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Time for Tax Reform?

After being delayed by multiple attempts to repeal and replace the Affordable Care Act, the Trump administration and Congressional Republicans recently sought to begin their tax reform efforts in earnest. The "Big Six" – *i.e.* Senate Majority Leader Mitch McConnell, Senate Finance Committee (SFC) Chairman Orrin Hatch, Speaker of the House Paul Ryan, Ways & Means Committee Chairman Kevin Brady, Treasury Secretary Steven Mnuchin, and Gary Cohn, Director of the National Economic Council – released their *Unified Framework for Fixing Our Broken Tax Code* (follow link to view full document, also posted under press center at treasury.gov) on September 27th. The document, though more detailed than the President's April 2017 "core principles," stops far short of being a comprehensive tax reform proposal. The Framework details major areas of agreement among the Big Six, but leaves several key decisions – and virtually all of the mechanics – to the House Ways & Means Committee and Senate Finance Committee.

The Framework highlights where the Big Six have reached agreement and gives guidance to the tax writing committees on what to handle next. The open items are substantial, and the timeline for passing tax reform this year is tight. However, the Framework provides the best indication to date of what the Big Six are considering, what issues could benefit from input from business, and what taxpayers can do now to prepare for tax reform.

Individual Provisions

Lower Individual Income Tax Brackets

Our tax code currently has seven ordinary income tax brackets (10%, 15%, 25%, 28%, 33%, 35% and 39.6%). The proposal would reduce the seven tax brackets to three (12%, 25% and 35%). It leaves open the possibility of a fourth tax rate that would apply only to the "highest-income taxpayers" so as to not shift the tax burden to lower and middle-income taxpayers.

The Framework is silent on the rates for long-term capital gains and qualified dividend income (currently 0%, 15% and 20%). Also not addressed is the future of the 3.8% net investment income tax. This tax was enacted as part of the Affordable Care Act, and its future is likely dependent on whether all of the taxes that were added by the Affordable Care Act are addressed in tax reform. Currently, Congress' plan appears to be to exclude the taxes added by the Affordable Care Act from the tax reform discussions.

With lower income tax rates on the horizon, taxpayers should consider accelerating deductions now.

Elimination of Many Itemized Deductions (charitable and mortgage interest stay)

Currently, taxpayers have the option of taking advantage of the standard deduction, or forgoing the standard deduction and instead itemizing their

Upcoming Tax Events

Doing Business Globally in the Digital Age

Chicago, IL
► November 7, 2017

Dallas, TX
► November 9, 2017

Global Tax Disputes Forum

New York, NY
► December 7, 2017

40th Annual North America Tax Conference

Dallas, TX
► January 25, 2018

19th Annual Latin America Tax Conference

Miami, FL
► February 26-27, 2018

To review the complete Tax Events Calendar visit www.bakermckenzie.com/tax/event

deductions which include deductions for mortgage interest, charitable contributions, medical expenses, state and local taxes, etc.

The Framework would double the standard deduction, raising it to $12,000 for single taxpayers (up from $6,350), and $24,000 for married taxpayers filing jointly (up from $12,700), eliminate the personal exemptions (currently $4,050), and eliminate many of the itemized deductions, retaining only the deductions for mortgage interest and charitable contributions. If the Framework is enacted, taxpayers would no longer be able to deduct state and local income taxes, and, likely, a shift in planning to protect income from such taxes will follow.

Repeal of the Estate and Generation Skipping Transfer Taxes

As expected, the Framework calls for the repeal of the estate tax and the generation-skipping transfer tax, and only includes this one sentence, "The framework repeals the death tax and the generation-skipping transfer tax."

The US federal transfer tax system includes three taxes all generally meant to complement each other: (1) the gift tax to capture lifetime transfers, (2) the estate tax to capture transfers made at death, and (3) the generation skipping transfer tax, which applies to transfers during life or at death that essentially skip a generation. Currently, for US residents, the federal estate tax rate is 40% and kicks in only after an individual's unified credit amount has been exhausted, US$5,490,000 in 2017 (married couples can share their credit amount and protect US$10,980,000 from the estate tax). The unified credit amount is applicable to both gifts and transfers of property at death. Non-US residents (non-US citizens, and non-US domiciliaries - i.e. those not physically present in the US with the intent to remain in the US) get the benefit of eight estate tax brackets ranging from 26% to 40%, and the estate tax applies after a US$60,000 exemption. Currently, the US federal estate tax applies to non-US residents who pass away holding US situs property directly, e.g. shares in a US corporation or US real estate. By way of example, a UK citizen and resident holds shares of ABC Corp., a Delaware corporation, at the time of his death, the UK citizen will be subject to the US federal estate tax on the value of the shares of ABC Corp. *subject to the US$60,000 exemption).

Notably, yet consistent with the President's one page proposal released in April 2017, the Framework does not include a repeal of the US federal gift tax. If the gift tax remains, what happens to the unified credit amount, will all gifts be taxable? Also, the Framework is silent on the future of the basis step up and whether this would be replaced with another mechanism, such as a deemed disposition tax similar to Canada's. Many questions are raised, but this repeal (albeit likely not permanent if history is any indicator) could also bring about many planning opportunities.

AMT Repeal

Under the framework, the alternative minimum tax (AMT) would also be repealed, which would greatly simplify the tax code. Currently taxpayers are required to compute their tax under the regular system and again under the AMT system to determine their tax liability, basically requiring taxpayers to compute their taxes twice.

Changes to IRAs and Qualified Retirement Plans

The Framework also comments that "Tax reform will aim to maintain or raise retirement plan participation of workers", although no specifics were mentioned.

Corporate Provisions

The Framework set forth several substantial changes in corporate taxation, the most significant of which being the reduction of the corporate tax rate to 20%. The Trump administration had previously advocated for a 15% rate, and the 2014 Camp proposal set the corporate rate at 25%. However, the House Blueprint's 20% rate appears to have prevailed. The Framework also established a maximum tax rate of 25% for small and family-owned businesses conducted as sole proprietorships, partnerships and S corporations. To address potential issues with the recharacterization of personal income into business income, the Framework tasked the tax writing committees with writing rules that will prevent wealthy individuals from avoiding the top personal tax rate. Secretary Mnuchin has suggested that the 25% rate may not be available to professional services firms.

The Big Six have also agreed to eliminate the corporate AMT and to consider methods to reduce the double taxation of corporate earnings. Though no details were provided on this later initiative, it provides an opportunity for the Senate to consider the corporate integration proposal that Senator Hatch and his staff have been working on. Under Senator Hatch's proposal, companies would be able to take a dividends paid deduction for dividends and interest, and only retained earnings would be subject to corporate income tax.

One of the key areas of disagreement between House and Senate Republicans was over whether to permit immediate expensing, in lieu of permitting interest deductibility. Although the House Blueprint favored immediate expensing, the Big Six reached a compromise and have proposed allowing immediate expensing of new investments in depreciable assets (other than structures) for at least five years. The proposal would apply for investments made after September 27, the date that the Framework was introduced. The Framework delegates the means for implementing this proposal to the tax writing committees, as well as specifically tasking them with providing relief for small businesses. Rather than eliminating interest deductibility (as the House Blueprint would have done), the Framework proposes to limit interest deductibility for C corporations. Again, the Framework did not provide details for how such a limitation would be put in place, meaning that a variety of mechanisms are on the table. This includes an absolute limitation, percentage haircuts, or even a thin-capitalization rule similar to the proposal under the OECD Base Erosion and Profit Shifting (BEPS) Action Item 4, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments. There are several unanswered questions regarding interest deductibility, including how current debt will be treated and whether certain industries will be exempt or otherwise subject to special rules.

The Framework also proposes eliminating most business deductions and credits to pay for the reduced 20% corporate income tax rate. Although the Framework only specifically identifies the section 199 domestic production deduction for elimination, other deductions and credits will likely be eliminated or restricted. Only credits and deductions relating to either research and development or low income housing are explicitly retained, according to the Framework. Whether

certain credits or reductions remain will therefore be highly dependent on decisions with respect to deficit spending and reconciliation instructions.

Special or industry-specific tax regimes may also be subject to reform. The Framework set forth a general goal to "modernize these rules to ensure that the tax code better reflects economic reality and that such rules provide little opportunity for tax avoidance." No specific regimes or provisions were highlighted in the Framework. However, the tax writing committees have been and will continue to look at this issue.

International Provisions

As expected, the Framework provides for the transition from the current worldwide system of taxation to a territorial system. The Big Six appear to have agreed on the mechanism for doing so: a 100% exemption for dividends paid by a foreign subsidiary to a US parent owning at least a 10% stake in the subsidiary. This differs from the 95% exemption proposed by former Ways & Means Chairman Dave Camp in his 2014 proposal, as well as the 95% dividends received deduction proposed by Senator Mike Enzi in 2012. The Framework pairs the transition to a territorial system with deemed repatriation of foreign earnings that have accumulated offshore. Though the Framework does not provide specifics with respect to the rate or mechanism for deemed repatriation, it does align with the House Blueprint and the Camp proposal by noting that there will be a lower rate on illiquid assets than for cash and cash equivalents. Tax due as a result of this deemed repatriation would be due over an unspecified number of years. The Framework is silent with respect to the measuring date for earnings and profits, but readers may recall that the 2014 Camp proposal had a measuring date earlier than the date that legislation was introduced.

The Framework acknowledged that to fulfill the goal of leveling the international playing field and stopping corporations from shipping jobs and capital overseas, the shift to a territorial system would need to be paired with certain offsets that will address base erosion. In that vein, it is up to the tax-writing committees to design "rules to protect the US tax base by taxing at a reduced rate and on a global basis the foreign profits of US multinational corporations." This appears to suggest some form of minimum tax, yet no specific proposals were detailed.

Senate Finance Committee Hearing on Tax Reform

On Tuesday, October 3rd, the Senate Finance Committee held its first hearing on tax reform since the Framework's release. The hearing was dedicated to international tax reform, which was one of the least detailed portions of the Unified Framework. Chairman Hatch noted this in his opening statement and emphasized that several options were still on the table. The panelists weighed in on the need for tax reform, but focused on the yet-unsettled question of what form the proposed base erosion protections would take. (*see*, *Hatch Opening Statement at Finance Committee Hearing on International Tax Reform,* United States Senate Committee on Finance, October 3, 2017)).

The Wells Base Protecting Surtax

The hearing's first witness, Professor Bret Wells of the University of Houston Law Center, presented his Base Protecting Surtax ("BPS") as a potential mechanism for protecting against base erosion under a new territorial system. Wells has written extensively on this proposal, and added only a few modifications in his

testimony to the Senate Finance Committee. (*see, Tax Base Erosion: Reformation of Section 482's Arm's Length Standard,* SSRN (August 15, 2013)).

In his written testimony, Wells explained that the BPS would be applied against five categories of payments he has determined to be earnings stripping transactions: (1) related party interest stripping transactions; (2) related party royalty stripping transactions; (3) related party lease stripping transactions; (4) supply chain restructuring exercises; and (5) related party service stripping transactions. He reasoned that the BPS serves as an upfront collection of an amount equal to the tax that would have been collected had the intercompany payment instead been paid as an intercompany dividend distribution. Wells also characterized the BPS as a tax on the payor, rather than a withholding tax on the payee, which approximates the payer's share of the residual profits earned by the payer. (*see, Testimony of Professor Bret Wells,* US Senate Committee on Finance, October 3, 2017)).

Under this proposal, a taxpayer can seek a refund if it can demonstrate, through application of a profit split methodology and disclosure of all books and records, that it is so entitled. This incorporates the second aspect of Professor Wells' proposal: mandating "two-sided" (*i.e.* profit split) transfer pricing methodologies. Professor Wells has advocated for profit split transfer pricing methodologies to be made mandatory, either as the primary method, or to confirm one-sided or cost sharing methodologies. This would, in effect, make profit splits the official "best method," and would place the burden of proof on the taxpayer to establish that the non-US party is entitled to a portion of the residual profit in every instance. According to Professor Wells, only profit split methodologies result in the allocation of residual profit to the functions that contribute significantly to their creation.

These two proposals have been advanced by Professor Wells as a package which he believes will incentivize transparency and cooperation with the IRS. By conditioning refunds of the surtax on application of a profit split and disclosure of all books and records, the two proposals essentially require up-front documentation under the prescribed methodology. While taxpayers are usually afforded a full audit before transfer pricing adjustments lead to assessment and collection of tax, the package presented by Professor Wells would instead force taxpayers to pay first and then initiate refund suits to defend their transfer pricing position. Professor Wells has acknowledged that this refund procedure would not completely displace the traditional audit procedure, particularly "where a two-sided transfer pricing methodology indicates that more tax on residual profits is due." As a result, taxpayers could be forced to manage parallel refund suits and transfer pricing audits. Given the decrease in IRS resources in recent years, taxpayers could be faced with ongoing uncertainty if these proposals were implemented. In his testimony, Professor Wells added some more detail to his proposed refund procedure for challenging over-assessments of the BPS. Wells referenced a "Base Clearance Certificate" process, but did not indicate whether the plan contemplated a process by which a rate or base could be pre-approved, such as through an APA.

According to Wells, the BPS is consistent with US treaty obligations because (1) the surtax can be reconciled with the arm's length standard and (2) the surtax is not a withholding tax on the recipient. Professor Wells has been clear that base erosion should be addressed through transfer pricing, "because it would create the least conflict with our existing tax treaty partners (many of whom endorse the arm's length standard)." In contrast, he has described other proposals as

"unilateral acts that create a significant risk of fostering an anti-competitive tax environment."

The Grinberg Inbound Corporate Minimum Tax

Georgetown University Law Center professor Itai Grinberg proposed, without detail, an inbound minimum tax as the solution to the same disparate treatment between US and foreign-headquartered multinational enterprises highlighted by Professor Wells. The inbound minimum tax was advanced in context of Grinberg's more general proposal for a transition to source-based taxation. Implementing such a source-based system of taxation would require reevaluating the United States' current sourcing rules, as well as US trade or business and permanent establishment thresholds.

Citing unilateral actions by other nations in the wake of BEPS – typically against U.S. multinationals – Professor Grinberg urged Congress to "seek to give the United States leverage" and "put the United States in a good position to bargain internationally about a future set of broadly accepted rules." Professor Grinberg did not elaborate on how this could be achieved other than through "inbound policy." He also advised the Committee to craft a reform that is "administrable by the U.S. alone, rather than being as intellectually or technically robust as possible," – though he did caution against "technical innovations that we would strenuously oppose if used abroad."

Global Minimum Tax

The panelists also weighed in on the concept of a global minimum tax, which was referenced in the Framework as a potential anti-base erosion measure. Dr. Kimberly Clausing of Reed College and Harvard professor Stephen Shay both advocated for a per country minimum tax, concluding that a global minimum tax would allow multinationals to blend the high and low rates in the various jurisdictions where multinational corporations operate, effectively balancing out the benefit of shifting income to tax havens with higher taxed foreign income. Professor Shay also cautioned against setting the minimum tax rate too low, citing statistics that foreign subsidiaries of U.S. multinational corporations in the aggregate paid an average foreign tax rate of 12%. According to Professor Shay, the minimum tax would have to be at a much higher percentage of the U.S. corporate rate in order to serve as a disincentive for base erosion.

Both Grinberg and Wells strongly objected to a per country minimum tax. Professor Grinberg characterized such a tax as overly complex and not in line with how multinational corporations function (noting that businesses organize their international operations along regional lines, instead of on a country-by-country basis). Both objected to a global minimum tax in general due to the fact that it would apply only to U.S. multinationals, further discouraging U.S. tax residence. Professor Grinberg also cautioned against pairing a minimum tax with foreign tax credits, as it could incentivize other jurisdictions to target U.S. multinationals that have no incentive to challenge or avoid the tax because its incidence will be borne by the U.S. fisc. Should a Subpart F-based minimum tax be imposed, Professor Grinberg advocated that it be at a low rate, paired with foreign tax credit haircuts, in order to incentivize U.S. multinationals "to risk tax disputes with foreign sovereigns rather than decreasing tax payments to the U.S.."

Other Potential Proposals

Committee members raised several other proposals that could be under consideration going forward. An active trade or business exception to base protection rules was discussed, mostly in reference to the EU rule. Professor Grinberg cautioned against adopting the EU's minimal substance requirement (which he described as requiring only "five guys and a dog" to qualify for the exception), as doing so would actually incentivize moving high-value and high-skilled individuals or positions outside the United States to benefit from the exception. Professor Shay noted that the EU has a higher threshold for its active trade or business exception for countries outside the EU.

Senator Cassidy questioned the panelists about a potential bifurcated rate for deemed repatriation, which is part of the Framework's proposal for shifting to a territorial system. All panelists cautioned against publicizing the bifurcated rates and advised that sophisticated taxpayers could plan into a better result by adjusting their cash vs. non-cash assets. Professor Shay specifically advocated for a single rate, arguing that most companies with a "lock-out" problem are creditworthy and have the liquidity to pay the tax so that a bifurcated rate is unnecessary.

Senator Cardin raised the prospect of a Value Added Tax or consumption tax in order to bring down the corporate tax rate. Professor Grinberg has advocated for imposition of a consumption tax, but advised that lowering the corporate tax rate was more important. In his written testimony, Grinberg highlighted a VAT's ability to naturally tax an immobile factor, making the tax less susceptible to base erosion.

The panelists also fielded questions regarding the taxation of intellectual property. Professor Wells discouraged any reform efforts targeted specifically at IP, reasoning that restrictions on royalty stripping payments will be circumvented by a variety of other payments having the same effect. He therefore advocated for a more comprehensive approach that would address all potential forms of payment, as well as strengthening the United States' approach to offshoring intangibles in the first place. Wells said that he believed Treasury could do more under section 367(d). Committee members were also interested in the concept of a patent box, though no panelist advocated for including a patent box in tax reform. Professor Grinberg suggested that any reform provide incentives for R&D and make it easy to repatriate IP back to the United States.

Timing and Next Steps

Before Congress can vote on tax reform, it needs to pass a budget, which will likely include reconciliation instructions that allow tax reform to pass the Senate with 51 votes. The Senate budget resolution currently includes a provision that would allow Senate Finance to mark up a tax bill that could include up to $1.5 trillion worth of deficit spending over the course of the budget window. The House budget resolution currently contains instructions for Ways & Means that would require tax reform to be revenue neutral, but those instructions are expected to be revised to align with the Senate instructions.

Both houses of Congress are expected to vote on a budget in October, followed by a mark-up of a tax bill in the Ways & Means committee at the end of October. If Congress follows the ambitious schedule that the Big Six have laid out for tax reform, then the Senate Finance Committee will consider the tax bill in late

November, with the expectation that legislation will be passed and ready for the President's signature before the end of the year. Given how tight that timeline is and the laundry list of other items on Congress' agenda (such as reauthorizing expiring legislation and funding the government before its funding expires on December 8), it is likely that the schedule will slip.

By: Alexandra Minkovich, Kathryn Rimpfel, Joshua D. Odintz, Washington, DC, and Ceci Hassan, Miami

Something's Fishy: *Avrahami* Provides Limited Guidance for Small Fry in Captive Insurance

The term "captive" in the insurance context generally refers to an insurance company that provides coverage primarily to related entities. Companies insure via captives for a variety of business reasons. For example, commercial insurers may not offer the desired coverage at an affordable price, or the corporate group may prefer to have more control over risk mitigation and claims management. However, the IRS has historically been suspicious of captive insurance arrangements because insurance companies are subject to unique tax accounting rules under Subchapter L of the Code, which allow them to, inter alia, currently deduct amounts set up as reserves for estimated future policy claims. By contrast, a taxpayer that does not qualify as an insurance company cannot currently deduct reserves for future-year liabilities.

The IRS has given particular scrutiny in recent years to captive insurance companies that qualify as "small" insurance companies under Code section 831(b). Section 831(b) provides that non-life insurance companies with annual premiums below a certain level ($1.2 million or below for years prior to 2017 and $2.2 million for later years) may elect to be taxed only on their "taxable investment income," leaving their underwriting income untaxed (but also disallowing deductions for underwriting losses). A captive insurance company that qualifies for and makes the election under section 831(b) is typically called a "microcaptive".

Microcaptives were caught in the IRS crosshairs last year, when the IRS first identified certain uses of 831(b) insurance companies as a type of abusive tax structure in one of its "Dirty Dozen" tax scam listings for 2016. See News Release 2016-25 (Feb. 16, 2016). In Notice 2016-66, issued November 21, the IRS upped the ante by classifying certain section 831(b) arrangements as "transactions of interest" subject to annual reporting and list maintenance requirements. Under Notice 2016-66, reporting may be required if an 831(b) captive is owned 20% or more (directly, indirectly, or by attribution) by an insured or a related person and either: (1) the microcaptive's liabilities are less than 70 percent of its premiums (less policyholder dividends paid), or (2) the microcaptive provided some portion of its insurance proceeds to related parties, including through a guarantee, loan or other transfer.

Caught in the Net

With the recent decision in *Avrahami v. Commissioner*, 149 T.C. No. 7 (2017), the IRS can celebrate snagging one microcaptive in its net. *Avrahami* is the first reported case to consider an insurance company that made an election under 831(b). However, the *Avrahami* opinion does not provide much general guidance

for microcaptive insurance companies as a whole. Rather, it concludes, under the specific facts presented in that case, that the microcaptive at issue will not be respected as an insurance company under the well defined rules for determining whether a company qualifies as an insurance companies for U.S. federal income tax purposes.

In *Avrahami*, Mr. and Mrs. Avrahami owned seven companies, one of which, American Findings, operated three jewelry stores in Phoenix, and six of which owned commercial real estate in Arizona. In 2007, on the advice of an attorney to whom they were referred by their CPA, the Avrahamis incorporated Feedback, a new St. Kitts company, to provide insurance to some of their business entities. Feedback was wholly owned by Mrs. Avrahami and issued various contracts intended to be treated as insurance to four of the companies owned by the Avrahamis. In addition, Feedback participated in a reinsurance pool that was set up and used exclusively by captive insurance clients of the Avrahamis' attorney, Celia Clark, to more broadly distribute their risks, a required element of insurance discussed further below.

However, the facts surrounding Feedback led the Tax Court to conclude that it was not a bona fide insurance company. For example, the Avrahami companies insured by Feedback still retained all of their commercial policies that were in place before Feedback's creation and instead of paying $150,000 in insurance premiums, as they collectively did in 2006, they paid $1.1 million and $1.3 million in 2009 and 2010, respectively, the years at issue in the *Avrahami* case, with the additional premiums going to Feedback. However, no claims were made under any of the Feedback policies until March 2013, after the IRS noted the lack of claims filed in its audit of the Avrahamis and Feedback. By the end of 2010, Feedback had accumulated premiums of over $3.8 million without paying any claims, and almost half of this amount ultimately made its way to the Avrahamis' bank accounts by the end of the year via loans and dividends. Ultimately, upon analyzing these and other circumstances, the Tax Court determined that Feedback was not an insurance company and denied all associated tax benefits.

A Pretty Kettle of Fish

The test for whether a company provides insurance and thus, can potentially qualify as an insurance company for tax purposes, is not set out in the Code or regulations, but has instead been left to the courts. Under the test created by case law, in order for a particular policy to be considered insurance (in either a related or an unrelated context), there are four requirements: (1) the policy's subject risk must be shifted from the insured to the insurer, (2) the risk must be distributed via pooling with other risks, (3) the transaction must constitute insurance "in its commonly accepted sense," and (4) the risk transferred must be an "insurance risk." The Tax Court in *Avrahami* held that Feedback did not have sufficient risk distribution and, although lack of risk distribution alone was sufficient to disqualify it as an insurance company, also found that its offerings did not constitute insurance in its commonly accepted sense.

Plenty of Fish in the Sea: Risk Distribution

Risk distribution occurs when an insurer pools a large enough collection of independent risks. By pooling risks and premiums, an insurer can use premiums earned in relation to unrealized risks or low-cost risks (compared to premiums) to cover any higher-cost claims. Existing precedent provides some guidance about

what is necessary to have sufficient risk distribution in the captive insurance context.

The IRS strongly opposed the deductibility of insurance premiums paid by related parties to captive insurance companies, on the theory that the risk remained in the same economic family and thus was not shifted and distributed, until several key cases were decided in favor of taxpayers in the late 1980s-1990s. In these cases, the courts identified two scenarios in which there could be risk shifting and risk distribution (and thus insurance) in the captive context.

In the first line of cases, the courts found risk distribution based on the pooling of risks from unrelated insureds with the risks of related entities. In *Amerco, et al. v. Commissioner*, 96 T.C. 18 (1991) and *The Harper Group, et al. v. Commissioner*, 96 T.C. 45 (1991) for example, the Tax Court focused on the percentage of premiums received from related versus insureds and held that there was sufficient risk distribution where more than half of the premiums (Amerco) or even as low as 30 percent of premiums (Harper Group) came from unrelated insureds.

In the second line of cases, the courts determined that if a captive insured the risk of sibling companies, the transfer of sibling (but not parent) risk from the sibling's balance sheet to the captive's would constitute risk shifting, and if pooled with a sufficient amount of other sibling risks could create adequate risk distribution to have insurance, even without unrelated risk in the pool. For example, In *Humana, Inc. v. Commissioner*, 881 F.2d 247 (6th Cir.1989), the Sixth Circuit found that risk distribution existed where the captive insured over 20 related corporations, which operated over 60 hospitals with more than 8,500 beds. In *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo 2014-225, the insurer provided insurance for the following risks: workers' compensation, automobile, employment practice, general, and fidelity liabilities. The Tax Court considered that premiums were received from 25 and 45 entities, in each relevant year, respectively, which related to over 200,000 employees in 20 countries, in addition to more than 2,000 vehicles, even though over 50 percent of total premiums were received from one sibling entity. And in *Rent-A-Center*, 142 T.C. No. 1 (2014), the Tax Court held that risk distribution was achieved when the captive offered workers' compensation, automobile, and general liability policies applicable to over 14,000 employees, 7,1000 vehicles, and 2,600 stores spread over all 50 states, even though up to 80 percent of premium was received from one sibling entity.

In contrast, in *Avrahami*, Feedback's direct insurance consisted of only a handful of policies covering three affiliates in 2009 and four in 2010. Specifically, Feedback issued an administrative action policy, which covered legal expenses arising from an administrative action or disciplinary proceeding, and a business risk indemnity policy, which covered business liability caused by construction defects or events excluded from the insured's commercial policies, to three of the Avrahami real estate holding companies. For American Findings (the operating company) Feedback issued a business income policy, which covered lost business income due to reputational damage or new competition; an employee fidelity policy, which covered losses caused by fraudulent or dishonest acts by employees of the insured; a litigation expense policy, which covered expenses incurred in legal defense or legal consultation and a loss of key employee policy, which covered lost business income resulting from the departure of Mr. or Mrs. Avrahami. The Tax Court noted, however, that even more important to a risk

distribution analysis than the number of covered entities was the number of independent risk exposures. In comparison to the cases mentioned above, Feedback's policies covered only 3 jewelry stores, 2 key employees, 35 employees, and 3 real estate properties in metropolitan Phoenix. While the court declined to provide a bright line regarding the number of independent risk exposures necessary for a company to have sufficient risk distribution, it did rule that Feedback's direct policies were not adequate for this purpose.

However, Feedback did not rely solely on sibling risk in order to satisfy the risk distribution requirement. Rather, Feedback took part in a risk pooling program run through a St. Kitts "fronting" insurance company, Pan American. Pan American sold terrorism insurance policies to American Findings and other businesses entities affiliated with captive insurance companies. Pan American then reinsured the risks assumed proportionately to Feedback and several dozen captive insurance companies via a quota share reinsurance agreement, such that each captive contractually assumed a small share of the terrorism risks of business entities affiliated with each of the other reinsuring captives. Cross-insurance pools are relatively common among captive insurers, which might otherwise not have sufficient risk distribution for their policies to be considered insurance. The IRS has recognized that such pools can help an insurer to achieve adequate risk distribution. *See, e.g.*, PLR 200907006. In a typical pool, the participants agree to exchange some of their individual risk for an equivalent share of a portfolio of similar risks, usually via reinsurance. The participants contribute a portion of their risks and associated premiums to the pool and receive the same amount of premiums in return, albeit associated with other risks.

In *Avrahami*, however, the Tax Court determined that Pan American was not actually a bona fide insurance company and that the arrangement it facilitated did not actually pool and distribute risk. Although the risk of terrorist attack is an insurable risk for which coverage is available in the commercial market, the court determined that the premiums charged under the Pan American policies were artificially high (for example, around 80 times more per dollar of coverage than American Findings paid for add-on terrorism coverage under a commercial policy during the same period), and that differences between the Pan American policies and commercial policies did not adequately explain the rate differential. Although the Pan-American policies included coverage against chemical and biological attacks (not covered under the commercial policies reviewed), other aspects of the policy pointed toward the Pan-American policies being lower risk. For example, they were limited to acts of terrorism that resulted in over $100 million in losses **and** occurred in the U.S. but not in a city with more than 1.5 million residents, which limitations had not been met by any event in history. Further, the Pan American terrorism policies charged the same rate to all participants regardless of location, despite evidence that terrorism risk is significantly higher in larger cities.

The court was also very skeptical of whether, if an insured event did befall one of the Pan American policyholders, either of Pan American or the reinsuring captives would have paid the claim. Pan American itself had minimal cash, as it passed on 100 percent of the premiums it received to the reinsuring captives, and the court did not believe that the reinsurance obligations could, or were expected to be, enforced. Mr. Avrahami's testimony was particularly damaging in this regard. Avrahami stated on the witness stand that he understood Feedback to only be at risk for the amount of premiums it paid in to Pan American each

year, and that he would "freak out" if Feedback lost money in the arrangement. Further, Pan American was not compensated like a typical fronting insurance company, which generally receive fronting fees in the neighborhood of 5% of premiums as a ceding commission, but instead received a much lower administration fee paid out of the annual fees that pool participants paid to the attorney sponsoring the pooling arrangement. Considering these and other factors, the court determined that, on balance, Pan American did not in substance operate as an insurance company and did not transfer additional insurance rusks to Feedback.

Neither Fish Nor Fowl: Insurance in its Commonly Accepted Sense

In much of the existing case law, the question of whether a policy constitutes insurance in its commonly accepted sense is given short shrift as compared to the other factors, so it is interesting that the Tax Court focused on this factor in *Avrahami*. Prior case law in the captive context considered several factors in determining whether an offering met this element of the insurance test. In *Avrahami*, the Tax Court took issue with the following factors: whether the insurer was organized, operated, and regulated as an insurance company; whether the insurer had valid and binding policies; and whether Feedback's and Pan American's premiums were reasonable.

The Tax Court first determined that while Feedback was organized as an insurance company, it was not operated as one, based not on the formalities, but the realities of the transactions. As noted earlier, there were no claims filed under Feedback policies prior to the IRS audit, and when claims did begin to flow in, in 2013, they were dealt with on an ad hoc and arbitrary basis, with a number of claims being approved despite being filed outside the term permitted by the relevant Feedback policies. Additionally, the court took Feedback to task for making "investment choices only an unthinking insurance company would make." Specifically, over the years at issue, Feedback delivered more than 65% of its assets either directly to Mrs. Avrahami or via poorly-documented, unsecured loans to an entity called Belly Button, LLC, which was wholly owned by the Avrahamis' three children (none of whom were aware of their ownership), which funds Belly Button used to repay loans from Mr. Avrahami. Belly Button, LLC owned land in Snowflake, Arizona. In addition to being poorly documented, the loans were not properly disclosed to St. Kitts, and impaired the potential payment of any catastrophic losses accrued by Feedback.

Additionally, the court criticized some of Feedback's policies as being poorly drafted and lacking clarity, because they had language that indicated that they were both claims-made policies, i.e. the claims had to be reported during the period, and occurrence policies, i.e. claims had to occur during the period. This was relevant to testing whether the policies were valid and binding, a factor on which prior case law was vague, but considered whether the insureds filed claims for all covered losses and such claims were paid and, additionally, whether the policies identified the insured, contained an effective period for the policy, specified what was covered by the policy, stated the premium amount, and was signed by an authorized representative.

Finally, but perhaps most importantly, the court found Feedback's premiums to be unreasonably high. Although they were set by an actuary, the court found his explanations of the prices at trial to be "often incomprehensible." Although the actuary used the price for comparable commercial coverage as a base rate, he

thereafter chose, seemingly without proper justification, adjustments that had the effect of driving up the premium amount. Even more concerning, the actuary received guidance from the Avrahamis' lawyer regarding the target premium amounts (close to the $1.2 million cap for qualification under section 831(b) during the years at issue), and made adjustments in accordance with that guidance, rather than based on any apparent actuarial decision making. The unreasonableness of the premiums was further confirmed by the fact that while the Avrahamis' businesses paid over $1 million to Feedback each year, they still maintained their commercial insurance coverage for under $90,000 during that same period.

Off the Hook

Overall, Judge Holmes wrote a straightforward but very entertaining opinion, notably by managing to introduce the word "omphaloskeptical" when discussing the IRS audit of the Avrahamis' business entities, including Belly Button. Still, other than setting out one example of a microcaptive that did not qualify as an insurance company, the *Avrahami* decision is light on guidance for other microcaptives and their owners and it leaves a lot of gray area between the arrangements that were accepted in prior case law and the arrangement rejected in *Avrahami*. It should also be noted that the Avrahamis filed a motion for reconsideration with the Tax Court and that motion is pending as of the date of publication of this article.

However, the discussion of penalties in the final pages of the opinion is interesting. Despite the IRS classification of this type of structure as an abusive scam and frequent indications throughout the opinion that the court was inclined to agree, the Tax Court ultimately chose not to apply penalties to the Avrahamis' understatements of income due to the insurance deductions. While the court did not permit the Avrahamis to rely on the advice of the attorney who promoted the scheme, it did agree that they reasonably relied on their trusted CPA, who referred them to that attorney. Further, in a brief sentence, the Tax Court noted that it had "previously declined to impose accuracy-related penalties when there is no clear authority to guide taxpayers." This is a clear call to the IRS to issue guidance on captive insurance, which it has so far failed to do, despite the topic having been included on the IRS Priority Guidance Plan since the 2014-2015 period. If it does take action, the IRS may be able to celebrate some even bigger catches.

By: Katie Marcusse, London and Angela Walitt, Washington, DC

Outside of the Safe Harbor for Reverse Like-Kind Exchanges, the IRS Intends for Benefits and Burdens to Reign

Last year, the Tax Court released its long awaited opinion in *Bartell v. Commissioner*, 147 T.C. No. 5 (Aug. 10, 2016), which addressed the standards applicable to accommodation ownership of property in a "reverse" Section 1031 exchange ("Like-Kind Exchange") that occurs outside of the safe harbor offered by Rev. Proc. 2000-37 (the "Safe Harbor"). A Like-Kind Exchange is a tax-free exchange of one business or investment property for another business or investment property of the same kind. Where a taxpayer would like to realize the

benefits of a tax-free exchange, it may be necessary for the taxpayer to enter into a deferred Like-Kind Exchange in order to satisfy the timing requirements for the purchase and sale of the relevant properties. In a deferred Like-Kind Exchange, an accommodation party takes title to the property being sold while an acceptable replacement property is sought. In a reverse Like-Kind Exchange, an accommodation party takes title to the replacement property before the other property is sold.

The Safe Harbor, applicable to transactions entered into on or after September 15, 2000, applies to deferred Like-Kind Exchanges (including reverse Like-Kind Exchanges) which utilize qualified exchange accommodation arrangements. Under the Safe Harbor, these deferred Like-Kind Exchanges must be completed within 180 days. Where the Safe Harbor requirements are met, the IRS has specifically provided that the accommodation party need not acquire the benefits or burdens of ownership for the deferred Like-Kind Exchange to qualify under section 1031. In *Bartell*, the Tax Court held that a reverse Like-Kind Exchange that did not qualify for the Safe Harbor nonetheless qualified for non-recognition treatment under Section 1031 even though the accommodation party did not take on the benefits or burdens of the ownership of the replacement property.

On August 14, 2017, the IRS issued its response to *Bartell* in an Action on Decision ("AOD"), I.R.B. 2017-33 (Aug. 14, 2017), announcing that it will not acquiesce to the Tax Court's holding that an exchange can qualify as a reverse Like-Kind Exchange outside the confines of the Safe Harbor where the accommodation party did not possess traditional burdens and benefits of ownership over the property.

Background

In August 2000, the taxpayer in *Bartell* arranged through a qualified exchange facilitator ("QEF") to purchase property (the "Replacement Property"). Since this transaction occurred before the September 15, 2000 effective date of the Safe Harbor, the protections of the Safe Harbor did not apply and the case was analyzed under prior case law. After the QEF acquired title to the Replacement Property, the taxpayer constructed a drug store on the site and entered into a lease with QEF to use the property beginning in June 2001. QEF's ownership of the Replacement Property is referred to as a "parking" arrangement through an accommodation party. An affiliate of QEF functioned as the qualified exchange intermediary ("QEI") for the Like-Kind Exchange. After selling the taxpayer's property (the "Relinquished Property") to a third party buyer on December 28, 2001, QEI took title to the Replacement Property from QEF. QEF held title to the Replacement Property for 17 months which would have failed the 180-day Safe Harbor timing requirement if the transaction had otherwise been eligible for the Safe Harbor. QEI subsequently transferred ownership of the Replacement Property to taxpayer on January 3, 2002 in completion of the reverse Like-Kind Exchange. The Like-Kind Exchange treatment resulted in the deferral of the $2.8 million gain realized on the sale of the Relinquished Property.

The IRS argued that the like-kind treatment claimed by the taxpayer should be rejected, reasoning that the taxpayer itself acquired the Replacement Property in August 2000 (i.e., before it disposed of the Relinquished Property in December 2001). The IRS disregarded QEF as the owner because QEF held none of the traditional benefits and burdens of ownership over the property. Under the 1991 regulations, the ownership status of an accommodation party that held title to the

property was addressed for forward section 1031 exchanges but withheld on reverse section 1031 exchanges. The taxpayer disagreed with the IRS position on its status as the owner of the Replacement Property and asserted instead that no applicable authority had imposed the traditional "benefits and burdens" test upon accommodation ownership structures involving reverse section 1031 exchanges. The taxpayer based its arguments on the liberality accorded by Section 1031 authorities towards accommodation ownership structures designed to facilitate like-kind exchanges.

The Tax Court agreed with the taxpayer and permitted the taxpayer's parking arrangement even though QEF held the Replacement Property for approximately 17 months without holding any of the traditional "benefits and burdens" of ownership. The Tax Court concluded that case law supported an accommodation ownership regime for Section 1031 that did not require the accommodation title holder to hold traditional "benefits and burdens" of property ownership and did not impose any specific timeframe for consummation of the exchange transaction. The IRS did not appeal this decision, which was likely driven by the lack of similar cases addressing reverse like-kind exchanges. Until the issuance of the AOD, the IRS position on *Bartell* was unclear. We now have clarity that the IRS does not agree with the decision and will not follow it when the facts of a reverse exchange does not fall within the bounds of the Safe Harbor.

Generally following an adverse Tax Court decision, the IRS will either appeal the ruling or issue an AOD to explain whether it agrees or disagrees with the ruling and whether it will follow the ruling going forward. An AOD is not binding on taxpayers, however, and cannot be cited as precedent. The IRS issues three types of AODs that express either its: (i) "acquiescence," (ii) "acquiescence in result only," (iii) or "nonacquiescence." When the IRS issues an acquiescence or acquiescence in result only AOD, the IRS acknowledges that it accepts the ruling and will follow it when dealing with the same controlling facts. When the IRS issues a nonacquiescence AOD, it indicates that the IRS does not agree with the holding of the case and does not intend to follow the decision although the case was not appealed.

AOD 2017-06

The IRS, through the AOD, announced that it does not acquiesce to the *Bartell* decision. The IRS has effectively stated that it does not agree with the *Bartell* holding that the taxpayer's sale and acquisition of business property qualified as a Like-Kind Exchange.

Implications

Through the AOD, the IRS has clarified its position regarding reverse Like-Kind Exchanges that do not qualify for the Safe Harbor. Specifically, the IRS will continue to review reverse Like-Kind Exchanges that fall outside the scope of the Safe Harbor using the "benefits and burdens" of ownership analysis. Ownership by the accommodation party will not be presumed and form will not prevail over substance. When the Safe Harbor does not apply to a reverse exchange, the accommodation party must actually acquire the benefits and burdens of ownership of the Replacement Property in order for its role in the deferred

transaction to be respected by the IRS. Otherwise, the IRS will continue to litigate parking arrangements for reverse exchanges that do not meet the Safe Harbor requirements provided in Rev. Proc. 2000-37.

By Nicole Renchen, Chicago

When Will Appeals Excuse Exam From an Appeals Conference? Who Knows.

Yet again, the IRS's Office of Appeals ("Appeals") has indicated its desire to allow IRS Compliance Examination teams ("Exam") to participate in Appeals conferences. Over the last few years, Appeals has increasingly permitted Exam to participate in Appeals conferences. On May 1, 2017, Appeals formally implemented its initiative (the "Initiative") to allow Appeals Team Case Leaders ("ATCLs") to permit Exam to participate in Appeals conferences. Rightfully so, taxpayers are concerned about the lack of a concrete standard to determine when Exam is no longer permitted in Appeals conferences. Further, tax practitioners have forcefully voiced their concern that this new Initiative could lead to a mandated Rapid Appeals Process ("RAP") in which taxpayers are forced to discuss settlement with Exam present during an Appeals conferences, reducing the independence of Appeals.

The Initiative

As of October 1, 2016, section 8.6.1.4.4 of the Internal Revenue Manual ("IRM"), *Participation in Conferences by IRS Employees*, was revised to provide:

1. Appeals has the discretion to invite Counsel and/or Compliance to the conference. The prohibition against ex parte communications must not be violated. See Rev. Proc. 2012-18. Appeals may also request that other experts attend conferences.

2. See other IRM Part 8 sections for participation by IRS employees in cases under the *Alternative Dispute Resolution (ADR) Program*. This includes IRM 8.26.5.4.7, *Participants*, that reflects Appeals' discretion to have Counsel, the originating function, or both participate in a *Post-Appeals Mediation* proceeding for a Non-Collection case.

To the extent the decision to include Exam in Appeals conferences is left to the discretion of the ATCL, these changes remain consistent with Treas. Reg. § 601.106(c), which provides: "At any conference granted by Appeals on a nondocketed case, the district director will be represented if the Appeals official having settlement authority and the district director deem it advisable."

In a letter dated November 4, 2016, the IRS's Chief of Appeals, Kirsten Wielobob, provided clarification regarding the IRS's revisions to section 8.6.1.4.4 of the IRM:

> Recently, we revised IRM 8.6.1.4.4, *Participation in Conferences by IRS Employees*. I have heard comments that we added this provision to force taxpayers to use a process similar to the early resolution technique we call the Rapid Appeals Process.

> Appeals always had the discretion to permit other IRS employees to attend conferences and, in fact, the bulk of this section predates the IRS Restructuring and Reform Act of 1998, although the section number has changed over time. The provision is designed to allow Appeals to invite others from IRS and Counsel to conferences to aid in case resolution. It is not intended to force any resolution technique on taxpayers and can actually aid the taxpayer and IRS compliance functions in understanding the cases and issues better.

Since November 4, 2016, Appeals was silent on providing additional information regarding Exam's involvement in Appeals conferences, leaving taxpayers and tax practitioners curiously wondering what extent Exam will be involved in their Appeals conferences. On May 1, 2017, Appeals formally implemented its Initiative to allow ATCLs to permit Exam in Appeals conferences. However, the implementation of the Initiative did not provide further guidance for taxpayers or tax practitioners. After almost a year of silence, on August 8, 2017, the IRS posted a series of "Frequently Asked Questions about Compliance Attendance at Conferences." While helpful, the document still leaves taxpayers and tax practitioners with several questions. The document states:

> On May 1, 2017, the IRS Office of Appeals implemented an initiative in which some Appeals Team Case Leaders (ATCLs) will hold Appeals conferences with representatives from Compliance Examination teams (Compliance) in attendance. For many years, Appeals Officers have had the discretion to invite IRS Compliance personnel to Appeals conferences; this initiative will make Compliance attendance routine for certain cases. The goals for this initiative are to improve conference efficiency, reach case resolution sooner, and offer earlier certainty for issues in future years. As in the past, settlement negotiations will be held between Appeals and the taxpayer without Compliance present.
>
> This initiative relies on taxpayers and Compliance participating in focused joint discussions to identify and, where possible, narrow the factual and legal differences, to assist in Appeals Officers in evaluating the hazards of litigation. The insight that all parties may gain from an open discussion of positions could facilitate resolution of the same or similar issues in subsequent cycles.

Some of the key Frequently Asked Questions are:

- ***If a taxpayer has already fully discussed the issues with Compliance, why have another conversation with Compliance and Appeals?***
  - For cases in this initiative, all parties actively participate to ensure a full understanding of any factual disagreements and the parties' legal positions. This will help the ATCL more rapidly focus on the most significant aspects of the dispute and aid in Appeals' evaluation of the hazards of litigation.
- ***How is this different from the Rapid Appeals Process (RAP) set out in IRM 8.26.11?***

- RAP is a voluntary, collaborative process intended to help Compliance and the taxpayer reach a mediated resolution. In RAP, the parties engage in active negotiation to reach a mutually-agreeable settlement. In contrast, this initiative is intended to allow the parties to listen to each other's presentations and give the ATCL the opportunity to clarify facts and legal arguments that have not otherwise been clearly outlined. Under this initiative, the parties have not agreed to work toward a mediated resolution.

- ***What if the taxpayer does not want to engage in direct settlement discussions with Compliance?***

  - Settlement discussion for cases in this initiative are held between the ATCL and the taxpayer without Compliance present. Settlement discussions between the taxpayer and ATCL occur only after Compliance and the taxpayer have presented their understanding of the facts and the law and have responded adequately to any questions. The ATCL will decide the appropriate time to engage in settlement discussions.

- ***Should a taxpayer expect the entire Compliance team to participate?***

  - No. Generally, only team members involved in the unagreed issues that are the subject of the conference will participate.

- ***Can the taxpayer elect not to participate in the initiative, or request a case transfer to avoid the initiative?***

  - No. For all ATCLs participating in this initiative, Compliance will be invited to attend Appeals conferences. Case transfers will not be granted for the purpose of electing out of the initiative.

- ***Can Compliance raise new issues during the Appeals conference?***

  - No. Compliance cannot raise new issues while a case is under Appeals' jurisdiction. Additionally, if a taxpayer raises new issues in Appeals, the ATCL will return the case to Compliance to examine the issue or make a determination prior to considering the merits of the issue. This is consistent with current guidance relating to Appeals' new issue policy (IRM 8.6.1.6.1 through 8.6.1.6.5).

- ***What is the role of LBI Division Counsel in the initiative?***

  - For purposes of the initiative, Chief Counsel attorneys may be invited to participate if requested by either Compliance or Appeals. This is consistent with current guidance regarding Counsel participating during pre-conferences (IRM 8.7.11.8.3) and Fast Track Settlement sessions (IRM 4.51.4.4.4.7).

Reactions to the Initiative

While the Frequently Asked Questions certainly provide taxpayers and tax practitioners with additional information regarding Exam's involvement in Appeals conferences, taxpayers and tax practitioners are still concerned about the extent of Exam's involvement in Appeals conferences. First, at what point will an ATCL excuse Exam from an Appeals conference so the ATCL and the taxpayer can discuss settlement? How many Appeals conferences are necessary until a taxpayer can engage in settlement discussions with an ATCL? While the Frequently Asked Questions reassure taxpayers that settlement discussions between the ATCL and the taxpayer will only occur without Exam present, the time at which an ATCL decides to excuse Exam from the Appeals conference is still uncertain.

Several taxpayers and tax practitioners have voiced concerns that the Initiative feels akin to the RAP. While the Frequently Asked Questions distinguish RAP from the Initiative, in substance, it seems as though taxpayers are being pushed into RAP. While taxpayers and tax practitioners appreciate Appeals' desire to make sure it fully understands the taxpayer's position and Exam's position, the Initiative sees issues in black and white, but Appeals is responsible for weighing the hazards of litigation in the dispute. Consequently, taxpayers and tax practitioners must be cautious in how they present their cases to Appeals.

The Initiative appears to limit Exam in what it can present as facts or analysis to what it shared in advance of the Appeals conference. While Appeals often permits Exam to raise new material at the Appeals conference, it will be interesting to see how strictly the ATCL enforces this restriction. At what point will an ATCL feel he or she believes it is necessary to return a case back to the examination level? These questions remain unanswered.

Guidance Going Forward

The Frequently Asked Questions provide a non-standard standard with little detailed instructions for ATCLs. Each ATCL will implement the Initiative differently, and consequently, taxpayers and tax practitioners have experienced different levels of involvement by Exam in the Appeals conference, including the number of Exam representatives. Taxpayers are encouraged to remind the ATCL that is within the ATCL's ***sound discretion*** to permit Exam's attendance at the Appeals conference. Further, taxpayers are encouraged to illustrate to the ATCL that the facts are established and the legal theories are known, and thus, Exam should be excused and settlement discussions should begin.

By Cameron Reilly, Chicago

Grecian Magnesite Mining: Tax Court Chimes in on Rev. Rul. 91-32, and It’s Music to Taxpayers’ Ears

On July 13, 2017, the Tax Court in *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner* 149 T.C. No. 3 (July 13, 2017), concluded that a foreign partner is not generally taxable on the gain recognized upon redemption of its membership interest in a domestic partnership doing business

in the United States. One exception to the aforementioned rule is the portion of the gain recognized that is attributable to US real property owned by the partnership.

More specifically, the Tax Court applied the "entity theory" to the disposition of a partnership interest by a foreign partner, and dismissed the decades-old Rev. Rul. 91-32, which applied an "aggregation theory." If upheld, and absent legislative action by Congress, the holding in *Grecian Magnesite Mining* will have far-reaching implications, even outside the area of US federal partnership taxation. Specifically, the holding is significant because it simplifies the manner in which nonresident individuals invest into US partnerships. Furthermore, the ruling further bolsters the argument that an interest in a partnership is not a US situs asset for estate tax purposes.

The *Grecian Magnesite Mining* case concerned the proper treatment of the gain recognized upon redemption of a foreign partner's membership interest in a US partnership. Grecian Magnesite Mining ("GMM") was a Greek corporation that had no office, employees, or business operation in the United States. GMM was a partner in a Delaware limited liability company ("Premier"), that was treated as a partnership for US federal income tax purposes. GMM entered into an agreement for Premier to redeem GMM's interest in Premier for USD 10.6 million, realizing gain of USD 6.2 million. Of the total gain realized, USD 2.2 million was attributable to Premier's US real estate. The remaining USD 4 million was the amount in dispute.

The Tax Court's analysis distinguished between gain that was attributable to Premier's US real estate and gain that was attributable to Premier's remaining non-real estate assets. Notably, the IRS did not argue that any of the disputed gain was attributable to Code Section 751 *hot assets.*

The Tax Court unequivocally held that GMM was subject to tax on the portion of its gain attributable to Premier's US real property interests under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). The Court confirmed that the "aggregation theory" applies in the context of Code Section 897(g), because FIRPTA "taxes the partner not as if it had sold its partnership interest but as if it had sold its portion of the real property interests held in the partnership."

The Tax Court then addressed the treatment of gain that was attributable to Premier's remaining non-real estate assets (the "disputed gain"). Central to the taxability of the disputed gain is the question of whether a foreign partner's liquidation of its interest in a US partnership should be determined under the "entity theory" or the "aggregation theory." In order to answer this question, the Tax Court first analyzed the nature of the disputed gain, and then considered whether such gain was "effectively connected" to the trade or business of Premier.

In accordance with Code Section 736(b)(1), the payments GMM received in the liquidation of its partnership interest were treated as a "distribution by the partnership." The tax effects of such distribution are governed by Code Section 731(a), which provides that any gain or loss recognized shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

Significantly, the court held that Code Section 741 adopts the "entity theory" to determine the gain or loss from the sale or exchange of a partnership interest.

The court recognized that section 741 is meant to operate as a "general rule, not a rule of absolute and universal application." In fact, Congress had expressly legislated for exceptions – such as the treatment of "hot assets" under section 751 or gain from the sale of US real estate under section 897(g). Accordingly, if Congress had intended section 741 to be interpreted as a look-through provision (under the "aggregation theory"), then the exceptions introduced by Congress in sections 751 and 897(g) would be superfluous. Therefore, rather than seeing a tension between section 897(g) and the "entity theory" mandated by section 741, the court believed that the enactment of section 897(g) reinforces the conclusion that the "entity theory" is the general rule of application for section 741.

Moreover, the court focused on the express language of section 741, which provides that income realized on the sale of a partnership interest shall be considered as gain from the "sale or exchange of a capital asset" (emphasis added). The court held that use of the singular "asset," rather than the plural "assets," is consistent with the treatment of the sale of a partnership interest according to the "entity theory" rather than the "aggregation theory." The court also drew support from the express language of section 731(a), which makes explicit that the "entity theory" applies to a partner's gain from a distribution because "any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner." (emphasis added)

In conclusion, the court held that the disputed gain is capital gain from the disposition of a single asset, because (in this logical sequence):

1. Section 736(b)(1) provides that payments such as those giving rise to the disputed gain "shall… be considered as a distribution by the partnership";

2. Section 731(a) provides that such gain "shall be considered as gain… from the sale or exchange of the partnership interest of the distributee partner"; and

3. Section 741 provides that such gain "shall be considered as gain… from the sale or exchange of a capital asset."

Having determined the nature of the disputed gain, the court then considered whether the disputed gain was "effectively connected with the conduct of a trade or business within the United States." More specifically, the court considered whether the disputed gain was effectively connected with the trade or business of Premier, which trade or business would be attributed to GMM by operation of Code Section 875(1).

The IRS relied on Rev. Rul. 91-32 to support its argument that the disputed gain was "effectively connected" with the conduct of a trade or business within the United States. In fact, the ruling held that gain realized by a foreign partner upon disposing of its interest in a US partnership should be analyzed under the "aggregation theory," and, to the extent the assets of the partnership would give rise to effectively connected income if sold by the entity, the departing partner's pro rata share of such gain should be treated as effectively connected income.

The court was critical of Rev. Rul. 91-32, and found that the ruling "is not simply an interpretation of the IRS's own ambiguous regulations." The court held that the ruling "lacks the power to persuade" particularly because the analysis of the partnership provisions was "cursory in the extreme."

Therefore, the court referred instead to Code Section 865(a), which provides the default source rule for income from the sale of personal property. Section 865(a)(2) generally provides that income from the sale of personal property by a nonresident shall be sourced outside the United States.

The IRS argued in response that the US office rule under section 865(e)(2)(A) should displace the default rule. More specifically, the IRS argued that the gain realized by GMM represents GMM's "share of the appreciation in value of Premier's business resulting from Premier's efforts to improve Premier's profits during Grecian's tenure as a partner." In other words, the IRS argued that because the appreciation in the value of GMM's partnership interest was ultimately generated by activities engaged in at Premier's offices, the disputed gain arising from the redemption of the partnership interest should be attributed to Premier's offices.

The court disagreed with this assessment, insofar as it presupposed that the redemption should be analyzed under the "aggregation theory" analysis, rather than the "entity theory" under section 741. Furthermore, the court argued that the *income* that needs to be attributable to the US office is the income arising from the redemption of the partnership interest, and not the income from the underlying business of the partnership. The court also held that the IRS was mistaken in conflating the increase in value arising from the operation of the business with the gain arising from the sale of an interest in the business. In fact, the disputed gain was not realized from Premier's trade or business in magnesite, nor did Premier regularly carry on activities of the type from which the disputed gain is derived. Significantly, the court stressed how increasing the value of Premier's business as a going concern, without a subsequent sale, would not have resulted in the realization of gain by GMM.

Therefore, the court concluded that the disputed gain was not US-source income under section 865(e)(2)(A), as it was not attributable to a US office or other fixed place of business, and that the default rule of section 865(a)(2) treating the sale of personal property by a nonresident corporation as non-US source income was applicable.

The *Grecian Magnesite Mining* decision has a number of significant implications. First, the decision provides certainty as to the treatment of partnership dispositions by nonresident partners. Second, although the *Grecian Magnesite Mining* decision has not changed the income taxation of real estate partnerships, the decision bolsters the argument that a partnership interest held by a nonresident individual is treated as a non-US situs asset for estate tax purposes.

By: Steven Hadjilogiou, Keith Hagan, Daniel Hudson, Miami and Jacopo Crivellaro, Zurich

IRS Actions in New Capital Fire were "Too Little Too Late"

On September 11, 2017, the US Tax Court issued its opinion in *New Capital Fire v. Commissioner*, T.C. Memo. 2017-177, holding that the Commissioner was barred from assessing deficiencies and penalties for a fire insurance company that was merged out of existence nearly 10 years before the Commissioner issued the statutory notice of deficiency. *New Capital Fire* serves as a reminder that there are exceptions to the general rule that the statute of limitations does not start to run until a taxpayer formally files a tax return for the year at issue.

On December 4, 2002, Capital Fire Insurance Co. ("Old Capital") merged via Code section 368(a)(1)(F) into New Capital Fire, Inc. ("New Capital"), with New Capital surviving. New Capital filed its 2002 return on September 12, 2003 (the "2002 return"). Old Capital did not file a return for 2002. Under Treas. Reg. § 1.381(b)-1 and past Treasury guidance, the acquiring corporation in a valid F reorganization must file an income tax return for the full taxable year, but the transferor corporation was not required to file a tax return for any portion of the year of the reorganization.

With its 2002 return, New Capital included information about the merger and Old Capital, including:

- A pro forma Form 1120-PC, US Property and Casual Insurance Company Income Tax Return for Old Capital's 2002 tax year, which ended on December 4, 2002, which was the date of the merger. The pro forma return contained certain information of Old Capital, such as Old Capital's employer identification number, income, deductions, and credits for the period January 1 through December 4, 2002.
- A statement regarding the merger and a copy of the certificate of merger.
- Old Capital's tax payments and checked the box stating that it was the "Final Return" for Old Capital.

New Capital's 2002 return was signed under penalties of perjury. On July 25, 2012—nearly 10 years after the merger and nearly 9 years after New Capital filed its 2002 return—the Commissioner issued Old Capital a notice of deficiency in which he determined, inter alia, that Old Capital was required to file a return for the short tax year ending December 4, 2002. The Commissioner's determination was based on its position that the merger failed to meet the section 368(a)(1)(F) requirements.

New Capital, as the successor to Old Capital, petitioned the deficiency determination to the Tax Court. New Capital filed a motion for summary judgment, which Judge Goeke denied. The parties subsequently appeared in New York for trial and filed post-trial briefs.

Judge Goeke held that the Commissioner's assessment was barred by the statute of limitations. Under section 6501(a), a notice of deficiency must be issued during the assessment period, which ends three years after the taxpayer files the relevant tax return. Here, the Commissioner issued the notice of deficiency nearly nine years after New Capital filed its 2002 return; thus, the period of limitations barred an assessment for that year, unless an exception applied. In this regard, the Commissioner argued that under section 6501(c)(3), the statute of limitations was still open because Old Capital failed to file a return. The Commissioner argued further that New Capital's 2002 return did not qualify as a valid return as it pertained to Old Capital's short tax year.

In reaching his conclusion, Judge Goeke found that it was unnecessary to determine whether Old Capital should have filed a return for the short tax year. Instead, he observed that filing of a tax return, even if it was an incorrect return, was sufficient to start the start the limitations period, provided that the return satisfied the four-part test articulated in *Beard v. Commissioner*, 82 T.C. 766, 777 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986). This four-part test requires that: (1)

the document contained sufficient data to calculate tax liability; (2) the document purported to be a return; (3) there was an honest and reasonable attempt to satisfy the requirements of the tax law; and (4) the taxpayer executed the document under penalties of perjury. Citing other US Supreme Court cases, Judge Goeke emphasized that "perfect accuracy" is not required for a document to constitute a return.

Judge Goeke found that the return New Capital filed satisfied all four parts of the test. Of particular note is that he rejected the Commissioner's argument that Old Capital failed the third prong of the test, on the grounds that New Capital's 2002 return was "purposefully misleading." In rejecting this argument, Judge Goeke observed that the Commissioner did not allege that New Capital's 2002 return was false or fraudulent with intent to evade tax as relating to Old Capital. Moreover, it was "respondent's duty to determine, within the period of limitations provided by section 6501(a), whether New Capital's 2002 return, as it pertains to Old Capital, was erroneous in any respect." Accordingly, the assessment of the deficiency and additions to tax were barred by the statute of limitations.

Because the case was resolved on the threshold legal issue of whether the statute of limitations barred the Commissioner's adjustments, few facts about the reorganization are discussed in the opinion. For instance, we do not know whether the merger actually satisfied the section 368(a)(1)(F) requirements. It is also unclear why the Commissioner waited until 2012 to issue the notice for the alleged 2002 deficiency. For New Capital's 2002 taxable year, the Commissioner issued a notice of deficiency in 2006, and New Capital petitioned that deficiency determination in December 2006 (that case, *New Capital Fire, Inc. v. Commissioner*, Docket No. 25505-06, is continued pending the outcome of this case). It is unclear why there was a three-year gap between the assessment of New Capital's and Old Capital's deficiencies.

Lastly, we do not have insight into how easy or difficult this decision was for the court. On one hand, this opinion is a memorandum opinion, meaning that the Chief Judge decided that this case did not involve a novel legal issue. The opinion also is short, clocking in at just under ten pages. On the other hand, Judge Goeke felt that the case warranted a trial. The parties appeared before Judge Goeke in New York for the trial on May 13, 2015. On April 6, 2015, Judge Goeke denied the petitioner's March 27, 2015 motion for summary judgment "because of the time pressure of the Court and without prejudice to the underlying merits." Either way, it seems that the Commissioner's actions were, in the wise words of JoJo, "Too Little Too Late."

By: Angela Chang, Palo Alto

Updating Partnership Agreements for January 1, 2018 New Audit Rules

The new partnership tax audit rules, enacted by Congress in 2015, are fully effective for partnership taxable years beginning after December 31, 2017. Under the default rules of the new audit regime, the IRS may assess and collect any federal taxes due as a result of a partnership audit at the partnership entity-level, rather than the partner level. The new rules also require each partnership to designate a "partnership representative" to act on behalf of the partnership in the event of an audit. It is imperative that every partnership agreement currently

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in effect be revised (or a side agreement is entered into) to address these rules as soon as possible, and preferably before December 31, 2017. For a more thorough discussion of the new partnership tax audit rules, please see the Baker McKenzie Client Alert "*Updating Partnership Agreements for January 1, 2018 New Audit Rules,*" distributed on October 10, 2017.

Dutch Tax Reform: Reduction in Corporate Tax Rate and Abolishment of Dividend Tax

After months of extensive negotiations, the new Dutch government was finally formed and on October 10th the coalition consisting of four Dutch political parties published their Policy Paper outlining agreed policy for the next four years. This agreement includes various important Corporate Tax Reform proposals. Key items of interest of these tax proposals to US multinational corporations, with operations located in the Netherlands include the reduction of the corporate tax rate to 21% and the abolishment of dividend withholding tax as of 2019. At the same time the proposals also include anti tax avoidance elements based on OECD and EU recommendations. One of the remarkable proposals that has caused consternation is to introduce a withholding tax on interest and royalty payments to low tax jurisdictions. While there are indications that this will only apply in cases where the Dutch payor has no relevant substance (to discourage the use of so called "letterbox companies"), and not affecting the many European headquarters and principal companies in the Netherlands, the coming months will provide more insight once the new government starts working on legislative proposals. Please see the Baker McKenzie Client Alert "*Dutch Tax Reform: Reduction in Corporate Tax Rate and Abolishment of Dividend Tax,*" distributed on October 11, 2017, for an overview of the tax proposals.

By: Mounia Benabdallah, Amsterdam / New York

"Subject To" Means "Actually Paid" for Virginia's Addback Exception

In a 4-3 decision, the Virginia Supreme Court found that royalty payments from a related party must be "actually taxed by another state" to qualify for the "subject-to-tax" exception to Virginia's addback statute. In *Kohl's Dep't Stores Inc. v. Virginia Dep't of Taxation*, Record No. 160681 (Va. 2017), the court read Virginia's "subject-to-tax" exception to apply on a post-apportionment, rather than a pre-apportionment, basis. The court's decision caps a storied past involving Virginia's addback statute, but is problematic for several reasons: (1) the plain language of the statute can be read without ambiguity and any ambiguity that exists should be construed in favor of the taxpayer; and (2) it implicates the constitutional issues of state's rights and sovereign immunity. Please see "*Subject To" Means "Actually Paid" for Virginia's Addback Exception* on the SALT Savvy blog, available at www.saltsavvy.com.

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Florida's Sourcing of Service Receipts – COP in Regulation, Market-Based in Application

The Florida Department of Revenue (the "Department") recently published Technical Assistance Advisement No. 17C1-004 (Aug. 25, 2017) (the "TAA"), which addresses how receipts from "other sales" (i.e., including services) are sourced under Florida Administrative Code Regulation 12C-1.0155(2)(l) (the "Regulation"). Despite the Regulation's clear costs-of-performance ("COP") sourcing language, the Department utilized a market-based sourcing approach, concluding that the receipts from certain services should be sourced to Florida when the taxpayer's customers are physically located in the state. While Technical Assistance Advisements have no precedential value, the TAA showcases Florida's propensity to use market-based sourcing for receipts from services, despite the COP directive in its Regulation. While the Department's position initially may seem surprising, this TAA is consistent with other administrative guidance in Florida. It would be prudent for service providers with an income tax filing obligation in Florida to take note of this TAA and the apparent disconnect between Florida regulatory guidance and Department practice, as well as consider both the potential opportunities and pitfalls it presents.

For more discussion and insight on Florida's sourcing regime applicable to services, please see the SALT Savvy blog post from October 3, 2017, *Florida's Sourcing of Receipts from Services – A Trap for the Unwary Or An Opportunity for the Advised?*, available at http://www.saltsavvy.com/.

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