have an established, company-wide purchasing

program under which it acquires goods or services, some of which are used for the benefit of the designated portion of the business.

If a CDE's loan or investment is applied to reimburse the company for actual costs it has advanced for materials, supplies, goods, or services actually used in the designated portion of the business, then such proceeds should be deemed to have been used in the portions of the business. We suggest that Treasury Regulation § 1.45D-1(d)(4)(iii) be modified to state:

> For purposes of this paragraph (d)(4)(iii), to the extent that the proceeds of a CDE's loan or investment are applied to either pay or reimburse the costs of materials, supplies, goods, or services used in or for the portion of the business, they will be deemed used in the trade or business that constitutes the portion of the business.

Exhibit B
NMTC Working Group
2013-2014 Guidance Priority List

Proposed Amendments to New Markets Tax Credit Regulations
Treasury Regulation Section 1.45D-1
Pursuant to I.R.C. § 45D(g)(3)(C)
Revisions in Red, Underlined Typeface

(e) Recapture.

(1) In general. If, at any time during the 7-year period beginning on the date of the original issue of a qualified equity investment in a CDE, there is a recapture event under paragraph (e)(2) of this section with respect to such investment, then the tax imposed by Chapter 1 of the Internal Revenue Code for the taxable year in which the recapture event occurs is increased by the credit recapture amount under section 45D(g)(2). A recapture event under paragraph (e)(2) of this section requires recapture of credits allowed to the taxpayer who purchased the equity investment from the CDE at its original issue and to all subsequent holders of that investment.

(2) Recapture event. There is a recapture event with respect to an equity investment in a CDE if—

(i) The entity ceases to be a CDE;

(ii) The proceeds of the investment cease to be used in a manner that satisfies the substantially-all requirement of paragraph (c)(1)(ii) of this section; or

(iii) The investment is redeemed or otherwise cashed out by the CDE.

(3) Redemption.

(i) Equity investment in a C corporation. For purposes of paragraph (e)(2)(iii) of this section, an equity investment in a CDE that is treated as a C corporation for Federal tax purposes is redeemed when section 302(a) applies to amounts received by the equity holder. An equity investment is treated as cashed out when section 301(c)(2) or section 301(c)(3) applies to amounts received by the equity holder. An equity investment is not treated as cashed out when only section 301(c)(1) applies to amounts received by the equity holder. Solely for purposes of subsection (e) of this section, a CDE that is included in a consolidated return shall treat cash payments made to its parent corporation or any members of the consolidated group as a payment of income taxes by the CDE to the extent of the CDE's allocable share of income taxes.

(ii) Equity investment in an S corporation. For purposes of paragraph (e)(2)(iii) of this section, an equity investment in a CDE that is an S corporation is redeemed when section 302(a) applies to amounts received by the equity holder. An equity investment in an S corporation is treated as cashed out when a distribution to a shareholder described in section 1368(a) exceeds the accumulated adjustments account determined under §1.1368-2 and any accumulated earnings and profits of the S corporation.

(iii) Capital interest in a partnership. In the case of an equity investment that is a capital interest in a CDE that is a partnership for Federal tax purposes, a pro rata

cash distribution by the CDE to its partners based on each partner's capital or profits interest in the CDE during the taxable year will not be treated as a redemption for purposes of paragraph (e)(2)(iii) of this section if either the distribution does not exceed the CDE's operating income for the taxable year or the distribution and all prior distributions do- not exceed the CDE's cumulative operating income for all years. In addition, a non-pro rata de minimis cash distribution by a CDE to a partner or partners during the taxable year will not be treated as a redemption. A non-pro rata de minimis cash distribution may not exceed the lesser of (A) 5 percent of the greater of (1) the CDE's operating income for that taxable year or (2) the CDE's cumulative operating income for all years less all prior distributions or (B) 10 percent of the partner's capital interest in the CDE. For purposes of this paragraph (e)(3)(iii), with respect to any taxable year, operating income is the sum of:

(A) The CDE's taxable income as determined under section 703, except that—

(1) The items described in section 703(a)(1) shall be aggregated with the non-separately stated tax items of the partnership; and

~~(2) Any gain resulting from the sale of a capital asset under section 1221(a) or section 1231 property shall not be included in taxable income;~~

(2) Interest income with respect to a loan that is a qualified low-income community investment that is not accrued for federal income tax purposes in connection with a payment default shall be included in the CDE's taxable income up to an amount equal to the CDE's loan loss reserve maintained in compliance with paragraph (d)(3) of this section.

(B) Tax-exempt income under section 103;

(C) Deductions under section 165, but only to the extent the losses were realized from qualified low-income community investments under paragraph (d)(1) of this section;

(D) Deductions under sections 167 and 168, including the additional first-year depreciation under section 168(k) and any other depreciation and amortization deductions under the Code

(E) Start-up expenditures amortized under section 195;

(F) Organizational expenses amortized under section 709; and

(G) Deductions under Section 162, with respect to expenses incurred by the CDE or the qualified active low-income community business in excess of operating revenues, and

(1) If incurred by the CDE, such expenses are funded by (a) the CDE's loan loss reserve maintained in compliance with paragraph (d)(3) of this section or (b) reserves or financing not funded by qualified equity investments provided to the CDE; or

(2) If incurred by the qualified active low-income community business, such expenses are funded by (a) reserves held by the qualified active low-income community business, or (b) financing provided to the qualified active low-income community business (other than qualified low-income community investments made by the CDE).

(3) Examples. – The application of paragraph (e)(3)(iii)(G) is illustrated by the following examples:

Example 1. (i) X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. Y acquires a qualified equity investment in X. X uses the proceeds of Y's qualified equity investment to make qualified low-income community investments that consist of a loan and an equity investment in B. B is a qualified active low-income community business. X makes the equity investment in B through A which is a wholly-owned subsidiary of X and a disregarded entity for federal income tax purposes. X is a calendar year taxpayer.

(ii) B rents a building to A. A's required annual lease payments of $400,000 are sufficient to cover the annual debt service payments of $350,000 due by B with respect to the loan QLICI and to pay B's operating expenses of $50,000.

(iii) For the year ended December 31, 2008, A has tax losses from operations of $150,000 and is only able to make lease payments of $250,000 to B. B makes the debt service payment of $350,000 to X and pays its operating expenses utilizing $150,000 of reserves held by B. For the year ended December 31, 2008, X's interest income is $350,000 and tax losses from its investment in A are $150,000. Under paragraph (e)(3)(iii)(G)(ii) of this section, $150,000 would be added to X's *operating income* for the year ended December 31, 2008.

Example 2. The facts are the same as in *Example 1* except that A borrows $150,000 from a lender and uses the loan proceeds to make the $400,000 lease payment to B. B makes the debt service payment of $350,000 to X. Under paragraph (e)(3)(iii)(G)(ii) of this section, $150,000 would be added to X's *operating income* for the taxable year ended December 31, 2008.

(iv) Solely for purposes of calculating a redemption under paragraph (e)(3) of this section, cash distributions made by the due date (including extensions) of a CDE's federal income tax return shall, at the election of the CDE, be treated as made in the prior taxable year.

Exhibit B
NMTC Working Group
2013-2014 Guidance Priority List

Proposed Amendments to New Markets Tax Credit Regulations
Treasury Regulation Section 1.45D-1
Pursuant to I.R.C. § 45D(b)(1)(B)
Revisions in Red, Underlined Typeface

(2) Payments of, or for, capital, equity or principal.

(i) In general. Except as otherwise provided in this paragraph (d)(2), amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment must be reinvested by the CDE in a qualified low-income community investment no later than 12 months from the date of receipt to be treated as continuously invested in a qualified low-income community investment. **For purposes of determining if a distribution from an equity investment is a payment of, or for, capital or equity, rules similar to the rules for determining whether a redemption occurred in accordance with paragraph (e)(3) shall apply as appropriate given the type of entity making the distribution to the CDE.** If the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph (d)(2)(i), an amount at least equal to such original cost basis, then an amount equal to such original cost basis will be treated as continuously invested in a qualified low-income community investment. In addition, if the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph (d)(2)(i), an amount less than such original cost basis, then only the amount so reinvested will be treated as continuously invested in a qualified low- income community investment. If the amounts received by the CDE are less than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests an amount in accordance with this paragraph (d)(2)(i), then the amount treated as continuously invested in a qualified low-income community investment will equal the excess (if any) of such original cost basis over the amounts received by the CDE that are not so reinvested. Amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment during the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section) do not have to be reinvested by the CDE in a qualified low-income community investment in order to be treated as continuously invested in a qualified low-income community investment.

Example: CDE A makes an equity investment in a partnership. The investment is a qualified low-income community investment in a qualified active low-income community business. The qualified business makes a distribution to CDE A. The distribution will not be considered a return of capital for reinvestment consideration if either the distribution does not exceed the partnership's operating income (as defined in the regulations pursuant to Reg. 1.45D-1(e)(3)) for the taxable year) or the distribution and all prior distributions do not exceed the partnership's cumulative operating income for all years.

Exhibit C

NOVOGRADAC & COMPANY LLP
CERTIFIED PUBLIC ACCOUNTANTS

March 13, 2009

Internal Revenue Service
CC:PA:LPD:PR (REG-149404-07)
Courier's Desk
1111 Constitution Avenue, NW
Ben Franklin Station
Washington, D.C. 20224

Re: New Markets Tax Credit Treasury Regulations Project – Clarifications

Dear Ladies and Gentleman:

In response to your request, we are submitting clarification of comments we sent on behalf of the New Markets Tax Credit ("NMTC") Working Group in a letter dated November 7, 2008. We have revised our recommendations to further address issues that are being raised in light of the current economic crisis. We are specifically providing clarification to our Working Capital and Redemption – Special Exceptions comments and have added a further recommendation regarding qualified low-income community ("QLICI") reinvestment requirements. The proposed amendments address the impact on a CDE's operating income and reinvestment requirements when a qualified active low-income community business ("QALICB") is in default or incurs losses during periods of economic distress consistent with the program's intent to maintain the community development entity's ("CDE") investment in the QALICB during the 7-year tax credit period. We believe that our suggestions for guidance will help clarify and minimize confusion related to current questions in the NMTC program. We appreciated the opportunity to submit comments originally and the opportunity to speak at the public hearing on this matter. We look forward to continuing the open dialogue regarding these issues and any others with the NMTC program.

1. Loan Loss Reserves.

The first proposal addresses the ability of the Community Development Entity (CDE) to make distributions funded by loan loss reserves held by the CDE if the Project Borrower (QALICB) is not making current interest payments. Interest payments made by the QALICB are used by the CDE to pay operating expenses and to make distributions to the Investment Fund/Investor (Fund). The distributions are used by the Fund to pay interest due with respect to a Leverage Loan (or the economic equivalent return on an equity investment) and pay operating expenses. Under the existing regulations, if a CDE has cash reserves set aside for loan losses it cannot distribute such funds if the interest income due from the QALICB to the CDE cannot be accrued or if it is uncertain as to its ability to accrue the interest income. This will result in a payment default on its leveraged loan by the Fund. The request is to clarify that a CDE can use loan loss reserves for their intended purpose in the event of a payment default by a QALICB without regard to the accrual of the interest income for federal income tax purposes. The proposed amendment will allow the CDE to provide patient capital to the QALICB and avoid enforcement action during periods of financial distress.

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The proposed modification to the Operating Income Safe Harbor is as follows:

Proposed Amendment to Treas. Reg. Section 1.45D-1(e)(3)(iii):

For purposes of this paragraph (e)(3)(iii), with respect to any taxable year, "operating income" is the sum of:

(A) The CDE's taxable income as determined under Section 703, except that –

(3) Interest income with respect to a loan that is a qualified low-income community investment that is not accrued for federal income tax purposes in connection with a payment default shall be included in the CDE's taxable income up to an amount equal to the CDE's loan loss reserve maintained in compliance with paragraph (d)(3) of this section.

(iv) Example. – The application of paragraph (e)(3)(iii)(A) is illustrated by the following example:

Example. (i) X is a partnership and a CDE that has received a new markets tax credit allocation from the Secretary. Y acquires a qualified equity investment of $10 million in X. X uses the proceeds of Y's qualified equity investment to establish a $500,000 loan loss reserve held by X and to make a $9,500,000 loan that is a qualified low-income community investment to B. B is a qualified active low-income community business. In the year ended December 31, 2008, B is unable to make required interest payments of $600,000. X does not accrue the unpaid interest as taxable income for federal income tax purposes. X can include $500,000 of unpaid interest in *operating income* and distribute up to $500,000 from the loan loss reserve to Y.

2. Losses

Under the existing operating income safe harbor, losses realized from equity investments in QALICBs taxed as partnerships adversely impact a CDE's operating income during periods of economic distress. For example, if a QALICB is incurring losses due to delays in lease-up or vacancies of a commercial rental building, the CDE partner will be allocated losses that may prevent distributions by the CDE of interest payments received from the QALICB in compliance with the safe harbor. If the QALICB is taxed as a corporation, such losses would not impact the CDE's operating income. The amendment proposed facilitates equity investments by the CDE and allows the CDE to provide patient capital to the QALICB, in particular during periods of economic distress. The proposed amendment provides that losses allocated to the CDE with respect to equity investments in QALICBs taxed as partnerships do not reduce operating income to the extent such losses exceed the cumulative taxable income allocated to the CDE with respect to the equity investment.

In addition, in combined historic and new markets tax credit transactions, the CDE may be the sole owner of the operator of a rental real estate property leased from the QALICB (a disregarded entity for federal tax purposes), and may recognize losses during startup operations and periods of economic distress, for example due to rental vacancies or delays in lease-up. Such expenses incurred by the CDE will reduce the CDE's operating income and may prevent distributions by the CDE in compliance with the operating income safe harbor. The proposed amendment below provides that losses recognized by the CDE with respect to equity investments in disregarded entities do not reduce operating income to the extent such losses exceed the CDE's cumulative taxable income recognized by the CDE with respect to the equity investment.

The proposed amendment to the definition of "operating income" is as follows:

Proposed Amendment to Treas. Reg. Section 1.45D-1(e)(3)(iii):

For purposes of this paragraph (e)(3)(iii), with respect to any taxable year, "operating income" is the sum of:

(F) losses (excluding deductions included in operating income pursuant to paragraph (e)(3)(iii) without regard to this paragraph (e)(3)(iii)(F)), but only to the extent that such losses are realized by the CDE from an equity investment in an entity that is either a partnership or disregarded entity for federal income tax purposes, and such losses exceed the CDE's cumulative taxable income realized from such equity investment.

(iv) Example. – The application of paragraph (e)(3)(iii)(F) is illustrated by the following examples:

Example. (i) X is a calendar year partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On January 15, 2008, Y acquires a qualified equity investment in X. On January 15, 2008, X uses the proceeds of Y's equity investment to make qualified low-income community investments that consist of a loan and an equity investment in B. X has a 49% interest in all partnership items of B. B is a qualified active low-income community business and a partnership for federal income tax purposes. B is required to make $250,000 in annual interest payments to X. For the year ended December 31, 2008, B realizes net tax losses of $400,000 (including $250,000 of interest expense and $150,000 of other operating expenses). B uses $400,000 of loan proceeds held in a working capital reserve to pay the operating expenses. For the year ended December 31, 2008, X's interest income is $250,000 and X's losses allocated from B are $196,000 (49% of $400,000). Under paragraph (e)(3)(iii)(F) of this section, $196,000 would be added to X's *operating income* for the year ended December 31, 2008, since such losses exceed X's cumulative taxable income realized from its equity investment in B.

3. CDE Expenses – QLICI Defaults

A CDE may incur unanticipated expenses if a QALICB is in default, for example, in connection with restructuring a QLICI or exercising remedies. These unanticipated, extraordinary expenses may reduce the CDE's operating income such that the CDE cannot make distributions in compliance with the operating income safe harbor. The proposed amendment below allows the CDE to add back expenses incurred in connection with QLICI defaults.

The proposed amendment to the definition of "operating income" is as follows:

Proposed Amendment to Treas. Reg. Section 1.45D-1(e)(3)(iii):

For purposes of this paragraph (e)(3)(iii), with respect to any taxable year, "operating income" is the sum of:

(G) losses (excluding deductions included in operating income pursuant to paragraph (e)(3)(iii) without regard to this paragraph (e)(3)(iii)(G)), but only to the extent that such losses are realized by the CDE with respect to servicing a qualified low-income community investment if the qualified active low-income community business is in default or is experiencing financial difficulties that are reasonably likely to cause a default with respect to the qualified low-income community investment.

(iv) Example. – The application of paragraph (e)(3)(iii)(G) is illustrated by the following example:

Example. X is a calendar year partnership and a CDE that has received a new markets tax credit allocation from the Secretary. On January 15, 2008, Y, a calendar year taxpayer, acquires a qualified equity investment in X. On January 15, 2008, X uses the proceeds of Y's equity investment to make qualified low-income community investments that consist of a loan and an equity investment in B. X has a 49% interest in all partnership items of B. B is a qualified active low-income community business. During 2008, B fails to perform as required under agreements entered into with X. As a result of such failures to perform (i.e., defaults), for the year ended December 31, 2008, X incurs $30,000 of attorneys' fees and travel expenses related to enforcement and/or restructuring of its qualified low-income community investments in B. X uses funds held in a loan loss reserve in compliance with paragraph (d)(3) of this section to pay the additional expenses incurred due to B's defaults. Under paragraph (e)(3)(iii)(G) of this section, to the extent X's additional operating expenses due to B's defaults are deductible, up to $30,000 would be added to X's *operating income* for the taxable year ended December 31, 2008.

4. QLICI Reinvestment - CDE expenses

As discussed above, a CDE may incur unanticipated expenses related to the restructuring of a QLICI that is in default or a QALICB that is experiencing financial difficulties that are reasonably likely to cause a default. Above, we proposed an amendment to allow a CDE to add back these extraordinary expenses in the calculation of operating income. We further recommend that the amount of proceeds received by a CDE in payment of, or for, capital, equity or principal that must be reinvested be reduced by these expenses since they are directly attributable and are only incurred when there is a troubled QLICI.

The proposed amendment to the reinvestment requirement is as follows:

Proposed Amendment to Treas. Reg. Section 1.45D-1(d)(2)(i):

(d)(2)(i) In general. Except as otherwise provided in this paragraph (d)(2), amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment must be reinvested by the CDE **(net any expenses realized by the CDE with respect to servicing a qualified low-income community investment if the qualified active low-income community business is in default or is experiencing financial difficulties that are reasonably likely to cause a default with respect to the qualified low-income community investment)** in a qualified low-income community investment no later than 12 months from the date of receipt to be treated as continuously invested in a qualified low-income community investment. If the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph (d)(2)(i), an amount at least equal to such original cost basis, then an amount equal to such original cost basis will be treated as continuously invested in a qualified low-income community investment. In addition, if the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph (d)(2)(i), an amount less than such original cost basis, then only the amount so reinvested will be treated as continuously invested in a qualified low- income community investment. If the amounts received by the CDE are less than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests an amount in accordance with this paragraph (d)(2)(i), then the amount treated as continuously invested in a qualified low-income community

investment will equal the excess (if any) of such original cost basis over the amounts received by the CDE that are not so reinvested. Amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment during the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section) do not have to be reinvested by the CDE in a qualified low-income community investment in order to be treated as continuously invested in a qualified low-income community investment.

(iv) Examples. – The application of paragraph (d)(2)(i) is illustrated by the following example:

Example 2. On April 1, 2003, A, B, and C each pay $100,000 to acquire a capital interest in X, a partnership. X is a CDE that has received a new markets tax credit allocation from the Secretary. X treats the 3 partnership interests as one qualified equity investment under paragraph (c)(6) of this section. In August 2003, X uses the $300,000 to make a qualified low-income community investment under paragraph (d)(1) of this section. In August 2005, the qualified low-income community investment is defaulted on. X pays legal fees of $20,000 in restructuring the defaulted loan. The original $300,000 qualified low-income community investment is redeemed for $250,000. In February 2006, X reinvests $230,000 of the $250,000 in a second qualified low-income community investment and uses the remaining $20,000 for the legal fees incurred as a result of the defaulted loan. Under paragraph (d)(2)(i) of this section, $300,000 of the proceeds of the qualified equity investment is treated as continuously invested in a qualified low-income community investment because the $20,000 used to pay costs in connection with restructuring or exercising remedies for the defaulted qualified low-income community investment are not required to be reinvested.

5. <u>Working Capital</u>

In our previous comments, we recommended that the reasonable working capital regulations be amended to allow proceeds to be expended for construction of real property within a 24 month period after the date a qualified low-income community investment ("QLICI") is made, rather than just 12 months. Our recommendation was based upon common industry practice that when an investor makes a qualified equity investment ("QEI") in a community development entity ("CDE"), it will generally require those funds be nearly simultaneously invested or loaned to a qualified project in the form of a QLICI. While a CDE has the ability to hold onto the QEI proceeds up to 12 months after receiving them before substantially all of the proceeds must be invested, it is not common practice for QEI investors to allow CDEs to do so. Investors believe that the risk associated with their investments increases the longer their proceeds remain uninvested. For this reason, we requested that the time period that the qualified active low-income community business ("QALICB") could hold the QLICI proceeds be extended to 24 months since 12 months was proving to be too short for many construction projects. If the 12 month period isn't changed, CDEs will be forced to make QLICIs in tranches in order to avoid having cash at the QALICB for periods of more than 12 months. Since, QLICIs will need to be made in tranches, investors will generally prefer to make their QEIs in corresponding tranches to avoid having the QEI proceeds remain uninvested. This creates an unnecessary and expensive burden on both the CDE and the QALICB. In nearly every case this decreases the amount of proceeds that makes it to the qualified project due to the increased transaction costs.

Conclusion

We commend the Department of Treasury and Internal Revenue Service for its continuing efforts to improve and clarify tax guidance for the NMTC program in order to ensure its continuing success. We are excited about the positive impact that the NMTC program is having on the nation's low-income communities and low-income persons and the potential the program has to be an economic stimulus in our low-income communities. We appreciate the opportunity to submit our clarifications for these issues regarding the NMTC regulations. We believe that further guidance on these issues is essential to sustain and increase the impact of the NMTC program on low-income communities. Thank you in advance for your time and consideration.

Please do not hesitate to contact us if you have any questions regarding our comments or if we can be of further assistance.

Yours very truly,
Novogradac and Company LLP

Michael J. Novogradac,
along with the undersigned

Novogradac and Company LLP

Brad Elphick,

Ruth Sparrow
Future Unlimited Law PC

Notice 2013-22

MAY 2 2013

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

May 1, 2013

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

VIA EMAIL to Notice.Comments@irscounsel.treas.gov

RE: Notice 2013-22, Recommendations for 2012-2013 Guidance Plan

To Whom It May Concern:

Thank you for the opportunity to recommend for inclusion on the Department of Treasury/Internal Revenue Service (IRS) 2013-2014 Priority Guidance Plan subjects critical to effective state administration of the Low Income Housing Tax Credit (Housing Credit) and Tax Exempt Bond programs.

As the Washington representative of the agencies that administer the Housing Credit and Bond programs, including the MCC program, in all 50 states, the District of Columbia, New York City, Puerto Rico, and the U.S. Virgin Islands, the National Council of State Housing Agencies (NCSHA) appreciates the Treasury Department's and IRS' expert oversight of these programs, your continued cooperative attitude toward NCSHA and state housing agencies, and your timely provision of program guidance.

To support continued effective state administration of the Housing Credit and tax-exempt Housing Bonds, we urge you to issue the following guidance as quickly as possible.

(1) Guidance concerning the exception under §42(d)(6) for any federally or State assisted building.

The Housing and Economic Recovery Act of 2008 exempts federally- or state-assisted buildings from the 10-year prior placement in service rule under §42(d)(2)(B)(ii). The term federally-assisted building means any building which is substantially assisted, financed or operated under section 8 of the United States Housing Act of 1937, section 221(d) (4), or 236 of the National Housing Act, Section 515 of the Housing Act of 1949 or any other housing program administered by the Department of Housing and Urban Development or by the Rural Housing Service of the Department of Agriculture. The term state-assisted building means any building which is substantially assisted, financed, or operated under any State law similar in purposes to

any laws relating to the definition of federally-assisted building. We urge the IRS to promptly issue guidance concerning how it defines "substantially" in this context, keeping in mind the need for as much flexibility as possible.

(2) Regulations concerning utility allowances under §42(g)(2)(B)(ii) for sub-metered buildings.

NCSHA urges the IRS to issue final guidance concerning utility allowance calculations for Housing Credit developments that sub-meter. In prior comments on proposed utility allowance regulations, NCSHA has expressed its appreciation that regulations generally allow for more accurate utility allowance determinations, provide greater flexibility to make such determinations, and help HFAs promote energy efficiency in Housing Credit properties. We have also maintained that more accurate utility allowances help keep Housing Credit properties financially sustainable. We reiterate these principles and urge the IRS to ensure that any final guidance concerning utility allowances for sub-metered buildings does not impose any unnecessary administrative burdens or complexity on HFAs.

(3) Regulations concerning §1.42-5 for compliance monitoring

Last year, the IRS issued proposed regulations concerning HFA Housing Credit monitoring procedures, in response to which NCSHA submitted comments suggesting a number of changes to the physical inspection and tenant file review requirements. To ensure that the Section 1.42-5 regulations continue to provide an efficient framework for compliance with Section 42 and provide the information necessary for IRS oversight, while allowing the greatest possible efficiency and effectiveness for the agencies charged with compliance monitoring, we urge IRS to issue final regulations as soon as possible, consistent with NCSHA's comments submitted in response to Notice 2012-18.

(4) Regulations concerning record retention requirements under §103 for tax-exempt bonds.

NCSHA urges the IRS to issue final guidance concerning the length of time issuers of tax-exempt bonds must maintain loan files. The IRS last requested comments on this issue in Notice 2006-63 but has not since issued final regulations. The current rules, requiring issuers to maintain loan records for the life a bond issue, as well as any refundings of that bond issue plus an additional 6 years, regardless of when the loan is paid off, generate excessive compliance costs, particularly with regard to older loans which are not stored electronically.

(5) Public hearing requirements under §147(f) for issuance of tax-exempt bonds.

On September 9, 2008, the IRS issued proposed regulations that would simplify the public approval requirements applicable to tax-exempt private activity bonds issued by state and local governments. The proposed regulations would permit the use of electronic notifications if a state's opening meeting laws so allow and cut in half the public notice requirement from 14 to 7

days. The proposed regulations are, however, applicable only after publication of final regulations and may not be applied until such time. NCSHA urges the IRS to issue final regulations consistent with the proposed changes referenced above, allowing HFAs to save time and money while bringing the federal rules in line with current technology and state laws.

NCSHA recommends that the IRS issue guidance on the above referenced items as soon as possible this year, as well as other guidance it believes necessary for the efficient implementation of the Housing Bond and Credit programs.

Thank you for this opportunity to provide input on the Department of Treasury/Internal Revenue Service 2013-2014 Priority Guidance Plan.

If you have any questions, please do not hesitate to contact me.

Sincerely,

Garth Rieman
Director, Housing Advocacy and Strategic Initiatives

Notice 2013-22

Johnson Regina L

From: Kien Liew <kien.liew@automatedpensions.com>
Sent: Tuesday, January 14, 2014 3:32 PM
To: Notice Comments
Cc: 'Mark Cavazos'
Subject: Notice 2013-22
Attachments: IRS Memo_20020606.pdf

JAN 15 2014

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

Dear Sir or Madam:

We recommend adding IRS Reg. §1.401(a)(26)-3(c)(2) on meaningful benefits to the Guidance Priority List.

The IRS has relied on an internal memorandum from Paul Shultz dated June 6, 2002 (memo attached) to apply penalty against a pension plan. This memo is not a public document. The use of this memo is not consistent with the IRS policy, leads to unequal applications, and leads to confusion among the taxpayers and their consultants.

Specifically:

1. The use of this memo is inconsistent with Executive Orders 12866 and 13563. For example, Section 6(a)(1) of Executive Order 12866 states, "Each agency shall (consistent with its own rules, regulations, or procedures) provide the public with meaningful participation in the regulatory process." This memo shows no evidence of any public participation.

2. The use of this memo is inconsistent with Internal Revenue Manual Part 32 - Published Guidance and Other Guidance to Taxpayers. Paragraph 32.1.1.1.3 states "Chief Counsel's primary means of providing correct and impartial interpretation of the internal revenue laws is through published guidance." Further, paragraph 32.1.1.1.4 states "The Office of Associate Chief Counsel is solely responsible for issuing published guidance." This memo does not appear to come from the Office of Associate Chief Counsel.

3. The IRS has misread the memo. The IRS has taken the position that the memo was issued "to define the minimum benefit accrual at .5% projected to Normal Retirement Age." In the two paragraphs where 0.5% of compensation is discussed, neither the word "define" or any derivation (except for its use as part of "defined benefit plan")nor the word "require" or any derivation appears. Only the more passive statement "questions should be asked" appears. We have requested that the IRS highlight the section of the memo where the definition occurs, but ***the IRS has not cooperated with this request***.

4. There is an inconsistency in application. We are aware of at least one case where the IRS has issued a favorable determination letter when the accrual rate was less that 0.5% of compensation. In that case, the IRS followed the memo and asked about the benefit accrual rate to which the actuary responded satisfactorily.

Please let us know if you need additional information or if you have any questions.

Respectfully,

Kien Liew, EA, FCA, MAAA
Consulting Actuary

Tel: 214.315.4279

Cordially,

Mark A. Cavazos

PensionBenefits
Total HR & Benefits Solutions
Tel: 972.424.2230 ext. 611
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June 6, 2002

MEMORANDUM FOR MANAGER, EP DETERMINATIONS QUALITY ASSURANCE

FROM: Paul T. Shultz, Director
Employee Plans, Rulings and Agreements

SUBJECT: Section 401(a)(26) Issue Arising in Cash Balance Plan Determination Letter Applications

Questions have been raised about whether certain newly established defined benefit plans with cash balance formulas provide "meaningful benefits" for employees. It has come to our attention that certain cash balance plans provide vastly different benefits for shareholder and non-shareholder employees (e.g., (1) an annual hypothetical allocation of $45,000 for the shareholder and $100 for the non-shareholder employees, or (2) an annual hypothetical allocation of $45,000 for the shareholder and 1 ½ % of compensation for the non-shareholder employees). The issue is whether such plans satisfy section 401(a)(26) of the Code. More specifically, the issue is whether the plans provide meaningful benefits as required under section 1.401(a)(26)-3 of the regulations.

Relevant Law

A qualified defined benefit plan must satisfy section 401(a)(26) of the Internal Revenue Code (Code). To satisfy section 401(a)(26), a plan must benefit at least the lesser of (i) 50 employees of the employer, or (ii) the greater of 40 percent of all employees of the employer, or 2 employees (or if there is only 1 employee, such employee). For these purposes, a plan may exclude from consideration employees described in paragraphs (3) and (4)(A) of section 410(b) of the Code. See Code sections 410(b)(3) and 410(b)(4)(A) and regulation section 1.410(b)-6 for definitions of excludable employees.

Section 1.401(a)(26)-3(a) of the Income Tax Regulations provides that a defined benefit plan that does not meet one of the exceptions in section 1.401(a)(26)-1(b) must satisfy section 1.401(a)(26)-3(c) with respect to its prior benefit structure. A plan's prior benefit structure satisfies that paragraph if the plan provides "meaningful benefits" to a group of employees that includes the lesser of 50 employees or 40 percent of the employer's employees. A plan will satisfy this requirement if at least 50 employees or 40 percent of the employer's employees currently accrue meaningful benefits under the plan, or if at least 50 employees and former employees or 40 percent of the employer's employees and former employees have meaningful accrued benefits under the plan.

A newly established defined benefit plan that does not meet one of the exceptions in section 1.401(a)(26)-1(b) must satisfy section 1.401(a)(26)-3(c). Section 1.401(a)(26)-3(c)(2) of the regulations provides that whether a plan is providing meaningful benefits, or whether individuals have meaningful accrued benefits under a plan, is determined on the basis of all the facts and circumstances. The relevant factors in making this determination include, but are not limited to, the following:

- the level of current benefit accruals;
- the comparative rate of accruals under the current benefit formula compared to prior rates of accrual under the plan;
- the projected accrued benefits under the current benefit formula compared to accrued benefits as of the close of the immediately preceding plan year;
- the length of time the current benefit formula has been in effect;
- the number of employees with accrued benefits under the plan; and
- the length of time the plan has been in effect.

A plan does not satisfy the meaningful benefit requirement if the facts and circumstances indicate that the plan exists primarily to preserve accrued benefits for a small group of employees and functions more as an individual plan for the small group of employees or for the employer.

Section 1.401(a)(26)-5 of the Income Tax Regulations provides that, generally, an employee is treated as benefiting under a plan for a plan year if and only if, for that plan year, the employee would be treated as benefiting under the provisions of regulations section 1.410(b)-3(a), without regard to section 1.410(b)-3(a)(iv). A former employee is treated as benefiting for a plan year if and only if the former employee would be treated as benefiting under the rules in section 1.410(b)-3(b).

Section 1.401(a)(26)-5(a)(2) of the Income Tax Regulations provides for the determination of whether a plan provides meaningful benefits in the case of a benefit offset arrangement. In this case, however, the requirements under 1.401(a)(26)-5(a)(2)(ii) or (iii) must be satisfied (relating to sequential or concurrent offset arrangements).

Application of Relevant Law

If a plan is a newly established defined benefit plan, there are no prior rates of accrual under the plan with which to compare current benefit accruals. Thus, when such a plan applies for a determination letter, whether the plan satisfies the meaningful benefit requirements of section 401(a)(26) of the Code and section 1.401(a)(26)-3(c) of the regulations must be determined by taking the benefits provided under the plan in the first plan year into consideration. For this purpose, the accrued benefits under a cash balance plan should be tested on a benefits basis (by crediting the hypothetical accounts with the hypothetical interest to the participant's normal retirement age, and

converting the resulting hypothetical account balance to an actuarially equivalent annuity benefit commencing at the same age). In the following examples, the effect of the type of formulas about which questions have been raised on the accrual rates of a group of participants is demonstrated. The accrual rates are calculated by dividing the participant's annuity benefit at normal retirement age by the participant's compensation. These examples are similar to actual cases in which this issue has been raised.

PLAN	SHAREHOLDER ALLOCATION	SHAREHOLDER ACCRUAL RATE (% of Comp.)	ALLOCATIONS FOR OTHER ELIGIBLE EMPLOYEES	OTHER EE'S ACCRUAL RATE RANGE (% of Comp.)
X	$45,000	5.99%	$100	0.03% - 0.37%
Y	$45,000	4.55%	1.25% of pay	0.24% - 0.60%

Some cash balance plans that have been submitted contain a provision that offsets the benefit provided under the cash balance plan by the benefit provided under a profit sharing plan maintained by the same employer. Under this kind of arrangement, there may be participants who do not receive any allocation to their hypothetical account balance (especially during the early years of the cash balance plan) because their accrued benefit under the cash balance plan is completely offset by their benefit under the profit sharing plan. It will be necessary to insure that the requirements of sections 1.401(a)(26)-5(a)(2)(ii) or (iii) of the regulations are satisfied prior to applying section 1.401(a)(26)-5(a)(2) to determine whether the cash balance plan provides meaningful benefits. Note that these rules will not be satisfied if the offset applies for some participants (usually non-highly compensated participants) but not all participants.

Conclusion

The extremely low accrual rates for all of the non-shareholder employees in Plan X and the majority of the non-shareholder employees in Plan Y suggest that Plan X and Plan Y do not provide meaningful benefits for the non-shareholder employees. The wide difference in the accrual rates for the shareholder and the non-shareholders suggest that the plans exist primarily to provide accrued benefits for the shareholder(s) and function more as an individual plan for the shareholder.

In general, where a defined benefit plan that is tested on a benefits basis is found to provide much larger benefit accruals to shareholders (or other principals) and benefit accrual rates of less than one-half of one percent (0.5%) of compensation (per year of participation or service) for non-shareholder employees, the questions of whether the plan provides meaningful benefits and whether the plan exists primarily to benefit shareholders should be raised when reviewing determination letter applications.

The facts and circumstances of each case must be taken into consideration. Determination cases with this issue should be processed in the area offices, taking the facts and circumstances into account to determine whether the plan provides meaningful benefits to at least the lesser of (1) 50 employees, or (2) the greater of 40 percent of all employees or 2 employees (1 employee if there is only 1 employee). (For these purposes, fractional parts of a number of employees are rounded up to the next whole number: e.g., 5.2 employees are rounded to 6 employees.) Technical advice may be requested in accordance with the usual procedures if deemed appropriate.

Additional Comments

Although this memorandum focuses on cash balance plans, questions of whether a plan provides meaningful benefits and whether a plan exists primarily to benefit shareholders should also be raised when reviewing determination letter applications for defined benefit plans that do not have cash balance formulas but provide much larger benefit accruals for shareholders (or other principals) and, when tested on a benefits basis, have benefit accrual rates of less than one-half of one percent (0.5%) of compensation (per year of participation or service) for non-shareholder employees.

Notice 2013-22

From: Pam Perdue <PPerdue@summerscomptonwells.com>
Sent: Saturday, March 23, 2013 2:34 PM
To: Notice Comments
Subject: Notice 2013-22

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS BRANCH

The following is in response to Notice 2013-22 inviting comments and/or recommendations for items that should be included in the 2013-2014 Guidance Priority List.

It is recommended that IRS/Treasury issue interim relief expanding the relief provided in Announcement 2011-81 to expressly provide that affected IRAs will be treated as tax exempt until final guidance is issued. While Announcement 2011-81 provides relief temporarily from the collection of the prohibited transaction excise tax, in the absence of an interim statement of tax exemption, IRAs are being aggressively targeted in the bankruptcy setting and may ultimately result in targeting by judgment creditors as well. This is because relief for bankruptcy purposes requires tax exemption and, in the absence, material compliance or if not, then a demonstration that the failure to be exempt is not the fault of the taxpayer. I recently worked with an attorney attempting to argue for exemption for his client's IRA where the provider had included, unbeknownst to the taxpayer, the type of language found to result in the loss of exemption in the In re Daley case. Because there is no way to "undue" or correct a prohibited transaction in the context of an IRA, the fact that the IRAs may now be reflected on documents without the language does not keep the IRA from being challenged. However, it does now keep most individuals from having standing to file suit currently.

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Notice 2013-22

SEP 4 2013

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
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Steptoe
STEPTOE & JOHNSON LLP

August 27, 2013

AUG 30 PM 1:26

The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Mr. Daniel Werfel
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Regulations under Section 7874

Dear Assistant Secretary Mazur and Acting Commissioner Werfel:

We submit these comments regarding the possible issuance of regulations under Section 7874 of the Internal Revenue Code. Our comments address proposed rules implementing Notice 2009-78, 2009-40 IRB 452 (the "Notice"), relating to surrogate foreign corporations, listed in the 2013-2014 Priority Guidance Plan. We appreciate the Treasury Department's thoughtful consideration of the difficult issues raised in implementing this complex statute in accordance with Congress's intentions and welcome this opportunity to comment on a narrow but important issue. Our comments focus on the need for the effective date of the regulations to include a grandfather clause for transactions that were subject to a binding commitment prior to the date of the Notice. Such a rule is required to make any regulations issued both fair and consistent with past Treasury practice.

Section 7874 provides that a foreign corporation may be treated as a domestic corporation for U.S. tax purposes if it meets three tests, including an "Ownership Test." Notice 2009-78 states that the IRS and Treasury intend to issue regulations providing that, among other things, stock issued in exchange for cash is not taken into account for purposes of the Ownership Test of Section 7874. The Notice states that such regulations would be effective for all transactions that closed after September 17, 2009, the date of the issuance of the Notice.

We urge that any proposed, temporary or final regulations implementing the Notice include a grandfather clause for transactions that were subject to a binding contract at the time of the Notice. Because the rule of the Notice is inconsistent with both the language of the statute and its legislative history, a taxpayer acting in good faith could not have reasonably anticipated that the Notice would be issued. Fairness thus requires that any regulations implementing it must be prospective from the date of the Notice, and not negatively impact transactions to which taxpayers were legally committed at the time of its publication. Moreover, other notices regarding Section 7874 and in numerous other international tax contexts have included a grandfather clause for transactions subject to a binding contract as of the notices' effective dates, and that practice should be followed here as well. Even notices and regulations targeted only at related party transactions that the IRS and Treasury deemed to be for the purpose of tax-avoidance include a grandfather clause.[1] We recognize that the Notice purports to target purported abuses. However, it applies far beyond the narrow class of abusive transactions and sweeps in business-driven transactions that Congress never intended to be within the scope of Section 7874, which further mandates that it include a grandfather rule to protect those legitimate transactions from its broad reach.

I. Section 7874

Under Section 7874, a foreign entity may be treated as a domestic corporation for U.S. tax purposes in certain instances (Section 7874(b)), or a U.S. corporation that "inverts" to become a foreign corporation may be subject to a tax on certain built-in gains as it exits the United States (Section 7874(a)). Section 7874 treats a foreign entity as a domestic entity for tax purposes where the foreign entity acquires stock in, or assets of, a U.S. corporation in a transaction that meets certain requirements.

In order for Section 7874 to apply, the foreign corporation must meet each of three tests:

- Ownership Test: This test requires that 60 percent (or 80 percent, in the case of Section 7874(b)) of the interests in the foreign corporation be held by the prior owners of the domestic corporation, and that those owners received their interests "by reason of" their prior interests in the domestic corporation.[2]

[1] For example, see Notices 2006-85 and 2007-48 and T.D. 9615 and 8876, discussed in section III.C below.

[2] Under this test, the percentage of ownership received by reason of ownership of the prior entity is determined by analyzing a fraction, the numerator of which is the interests in the new entity received by owners of the old entity by reason of their prior ownership interests, and the denominator of which is all interests in the new entity. Under the statute, interests received for (Continued...)

- Substantially All Test: This test requires that the foreign corporation have acquired "substantially all" of the assets of the domestic corporation for Section 7874 to apply.
- Substantial Business Activities Test: This test requires that "the expanded affiliated group which includes the entity does not have substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of such expanded affiliated group."

In calculating stock ownership for purposes of the Ownership Test, Section 7874(c)(2)(B) instructs that one disregards "stock of such foreign corporation which is sold in a public offering related to the acquisition."

II. <u>Notice 2009-78</u>

On September 17, 2009, the IRS and Treasury issued the Notice, which purports to provide guidance on which ownership interests are not taken into account for purposes of the Ownership Test. The Notice provides that stock issued in exchange for cash, even in a private placement, is not taken into account for purposes of the Ownership Test. It states that the IRS and Treasury intend to issue regulations that "provide that stock of the foreign corporation issued in exchange for 'nonqualified property' ... is not taken into account for purposes of the Ownership Condition, without regard to whether such stock is publicly traded on the date of issuance or otherwise." The Notice defines the term "nonqualified property" to include cash. It states that it was promulgated because of certain transactions about which the IRS had become aware that were structured using the sale of stock to investors so as to avoid the application of Section 7874.

The effect of the Notice is to increase the percentage of shares received by reason of prior ownership because it reduces the denominator by disregarding interests received for cash. Imagine a situation in which 20 percent of the interests in a new entity are received by reason of prior ownership and 80 percent are received for cash in a private placement. Under the statute, the percentage of interests received "by reason of" would be 20/100 or 20 percent. Under the Notice, the percentage would be 20/20 or 100 percent, because the 80 percent acquired for cash would be disregarded from the denominator, and the Ownership Test would be satisfied.

---

cash in a public offering are not included in the denominator, thereby increasing the percentage of ownership interests received by reason of prior ownership.

The Notice states that the "regulations described in this notice shall apply to acquisitions completed on or after September 17, 2009," the date of issuance of the Notice. It does not provide any grandfather clause for transactions that were subject to a binding commitment, but not yet completed. As a result, it purports to apply to transactions that close after September 17, 2009, even if the parties were contractually committed to consummate those transactions prior to that date. Likewise, by applying to all transactions involving the purchase of stock for cash, the Notice purports to cover transactions that were not structured for the purpose of avoiding the application of Section 7874, but rather for valid business reasons that required the investment of new capital. It thus reaches far beyond the abuse it purports to address.

III. Proposed Regulations Should Include a Grandfather Clause for Transactions Subject to Binding Commitments as of the Date of the Notice

We urge that any proposed, temporary, or final regulations include a grandfather clause excepting transactions that were subject to a binding commitment at the time of the issuance of the Notice. There are several reasons why such a provision is appropriate:

- Fairness requires that taxpayers have an actual opportunity to conform their transactions to new and fundamentally different interpretations of the law and not be subjected to a rule that they cannot avoid because they are legally bound to conclude the transaction at the time the rule is first announced;

- While the Notice purports to target transactions structured to avoid the purposes of Section 7874, its scope is broad and sweeps in transactions with substantial business purpose that are not structured to avoid the application of the Section;

- Prior notices regarding this statute, and a broad range of other international transactions, have included grandfather clauses, making inclusion of a grandfather clause in this context appropriate.

We address each of these reasons in turn, below.

A. Fairness Requires a Grandfather Clause to Protect Taxpayers From a Provision That They Could Not Reasonably Have Anticipated

Grandfather clauses exist because lawmakers recognize that it is unfair to apply a new rule to transactions to which the parties are contractually committed at the time the rule is announced, especially when the rule could not reasonably have been anticipated by the involved taxpayer. They provide taxpayers certainty that the treatment of a transaction will not be changed after the parties have bound themselves to it, particularly when the binding commitments are among unrelated parties. Not providing a grandfather clause causes a new rule to apply to transactions which are subject to binding commitments and cannot be undone. As the legislative history of Section 7805(b) explains, "the Committee believes that it is generally

inappropriate for Treasury to issue retroactive regulations." HR Rep. No. 506, 104th Cong., 2d Sess., at 44 (1996).

1. The Rule Established by the Notice is Inconsistent with Both the Language and the Legislative History of Section 7874

The rule established in Notice 2009-78 goes beyond the scope of Section 7874 and is inconsistent with the legislative history of the section. As a result, taxpayers acting in good faith could not have anticipated that the Notice would be issued. Since the Secretary's authority to promulgate this rule at all is questionable under both the language and legislative history of the statute, the rule in proposed regulations should include a grandfather clause for transactions subject to a binding commitment.

In calculating stock ownership for purposes of the Ownership Test, Section 7874(c)(2)(B) clearly instructs that one disregards stock sold *in a public offering*. Both basic logic and the widely followed canon of interpretation that the overt expression of one thing excludes all others indicate that that exception cannot be extended to cover stock sold in a private transaction. Hence, applying this exclusion to private placements would require legislative action. The Notice itself acknowledges that it goes beyond the scope of the statute, stating that that "[t]he regulations will identify stock of the foreign corporation that shall not be taken into account for purposes of the Ownership Condition, even if such stock may not otherwise be described in section 7874(c)(2)(B) ["stock ... sold in a public offering"]. The regulations will also clarify that certain stock, which may be described in section 7874(c)(2)(B), shall nonetheless be taken into account for purposes of the Ownership Condition."

In addition, the legislative history of the provision establishes that Congress specifically considered, and rejected, excluding shares purchased in a private placement. The Senate version of the bill had excluded private placements as well as public offerings, but this exclusion was removed from the final bill. Thus, taxpayers would have had no basis to anticipate the announcement of a rule purporting to disregard interests purchased for cash in a private placement in computing the "by reason of" percentage.

2. Because the Rule of the Notice is Inconsistent with the Language and Legislative History of Section 7874, it Should Not be Applied Retroactively

Because the language of Section 7874(c)(2)(B) is unambiguous, and on its face does not apply to private placements for cash, it would be grossly unfair to promulgate regulations that apply it to such private transactions on a retroactive basis. This is particularly true because the prior notice issued regarding Section 7874, discussed below, did include a grandfather clause in connection with different proposed regulations under Section 7874.

Furthermore, Notice 2009-78 was announced with no notice or opportunity to comment. There were no pronouncements from the IRS or Treasury prior to the Notice that forecast that the government would take the position reflected in the Notice. To apply it to transactions which the parties were legally bound to complete on the date of its announcement places taxpayers in the untenable position of having to breach binding contracts or face the draconian penalty of Section 7874, even with respect to non-abusive, business-driven deals for which application of Section 7874 could never have been anticipated.[3]

B. The Notice States that it is Targeted at Avoidance Transactions, But its Scope Includes Transactions with Significant Business Purpose

One exception to the general prohibition of retroactive regulations under Section 7805(b) applies when the rule addresses so-called abusive transactions. However, the rule announced by the Notice cannot be argued merely to be an anti-abuse provision because its provisions apply far more broadly than that and are not limited to abuse situations. The Notice states that its rule was aimed at transactions structured to avoid the application of Section 7874, and cites the authority granted by Section 7874(g) to issue regulations to prevent the avoidance of the purposes of Section 7874. However, the rule applies to Section 7874 indiscriminately, including against a taxpayer whose transaction required the private sale of ownership interests for valid business reasons, such as the need for invested capital to maintain its viability. Indeed, the broad language may apply to transactions driven by business exigencies, with only a modest overlap of shareholders between the domestic corporation and the foreign corporation, if a significant percentage of the new shares were purchased with cash and therefore excluded by the Notice. This is not the type of transaction that Section 7874 was intended to address.

For example, a U.S. corporation with a need for significant funding to ensure its viability could identify a single foreign investor who agrees to purchase a 50 percent equity stake in exchange for the investment, but conditions it on the company's reincorporating in the investor's home jurisdiction. Under the rule of the Notice, this 50 percent stake would be disregarded for purposes of the Ownership Test, even though it results in a substantial change in ownership, there was a significant business purpose behind its sale, and it evidences no intent to avoid the application of Section 7874. This is not what the statute intended.

It would not be appropriate, with no notice or comment, to apply Section 7874 to transactions which have substantial business purpose and look nothing like the inversion transactions contemplated by the legislative history and Treasury's 2002 report. *See* S. Rep. No. 108-192, 108th Cong., 1st Sess., at 142 (2003) (the Senate Finance Committee intended that

[3] If the IRS and Treasury are concerned about abusive transactions, they could provide that the grandfather clause will not apply to transactions without a *bona fide* business purpose where the private placement was inserted to avoid the application of Section 7874.

"inversion transactions resulting in a minimal presence in a foreign country of incorporation" that "permit corporations ... to continue to conduct business in the same manner as they did prior to the inversion... have little or no non-tax effect or purpose and should be disregarded for U.S. tax purposes."); U.S. Dep't of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions, Tax Policy Implications*, at 1 (May 2002) (describing an inversion as "a transaction through which the corporate structure of a U.S.-based multinational group is altered so that a new foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group. The transactional forms through which this reincorporation outside the United States can be accomplished vary as a technical matter, but all involve little or no immediate operational change," continuing that these transactions are "complicated technically but virtually transparent operationally.").

Moreover, the Notice itself likely shut down any avoidance transactions that had not closed before September 17, 2009. Any taxpayer that designed a tax-driven transaction to reorganize outside the United States that contemplated the sale of ownership interests for cash for the purpose of avoiding Section 7874 no doubt terminated the transaction in the face of the Notice. Hence, it is likely that the only transactions that continued were those with a substantial business purpose that were forced to proceed. Transactions that continued despite the Notice likely could not have been stopped and restructured in light of the Notice, because of forces beyond anyone's control, and the parties involved in those transactions could not have anticipated the Notice. There are likely a very small number of transactions that proceeded despite the Notice and to which a grandfather clause would apply. As a result, the primary impact of the Notice's retroactivity is likely on a few business-driven transactions and not on transactions structured to avoid the application of Section 7874, and therefore such retroactivity should not be permitted.

C. Other Notices Have Included a Grandfather Clause, Making it Appropriate Here as Well

Other notices issued under Section 7874 and in the international corporate context have included a grandfather clause for transactions subject to a binding contract. For example, in the Section 7874 context, Notice 2006-70 added a grandfather clause that had not originally been included in temporary and proposed regulations. On June 5, 2006, the IRS and Treasury issued temporary and proposed regulations under Section 7874. These temporary and proposed regulations applied to acquisitions completed on or after June 6, 2006. T.D. 9265 (June 5, 2006). Notice 2006-70, issued on July 28, 2006, provided that the final regulations would include a grandfather clause for transactions subject to a binding commitment prior to the date of the temporary and proposed regulations. Notice 2006-70, 2006-2 CB 252 (July 28, 2006).

Even those notices and regulations directed solely at transactions, among related parties, that the IRS and Treasury considered "avoidance" transactions ultimately included a grandfather clause for transactions that were subject to a binding commitment as of the date of the notice. Notices 2006-85 and 2007-48 addressed "Killer B" transactions, which the IRS and Treasury

believed to be avoidance transactions. The notices announced that the IRS would issue regulations under Section 367(b) addressing certain triangular reorganizations involving foreign corporations wherein a subsidiary exchanges property for parent stock used to acquire third party stock or assets. Both notices stated that they were effective for transactions that occurred on or after the date of the notice, but would not apply to transactions subject to a binding commitment as of the date of the notice, with certain other conditions. Notice 2006-85, 2006-2 CB 677 (Sept. 22, 2006); Notice 2007-48, 2007-1 CB 1428 (May 31, 2007).

In Notice 2008-10, the IRS and Treasury addressed "Deadly D" transactions, which they also believed to be avoidance transactions. This notice announced that they will clarify existing regulations under Section 367(a). Notice 2008-10, 2008-1 CB 277 (Dec. 27, 2007). Although the original notice stated that regulations would be effective for transactions occurring on or after the date of the notice's issuance, subsequent regulations implementing the rule provided in the notice were made effective as of the date of the publication of the regulations. T.D. 9615 (Mar. 19, 2013). *See also* Notice 2008-9, 2008-1 CB 277 (Dec. 21, 2007) (proposed regulations had included no grandfather clause for binding commitments; the notice announced that final regulations, when issued, would include such a grandfather clause, explaining that "[p]ractitioners have observed that the proposed effective date presents a significant burden on taxpayers attempting to negotiate transactions prior to the publication of the final regulations. The IRS and Treasury Department recognize that it is inappropriate to impose this level of uncertainty on taxpayers negotiating these transactions."); T.D. 8876 (Feb. 29, 2000) (temporary regulations under Section 6111 required the registration of confidential tax shelters offered for sale after the temporary regulations' issuance date, with the exception of sales that were pursuant to a binding contract executed prior to that date).

Given the IRS and Treasury's history of providing grandfather clauses, even for rules aimed solely at avoidance transactions, it is appropriate to include one here. It is unusual that the Notice did not include a grandfather clause, especially given that its rule sweeps in transactions that were not structured to avoid the application of Section 7874 but instead had substantial business purpose. There is no reason not to follow the precedent established by these prior pronouncements and grandfather transactions subject to a binding commitment as of September 17, 2009.

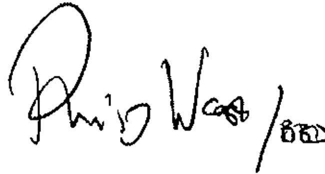
IV. Conclusion

Basic notions of fairness mandate that any regulations should include a grandfather clause for transactions subject to a binding commitment. The rule described in the Notice is outside the scope of the statute, and sweeps in transactions with substantial business purpose. Other notices that were aimed only at avoidance transactions provided such a grandfather clause; it would be unusual to not include one here. Not including a grandfather clause, without notice or opportunity to comment, will cause transactions that were not intended to be included in Section 7874 and had substantial business purpose to be subject to a harsh statute.

Steptoe
STEPTOE & JOHNSON LLP

Thank you again for the opportunity to comment on possible upcoming regulations. Please do not hesitate to contact us with any questions.

Sincerely,



Mark J. Silverman
Steptoe & Johnson LLP
Washington, DC

Philip R. West
Steptoe & Johnson LLP
Washington, DC

cc:
Emily McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Robert Stack, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
Danielle Rolfes, International Tax Counsel, Department of the Treasury
William Wilkins, Chief Counsel, Internal Revenue Service
Steven Musher, Associate Chief Counsel (International), Internal Revenue Service
Michael Danilack, Deputy Commissioner (International), LB&I, Internal Revenue Service

Notice 2013-22

From: Andrew Montagnola <andy2850@msn.com>
Sent: Saturday, March 23, 2013 9:07 AM
To: Notice Comments
Subject: recommendations on Notices

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

This is a great idea.

My thought may not help prioritize issues to describe, but I think it will help make the notices to be used more efficiently by readers.

In your "N-2013-22: Priority Guidance Plan Request for Recommendations" is a suggested recommendation as follows.

3. Whether the recommended guidance can be drafted in a manner that will enable taxpayers to easily understand and apply the guidance

Your synopsis at the beginning usually does not identify the main topic of the notice. For example, Innocent spouse, Depreciation, Investment Credit, etc. It would make it much easier for users of the service to read or dismiss the notice.

Thanks for the opportunity,
Andrew Montagnolo
former IRS agent.

Notice 2013-22

From: Dale Cook <dalemcook@hotmail.com>
Sent: Friday, March 22, 2013 4:01 PM
To: Notice Comments
Subject: N-2013-22: Priority Guidance Plan Request for Recommendations

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS BRANCH

I would like information on the following.

In 2013, the IRS will allow a home office deduction on $5 per square foot. This would be used instead of itemizing many home costs. It is a simplification of determining the dollar amount of the home office deduction.

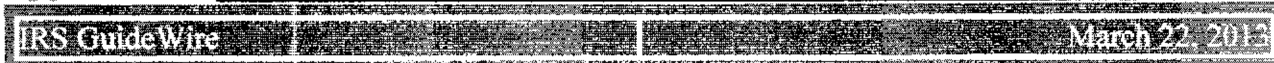
My question is: After using this $5 per square foot deduction for many years and then subsequently selling the personal residence / home, is there any recapture of the deduction back into income ?

Anything similar to recapturing home office depreciation previously taken upon the subsequent sale of the personal residence / home ?

Thanks

Subject: N-2013-22: Priority Guidance Plan Request for Recommendations
Date: Fri, 22 Mar 2013 13:21:08 -0500
To: dalemcook@hotmail.com
From: irs@service.govdelivery.com

SHARE



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Issue Number: N-2013-22

Inside This Issue

Notice 2013-22 invites the public to submit recommendations for items that should be included on the 2013-2014 Guidance Priority List. Notice 2013-22 will be published in Internal Revenue Bulletin 2013-15 on April 8, 2013.
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Notice 2013-22

From: Donna Davenport <donnadav33@yahoo.com>
Sent: Tuesday, February 25, 2014 6:04 PM
To: Notice Comments
Subject: Notice 2013-22

MAR 5 2014
LEGAL PROCESSING DIVISION
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BRANCH

It is not the business of the IRS, nor should it be, to make judgements on the merits of an individual's, or an organization's, political leanings or activities. So long as the organization meets the standards set forth in the *existing* law, they should be either approved or notified of the reason they were not approved so they have the opportunity to argue their points.

The federal government, and all its departments and bureaus, need to worry more about their own activities and expenditures and much less about those practices of private persons and organizations.

Sincerely,

Donna Davenport
Waller, TX

Notice 2013-22

From: Fred Nickerson <NickersonCPA@windstream.net>
Sent: Friday, March 29, 2013 6:30 PM
To: Notice Comments
Subject: Notice 2013-22

APR 1 2013
LEGAL PROCESSING DIVISION
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It would save IRS and practitioners and taxpayers a lot of time if you would develop a process to allocate jointly paid estimated taxes to separate returns. If the Ohio Department of Taxation can figure this out, why can't you?

Notice 2013-22

From: Gary Kincaid <gary_kincaid@msn.com>
Sent: Wednesday, February 26, 2014 11:31 AM
To: Notice Comments
Subject: NOTICE 2013-22

LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS BRANCH

FEB 27 2014

American citizens who are over the age of 65 and who had retired and then had to return to work because of a harsh economic environment, should have to pay LITTLE OR NO INCOME TAX. Having to pay income tax on Social Security and/or Pensions for which income which was previously taxed in absurd. Many of us are having to face a future that becomes more uncertain everyday. It is frightening to the max.

LEGAL PROCESSING DIVISION
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BRANCH

Notice 2013-22

JUN 2 1 2013

From: Martha Hutzelman <mhutzelm@insight.rr.com>
Sent: Thursday, June 20, 2013 11:00 AM
To: Notice Comments
Subject: Notice 2013-22 - Suggested New Items for 2013 - 2014 Guidance Priority List

TO: Mark Iwry and Victoria Judson

RE: Suggested New Employee Benefits Items for 2013 – 2014 Guidance Priority List

Since the ABA Tax Section May Meeting, several suggestions have come to our attention as new employee benefits items that we recommend be added to the Treasury/IRS 2013-2014 Guidance Priority List. I've listed these suggested new guidance items below. If you would like additional information regarding any of these items, please let me know.

Proposed additional employee benefits items for the Treasury/IRS guidance plan:

1) Guidance expanding the ability to make certain mid-year changes to "safe harbor" 401(k) plans under Code Section 401(k)(12) and (13) that will not result in the loss of safe harbor status.

2) Guidance addressing circumstances when in connection with a business transaction a "safe harbor" 401(k) plan under Code Section 401(k)(12) and (13) may be merged with either another "safe harbor" 401(k) plan or a non-"safe harbor" 401(k) plan and maintain safe harbor status.

3) Guidance on pension equity plans under the hybrid plan rules, such as under Code Section 411(b)(1), generally, and Code Section 411(b)(1)(G) (along with any open issues under Code Section 436 that apply to hybrid plans).

4) Guidance on affiliated service group under Code Section 414(m) including further definition of organization performing management functions under Code Section 414(m)(5).

5) Updated Code Section 4975 regulations regarding leveraged and unleveraged employee stock ownership plans.

6) Guidance permitting flexibility under 409A for time, form and amount of benefits under nonqualified deferred compensation plans to be adjusted in connection with say on pay votes.

Best,

Martha

Martha L. Hutzelman
Law Office of Martha L. Hutzelman
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New Albany, OH 43054
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Notice 2013-22

VENABLE® LLP

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MAY 2 2013
LEGAL PROCESSING DIVISION
PUBLICATION & REGULATIONS
BRANCH

May 1, 2013

VIA ELECTRONIC TRANSMISSION

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2013-22)

RE: Recommendations for 2013-2014 Guidance Priority List (Notice 2013-22)

Dear Sirs and Madams:

Pursuant to Notice 2013-22, we recommend that the Internal Revenue Service (the "Service") include, on the 2013-2014 Guidance Priority List, a revenue ruling or other guidance project clarifying the appropriate application of the rules under section 409A of the Internal Revenue Code (the "Code") to certain contingent compensation payment arrangements prevalent in various industries. In addition, we request that the revenue ruling or other guidance clarify the types of revenue that would be included in income when applying the 70% test in cases where a service provider is an independent contractor that provides significant services within the meaning of Treasury Regulation section 1.409A-1(f)(2)(iii). Furthermore, we recommend that the guidance examine specific issues relating to an employment agreement between a service provider, a service recipient, and a corporation, all of the stock of which is owned by a service provider (a "Loan-Out Corporation").

Guidance on this issue satisfies the standards set forth in Notice 2013-22 for the reasons set forth below.

1. The recommended guidance resolves significant issues relevant to many taxpayers. In the case of contingent compensation payment arrangements, the guidance will allow taxpayers and the Service to identify when a taxable event has occurred and to confirm that the penalties under Code section 409A do not apply. In addition, in the case of an independent contractor performing significant services for a service recipient, the guidance will clarify whether compensation paid to the independent contractor is subject to the rules under Code section 409A. Furthermore, the recommended guidance will assist taxpayers seeking to establish a Loan-Out Corporation and a service recipient entering into an employment agreement with the Loan-Out Corporation.

2. The recommended guidance promotes sound tax administration because it will allow taxpayers and the Service to confirm the appropriate tax rules that apply to common payment practices and employment agreements prevalent in various industries, and it will provide much-needed guidance on the timing of when a taxable event occurs.

3. The recommended guidance can be drafted in a manner that will enable taxpayers to easily understand and apply the guidance. This issue has been discussed with Service officials who, we believe, are comfortable that the proposed guidance does not involve drafting issues.

4. The recommended guidance does not involve outmoded regulations. Rather, the guidance would provide clarity where the current rules and regulations under Code section 409A are silent.

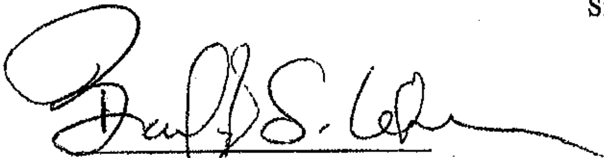
5. We believe the Service can administer the recommended guidance on a uniform basis where these compensation practices and employment agreements are prevalent.

6. The recommended guidance would reduce possible controversy and uncertainty for both taxpayers and the Service by eliminating any misunderstanding of how the current rules and regulations under Code section 409A apply to these common compensation practices and employment agreements.

Enclosed for your review is a draft document setting forth specific facts that describe the types of compensation practices and employment agreements that have been adversely impacted by Code section 409A, along with legal analyses and conclusions providing clarification as to the appropriate application of the rules under Code section 409A to the specific set of fact patterns.

Please do not hesitate to contact any of us at the below phone numbers if you have questions or if you need additional information. We would welcome the opportunity to meet with you to discuss the facts, legal analyses, and conclusions set forth in the enclosed document and/or any other issue of importance to you.

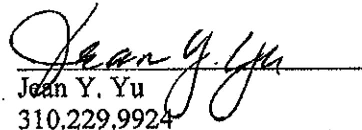
Sincerely,



Bradford S. Cohen
310-229-9942

Christopher E. Condeluci
202-344-4231

Alan J. Epstein
310-229-0346



Jean Y. Yu
310.229.9924

Enclosure

Proposed Revenue Ruling

Issues

1. Are payments of contingent compensation that are payable to a service provider and determined by reference to the timing of the receipt of certain payments by a service recipient subject to a risk of forfeiture for purposes of determining if the payments comply with Section 409A of the Internal Revenue Code of 1986, as amended (the "Code")?

2. If so, when is the determination made regarding whether the risk of forfeiture is substantial?

3. In determining whether a service provider is an independent contractor that provides significant services within the meaning of Treasury Regulations Section 1.409A-1(f)(2)(iii), what revenues are included for the taxable year in applying the 70% test?

Facts

A service provider has entered into an agreement to provide services to a service recipient. The agreement provides that the service provider is entitled to receive contingent compensation upon the service recipient's receipt of certain payments.

Situation 1:

In year 1, A ("service provider") enters into an agreement (the "agreement") with B ("service recipient") pursuant to which A will perform services for B in connection with the development and/or production (collectively, "development") of a product that will be sold, licensed, distributed and/or otherwise exploited (collectively, "sold") by B. The agreement between A and B provides that once A has performed the services required by the agreement, A will receive a fixed payment of $100x and a contingent payment equal to x% of B's receipts from the sale of the product by B, in any future year, in perpetuity, after B has recouped sales proceeds equal to certain costs and expenses that B has incurred in developing the product. The agreement specifically identifies these costs and expenses. A has no right, title or interest in the products that B will sell. A's right to receive such contingent payments will vest over the period of time when A is required to perform services. Once A has completed the performance of services, A's entitlement to receive contingent payments will be fully-vested.

Once B has recouped its costs and expenses, the agreement requires B to send a statement to A during the 90 day period after the end of each calendar year quarter, which calculates the amount that A is entitled to receive with respect to such reporting period, except with respect to the fourth calendar quarter, in which case the statement and payment must be sent to A during the period beginning January 1st and ending March 15th

of the following calendar year (such 90-day or other period, the "payment window") This payment window is required because B relies on information and collections received from the purchasers of B's product to determine the amount of the contingent compensation payable to A, if any, and has no control over when the purchasers provide such information.

In Year 1, A performs all of the services required under the agreement and receives a fixed payment of $100x. In Years 1 and 2, B does not owe any contingent compensation to A. In the first calendar year quarter of Year 3, B has recouped all of its costs and expenses and pays A $200k in contingent compensation, as required by the agreement, within the payment window following the end of such quarter in accordance with the statement for such quarter.

The product to be developed and sold by B is of the type that is regularly developed and sold by B in the ordinary course of B's business.

A is not an officer or a member of the Board of Directors of B. A also does not have effective control of B, the persons to whom B will sell the product, or the collection of the amounts due to B. A first has a legal right to payments from B in Year 1. The agreement provides that each payment made by B to A will be treated as a separate payment for purposes of Code Section 409A.

<u>Situation 2</u>:

The same facts as in Situation 1, except that B recoups all of its costs and expenses during the fourth calendar quarter of Year 3.

B receives the information and collections necessary to determine the amount of the contingent compensation payable to A, if any, from purchasers of the products later than usual, such that it is administratively impracticable to determine the amount of contingent compensation payable to A and to make payment during the payment window. This impracticability was unforeseeable to A at the time A first had a legally binding right to the contingent compensation. A is neither a purchaser of B's product, nor in control of any such purchaser. B ultimately determines that contingent compensation in the amount of $200k is payable to A under the agreement and sends a statement and payment to A as soon as administratively practicable within the same taxable year as the payment window, but after the last day of the payment window.

<u>Situation 3</u>:

The same facts as in Situation 1. Additionally, in Year 1, the risk of forfeiture that A will not receive the contingent consideration is substantial.

In Year 3, within the payment window following the end of the first quarter, B agrees to pay A an advance of the contingent compensation equal to $300x in addition to the $200x

that A is entitled to under the agreement as shown on the statement. The agreement does not require B to pay the $300k advance.

Situation 4:

In Year 1, service provider C has entered into an agreement with service recipient D to perform service in connection with the development of a product that will be sold by D. C is an independent contractor for D, is not an officer of D and is not on D's Board of Directors. C is also not providing management services on behalf of D as set forth in Treasury Regulations Section 1.409A-1(f)(2)(iv).

The agreement between C and D provides that once C has performed the services required by the agreement, C will receive a fixed payment of $100x and a contingent payment that is equal to x% of the proceeds that D receives from the sale of the product after D has received sales proceeds equal to certain costs that D has incurred in developing the product. The agreement specifically identifies these costs.

Once D has received enough sales proceeds to recoup its costs incurred in developing the product, the agreement requires D to send statements to C within the payment window after the end of each calendar year quarter which calculate the positive amount (if any) that C is entitled to receive with respect to such reporting period, along with a payment equal to the amount set forth in the statement. The agreement provides that C has no right, title or interest in the products that D will sell.

In Year 1, C performs all of the service required by the agreement with D and receives $100x.

In Year 2, D receives $2000x from the sale of the product in excess of D's costs incurred in producing the product that were identified in the contract, and makes a payment of $160x to C.

In Year 2, C enters into an agreement with service recipient E, substantially similar to the agreement that C entered into with D, except that C is entitled to a payment of $200x upon C's completion of services in developing the product for E and C is entitled to a payment of z% of the sales proceeds that E receives from the sale of the product in excess of certain costs incurred by E in developing the product. These costs are specifically identified in the agreement between C and E.

C is an independent contractor for E, is not an officer of E and is not on E's Board of Directors. C is also not providing management services on behalf of E as set forth in Treasury Regulations Section 1.409A-1(f)(2)(iv).

In Year 2, C performs the services required by the agreement with E and C receives a payment of $200x from E in Year 2.

D and E are not related to C or to each other as defined in Treasury Regulations Section 1.409A-1(f)(2)(ii).

D and E are in the same business. The products to be developed and sold by D and E are products of the type that are regularly developed and sold by D and E in their respective businesses.

C does not have effective control of D, E, the persons to whom D and E sell their respective products or the collection of the amounts due to D and E.

The amounts set forth above are the only payments that C receives in Years 1 and 2 for services performed by C.

Situation 5

The same facts and in Situation 4, but C enters into the agreement with E in Year 1 and receives $200x from E in Year 1, for services performed by C in Year 1.

In Year 2, C is entitled to $200x of contingent compensation from E in accordance with their agreement. However, E agrees to pay C an advance of the contingent compensation in the amount of $300x in Year 2.

The amounts set forth above are the only amounts that C receives in Years 1 and 2.

Law

Code Section 409A provides certain rules that are applicable to nonqualified deferred compensation plans. For purposes of Code Section 409A, a nonqualified deferred compensation plan is any arrangement, other than a qualified pension or profit sharing plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan, which provides that a service provider may receive payment for services in a taxable year later than the year in which the service provider first has a legal right to receive the payment. Code Section 409A(d)(3) provides that the term "plan" includes any agreement or arrangement, including an agreement or arrangement that includes one person.

Treasury Regulations Section 1.409A-1(f)(1) provides that a service provider includes an individual, corporation, subchapter S corporation, partnership and certain other entities for any taxable year in which such individual, corporation, subchapter S corporation, partnership, or other entity accounts for gross income from the performance of services under the cash receipts and disbursements method of accounting.

Code Section 409A(a)(1) provides that if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of Code Sections 409A(a)(2), 409A(a)(3) and 409A(a)(4) or is not operated in accordance with the requirements set forth in Code Sections 409A(a)(2), 409A(a)(3) and 409A(a)(4): (1) all amounts deferred

under the nonqualified deferred compensation plan for all taxable years are includible in the gross income of a service provider in the year in which the plan fails to comply with such rules, to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, (2) all amounts so includable in income are subject to interest at a annual rate equal to the rate applicable to underpayments of tax plus one percent on the underpayments that would have occurred had the deferred compensation been included in income for the taxable year in which first deferred, or, if later, the first taxable year in which the deferred compensation is not subject to a substantial risk of forfeiture, and (3) a tax equal to 20 percent of the compensation that is required to be included in gross income is imposed in addition to the regular income tax.

Code Section 409A(a)(2) provides that compensation under a deferred compensation plan may not be distributed earlier than (i) the service provider's separation from service, (ii) the date the service provider becomes disabled, (iii) the death of the service provider, (iv) a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation, (iv) a change in ownership or effective control of the service recipient or in the ownership of a substantial portion of the assets of the service recipient, or (v) the occurrence of an unforeseen emergency.

Code Section 409A(a)(3) provides that a plan will meet the requirements of this sub-section if the plan does not permit the acceleration of the time or schedule of any payment under the plan, except as provided by Treasury Regulations.

Code Section 409A(a)(4) governs when an election to defer nonqualified compensation must be made by a service provider. Treasury Regulations Section 1.409A-2(a)(2) provides that where a nonqualified deferred compensation plan does not provide the service provider with an opportunity to elect the time or form of payment of such compensation, the time and form of the nonqualified deferred compensation must be designated no later than the time the service provider first has a legally binding right to payment or, if later, the time the service provider would be required to make the election under Treasury Regulations Section 1.409A-2 if the service provider had been provided the right to make such an election.

Treasury Regulations Section 1.409A-1(b)(4)(i) provides that a deferral of compensation does not occur under a plan with respect to any payment (as defined in Treasury Regulations Section 1.409A-2(b)(2)) that is not a deferred payment, provided that the service provider actually or constructively receives such payment on or before the later of (a) the 15th day of the third month following the end of the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture or (b) the 15th day of the third month following the end of the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture.

Treasury Regulations Section 1.409A-1(b)(4)(ii) provides that a payment otherwise qualifies as a short-term deferral under Treasury Regulations Section 1.409A-1(b)(4)(i) but is made after the applicable 2-1/2 month period may continue to qualify as a short-

term deferral if the taxpayer establishes that it was administratively impracticable to make the payment by the end of the applicable 2-1/2 month period and, as of the date upon which the legally binding right to the compensation arouse, such impracticability was unforeseeable, or the taxpayer establishes that making the payment by the end of the applicable 2-1/2 month period would have jeopardized the ability of the service recipient to continue as a going concern, and provided further that the payment is made as soon as administratively practicable or as soon as the payment would no longer jeopardized the ability of the service recipient to continue as a going concern, as the case may be. For purposes of Treasury Regulations Section 1.409A-1(b)(4)(ii), the action or inaction of the service provider or a person under the service provider's control, such as a failure to provide necessary information or documentation, is not an unforeseeable event.

Treasury Regulations Section 1.409A-2(b)(2)(i) provides that, except as provided in Treasury Regulations Section 1.409A-2(b)(2)(ii) (applicable to life annuities) and Treasury Regulations Section 1.409A-2(b)(2)(iii) (applicable to installment payments), the term "payment" refers to each separately identified amount to which a service provider is entitled to payment under a plan on a determinable date. Treasury Regulations Section 1.409A-2(b)(2)(i) provides further than an amount is separately identified only if the amount may be objectively determined under a nondiscretionary formula, such as 10 percent of an account balance as of a specified date.

Treasury Regulations Section 1.409A-2(b)(2)(iii) provides that entitlement to a series of installment payments that is not a life annuity is treated as the entitlement to a single payment, unless the plan provides at all times with respect to the amount deferred that the right to the series of installment payments is to be treated as a right to a series of separate payments.

Treasury Regulations Section 1.409A-1(d)(1) provides that compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance or substantial future services by any person or the occurrence of a condition related to the purpose of the compensation, and the possibility of forfeiture is substantial. Treasury Regulations Section 1.409A-1(d)(1) provides further that a condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organization goals, such as the attainment of a prescribed level of earnings or equity value or the completion of an initial public offering.

Treasury Regulations Sections 1.409A-1(f)(2)(i) provides that, except as provided in Treasury Regulations Sections 1.409A-1(f)(2)(iv) (applicable where a service provider provides management services to a service recipient), Code Section 409A does not apply to an amount deferred under a plan between a service provider and a service recipient with respect to a particular trade or business in which the service provider participates, if during the service provider's taxable year in which the service provider obtains a legally binding right to the payment of amount deferred: (1) the service provider is actively engaged in a trade or business of providing services, other than as an employee or as a member of the board of directors of a corporation (or similar position with an entity that

is not a corporation), (2) the service provider provides significant services to two or more service recipients to which the service provider is not related and which are not related to each other (as defined in Treasury Regulations Section 1.409A-1(f)(2)(ii)); and (3) the service provider is not related to the service recipient (applying the definition of related person contained in Treasury Regulations Section 1.409A-1(f)(2)(ii), modified by substituting 20 percent for 50 percent each time 50 percent appears in Code Section 267(b) and Code Section 707(b)(1)).

Treasury Regulations Section 1.409A-1(f)(2)(ii) provides that a person is related to another person if the persons bear a relation to each other that is specified in Code Section 267(b) or Code Section 707(b)(1), subject to the modification that 20 percent is used instead of 50 percent each place it appears in Code Sections 267(b) and 707(b)(1) and Code Section 267(c)(4) is applied as if the family of an individual includes the spouse of any member of the family, or the persons are engaged in trades or businesses under common control, within the meaning of Code Sections 52(a) and (b). In addition, an individual is related to an entity if the individual is an officer of an entity that is a corporation or holds a substantially similar position in an entity that is not a corporation.

Treasury Regulations Section 1.409A-1(f)(2)(iii) provides that whether a service provider is providing significant services depends on the facts and circumstances of each case. However, Treasury Regulations Section 1.409A-1(f)(2)(iii) provides that a service provider who provides services to two or more service recipients to which the service provider is not related and which are not related to each other will be deemed to be providing significant services to two or more of such service recipients for a given taxable year, if the revenues generated from the services provided to any of the service recipients or group of related service recipients during such taxable year do not exceed 70 percent of the total revenue generated by the service provider from the trade or business of providing such services.

Analysis and Holdings

Situation 1:

The contingent compensation that is payable by B to A constitutes nonqualified deferred compensation under Code Section 409A, because it may be received by A in a taxable year later than the year in which A first obtains a legally binding right to the compensation, unless an exception applies.

The contingent compensation payable by B to A is conditioned on the occurrence that relates to the service recipient's business activities and thus is subject to a risk of forfeiture within the meaning of Treasury Regulations Section 1.409A-1(d).

The issue of whether the risk of forfeiture is substantial is based on the facts and circumstances of each case and therefore, no ruling is given regarding whether the risk of forfeiture is substantial. However, the determination of whether the risk of forfeiture is substantial shall be made at the time that the service provider first has a legally binding

right to the compensation. In this case, A first had the legally binding right to the compensation in Year 1, which is the year in which A and B entered into the agreement and A completed the services.

If the risk of forfeiture is deemed to be substantial, then the contingent compensation to be paid by B to A during the payment window following the end of the first quarter of Year 3 will qualify as a short term deferral under Treasury Regulation Section 1.409A-1(b)(4), provided that the payments are made to A no later than the later of (1) the 15th day of the third month of the taxable year following the taxable year of the service provider in which the payments are no longer subject to a substantial risk of forfeiture, or (b) the 15th day of the third month of the taxable year following the taxable year of the service recipient in which the payments are no longer subject to a substantial risk of forfeiture.

Situation 2:

The same result as in Situation 1 with respect to the contingent compensation to be paid to A by B during the payment window following the end of the fourth calendar quarter of Year 3. The fact that the payment was made after the last day of the payment window does not violate Code Section 409A since the payment during such payment window was administratively impracticable, such impracticability was unforeseeable at the time A first had a binding legal right to the compensation, A had no role in causing any delay in payment and payment ultimately was made to A by B as soon as administratively practicable.

Situation 3:

The same result as in Situation 1 with respect to the contingent compensation to be paid to A by B within the payment window at the end of the first calendar quarter of Year 3.

The amount of contingent compensation payable to A by B in Year 3 is paid within the short term deferral period and is not subject to Code Section 409A. Therefore, the advance payment of the contingent compensation made to A by B within 75 days of the end of the first quarter of Year 3 does not violate Code Section 409A(a)(3).

Situation 4:

The payments to be made from D to C in Year 2 are made with respect to services that were performed by C in Year 1. Therefore, those payments are not counted in determining whether E has met the test for providing significant services for Year 2, set forth in Treasury Regulations Section 1.409A-1(f)(iii).

C will not be deemed to meet the safe harbor test for providing significant services contained in Treasury Regulations Section 1.409A-1(f)(iii) unless C receives sufficient revenue in Year 2 for services performed by C for another service recipient that is not related to C, E or F, so that the revenues received by D for services performed by C in

Year 2 from any of such unrelated service recipients does not exceed 70 percent of the gross revenue that C receives in Year 2 from services provided in Year 2.

Situation 5

The payment of the $300x advance made by E to C in Year 2, and any advances made in any subsequent years, do not violate Code Section 409A(a)(3). In Year 1, the year in which C first had a binding legal right to payment from E, C received $100x for services that C performed for D in Year 1 and $200x for services that C performed for E in Year 1. The amount that C received from D did not exceed 70 percent of the gross revenue of $300x ($100x + $200x) that C received for performing services in Year 1 ($100x / $300x = 33 1/3 percent) and the amount that C received from E in Year 1 did not exceed 70 percent of the gross revenue of $300 x that C received for performing services in Year 1 ($200x / $300x = 66 2/3 percent). Therefore, C meets the significant services safe harbor contained in Treasury Regulations Section 1.409A-1(f)(2)(iii) and the contingent compensation to be paid to C by D and E does not constitute nonqualified deferred compensation for purposes of Code Section 409A.