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Tax Controversy Services

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In this issue:

For Taxpayer who Underwent Statutory Mergers, the Court of Federal Claims Allows Interest Netting on Pre- and Post-Merger Underpayments and Overpayments

Generally, interest is payable on tax deficiencies (IRC § 6601) and is allowed on tax overpayments (IRC § 6611). In accordance with the Code, however, taxpayers pay interest at a higher rate on tax underpayments than the interest they receive from the Internal Revenue Service ("IRS"). The Internal Revenue Code provides some measure of relief for this inequity in the form of "interest netting" under section 6621(d). Under section 6621, overlapping periods of overpayment and underpayment for the same taxpayer have a net rate of interest of zero. In order to qualify for interest netting, payments must have been made by the "same taxpayer," but neither the Internal Revenue Code nor the Treasury Regulations define the term.

In *Wells Fargo & Company v. United States*, 2014 US Claims LEXIS 588 (Ct. Fed. Cl. 2014), Wells Fargo was the surviving entity in a long line of statutory mergers. It filed with the Internal Revenue Service ("IRS") a number of refund claims, which, among other things, requested interest netting in connection with underpayments and overpayments in three different scenarios:

1. Between a pre-merger acquiring corporation and a pre-merger acquired corporation,
2. Between pre-merger acquiring corporation and the post-merger surviving corporation, and
3. Between a pre-merger acquired corporation and the post-merger surviving corporation.

The IRS denied the refund claims for the pre-merger scenarios, based on its position that the "same taxpayer" means the same Taxpayer Identification Number ("TIN"), and that the TINs must have been the same when the payments were made. Because an acquired company never has the same TIN as the acquiring or surviving corporation, the government argued that interest on a tax underpayment or overpayment attributable to income from entities later acquired by Wells Fargo cannot be netted with interest on overpayments or underpayments attributable to Wells Fargo.

Wells Fargo argued that § 6621(d) allows for interest netting among merged entities on the grounds that, following a merger, the acquiring corporation becomes one and the same with the corporation it acquired by operation of law. Wells Fargo argued that the government's interpretation of "same taxpayer" was legally incorrect because it failed to take into account the legal realities of corporations following mergers, including the obligation of the surviving corporation to assume the tax liabilities of the acquired entity. Wells Fargo further argued that, following a statutory merger, the acquired entity ceases to exist, along with its TIN, and thus at the time a taxpayer seeks interest netting following a merger, the TIN no longer serves as an adequate representation of taxpayers for purposes of determining "same taxpayer" status.

The IRS position was derived in large part from two cases: *Energy East Corp. v. United States*, 645 F.3d 1358 (Fed. Cir. 2011) and *Magma Power Co. v. United States*, 101 Fed. Cl. 562 (2011). In *Energy East*, the plaintiff acquired two subsidiaries and then tried to net interest on underpayments and overpayments, all of which were made prior to the acquisition. The court held that because they were not the same taxpayer when the payments were made, netting was not available. Magma Power addressed a situation in which a taxpayer wanted to net a subsidiary's portion of a consolidated group's overpayment against prior, pre-consolidation underpayments by the subsidiary. The court allowed the netting, reasoning that because the subsidiary retained its TIN, it was the "same taxpayer" pre- and post-consolidation. In Wells Fargo, the IRS argued that the same result should apply for companies that have undergone a statutory merger: no netting should apply because their TINs were different when the payments were made.

The Court of Federal Claims ("Court") rejected the IRS position and allowed interest netting in all three of Wells Fargo's scenarios. It distinguished Energy East and Magma Power by noting that those were affiliated companies filing as consolidated groups. The companies in Wells Fargo, on the other hand, were associated with one another through statutory mergers, wherein the corporations become one and the same. Because the acquired corporations are treated by law as though they had always been part of the surviving entity, any payments made are deemed to be by the "same taxpayer" under section 6621.

A prior version of this opinion was released on June 27, 2014. On October 20, 2014, an amended opinion was released which included language certifying the issue for appeal.

The Ninth Circuit Deals Another Blow to the IRS's Proposed Transferee Liability Analysis under §6901

Under IRC §6901, the IRS is able to collect taxes from parties other than the original taxpayer if it can establish that the following two-prong test is satisfied:

1. The party is a "transferee" under IRC §6901 and federal tax law; and
2. The party is substantively liable for the transferor's unpaid taxes under state law.

In several recent cases, the IRS has attempted to recover taxes that remain unpaid as a result of Midco[1] transactions.[2] In Midco transactions, shareholders who desire to sell stock are matched with a buyer who wishes to purchase only assets through an intermediary company, which purchases the stock and sells the assets. The intermediary company is liable for tax on the resulting sale, but attempts to offset the gain with unrelated losses. A tax liability results if that offsetting of gains and losses is unsuccessful. If, as in this case, the intermediary company does not have assets to satisfy its additional tax liability, the IRS, in order to attempt to collect some or all of this additional tax liability, can look beyond the intermediary company under a transferee liability theory.

In attempting to satisfy the requirements under §6901 and collect the tax liabilities from the original shareholders, the IRS has argued that the two prongs of the §6901 test should not be analyzed independently from one another. The IRS position is that courts should use federal law, including the "substance over form" doctrine, to recharacterize the transaction in the first prong of the analysis of "transferee" status. If the court finds that a taxpayer is a transferee under federal law and moves on to a state law analysis in the second prong, the IRS argues that courts should apply the relevant state's substantive liability law to the transaction as recharacterized in the first prong. If the prongs of the §6901 test are instead applied independently, as taxpayers have argued, under the second prong the transaction would only be recharacterized if doing so would be in accordance with the law of the relevant state.

The Ninth Circuit Court of Appeals is the most recent appellate court to reject the IRS's proposed analysis and to instead analyze the two prongs of the §6901 analysis independently. In *Salus Mundi Foundation v. Commissioner*,[3] the Ninth Circuit considered an IRS appeal on the state law portion of a transferee liability case centered on a Midco transaction that has been extensively litigated.[4] The Ninth Circuit considered the IRS's argument but rejected it and found that the two factors should be applied independently. Previously, the First Circuit, Second Circuit, Fourth Circuit, and US Tax Court have all held that the second prong of the §6901 analysis should be made in the same way as the Ninth Circuit held in *Salus Mundi*

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[1] *See* Notice 2001-16 (I.R.S. 2001), which addresses "intermediate transactions" tax shelters, also referred to as "Midco transactions."
[2] See *Diebold Found. Inc. v. Commissioner*, 736 F.3d 172 (2nd Cir. 2013); *Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012); and *Julia Swords Trust v. Commissioner*, 142 T.C. No. 19 (2014).
[3] 2014 US App. LEXIS 24240 (9th Cir. 2014).
[4] Covered previously in *IRS Insights*. (http://newsletters.usdbriefs.com/2014/Tax/IRSI/140113_2.html)

Foundation -basing their analyses entirely on state law, without modification by federal law.[5] The IRS has not issued any Action on Decision with respect these prior cases. As a result, it is unclear whether the IRS will continue to pursue this transferee liability issue in cases that are appealable to circuits other than the First, Second, Fourth or Ninth Circuits.

The Joint Committee on Taxation Review Threshold for C Corporation Refunds has been Raised to $5,000,000

Public Law 113-295, commonly referred to as the extenders package, retroactively extends most – but not all – of the 2013 expired federal tax provisions for one year (through 2014). However, it also includes a tax administration provision raising the dollar threshold for refunds for which a report is required to be sent to the Joint Committee on Taxation ("Joint Committee") prior to payment.

Under Internal Revenue Code §6405, the Internal Revenue Service is required to send a report to the Joint Committee prior to issuing certain refunds and credits. Previously, section 6405(a) provided that no refund or credit of any income tax (and some other types of taxes) in excess of $2,000,000 shall be made until after expiration of 30 days from the date upon which a report is submitted to the Joint Committee on Taxation.

Public Law 113-295 includes a provision that, for C-corporations only, raises the refund dollar threshold requiring a report to be submitted to the Joint Committee to $5,000,000. The change is effective December 19, 2014, but does not apply to any report that had already been made to the Joint Committee before December 19, 2014.

Large Business & International Division Issues Directive Related to Section 166 Deductions for Eligible Debt and Eligible Debt Securities

On October 24, 2014, the IRS issued LB&I-04-1014-008 ("Directive"), which provides Large Business & International Division (LB&I) examiners with guidance regarding bad debt deductions claimed under IRC § 166 by a bank or bank subsidiary.

According to the Directive, independently determining worthlessness amounts under IRC § 166 imposes a significant burden on banks, bank subsidiaries, and LB&I examiners. Moreover, the Directive notes that changes in bank regulatory standards and processes have created concerns about how to comply with the conclusive presumption regulations under § 166. In an attempt to alleviate the burdens and concerns, the Directive provides an administrative resolution generally based on accepting charge-off amounts reported by banks and bank

[5] See *Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013); *Diebold Found. Inc. v. Commissioner*, 736 F.3d 172 (2nd Cir. 2013); *Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012); and *Julia Swords Trust v. Commissioner*, 142 T.C. No. 19 (2014).

subsidiaries for Generally Accepted Accounting Principles ("GAAP") and regulatory purposes as sufficient evidence of worthlessness.

The Directive instructs LB&I examiners not to challenge a bank's bad debt deduction if the bank or bank subsidiary properly uses any of the following methods to determine the amount of a claimed bad debt deduction: the general facts and circumstances method in Treas. Reg. § 1.166-2(a); the specific order method in Treas. Reg. § 1.166-2(d)(1); or the book conformity method in Treas. Reg. § 1.166-2(d)(3). The Directive is applicable to any debts or debt securities reported on the bank's financial statement that are subject to IRC § 166. On examination, any bank or bank subsidiary that has chosen to apply the new Directive will be asked to certify, under penalties of perjury, the applicable method and charge-off amounts, and provide, upon request, the underlying documentation to support its certification.

This Directive applies only to the 2010 through 2014 tax years, and does not apply to small banks that use the reserve method of accounting under IRC § 585.

IRS Updates Post-Appeals Mediation Guidelines with Revenue Procedure 2014-63

Under Internal Revenue Code ("IRC") section 7123(b)(1), the Internal Revenue Service ("IRS") is required to prescribe procedures for mediation between taxpayers and the IRS Office of Appeals. Recently, the IRS issued Rev. Proc. 2014-63, which provides to taxpayers the most recent guidelines for the post-appeals mediation program. It updates Rev. Proc. 2009-44 and incorporates provisions of Announcements 2008-111 and 2011-6 (which provided for mediation in certain offer-in-compromise (OIC) and Trust Fund Recovery Penalty TFRP cases in Appeals offices in select cities).

Mediation is a nonbinding process that uses the services of a mediator, as a neutral third party, to help Appeals and the taxpayer reach their own negotiated settlement. This is only available after Appeals settlement discussions are unsuccessful. To accomplish this goal, the mediator will act as a facilitator, assist in defining the issues, and promote settlement negotiations between Appeals and the taxpayer. The mediator will not have settlement authority in the mediation process and will not render a decision regarding any issue in dispute.

Section 4.03 of the Revenue Procedure 2014-63 sets forth the issues for which mediation is available. The issues for which mediation is available include:

1. Legal issues;
2. Factual issues;
3. A Compliance Coordinated Issue (CCI) or an Appeals Coordinated Issue (ACI), unless the taxpayer has declined the opportunity to discuss the CCI or ACI issue with the Appeals CCI or ACI coordinator during the course of regular Appeals settlement discussions. (CCI and ACI issues are listed online at www.irs.gov/appeals);
4. An early referral issue when an agreement is not reached;
5. Issues for which a request for competent authority assistance has not yet been filed;
6. Unsuccessful attempts to enter into a closing agreement under section 7121;

7. Certain OIC issues; and
8. Certain TFRP issues.

Section 4.04 of the Revenue Procedure 2014-63 sets forth the issues for which mediation is not available. Mediation is not available for:

1. Cases in which mediation is not appropriate under either 5 U.S.C. § 572 or 5 U.S.C. § 575, which provide the general authority and guidelines for use of alternative dispute resolution in the administrative process;
2. Issues designated for litigation;
3. Issues docketed in any court;
4. Collection cases, except for certain OIC and TFRP cases;
5. Issues for which mediation would not be consistent with sound tax administration;
6. Frivolous issues;
7. "Whipsaw" issues;
8. Cases in which the taxpayer did not act in good faith during settlement negotiations;
9. Cases that were previously mediated through a different alternative dispute resolution program within Appeals, such as Fast Track Settlement or Fast Track Mediation; and
10. Issues that have been otherwise identified in subsequent guidance issued by the IRS as excluded from the mediation program.

The revenue procedure sets forth instructions as to how a taxpayer requests mediation, as well as a description of the mediation process, including how a mediation session is conducted, and the post-mediation session procedures.

IRS Releases Final Regulations Concerning the Manner of Filing Form 5472

On December 24, 2014, the IRS published final regulations (T.D. 9707, 79 FR 77388) relating to the filing of Form 5472, *Information Return of a 25% Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business*.

The final regulations adopt, without substantive change, the proposed regulations published in the Federal Register by the Department of the Treasury and the IRS in a notice of proposed rulemaking, REG-114942-14, on June 6, 2014. Consistent with the proposed regulations, the final regulations remove a provision for timely filing Form 5472 separately from an income tax return that is untimely filed. As a result, Form 5472 would be required to be filed in all cases only with the filer's income tax return for the tax year by the due date (including extensions) of that return.

Under the prior version of the section 6038A regulations, if the taxpayer filed Form 5472 separately before the due date for its income tax return, and then subsequently attached Form 5472 to its untimely tax return, the taxpayer could avoid a late-filing penalty under IRC § 6038A ("untimely return provision"). The final regulations bring the 5472 regulations into conformity with similar international reporting obligations. For example, Form 5471, "Information Return of US Persons With Respect to Certain Foreign Corporations," and Form 8865, "Return of US Persons With Respect to Certain Foreign Partnerships," must be filed with the filer's income tax return for the tax year by the due date (including extensions) of the return, and there is no provision equivalent to the untimely filed return provision that would require or permit separate filing of those forms.

In declining to adopt a comment that would have retained the Form 5472 untimely filed return provision and made conforming changes to the regulations for Form 5471 and Form 8865, *Return of US Persons With Respect to Certain Foreign Partnerships*, the Department of the Treasury and the IRS reasoned that they “have determined that tax administration is generally more efficient when forms (for example, Form 5471, Form 5472, and Form 8865) are filed with the filer’s timely filed income tax return.” The final regulations are effective on December 24, 2014.