

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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date: April 07, 2006

to: Terri Harris, Motor Vehicle Technical Advisor

from: Eric R. Skinner
Associate Area Counsel

subject: PORC Audit Issues

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

ISSUES

1. What is the appropriate filing requirement and applicable statute of limitations for assessment and collection of any tax for the CFC after TEGE has determined it is not properly classified as a tax exempt entity pursuant to I.R.C. section 501(c)(15).

a. When is the 953(d) election terminated?

b. What is the effect of the 953(d) election termination for purposes of I.R.C. section 367?

2. Is the failure to pay penalty appropriate to pursue and will reasonable cause apply to that failure? Is the reasonable cause standard similar to the failure to file standards?

3. Whether the current Forms 2848 Power of Attorney and Declaration of Representative are valid if they identify the entities, the years involved, but do not

identify the type of tax or the new tax form(s) at issue as a result to the tax-exempt revocation.

FACTS

TEGE has determined that a number of CFC's, that have made elections under section 953(d) and that were previously classified as tax exempt insurance companies pursuant to I.R.C. section 501(c)(15) do not qualify for tax exempt status since they do not qualify as insurance companies under Subchapter L. TEGE has/will issue (d) determination letters revoking the entities' tax exempt status. A number of LMSB/SBSE Examination Division groups are now, or will be, conducting income tax audits of the CFCs to determine the tax liabilities of the CFCs and/or shareholders as a result of the TEGE determination.

LAW AND ANALYSIS

1. What is the appropriate filing requirement and applicable statute of limitations for assessment and collection of any tax for the entity after TEGE has determined it is not properly classified as a tax exempt entity pursuant to I.R.C. section 501(c)(15).

The entities at issue are foreign corporations classified as insurance companies in their respective jurisdictions¹ and considered controlled foreign corporations as that term is defined in I.R.C. section 953(d)(1)(A). The entities have filed elections under I.R.C. section 953(d)(1)(D) to be treated as domestic corporations and also filed an application (or self declared themselves) to be treated as a tax exempt insurance company pursuant to I.R.C. section 501(c)(15). For all years at issue the entities have filed Forms 990.

Following an examination by the Tax Exempt and Governmental Entities (TEGE) division the entities' tax exempt status pursuant to I.R.C. section 501(c)(15) was revoked on the grounds that the entity was no longer qualified as an insurance company under Subchapter L. Such revocation is effective for the first year under examination and for all future periods. For the year in which the tax exempt status is revoked the entity then becomes subject to U.S. taxation. As a result of the I.R.C. section 953(d) election (discussed in greater detail below) the foreign corporation is still treated as a domestic U.S. Corporation for the **first** year TEGE determines tax exempt status is no longer proper. As such, the entity's tax liability for that year should be calculated and reflected on Form 1120. U.S. Corporation Income Tax Return.

If the entity determined in good faith that it was an exempt organization and filed an exempt organization return and, subsequently, the taxpayer is held to be a taxable

¹ Based on a review of the underlying cases the corporations are usually incorporated in tax haven countries such as Turks & Caicos, Bermuda, etc. The specific identify of the foreign jurisdiction of incorporation for the entities is irrelevant for the purposes of this memo.

organization, the three-year period for assessment or collection starts to run on the date the exempt organization return (e.g. the Form 990) was filed. I.R.C. section 6501(g)(2). Note: I.R.C. section 6501(g)(2) overturned the portion of the decision in Automobile Club of Michigan v. Comm., 353 U.S. 180 (1957), which provided that the filing of Forms 990 did not trigger the three-year period for assessing corporate income tax, for lack of data necessary to compute the deficiencies. Also, to invoke this rule, the entity did not have to have an IRS determination of its exempt status at the time the return was filed. See, Knollwood Memorial Gardens v. Commissioner, 46 T.C. 764 (1966). Thus, the filed Forms 990 statute dates control the statute of limitations for the Form 1120 in the year of revocation and any returns for subsequent years that should have been filed.

a. When is the 953(d) election terminated?

Revenue Procedure 2003-47, 2003-28 I.R.B. 55 provides the rule for determining the timing of the 953(d) election termination following a determination by TEGE that the entities are not tax exempt insurance companies. Specifically the ruling provides:

.02 Termination or Revocation of Section 953(d) Election.

(1) Once approved, the election generally remains effective for each subsequent taxable year in which the requirements of this revenue procedure and section 953(d) are satisfied unless revoked by the electing corporation with the consent of the Commissioner. **However, if the electing corporation fails to timely file a return, pay the tax due as stated on the return, or comply with any other requirement for making the election contained in this revenue procedure and section 953(d), the Commissioner, in his discretion, may terminate the election as of the beginning of the taxable year after the taxable year with respect to which the failure occurs.** If an election is terminated or revoked, the foreign corporation and its successors will be barred from making another election under section 953(d) without the consent of the Commissioner. (emphasis added).

Thus, in the year TEGE determines the entities are not tax exempt insurance companies (e.g. "comply with any other requirement for making the [953(d)]" the Commissioner may terminate the I.R.C. section 953(d) election as of the beginning of the next year. See also I.R.C. section 953(d)(2)(B). The practical effect of terminating the I.R.C. section 953(d) election will be to treat the entities as CFCs beginning in the year **after** the TEGE determination. As discussed above, the entities will be treated as U.S. Corporations for the year in which TEGE makes its determination.

b. What is the effect of the 953(d) election termination for purposes of I.R.C. section 367?

Revenue Procedure 2003-47 also provides that If a corporation's section 953(d) election ceases to apply for any subsequent taxable year after making the election, for purposes of section 367, the corporation will be treated as a domestic corporation transferring (as

of the first day of the subsequent taxable year) all of its property to a foreign corporation in connection with an exchange to which section 354 applies. Thus, the first day of the year **after** the TEGE determination that the entities are not tax exempt pursuant to I.R.C. section 501(c)(15), the entities will be treated as making an outbound transfer of its assets to a CFC "in connection with an exchange to which section 354 applies."

As such, the entity will be taxable as a U.S. Corporation (filing a Form 1120 U.S. Corporation Income Tax Return) for the first day of the year after the IRC 953(d) election termination. The outbound transfer (and any capital gain) will be reflected on a "one-day" Form 1120. Immediately after the outbound transfer on the first day of the taxable year after the IRC 953(d) election termination, the entity will be treated for U.S. tax purposes as a controlled foreign corporation.

2) Is the failure to pay penalty pursuant to I.R.C. section 6651(a) appropriate to pursue.

Section 6651(a)(2) penalizes a taxpayer who fails to timely pay the amount shown as tax on any return required by subchapter 61A relating to income, self-employment, estate, and gift tax returns. The penalty does not apply, however, if the failure is due to reasonable cause and not willful neglect.

Substitute for Returns

If, in the present case, the Service prepare substitutes for return in connection with the income tax examinations of entities previously classified as tax exempt (e.g. prepares an SFR Form 1120 for an entity that filed a Form 990) special rules must be followed in connection with the assertion of a failure to pay penalty. As a general rule a return prepared by the IRS will be treated as a return filed by the taxpayer for purposes of the failure to pay the tax shown penalty of § 6651(a)(2).

In June, 2003, the IRS announced that it will no longer assert the failure to pay penalty in cases where the return was prepared by the IRS unless the IRS has processed, as a return, documents that:

- (1) identify the taxpayer,
- (2) provide a basis for the taxpayer's tax computation, and
- (3) are signed by an IRS employee delegated the authority to sign such § 6020(b) returns.

Under Treas. Reg. § 301.6020-1T(b)(2), a document (or set of documents) signed by an authorized IRS official or employee is a return for purposes of § 6020 if the document(s): (1) identifies the taxpayer by name and TIN; (2) contains sufficient information to compute the taxpayer's tax liability; and (3) purports to be a return. A Form 13496, an ASFR Certification, or any other form that an authorized IRS official or employee signs and uses to identify a set of documents as a § 6020(b) return, and the

documents identified, constitute a § 6020(b) return. To address situations where the IRS prepares and signs § 6020(b) returns by hand or through automated means, the temporary rules provide that the name or title of an internal revenue officer or employee appearing on the return is sufficient as a subscription by that officer or employee to adopt the document as a return for the taxpayer without regard to whether the name or title is handwritten, stamped, typed, printed, or otherwise mechanically affixed to the document. The document(s) and subscription may be in written or electronic form. A return made in accordance with the temporary regulations and signed by an authorized IRS official or employee is considered prima facie good and sufficient for all legal purposes, including for purposes of determining the failure to pay penalty. Regs. § 301.6020-1T(b)(3).

Reasonable Cause

Most of the civil tax penalties including failure to pay provide an exception if the required performance is not forthcoming as a result of reasonable cause. For the failure to file penalty the taxpayer must also show that the failure is not due to willful neglect.

Reasonable cause is based on all the facts and circumstances in each situation and is generally agreed to exist when a taxpayer exercises ordinary care and prudence in determining his tax obligations but is unable to comply with those obligations.

In determining whether the taxpayer exercised ordinary business care and prudence, the IRS reviews all available information including:

- the taxpayer's reason;
- the taxpayer's compliance history;
- the length of time between the event cited as the reason for noncompliance and subsequent compliance; and
- whether the circumstances were beyond the taxpayer's control.

In the present set of cases the agents must also consider the fact that the taxpayers' classification has been changed as a result of IRS (TEGE) action and should consider that factor in connection with the other factors listed above in determining whether the failure to pay penalty is appropriate.

Taxpayers who did not receive a determination letter may not qualify for the reasonable cause defense if the belief that they are a tax-exempt organization, alone, is their basis for requesting relief. In *Knollwood Memorial Gardens v. Commissioner*, 46 T.C. 764, 794 (1966), the Tax Court determined that although the taxpayer's good faith belief that it was tax exempt was sufficient to start the running of the statute of limitations under section 6501(g)(2), such good faith belief was not sufficient to avoid the failure to file penalty of section 6651(a). Because Treasury Regulation §§ 1.1501(a)-1(a)(2) and 1.6033-1(c) provide that an organization must file an application to be exempt from tax, and any returns or tax due prior to establishing exemption must be filed and paid, a good faith belief that an organization is exempt is not reasonable cause for failure to file a return. In fact, solely a belief that one is not required to file a return is not enough to discharge the penalty. The filing of Form 990 information returns does not constitute reasonable cause or demonstrate absence of willful neglect in failing to file the correct forms as required by the regulations. Thus, in instances where taxpayers did not receive a determination letter, absent other facts and circumstances, the reasonable cause defense may not be valid. Although the analysis in *Knollwood* was for the failure to file penalty under the 1954 code, the statutory language for the current code is the same, and the same reasoning could be applied to the failure to pay penalty. If the taxpayer was required to file the return and pay the tax if such return was due prior to receiving the determination letter, then the taxpayer should be subject to the failure to pay penalty. As a practical matter the revenue agent should differentiate between taxpayers who have received determination letters and those who have not.

3) Whether the current Forms 2848 Power of Attorney and Declaration of Representative are valid if they identify the entities, the years involved, but do not identify the type of tax or the new tax form(s) at issue as a result to the tax-exempt revocation.

In the present case, the examination of the entities began as an exempt organization exam by TEGE. As a result of TEGE's examination/determination, the previously claimed tax exempt status of the entities has been revoked.

The Forms 2848 solicited at the beginning of the (now taxable) entities' income tax examination should identify the return(s) the entities are required to file as a result of the tax exempt status revocation (e.g. 1120). If Forms 2848 have already been secured for the entities but identify the Form 990, the Forms 2848 should be resolicited.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (313) 237-6426 if you have any further questions.

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