



April 2009

Dear ,

This issue of the WKBK&Y newsletter addresses:

1. IRS Offers Compromise for Those with Unreported Offshore Income;
2. Family Limited Partnerships Face Potentially Devastating Impact from Proposed Law; and
3. New Code Section 108(i) allows for CODI Deferral

1. IRS Offers Compromise for Those with Unreported Offshore Income

Introduction

In three (3) memoranda issued to field personnel, the Internal Revenue Service (“IRS”) has offered a mitigated penalty assessment, including the avoidance of criminal prosecution, to those who voluntarily disclose unreported offshore income. Taxpayers have limited time to take advantage of the IRS’ policy – after September 30, 2009, the relaxation of the penalties for voluntary disclosure will end.

Background

A substantial problem facing the IRS has been taxpayers who avoid reporting income by hiding wealth and earnings in offshore accounts and entities. While the IRS has instituted massive penalties for those who do not report offshore income and has developed a strong network with many foreign jurisdictions to help locate such offshore accounts and entities, the issue remains a problematic area for the IRS. The IRS hopes that guidance to field personnel will provide taxpayers with an incentive to come forward and report their unreported foreign income by providing a quasi-safe harbor from the harsher penalties such taxpayers might otherwise face. IRS Commissioner Doug Shulman commented that the “goal is to have a predictable set of outcomes to encourage people to come forward and take advantage of our voluntary disclosure practice”.

IRS Offer

For a limited time period ending September of 2009, the IRS has agreed to resolve a taxpayer's issue of unreported offshore income as outlined below:

1. The taxpayer will be assessed all taxes and interest for the prior six (6) years. And of course, the taxpayer must file or amend past tax returns and other forms, including Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, also know as the "FBAR".

2. The tax payer will be assessed either an accuracy or delinquency penalty.

3. In lieu of any other penalties that may apply, including the potentially massive penalties related to the to the FBAR and other penalties which can be assed in connection with tax evasion, the IRS will assess a penalty equal to 20% of the amount in foreign bank accounts or entities in the year with the highest account or asset value.

This 20% penalty may be reduced to 5% if the following conditions are met:

- a. the taxpayer did not open any accounts or form any entities;
- b. there has been no activity in any account/entities during the time the taxpayer was in control; and
- c. all other US taxes have been paid so that only earnings have escaped taxation.

While the IRS' offer may seem costly, the offer will likely produce penalties far below the penalties that a taxpayer would face if the IRS was to discover the error on its own.

WKBKY Takeaway

The IRS' offer is a remarkable opportunity for taxpayers to resolve outstanding issues in relation to unreported offshore income and move forward with a clean slate. With the avoidance of criminal prosecution and a likely reduced assessment, taxpayers have much to gain by taking advantage of the IRS' offer by September of 2009.

Perhaps, if the program proves successful, the IRS may establish a formal policy for voluntary disclosure of such offshore accounts and income. Though that is pure speculation.

2. Family Limited Partnerships Face Potentially Devastating Impact from Proposed Law

Introduction

A bill has been introduced in the House, HR 436, that would disallow valuation discounts in the transfer of interests in certain entities including family limited partnerships.

Background

A useful device for succession planning has been to set up a family limited partnership (“FLP”). Interests in a FLP are owned by family members. When a family member’s interests are transferred to another family member, taxpayers often utilize marketability and minority discounts for transfer tax purposes. Such discounts allow taxpayers to leverage annual gifting exclusions and the lifetime exclusion. The IRS has traditionally highly scrutinized FLPs; however, as WKBKY has reported numerous times over the past year, there have been a number of recent Tax Court cases ruling favorably on discounts in the FLP context.

Proposed Law

Rep. Earl Pomeroy [D-ND] sponsored HR 436: Certain Estate Tax Relief Act of 2009. The proposed bill would, *inter alia*, change valuation rules so that valuation discounts would no longer be allowed for transfers of entities, not actively traded, if the transferee and members of the transferee’s family have control of the entity. The bill would also disallow valuation discounts for nonbusiness assets held within entities not actively traded. The effect would be to eviscerate many of the succession planning purposes of family limited partnerships (FLP) and other entities with a similar intention by disallowing discounted valuations at the time of transfer. Should HR 436 become law it would apply to transfers occurring after the effective date which would allow taxpayers a limited time to try and maximize succession planning based on prior law.

(As an aside, HR 436 would also freeze the unified credit exclusion at \$3.5 million and the maximum estate tax rate at 45%.)

Presently, the bill has been referred to the House Ways and Means Committee and is still far removed from becoming law. As the bill is in the early stages of the legislative process, this is an excellent juncture to contact your representative in the House and let him or her know your viewpoints in regard to HR 436.

WKBKY Takeaway

HR 436 should be monitored and kept in mind when contemplating or working with succession structures which may be impacted should the bill become law. In addition, this is an ideal time to utilize the political process and contact your representative and let them know your views on HR 436. With all the tax legislation due to come over the next year, the reformation of the estate and gift tax law, and the deficit and need to increase revenue, revenue generating laws, such as HR 436, may see increased attention in the Congress this year. WKBKY will strive to monitor this bill and provide practitioners with updates regarding the bill’s status in the legislative process.

3. New Code Section 108(i) allows for CODI Deferral

Introduction

In our February edition, we reported on a number of changes to the Internal Revenue Code (“Code”) made by the American Recovery and Reinvestment Act of 2009 (“ARRA”). In that article, we highlighted briefly that qualifying cancellation of debt income (“CODI”) realized in 2009 and 2010 can be deferred and recognized ratably over five (5) years, beginning in 2014. Due to the nature of the current economic climate, and the recognition that more and more businesses will be facing loan workouts in 2009 and 2010, WKBKY is pleased to bring you this more detailed account of the new provisions.

Background

Practitioners are aware that cancelled debt is gross income under Code section 61 because it represents and accession to wealth in the form of a forgiven liability. Moreover, we are all aware of the exclusions to CODI recognition covered in Code section 108(a).

ARRA Adds New Section 108(i)

The ARRA added new subsection (i) to Code section 108. The new provision allows a taxpayer that modifies or repurchases a debt instrument during calendar year 2009 or 2010 to elect to defer certain CODI. The deferral election is only available for a “qualifying reacquisition” of an “eligible debt instrument”.

“Qualifying reacquisitions” include the following:

1. The acquisition of a debt instrument for cash;
2. The exchange of a debt instrument for another debt instrument (including a modification resulting in a deemed exchange);
3. The exchange of a debt instrument for equity of the issuer;
4. The contribution of a debt instrument to the capital of the issuer by an equity owner; or
5. The complete forgiveness of a debt instrument by a holder.

An “eligible debt instrument” is defined rather broadly. It includes (i) any indebtedness issued by a C corporation, and (ii) indebtedness issued by any other person in connection with the conduct of a trade or business.

Making the Election

The election is made by attaching a statement to the taxpayer’s return for the taxable year in which the qualifying reacquisition occurs. The statement must clearly identify the debt instrument subject to the election, the amount of deferred CODI, and any other information that may be prescribed the IRS. To date, the IRS has yet to publish any guidance, Notice or form

relating to the election, so for now we are stuck with the statutory provisions outlined immediately preceding as to the manner of election.

The election is irrevocable once made.

Deferral Period and Acceleration Events

The CODI deferral is quite generous. First, no qualifying CODI is required to be recognized until 2014. Then from 2014 through 2018, the CODI is recognized ratably (twenty percent (20%)) each year.

Certain events will accelerate the recognition of the deferred income:

1. The death of the taxpayer;
2. The liquidation of the taxpayer;
3. The sale of substantially all of the taxpayer's assets (including in a bankruptcy or similar case); or
4. The taxpayer's cessation of business; or
5. In the case of a passthrough entity, the sale, exchange or redemption of an equity interest in the entity by the holder of such interest.

Section 108(i) authorizes the IRS to prescribe regulations for acceleration in other appropriate circumstances. Again, IRS has yet to prescribe any regulations or other guidance on new section 108(i).

Special Rules for Partnership CODI

For partnerships, section 108(i) requires that the deferred CODI be allocated to the partners immediately before the debt repurchase event in the same manner as such amounts would have been included in the distributive shares under Code section 704 if the income were recognized at the time of discharge. Any decrease in a partner's share of liabilities as a result of such discharge is not taken into account for purposes of Code section 752 to the extent that the deemed distribution would result in gain recognition under Code section 731 (i.e., gain from a deemed distribution in excess of the partner's basis). Any excess deemed distribution is deferred and is taken into account at the same time and to the extent remaining as the deferred CODI is recognized in subsequent years.

WKBKY Takeaway

Code section 108(i) is one of many gifts the Congress has given taxpayers in response to the recession. It is one that a number of clients should find particularly useful because many businesses are facing serious debt restructuring issues at present.

In particular, the special treatment for partnerships shows that Congress was on top of the ball on this one because leaving out the 731 implications of a debt restructure could easily result in many partners having to recognize gain (albeit generally a capital gain) on the back-end when

the deemed 752 distribution hits. The provision also avoids the risk of low-basis partners from essentially being taxed twice—once as a result of the deemed distribution via 731, and then again when the deferred CODI is recognized at the partnership level. The partnership provisions are helpful in that they coordinate the deemed distribution (which reduces the partner's outside basis) with the deferred CODI recognition (which increases the partner's outside basis).

Practitioners will recognize that in some instances, section 108(i) may not be the proper choice to make. This is particularly so where another exclusion under section 108(a) (e.g., insolvency or bankruptcy) may apply. Careful evaluation is warranted in these circumstances, however, as choosing exclusion under 108(a) will often require a taxpayer to reduce other tax attributes to account for the excluded income. Another reason taxpayers may reject the 108(i) election is where they have substantial losses to carry forward to 2009 or 2010. Such taxpayers might well prefer to recognize the CODI in the year it is realized and offset that against the losses it took in prior years. Practitioners are advised to keep these considerations in mind in consulting clients on whether to make the 108(i) election.

WKBKY will keep you updated when and if the IRS publishes additional guidance on the new provision.

We hope that you find these items of interest to you. If you need further information or would like to discuss a particular issue, feel free to call any one of the lawyers listed below. We will get you to the right person.

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