OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: December 15, 1999

MEMORANDUM FOR:

FROM: Elizabeth G. Beck
Senior Technical Reviewer, CC:INTL:BR6

SUBJECT:

This Field Service Advice responds to your memorandum dated May 24, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Amount A =
Amount B =

CFC1 =
Cost 1 =
Country A =
Country B =
Country C =

Date A =
Date B =
Date C =

Federal Circuit A =

Holding Company1 =
Holding Company2 =

Product A	=
State A	=
State B	=
Taxable Year 1	=
Type X	=
USCorp	=
USSub	=

ISSUE:

For Taxable Year 1, whether a controlled taxpayer may claim that a cost sharing arrangement is a qualified cost sharing arrangement under Treas. Reg. § 1.482-7(a)(1) despite its failure to substantially comply with Treas. Reg. § 1.482-7(c)(1)(iii) and the administrative requirements of Treas. Reg. § 1.482-7(j) due to its failure to attach a cost sharing statement to its U.S. income tax return or Forms 5471.

CONCLUSION:

No. A controlled taxpayer may not claim that a cost sharing arrangement is a qualified cost sharing arrangement where it did not substantially comply with the administrative requirements for qualified cost sharing arrangements because it did not attach a cost sharing statement to its Taxable Year 1 U.S. income tax return and related Forms 5471 as required by Treas. Reg. §§ 1.482-7(c)(1)(iii) and 1.482-7(j).

FACTS:

USCorp, a U.S. corporation organized under State A law on Date C with its principal place of business in State B, is engaged in the manufacture of Product A. USCorp is not a Coordinated Examination Program taxpayer, and therefore is subject to random audit as opposed to continuous audit on a three-year cycle. USCorp and its subsidiaries filed a consolidated U.S. income tax return (Form 1120) for Taxable Year 1, which began subsequent to January 1, 1996. USCorp also filed Forms 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) for nine controlled foreign corporations located in several countries, including Country A, Country B and Country C.

A. Taxable Year 1

The beginning of USCorp's Taxable Year 1 was Date B, a date subsequent to January 1, 1996. For Taxable Year 1, USCorp did not attach a cost sharing statement to its Form 1120 or Forms 5471 filed on behalf of its nine controlled foreign corporations. Furthermore, USCorp did not file Forms 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business).

With reference to its Taxable Year 1 Form 1120 filed by USCorp and its subsidiaries, USCorp listed a Cost 1 payment received totaling $ Amount A. USSub, a domestic subsidiary of USCorp organized under State A law, listed a Cost 1 payment received totaling $ Amount B. No information was provided on, or attached to, the Form 1120 to explain why USCorp or USSub received the Cost 1 payments and specifically, whether they were received pursuant to a cost sharing arrangement.

As regards the Taxable Year 1 Forms 5471 filed by USCorp and its subsidiaries, two of the Forms 5471 related to transactions with two of USCorp's wholly-owned foreign subsidiaries, Holding Company1 and Holding Company2. On both Forms 5471, Holding Company1 and Holding Company2 listed "partnership income" which Examination believes includes income and expenses relating to transactions between USCorp and CFC1. CFC1 is a Country A "Type X Corporation" which is jointly owned by Holding Company1 and Holding Company2, which have elected to treat CFC1 as a partnership for U.S. tax purposes.

During audit, USCorp provided Examination with a copy of a Date A cost sharing agreement between USCorp and CFC1.

B. <u>Overview of the Cost Sharing Arrangement between USCorp and CFC1</u>

As of Date A, a date prior to January 1, 1996, USCorp and CFC1 entered into a "Technology Cost and Risk Sharing Agreement" ("CSA") with the intent to "establish a structure whereby each party will share in the research and development costs incurred . . . in order to further develop the Existing Technology, and whereby each party will be a joint owner of any technology developed on or after [Date A]." CSA, Recitals. "Existing Technology" was defined to mean,

> any proprietary designs, plans, processes, instruments, machines, materials, compositions, test procedures, manufacturing procedures, techniques, formulations, methodologies, software, data and information which is owned, discovered or developed by [USCorp], other than in cooperation with [CFC1], and which is involved in the manufacture, use or sale of the Products.

CSA, Sec. 1. We note that “Products,” which is apparently the focus of the research and development performed pursuant to the CSA, is not defined in the agreement. Additionally, the CSA does not clarify or describe the scope of the research and development to be undertaken, or the intangible or class of intangibles intended to be developed. No further information is provided in the CSA regarding the role of each party in the research, design, manufacture, distribution or geographic exploitation of the covered intangible(s).

The CSA provides that it will remain in force until terminated by either party giving thirty days written notice during the thirty-day period following the close of a fiscal quarter. CSA, Sec. 12.

In accordance with the terms of the CSA, USCorp and CFC1 agreed to jointly own “all right, title and interest” in new technology developed by either party. CSA, Sec. 2. “New Technology” refers to technology developed by either USCorp or CFC1 on or after the Date A effective date of the CSA. CSA, Sec. 1(c). USCorp technology is deemed to include technology of USCorp subsidiaries that are included in USCorp’s consolidated Federal income tax return. Id. It is not clear whether one or both parties retained legal title to the new technology, nor whether exploitation was divided between the participants geographically. USCorp retained responsibility for obtaining worldwide legal protection for new technology. CSA, Sec. 10. CFC1 retained the right to obtain protection for new technology where USCorp elected not to do so, provided that such legal protection remained in USCorp’s name so long as USCorp took steps reasonably requested by CFC1 to facilitate registration of the new technology. CSA, Sec. 10.

LAW AND ANALYSIS:

A. Cost Sharing Arrangements Generally

Pursuant to Code section 482, transfers of intangible property between controlled taxpayers must reflect arm’s length consideration, typically in the form of a royalty payment. Treas. Reg. §§ 1.482-1, 1.482-4 through 1.482-6. A cost sharing arrangement is an alternative available to controlled taxpayers engaged in the codevelopment of intangible property, and permits exploitation of the developed intangible property absent payment of consideration (i.e., a royalty) between the controlled participants as is otherwise required under the transfer pricing rules. Pursuant to the terms of the cost sharing arrangement, the parties agree to share the costs of development of the intangible in proportion to their shares of reasonably anticipated benefits from their individual exploitation of their interests in the intangible. Treas. Reg. § 1.482-7(a)(1).

B. Development of the Cost Sharing Regulations

Section 482 provides that the Service "may distribute, apportion or allocate gross income, deductions, credits or allowances" among controlled businesses where " . . . such distribution, apportionment or allocation is necessary in order . . . clearly to reflect the income . . . " of such controlled businesses. I.R.C. § 482. The intent of section 482 is,

> [T]o place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer . . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Treas. Reg. § 1.482-1(b)(1) (1968). See also Treas. Reg. § 1.482-1(a)(1) (1994), effective for USCorp's Taxable Year 1.

1. Pre-1995 Final Cost Sharing Regulations

In 1968, specific guidance on the application of the arm's length standard regarding transfers of intangible property was added to the section 482 regulations. 33 Fed. Reg. 5848 (April 16, 1968). These intangible property regulations included a provision on cost sharing arrangements, which provided:

> A bona fide cost sharing arrangement is an agreement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced. In order for the arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of development on an arm's length basis. In order for the sharing of costs and risks to be considered on an arm's length basis, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement.

Treas. Reg. § 1.482-2(d)(4) (1968).

Under the 1968 cost sharing regulations, a cost sharing arrangement was "bona fide" if the agreement was written and reflected a good faith effort of the participants to share costs and risks associated with the development of covered intangibles on an arm's length basis. Id. Additional administrative requirements for participants of a bona fide cost sharing arrangement were not imposed until the issuance of the 1995 cost sharing regulations.

In 1986, concerned about income tax deferral and effective tax exemptions resulting from U.S. corporations transferring intangible property to related foreign corporations in low tax jurisdictions while retaining the value of the earnings in the related group, Congress amended section 482 by adding an additional sentence. Joint Committee on Taxation Staff, General Explanation of the Tax Reform Act of 1986, 99th Cong. 2d Sess., 1013-1014 ["JCT Explanation"]. Section 1231(e) of the Tax Reform Act of 1986 added the requirement to section 482 that where there is a transfer or license of intangible property between controlled parties, "the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2561, *et. seq.*, 1986-3 C.B. (Vol. 1) 1, 478-81. Congress intended that this "commensurate with income" standard meet the objective that the allocation of income between related parties reasonably reflect the economic activity and risks undertaken respectively. See H.R. Rep. No. 426, 99th Cong., 1st Sess. (1985), 1986-3 C.B. 424-26; JCT Explanation at 1015. A related concern was the Service's ability to administer section 482 regulations due to difficulties in obtaining pricing and valuation information for transferred intangibles. See JCT Explanation at 1015 (stating "There are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable. Congress thus concluded that it is appropriate to assure that the division of income between related parties reasonably reflect the relative economic activities undertaken by each"). Congress explicitly noted that amendments to section 482 were not intended to preclude the use of

> [C]ertain bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such agreements are consistent with the purposes of this provision that the income allocated among the parties reasonably reflect the economic activity undertaken by each.

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 638 (1986), 1986-4 C.B. 638.

In 1988, following a Congressional recommendation, the Treasury Department and the Service conducted and published for comment a study of intercompany transfer pricing, which included among other things, the Service's proposed administrative requirements for taxpayers seeking to participate in a cost sharing arrangement.

Notice 88-123, 1988-2 C.B. 458 ("White Paper"). The White Paper proposed that taxpayers seeking to enter into cost sharing arrangements make a formal election and contemporaneously document the specifics of the cost sharing arrangement. White Paper, 1988-2 C.B. 458, 498. Furthermore, any U.S. participant in a cost sharing arrangement was to include a copy of the agreement with its first return filed after the effective date of the agreement. Id. Additionally, within 60 days of the Service's request, participants were to agree to produce, in English, the records of foreign participants to verify computation and appropriateness of cost shares. Id.

Following review of public comments, the Service issued proposed regulations on the transfer of intangible property and cost sharing arrangements. 57 Fed. Reg. 3571 (Jan. 30, 1992), 1992-1 C.B. 1164. The proposed cost sharing regulations required that taxpayers substantially comply with each administrative requirement to be deemed a participant in the cost sharing arrangement. Prop. Treas. Reg. § 1.482-2(g)(6)(ii) (1992). The proposed administrative requirements for participants were as follows:

> (A) The material provisions[1] of the arrangement are summarized in (or a copy of the agreement is attached to) the income tax return filed by the participant, if any, or they are summarized in any attachment to Schedule M of Form 5471 or any attachment to Form 5472 filed with respect to that participant in each year that the arrangement is in effect;
>
> (B) The participant maintains records that are sufficient to verify the material provisions of the arrangement, the amount of the costs borne under the arrangement by each participant during the taxable year, and the computation of each participant's operating income resulting from the arrangement; and
>
> (C) The records described [in paragraph (B) above] are produced within 60 days of a request by the district director for such records . . . .

Prop. Treas. Reg. §§ 1.482-2(g)(6)(ii) (A)-(C) (1992).

In 1993, the Service issued temporary section 482 regulations, which incorporated verbatim the 1968 regulation on cost sharing. 58 Fed. Reg. 5263 (Jan. 21, 1993), 1993-1 C.B. 90; Temp. Treas. Reg. § 1.482-7T (1993). Thus, the administrative requirements suggested in the White Paper and 1992 proposed cost sharing

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[1] "Material provisions" of the cost sharing arrangement included, but were not limited to, identification of the arrangement's participants, duration, intangible development areas covered by the arrangement, and the method for dividing costs of developing intangibles. Prop. Treas. Reg. § 1.482-2(g)(6)(iii) (1992).

regulations were not incorporated in the 1993 temporary cost sharing regulations, which were effective for taxable years beginning after April 21, 1993. Temp. Treas. Reg. § 1.482-1A (1993).

On July 8, 1994, the Service published final section 482 regulations, which included general transfer pricing rules relating to intangible property, but did not include final cost sharing regulations. T.D. 8552, 1994-2 C.B. 93. Thus, the 1993 temporary cost sharing regulations, which incorporated the text of the 1968 regulations, continued to apply. Id. at 112.

2. 1995 Final Cost Sharing Regulations

On December 20, 1995, the Service published final cost sharing regulations. 60 Fed. Reg. 65553 (Dec. 20, 1995), 1996-1 C.B. 85. These final regulations replaced the 1993 temporary cost sharing regulations for taxable years beginning on or after January 1, 1996. Treas. Reg. § 1.482-7(k) (1995).

Section 1.482-7(a)(1) defines a cost sharing arrangement as

> [A]n agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement.

Treas. Reg. § 1.482-7(a)(1) (1995).

Under the final cost sharing regulations, a taxpayer may claim that a cost sharing arrangement is a "qualified cost sharing arrangement," provided it meets the requirements of Treas. Reg. § 1.482-7(b). Treas. Reg. § 1.482-7(a)(1). In general, the district director shall not make section 482 allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each controlled participant's share of the costs of intangible development under the qualified arrangement equal to its share of reasonably anticipated benefits attributable to such development. Treas. Reg. § 1.482-7(a)(2). Among the requirements set forth in Treas. Reg. § 1.482-7(b), a qualified cost sharing arrangement must include two or more participants and be recorded in a document contemporaneous with the formation of the cost sharing arrangement. Treas. Reg. §§ 1.482-7(b)(1), (4). A "participant" in a cost sharing arrangement may be either a "controlled participant," defined as a controlled taxpayer meeting the requirements of Treas. Reg. § 1.482-7(c)(1), or an "uncontrolled participant," defined as an uncontrolled taxpayer that is a party to the cost sharing arrangement. Treas. Reg. § 1.482-7(c)(1).

A “controlled taxpayer” is defined as any one of two or more taxpayers owned or controlled directly or indirectly by the same interests; whereas an “uncontrolled taxpayer” is defined as any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests. Treas. Reg. § 1.482-1(i)(5).

A controlled taxpayer may be a controlled participant in a qualified cost sharing arrangement only if it:

> (i) Reasonably anticipates that it will derive benefits from the use of covered intangibles;
> (ii) Substantially complies with the accounting requirements described in paragraph (i) of this section; and
> (iii) <u>Substantially complies with the administrative requirements described in paragraph (j) of this section</u>.

Treas. Reg. § 1.482-7(c)(1)(i)-(iii) (emphasis added). Thus, to qualify as a “controlled participant” in a qualified cost sharing arrangement under the final cost sharing regulations, the taxpayer must “substantially compl[y] with the administrative requirements described in paragraph (j) ... ” Treas. Reg. § 1.482-7(c)(1)(iii) (1995).

Pursuant to section 1.482-7(j), the administrative requirements are divided into two categories, the documentation requirements of Treas. Reg. § 1.482-7(j)(2) and the reporting requirements of Treas. Reg. § 1.482-7(j)(3). The documentation prong of the administrative requirements requires a controlled participant to maintain sufficient documentation to establish that the requirements of Treas. Reg. §§ 1.482-7(b)(4) and 1.482-7(c)(1) have been met, as well as additional documentation specified in Treas. Reg. § 1.482-7(j)(2). Treas. Reg. § 1.482-7(j)(2)(i). A controlled participant is not required to attach this documentation to its income tax return, rather such documentation must be provided to the Service within thirty days of a request. Treas. Reg. § 1.482-7(j)(2)(i).

The reporting prong requires:

> A controlled participant <u>must attach to its U.S. income tax return</u> a statement indicating that it is a participant in a qualified cost sharing arrangement, and listing the other controlled participants in the arrangement. A controlled participant that is not required to file a U.S. income tax return must ensure that such a statement is attached to Schedule M of any Form 5471 or to any Form 5472 filed with respect to that participant.

Treas. Reg. § 1.482-7(j)(3) (emphasis added).

In sum, a controlled participant must substantially comply with the administrative requirements of Treas. Reg. § 1.482-7(j) to claim qualified cost sharing arrangement treatment. Treas. Reg. §§ 1.482-7(a)(1), 1.482-7(b) and 1.482-7(c)(1)(iii). Furthermore, the district director may apply the cost sharing regulations to any arrangement that in substance constitutes a cost sharing arrangement, notwithstanding a failure to comply with any of the qualified cost sharing arrangement requirements. Treas. Reg. § 1.482-7(a)(1). Finally, where a controlled taxpayer acquires an interest in intangible property (other than in consideration for bearing a share of the costs of the intangible's development), the district director may make appropriate allocations to reflect an arm's length consideration for the acquisition of the interest in such intangible under the rules of Treas. Reg. §§ 1.482-1 and 1.482-4 through 1.482-6. Treas. Reg. § 1.482-7(a)(2). If, after any cost allocations the district director may make pursuant to Treas. Reg. § 1.482-7(a)(2), a controlled participant bears costs of intangible development that over a period of years are consistently and materially greater or lesser than its share of reasonably anticipated benefits, then the district director may conclude that the economic substance of the arrangement between the controlled participants is inconsistent with the terms of the cost sharing arrangement. In such case, the district director may make an allocation by which the participant that bore a disproportionately greater share of costs must receive an arm's length payment (under Treas. Reg. §§ 1.482-1 and 1.482-4 through 1.482-6) from the controlled participant whose share of the intangible development costs is less than its share of reasonably anticipated benefits over time in consideration for the effective receipt of additional interests in the covered intangibles. Treas. Reg. § 1.482-7(g)(5).

C. Substantial Compliance under Treas. Reg. § 1.482-7(j)(3)

Initially, we note that "substantial compliance" is defined neither in Code section 482, nor the 1995 final cost sharing regulations, nor the general definitions of Code section 7701. See I.R.C. §§ 482, 7701, and Treas. Reg. § 1.482-7.[2]

[2] There are numerous sections of the Internal Revenue Code and Treasury Regulations which employ the term "substantial compliance" or a derivation thereof, but which also fail to define the term.

For Internal Revenue Code sections employing the language of substantial compliance, see I.R.C. §§ 401(i)(2) (Employee benefit plans - Qualified pension, profit-sharing, and stock bonus plan); 982(a) (Income from foreign sources - Admissibility of documentation maintained in foreign countries); 1391(d)(2)(B) (Cooperatives - Designation procedure for empowerment zones, enterprise communities, and rural

In the absence of a definition of "substantial compliance," we rely on case law to interpret the meaning within the context of Federal tax law. While Federal Circuit A case law would control this issue because USCorp's principal place of business is in State B, the leading cases on substantial compliance for federal tax purposes are decisions by the 7th Circuit Court of Appeals and the United States Tax Court, see infra.

Case law has established two constructs for evaluating "substantial compliance," a plain-language test and a Federal common law doctrine. The Federal common law

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development investment areas); 2032A(d)(3) (Estate Taxes - Election; agreement); 3303(b)(3) (Employment taxes - Conditions of additional credit allowance); 3304(c) (Employment taxes - Approval of State laws); 3305(j) (Employment taxes - Applicability of State law); 6038A(e)(2)(C) (Information and returns - Information with respect to certain foreign-owned corporations); 7611 (Miscellaneous provisions - Restrictions on church tax inquiries and examinations); 7701(b)(5) (Miscellaneous provisions - Definitions - "exempt individual").

For additional Treasury regulation sections employing the language of "substantial compliance", see Treas. Reg. §§ 1.167(a)-11(f) (Depreciation based on class lives for property first placed in service after Dec. 31, 1970); 1.167(a)-12(f)(1) (Depreciation based on class lives for property first placed in service before Jan.1, 1971); 1.274-5A(c)(2) (Items not deductible - Substantiation requirements); 1.274-5T(c) (Items not deductible - Substantiation requirements (temporary)); 1.367(a)-3(c)(9) (Corporate Organizations and Reorganizations - Treatment of transfers of stock or securities to foreign corporations); 1.468A-3(h)(1) (Methods of accounting - Ruling amount); 1.1248-7(a)(2)(i) (Rules for determining Capital Gains and Losses - Taxpayer to establish earnings and profits and foreign taxes); 1.1461-2(c)(4) (Application of withholding provisions - Return of tax withheld); 1.6038-1(j) (Tax Returns or Statements - Information returns required of domestic corporations with respect to annual accounting periods of certain foreign corporations beginning before January 1, 1963); 1.6038-2(k)(4) (Tax Return of Statements - Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations beginning after December 31, 1962); 1.6038A-4(b)(1) (Tax Returns or Statements - Monetary penalty); 5f.168(f)(8)-1 (A-14) (Itemized Deductions for Individuals and Corps. - Questions and answers concerning transitional rules and related matters regarding certain safe harbor leases (Temporary)); 31.3121(k)-1(e) (Federal Insurance Contributions Act - Waiver of exemption from taxes); 48.4061(a)-1(e)(2)(iii)(B) (Imposition of tax, exclusion for light duty trucks, etc.); 301.7611-1 (A-11) (Examination and Inspection - Questions and answers related to church tax inquiries and examinations); 301.7701(b)-3 (Definitions - Days of presence in the United States that are excluded for purposes of section 7701(b)).

doctrine of substantial compliance generally does not control in instances where, as here, the plain-language of a statute or regulation specifically includes the language of substantial compliance. Estate of Gunland v. Commissioner, 88 T.C. 1453, 1459 (1987) citing Taylor v. Commissioner, 67 T.C. 1071, 1080, acq. 1979-2 C.B.; Thorrez v. Commissioner, 31 T.C. 655 (1958), aff'd, 272 F.2d 945 (6th Cir. 1959). Therefore, our analysis focuses on the plain-language test.

The leading case which analyzes the plain-language test of substantial compliance is Prussner v. United States, 896 F.2d 218 (7th Cir. 1990), aff'g 87-2 USTC ¶ 13,739 (C.D. Ill. 1987). In Prussner, the Seventh Circuit concluded that failure to attach a recapture agreement to a timely filed estate tax return meant that the taxpayer had not substantially complied with the special use valuation requirements of Treas. Reg. § 20.2032A-8(c) as required by Code section 2032A(d)(3). Thus, a review of the issue and facts in Prussner is instructive on what constitutes substantial compliance.

The issue in Prussner involved a "special use valuation" election pursuant to Code section 2032A, which permits heirs to family farms and closely-held businesses to value farm or business assets based on actual use, rather than on the basis of the most commercially lucrative use. Special use valuation is an irrevocable election that mandates compliance with several requirements before farm or family business assets may be valued based on actual use. Specifically, an estate tax return must be timely filed, and a notice of election and recapture agreement both must be attached to a timely filed return. See I.R.C. § 2032A; Treas. Reg. § 20.2032A-8(a)(3); Form 706 ("United States Estate (and Generation-Skipping Transfer) Tax Return"). The recapture agreement must be signed by every heir with a vested or contingent interest in the estate.

In Prussner, the estate's attorney did not attach a recapture agreement to the timely filed estate tax return and notice of election, but instead attached a letter explaining that the recapture agreement would be forwarded to the Service once it had been signed by all heirs who were located throughout the United States. Prussner, 896 F.2d at 221. Four months later, the attorney filed a recapture agreement that complied with all the requirements except timeliness. Id. The Service subsequently revalued the farmland based on its most commercially valuable use because the recapture agreement was not attached to the timely filed estate tax return. Id. The plaintiff appealed the district court decision in favor of the Service, arguing that the estate substantially complied with the special use valuation requirements of Code section 2032A and the corresponding regulations. Id.

Code section 2032A(d)(3) prescribes procedures whereby substantial compliance with the special use valuation regulatory requirements is sufficient if a taxpayer makes a timely election and submits a recapture agreement, but fails to provide all the necessary information.[3] Specifically, a taxpayer is deemed to have substantially complied with the election requirements where the timely filed notice of election does not contain all the required information, or where required information or signatures of one or more persons are not included in the timely filed recapture agreement. I.R.C. § 2032A(d)(3). In both instances, the election for special use valuation is deemed valid if the executor provides the necessary information within 90 days of a request from the Service. Prussner, 896 F.2d at 221. The purpose of the recapture agreement, which must be signed by every heir with a vested or contingent interest in the estate, is two-fold: first, to provide consent for the collection of additional estate tax which may be imposed if the property is not used for its designated special use within 10 years of the decedent's death, and second, to designate an agent acting on behalf of the heirs in dealings with the Service. I.R.C. § 2032A(d)(2); Treas. Reg. § 20.2032A-8(a)(3). Thus, the recapture agreement simplifies the collection of estate tax if it later becomes due.

In Prussner, the estate's attorney neither sought an extension of time to file the recapture agreement nor filed an incomplete recapture agreement. The Seventh Circuit found that the failure to file a recapture agreement with the timely filed estate tax return was not a form of "substantial compliance" contemplated under the

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[3] Code section 2032A(d)(3) (1985), in effect at the time the executor attempted to make the special use valuation election, required the Secretary to direct promulgation of regulations where,

> (A) the executor makes [a special use valuation] election under paragraph (1) within the time prescribed for filing such election, and
> (B) substantially complies with the regulations prescribed by the Secretary with respect to such election, but –
>   i. the notice of election, as filed, does not contain all required information, or
>   ii. signatures of one or more persons required to enter into the [recapture agreement] are not included on the agreement as filed, or the agreement does not contain all required information,
>
> the executor will have a reasonable period of time (not exceeding 90 days) after notification of such failures to provide such information or agreements.

I.R.C. § 2032A(d)(3) (emphasis added).

statute. Prussner, 896 F.2d at 222, 223. The court concluded, "For this default the statute provides, as the Eighth Circuit has also concluded, no absolution." Id. (referring to Eighth Circuit decision in Foss v. United States, 865 F.2d 178 (8th Cir. 1989) holding that a failure to attach a notice of election and a recapture agreement to a timely filed estate tax return precluded a finding of substantial compliance with special use valuation requirements). Thus, the Seventh Circuit employed a strict and literal reading of the special use valuation statute and regulations, and held that the estate's failure to attach a recapture agreement was not a form of noncompliance curable within 90 days. As a result, the taxpayer was precluded from benefitting from special use valuation under section 2032A(d)(3), even though the Service was on notice that the estate sought special use valuation. A series of special use valuation cases are in accord with the Prussner substantial compliance holding on section 2032A(d)(3). See Estate of Lucas v. United States, 97 F.3d 1401 (11th Cir. 1996), cert. denied, 520 U.S. 1186 (1997); Estate of Hudgins v. Commissioner, 57 F.3d 1393 (5th Cir. 1995), reh'g denied, 1995 U.S. App. LEXIS 27954 (5th Cir. 1995); Bartlett v. Commissioner, 937 F.2d 316 (7th Cir. 1991), reh'g denied en banc, 1991 U.S. App. LEXIS 21217; Estate of Merwin v. Commissioner, 95 T.C. 168 (1990); Estate of Gunland, 88 T.C. 1453 (1987).

The Prussner court also analyzed the case under the Federal common law doctrine of substantial compliance and applied the American Air Filter five factor test to distinguish between essential and procedural regulatory requirements. Prussner, 896 F.2d at 223-24. The Seventh Circuit noted that multifactored tests, like the American Air Filter test, are difficult to apply, and criticized the "incomplete dichotomy [between essential and procedural requirements] that the Tax Court commonly uses to frame the issue of substantial compliance . . . ." Id. at 224. Nevertheless, the Prussner court applied the essential-procedural distinction embodied in the American Air Filter five factor test, because in several other cases, the Tax Court had concluded previously that there was no defense of substantial compliance for failure to comply with an "essential requirement" - a requirement which harms or prejudices the Service when not complied with. Prussner, 896 F.2d at 224 citing Hewlett-Packard Co. v. Commissioner, 67 T.C. 736, 748 (1977); Sperapani v. Commissioner, 42 T.C. 308, 332-34 (1964).

Before reviewing the Prussner court's application of the five factor test, review of American Air Filter, Co., Inc. v. Commissioner, 81 T.C. 709, 711 (1983), is instructive. In American Air Filter, the petitioner was a U.S. shareholder of 22 foreign subsidiaries, and claimed that it intended to exclude Subpart F income of two of its foreign subsidiaries pursuant to Code section 963 ("Receipt of Minimum Distributions by Domestic Corporations") minimum distribution rules (repealed in 1975 for taxable years beginning after December 31, 1975). See Sec. 602(a) Tax

Reduction Act of 1975, P.L. 94-12, 89 Stat. 26).[4] American Air Filter Co., 81 T.C. at 711. Due to a clerical error, the petitioner failed to file an election statement with its timely filed 1974 income tax return as required by the statute and regulations under section 963. Id. at 712. No amount was included on the petitioner's 1974 income tax return as Subpart F income from the two controlled foreign corporations at issue. Additionally, on the Forms 3646 ("Income from Controlled Foreign Corporation") filed for the two foreign subsidiaries for the which petitioner sought to exclude Subpart F income, the petitioner represented that no 963 election had been made. Id. at 722. Other portions of the Forms 3646 were completed in a manner contradictory to the representation that no 963 election was made. Id. The petitioner later provided the Service with an election statement when notified during audit in that no such election statement had been filed. Id. at 721. In Tax Court, petitioner contended that it substantially complied with the election requirements of Code section 963; whereas the Commissioner claimed that the failure to include the election statement with the income tax return prejudiced the conduct of the audit, that the Service was unable to determine from the return the petitioner's method for computing the minimum distribution, the corporations involved in the elections and the correct amounts of the distributions. American Air Filter, 81 T.C. at 722.

In evaluating the petitioner's substantial compliance argument, the American Air Filter court noted that full compliance with regulations may be required when the requirements relate to the substance or essence of a statute, but that substantial compliance suffices where requirements are procedural and the essential regulatory purpose of the requirements was fulfilled. American Air Filter Co., Inc. v. Commissioner, 81 T.C. 709, 719 (1983) (citations omitted). The American Air Filter court cited the following five factor test to determine whether substantial compliance is appropriate when weighed against the harm to the Service resulting from the lack of taxpayer's full compliance with certain regulatory requirements. The American Air Filter court considered whether:

1) the taxpayer's failure to comply fully defeats the purpose of the statute;
2) the Commissioner is prejudiced by the untimely election;

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[4] Prior to its repeal in 1975, section 963 permitted United States shareholders of controlled foreign corporations to exclude from gross income a controlled foreign corporation's Subpart F income if the United States shareholder received a minimum distribution of earnings and profits for the taxable year at issue. To qualify for such treatment, an election was to be timely filed for each year that the shareholder sought to exclude Subpart F income. Treas. Reg. §§ 1.963-1(c)(2), (3). Additionally, neither the relevant Code provision nor Treasury regulations employ the language of "substantial compliance."

3) the regulation provided with detailed specificity the manner in which an election was to be made;
4) the sanction imposed on the taxpayer for the failure is excessive and out of proportion to the default; and
5) the taxpayer attempts to benefit from hindsight by adopting a position inconsistent with his original action or omission.

American Air Filter Co., Inc. v. Commissioner, 81 T.C. 709, 719 (1983).

Despite the failure to timely file an election statement for section 963 treatment, the American Air Filter court concluded that the petitioner had substantially complied with the requirements for the following reasons. First, filing the election statement merely would have confirmed that the petitioner had made the election in substance. American Air Filter, 81 T.C. at 720-21. Second, the petitioner did not adopt a position inconsistent with its earlier treatment of the minimum distributions as non-Subpart F income, nor did it attempt to "whipsaw" the Commissioner based on hindsight since the treatment of payments as minimum distributions on its 1974 income tax return were consistent with the minimum distribution election. Id. at 721. Third, the Commissioner was not prejudiced by the petitioner's omission of the election statement because the petitioner's income tax return alone provided most of the information required by the regulations although it was not included in a timely filed election statement. Id. at 722. Fourth, the court believed that precluding the petitioner's use of section 963 treatment due to its delay in filing the election statement would disproportionately punish the petitioner for a clerical omission. Id. at 721. Fifth, the court concluded that the information returns filed by the petitioner (Forms 3646) were ambiguous and contradictory, and did not clearly indicate that a 963 election was not made. Id. at 722.

Returning to Prussner, in applying the five factor American Air Filter substantial compliance test, the Prussner court concluded that the estate had not substantially complied with the special use valuation requirements of section 2032A(d)(3). The Seventh Circuit stated that the common law doctrine of substantial compliance should be applied narrowly, and courts should not use it to "nullify valid regulations." Prussner, 896 F.2d 218, 224-25 (7th Cir. 1990). Accord Sawyer v. County of Sonoma, 719 F.2d 1001, 1008 (9th Cir. 1983) (holding the appellant's claim for additional retirement benefits was barred by his failure to timely file a claim because the doctrine of substantial compliance is not applicable where the purpose of statutory requirements would be defeated, and where the party seeking to apply the doctrine has knowledge of the statutory prerequisites). The court noted that the special use valuation regulation "unequivocally required the filing of a recapture agreement with the return," and that the estate's attorney made no attempt to either attach the recapture agreement nor to seek an extension of time to file the agreement. Id. at 225. In conclusion, the court stated that although the requirement to attach a recapture agreement to a timely filed estate tax return may not be essential, it is also not unimportant because the Service cannot permit qualified-use valuation until the recapture agreement is filed, which is a condition of a valid election. Id.

Several judicial doctrine cases unrelated to special use valuation are in accord with Prussner, holding that failure to file a form required for a valid election is not a procedural requirement for which substantial compliance is permissible. See Dunavant v. Commissioner, 63 T.C. 316 (1974) (holding petitioners were not qualified electing shareholders under Code section 333 where they failed to file an election on Form 964, although the same information was supplied on Form 966; and petitioners failed to comply with a substantive requirement for specific, contemporaneous and incontrovertible evidence of a binding election); Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837 (1978) (stating election for rapid amortization of pollution control facility was invalid under Treas. Reg. § 1.169-4(a)(1) where the taxpayer did not comply with an essential regulatory requirement due to its failure to attach to its income tax return a statement of certification for the pollution control facility).[5] But see Columbia Iron & Metal Co. v. Commissioner, 61

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[5] In Penn-Dixie, the taxpayer sought rapid amortization for one of its pollution control facilities for the taxable year ending January 1, 1972. Pursuant to Treas. Reg. § 1.169-4(a)(1), the taxpayer was required to attach to its income tax return a statement and certificate of proof that the facility was certified by the Federal government. Penn-Dixie Steel Corp., 69 T.C. at 845. If the facility had not been certified by the time the income tax return was filed, the taxpayer was required to attach a statement and the application as proof that it had applied for certification of the facility. Id. In Penn-Dixie Steel Corp., the taxpayer failed to attach both the statement and either proof of application or certification to its income tax return because it had not sought certification for the taxable year for which it applied the rapid amortization deduction. The United States Tax Court held that taxpayer failed to comply with an essential requirement for rapid amortization under section 169 and noted,

> We disagree with petitioner's assertion that Continental has only failed to comply with a procedural detail. While the actual filing of a copy of the required certification or application therefor may be a procedural detail, the implicit requirement that such application must have been made goes to the very essence of the statute . . . . The essential prerequisite to rapid amortization under section 169 is that the taxpayer's pollution control facility must be certified . . . . The underlying requirement that such an application, in fact, be made before the return is filed relates to the essential qualification for election under section 169 and cannot be dismissed as a mere procedural detail.

T.C. 5 (1973) (holding that petitioner had substantially complied with the procedural requirements for charitable deductions where all underlying requirements were met pursuant to I.R.C. § 170(a)(2) and Treas. Reg. § 1.170-3(b) despite its failure to attach to its income tax return a copy of the corporate minutes authorizing the contribution and a verified written declaration of an officer of the corporation, and where the regulations failed to delineate the consequences of noncompliance with the requirements), acq. 1979-2 C.B. 1.

We note also that in several cases, Federal courts have required complete compliance with reporting requirements where taxpayers have sought to avail themselves of a benefit afforded by regulation or election. See Credit Life Ins. Co. v. United States, 948 F.2d 723 (Fed. Cir. 1991) (requiring strict compliance with reporting requirements for section 166 "bad debt" deduction and noting that doctrine of substantial compliance should be narrowly applied); Fischer Indus., Inc. v. Commissioner, 843 F.2d 224 (6th Cir. 1998) (holding that taxpayer did not substantially comply with inventory accounting election requirements due to failure to file a Form 970 ("Application to Use LIFO Inventory Method") although information required on the form was provided subsequently during the audit). Of particular relevance to the present situation is a statement by the Federal Circuit in Credit Life regarding the purpose of the reporting requirements,

> [T]he purpose of the reporting requirement is obvious: [it] places the Service on notice of the taxpayer's position and gives [the Service] an opportunity to investigate and verify . . . . Thus, to apply the doctrine of substantial compliance here would not only be inconsistent with our own cases limiting its application, but even with the Tax Court's application of it as well.

Credit Life Ins. Co. v. United States, 948 F.2d at 727-28.

In sum, a controlled participant must substantially comply with the administrative requirements of Treas. Reg. § 1.482-7(j), including both the documentation and reporting requirements, to claim qualified cost sharing arrangement treatment. Treas. Reg. §§ 1.482-7(a)(1), 1.482-7(b) and 1.482-7(c)(1)(iii). Due to the importance of attaching the cost sharing statement to Forms 1120, 5471 and 5472, as discussed infra, the failure to comply with the reporting requirement alone leads to the conclusion that the taxpayer failed to substantially comply with the administrative requirements in toto.

Penn-Dixie Steel Corp., 69 T.C. at 846-47.

DISCUSSION:

Issue 1 USCorp may not claim treatment as a qualified cost sharing arrangement for Taxable Year 1 due to its failure to substantially comply with the administrative requirements of Treas. Reg. § 1.482-7(j)

Treas. Reg. § 1.482-7 applies to USCorp's Taxable Year 1, which began on Date B, a date subsequent to the January 1, 1996 effective date of the final cost sharing regulations. Here, the issue is whether USCorp failed to substantially comply with the administrative requirements of Treas. Reg. § 1.482-7(j) due to its failure to attach a cost sharing statement to its U.S. income tax return and Forms 5471.

A. The Plain-Language Test of Substantial Compliance

In determining whether USCorp substantially complied with the reporting requirements for controlled participants in a qualified cost sharing arrangement, we believe the plain-language test governs this case based on the "substantial compliance" language in Treas. Reg. § 1.482-7(c)(1)(iii). Accordingly, we begin our analysis with the plain-language review of the cost sharing regulations and follow with an application of the American Air Filter five factor test, as did the Seventh Circuit in Prussner.

The flush language of Treas. Reg. § 1.482-7(j)(3) explicitly requires a controlled participant, i.e., USCorp, to attach a cost sharing statement to its U.S. income tax return. USCorp failed to do so. USCorp cannot claim that it did not have notice of this requirement since the 1995 final cost sharing regulations were published in December 1995 and became effective on January 1, 1996, prior to the commencement of USCorp's taxable year under examination. Therefore, USCorp had at least 14 ½ months notice of the requirement prior to the due date of its tax return.

Applying the Tax Court's analysis in Prussner, we believe that failure to file a cost sharing statement altogether cannot be deemed substantial compliance, as "no compliance" cannot constitute substantial compliance. The fact that there is a separate documentation requirement under Treas. Reg. § 1.482-7(j)(2) does not alter this conclusion given the importance of compliance with the reporting requirement. (See discussion infra regarding import). Therefore, pursuant to the plain-language test of substantial compliance, USCorp did not substantially comply with the administrative requirements of Treas. Reg. § 1.482-7(j) due to its failure to attach a cost sharing statement to its Taxable Year 1 income tax return.

B. The Federal Common Law Doctrine of Substantial Compliance

Additionally, we believe that the Federal common law doctrine of substantial compliance supports the above conclusion that USCorp's failure to attach a cost sharing statement to its U.S. income tax return does not constitute substantial compliance. In applying the five factor American Air Filter test to the present situation to determine whether the requirement to attach a cost sharing statement to a timely filed income tax return is either essential or procedural, we conclude that it is an essential requirement with which taxpayers must comply. Otherwise, failure to comply circumvents the purpose of the requirement and results in prejudice to the Service.

First, USCorp's failure to substantially comply with the reporting requirement of Treas. Reg. § 1.482-7(j)(3) defeats the purpose of the cost sharing regulations. The purpose of attaching the cost sharing statement to an income tax return or Forms 5471/5472 is to provide timely notice to the Service that the taxpayer claims a qualified cost sharing arrangement and provides the identities of the participants. As in Credit Life Ins. Co., the cost sharing statement alerts the Service of the possible need to investigate and verify the special requirements associated with a qualified cost sharing arrangement, including issues that may arise such as a buy-in or a buy-out.

Second, the Commissioner is prejudiced by USCorp's failure to attach cost sharing statements to its Forms 1120 and 5471. USCorp may argue that the Commissioner has not been harmed because Examination was able to discern the existence of a cost sharing arrangement during the audit and thus request additional supporting documentation pursuant to Treas. Reg. § 1.482-7(j)(2). Nevertheless, effective tax administration is harmed or prejudiced to the extent that Examination may not be able to discern the existence of a cost sharing arrangement from the tax return or Forms 5471/5472 in order to timely and effectively audit such arrangements. Taxable years do not remain subject to audit for an indefinite duration. Specifically, situations may arise where there should have been a cost sharing-related adjustment in a year of the cost sharing arrangement, but such year is closed to audit when, owing to lack of notice via the cost sharing statement, Examination discerns the existence of the cost sharing arrangement and identifies the participants.

Third, the cost sharing regulations articulate the reporting requirement with detailed specificity. Applying the 9th Circuit's reasoning in Sawyer, USCorp could not prevail here by relying on the doctrine of substantial compliance because it had knowledge of the prerequisites for qualified cost sharing arrangement treatment since the 1995 final cost sharing regulations were published and effective prior to the beginning of Taxable Year 1. Support for this conclusion can also be found from the Tax Court's analysis in Columbia Iron & Metal Co. because here, the cost sharing regulations clearly make the attachment of a cost sharing statement to a Form 1120 or 5471 a sine qua non for qualified cost sharing treatment. See generally Treas. Reg. § 1.482-7(c)(1)(iii). Furthermore, the requirement to attach a cost sharing statement to a timely filed income tax return cannot be deemed a burdensome requirement that is difficult with which to comply given that the only information required is a statement that the taxpayer is a participant in the arrangement and the identification of other participants.

Fourth, the sanction imposed on USCorp for the failure to substantially comply with the administrative requirements of Treas. Reg. § 1.482-7(j) is neither excessive nor disproportionate compared with its default. Specifically, USCorp is precluded from claiming qualified cost sharing arrangement treatment due to its failure to alert the Service that it was a controlled participant in a cost sharing arrangement. The situation here is not like that in Columbia Iron & Metal Co. where the applicable Code section and regulations failed to specify the consequences of a failure to comply with the requirements for charitable deductions. Here, the cost sharing regulations plainly state that the taxpayer may not claim treatment as a qualified cost sharing arrangement in the absence of meeting certain requirements, including substantial compliance with the administrative requirements.

Finally, whereas it is not clear that USCorp attempts to benefit from hindsight by adopting a position inconsistent with its original action or omission, it is possible that taxpayers in similar situations could do so. Since the essence of a cost sharing arrangement is to share the risks and benefits of the exploitation of intangibles, taxpayers may be tempted not to reveal their cost sharing arrangements by timely and properly notifying the Service as required in Treas. Reg. § 1.482-7(j)(3) in order to use hindsight to gain significant tax benefits.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As a result of its failure to substantially comply with the administrative requirements of Treas. Reg. § 1.482-7(j), USCorp is precluded from claiming qualified cost sharing arrangement treatment. That, however, does not end the inquiry nor translate immediately into an adjustment. Examination needs to further develop the facts of the case [redacted] (see Treas. Reg. § 1.482-7(b)(4)(iii)).

[redacted]

If you have any further questions, please call (202) 874-1490.

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