

## Tax Regulation Changes and Interpretations

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AUGUST 2010

### FEDERAL TAX UPDATES

- **New § 382 developments**

#### **Notice 2010-49**

The IRS wants to ensure the proper treatment of small shareholders under § 382(g)(4)(C) given the policy underlying § 382, which is to limit the transfer of loss corporations. Currently, “small shareholders” are aggregated and treated as a single 5-percent shareholder.

The Notice presents two approaches: (1) the Ownership Tracking Approach (OTA), and (2) the Purposive Approach (PA). The two differ in the extent they seek to identify and limit their effect to circumstances in which abuse is most likely to occur.

- **Ownership tracking approach:** Under the OTA, it's not significant whether small- or 5-percent shareholders increase their ownership. All ownership changes are tracked regardless of circumstances to observe abusive transactions. All transactions allowing the corporation to track the increase in small shareholders' ownership interests create a new “public group,” which is treated as a 5-percent shareholder. The OTA does not, however, account for “public trading” between small shareholders because it would be unduly burdensome. The current regulations primarily reflect this approach.
- **Purposive approach:** The PA seeks to specifically identify the circumstances where abuse can arise. It's unnecessary, therefore, to identify and track all readily identifiable acquisitions of stock by small shareholders because they aren't generally in a position to effect the abuses that § 382 seeks to prevent.

Application of the PA would likely preclude the creation of new, segregated public groups when stock is acquired by small shareholders. The original public group could be treated as having reacquired the shares.

#### **Notice 2010-50**

Generally, changes in proportionate ownership attributable to fluctuations in the fair market value (FMV) of different classes of stock aren't considered when determining whether an owner shift has occurred. However, two approaches are acceptable to account for such fluctuations when other events mandate testing for ownership changes: 1) the Full Value Methodology (FVM), and 2) the Hold Constant Principle (HCP).

Under the FVM, the percentage of stock owned by any person is determined on the basis of FMV of that stock relative to the FMV of all of the corporation's outstanding stock. Any changes in ownership percentage resulting from value fluctuations are taken into account if a testing date occurs; shares are “marked-to-market” on each testing date.

Under the HCP, the value of a share is determined on the date that share is acquired. On subsequent testing dates the percentage interest represented by that “tested share” is determined by factoring out any fluctuations in the relative FMV of the loss corporation's share classes that occurred since the tested share was initially acquired.

As long as they consistently apply the methodology, taxpayers may use any reasonable application of the FVM or HCP to determine whether an ownership change has occurred. They may also file amended returns to maintain consistency in prior years.

The guidance in Notice 2010-50 may be relied upon until regulations are issued under § 382(l)(3)(C).

- **Covenant not to compete considered § 197 intangible**

Covenants not to compete (CNC) are § 197 intangibles subject to 15-year amortization to the extent they are created in connection with a direct or indirect acquisition of an interest in a trade or business, or a substantial portion thereof.

A CNC acquired in connection with any acquisition of an interest in a trade or business is a § 197 intangible, and it's not necessary for the interest acquired to be "substantial." Further, "substantial portion thereof" referred to the acquisition of a substantial portion of the trade or business' assets, and not an *interest* in the trade or business. *Recovery Group, Inc., T.C. Memo 2010-76*

- **LLC's "90-percent stock loan program" treated as disguised sale**

An LLC's "90-percent stock loan program" involved the transfer of a block of shares to an LLC in exchange for 90-percent of the shares' FMV in cash (the loan). The transaction was characterized as a three-year loan, with the shares pledged as collateral.

Among the terms of the loan were: The LLC was allowed to sell the shares immediately upon receipt; it was non-recourse as to the borrower; dividends were to be received as cash payments against interest due; the balance of interest was to accrue until maturity; and a balloon payment was due at maturity. At maturity, the borrower could pay the balance due and recover the collateral, renew the loan for an additional term, or satisfy the loan by surrendering the collateral. At the end of the term, the loan balance was higher than the FMV of the shares, and the borrower satisfied the loan by surrendering any claim to his shares.

The Tax Court held this was a sale because the benefits and burdens of stock ownership shifted to the LLC; the LLC obtained title, possession and control of the shares immediately upon share transfer; the borrower retained no property interest in the shares; and the borrower bore no risk of loss following the transfer — in the event the shares' value decreased, he was entitled to retain all the cash he received. *Calloway, et vir. v. Comm'r, (2010) 135 T.C. No. 3*

- **Prepayment of contingent obligations does not create COD income**

A common parent of a U.S. consolidated group didn't incur COD income under § 61(a)(12) upon prepayment of a contingent obligation where the obligation was contingent upon: 1) future earnings, 2) future tax rates in jurisdictions where the taxpayer operated, and ultimately, 3) the taxpayer's realization of future tax benefits. *PLR 201027035, 7/9/2010*

## INTERNATIONAL TAX UPDATES

- **Domestic partnerships treated as foreign in blocker structures**

The IRS and Treasury Department will issue regulations classifying domestic partnerships as foreign in specific transactions where a U.S. taxpayer owns two or more subsidiary controlled foreign corporations (CFCs), which in turn own another CFC subsidiary through a domestic partnership to avoid subpart F inclusions.

The IRS takes issue with taxpayers' positions that they do not have an inclusion under § 951(a)(1) because the partnership is the first U.S. person in the chain of ownership, and yet is not a taxpayer, which is contrary to the intent of § 951. *Notice 2010-41, 2010-22 I.R.B., 715*

- **Commissionaire agreement did not create French PE**

The French Supreme Administrative Court rendered its final resolution that although a commissionaire agreement authorized a French agent to conclude contracts on behalf of its UK parent, it didn't create permanent establishment (PE) in France because the contracts didn't bind the UK principal to the co-

contracting party of the commissionaire.

Under the UK-France Permanent Establishment treaty article at issue, a PE could only arise if a dependent agent habitually exercised the authority to conclude contracts in the name of the principal, which doesn't happen when a sales entity acts under a commissionaire arrangement and enters into contracts under its own name. *Zimmer Ltd. C.E. Mars 2010*

- **Other developments**

- Ireland modified VAT regulations relating to reverse charges for services received abroad since 1/1/2010. *European Comm. Reg. of 2010 (SI 317 of 2010)*
- The Senate Foreign Relations committee recommends ratifying a treaty protocol with New Zealand to reduce current treaty withholding tax rates on dividends, interest and royalties. *Protocol Amending Tax Convention with New Zealand, 111<sup>th</sup> Congress, 2d. Session, June 30, 2010*
- In his Budget Speech of July 1, 2010, Gibraltar Chief Minister Peter Caruana announced proposed tax reform legislation that would reduce the corporate tax from 22 percent to 10 percent. The legislation would also subject "offshore companies," which were previously exempt, to the Gibraltar corporate tax.

## STATE TAX UPDATES

- **Illinois**

The Small Business Job Creation tax credit was implemented effective July 1, 2010. Eligible applicants must: 1) operate a business in Illinois; 2) engage in inter- or intrastate commerce; and 3) have 50 or fewer full-time employees. A credit may be taken of up to \$2,500 per full-time employee hired during the incentive period (7/1/2010 to 6/1/ 2011) that results in a net increase in the employer's full-time Illinois employees, which is then maintained for at least 12 months. See *14 Ill. Admin. Code §§ 529.10 – 529.110 and L. 2010, S578 (P.A. 888)*

A pass-through entity — and its shareholders or partners — that has been awarded an Economic Development for a Growing Economy (EDGE) tax credit may treat some or all of the awarded credit as a "tax payment" for purposes of the Illinois Income Tax Act. This includes composite income tax payments by the entity on behalf of any of its partners or shareholders. See *35 ILCS § 10/5-15(g), as amended by L. 2009, H2414 (P.A. 836)*

- **Indiana**

Watch Indiana tax filing requirements closely. In March, an S Corporation failed to properly file a Form WH-1 and remit withholding tax for a non-resident shareholder. Even though the shareholder had properly paid the tax, the Indiana Department of Revenue assessed a 20-percent penalty on the S Corporation, noting that "the issue is not whether the tax was paid, but rather whether the taxpayer complied with Indiana laws governing withholding...a statutory mechanism designed to ensure compliance and ease of enforcement." *Indiana Dept. of Rev., Letter of Finding 09-0961P, 3/1/10*

Further, claims for refunds must be filed on Form GA-110L, an amended return, or withholding tax return indicating overpayment, and must state both the amount of the refund and the reasons entitling the taxpayer to a refund. If this or any further information requested isn't provided, the claim will be administratively closed but the statute of limitations will continue to run. See *Ind. Dept. of Rev., Rev. Rul. 2010-01IND 1/1/10; Indiana Tax Policy Directive 4, 7/1/2010*

- **Minnesota**

For tax years beginning on or after January 1, 2010, partners and S Corporation shareholders can claim the state research and development credit. It's equal to 10 percent of the first \$2 million of the excess of qualified research expenses for the year over the "base amount," less 2.5 percent on all excess expenses over \$2 million. *Minn. Stat. § 290.068*

- **Wisconsin**

Real property transfers between two commonly owned LLCs are not exempt from the state real estate

transfer fee, which only applies to transfers between LLCs and their members. A transfer from the LLC to its members followed by a second transfer from the members to the other LLC would, however, avoid this fee. *Collegiate LLC vs. Dep't. of Rev., Wisc. Tax App. Comm., Dkt. No. 08-T-047, 12/15/09*

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