Interim MTM RIT Supplemental Guide

Conclusion:
Interim alternative method Mark-To-Market (MTM) losses are to be carried forward until the final year of the disclosure period per prior issued guidance. There are two methods of doing this as discussed herein.

Background:
We are beginning to see a number of Offshore Voluntary Disclosure Initiative (OVDI) cases with MTM losses during interim years of the initiative. For example, where the taxpayer has come into OVDI for years 2003 through 2010, they may recognize PFIC MTM gains for tax years 2003 through 2007 and then recognize a PFIC MTM loss for 2008. While this wasn't as much of an issue in the 2009 OVDI program, we are seeing some inconsistencies in the presentation and tax treatment of the MTM loss generated in the 2008 year. Since the approved language for the closing agreement refers to carrying back of the PFIC reduction in tax only in the last year in which the RIT is not fully absorbed in that year, we wanted to clarify and standardize the tax treatment and presentation of the calculated reduction in tax that occurs in an interim year when the reduction is not fully absorbed.

Initial Example Facts:
We'll continue with the above example by providing these additional facts and assumptions. Let's assume MTM tax for tax years 2003 through 2007 totals $125,000 ($625,000 gross) earned ratably, while in 2008 the taxpayer incurs a MTM loss of $95,000. Since there are sufficient unreversed inclusions, the taxpayer is entitled to a MTM Reduction In Tax (RIT) of $19,000 ($95,000 x 20%). The tax liability in 2008 is $11,000 (exclusive of the MTM RIT), therefore, of the $19,000 MTM RIT, $11,000 can be absorbed in 2008.

Observed handling of interim excess RIT:
What does the taxpayer do with the remaining RIT that wasn't absorbed in the interim 2008 year? Well, we've seen the following approaches taken:

1. Some agents carry the remaining $8,000 RIT back to prior years where MTM tax and/or regular tax can absorb this amount.
2. Some agents have carried forward the amount to offset future years' tax deficiencies.
3. Finally, others have simply not reduced the basis in the PFIC(s) below the loss recognized that resulted in a reduction in tax and used the resulting basis for future tax years' gain or loss computation. For example, since $8,000 of the total $19,000 RIT wasn't absorbed in 2008, the basis in the PFIC(s) would only be reduced by $55,000 ($11,000 / 20%) and that would be the basis used in subsequent years to determine MTM gains and losses.

Through analysis and discussion, we've determined that regardless of the approach used, the resulting net MTM tax during the OVDI period is the same. MTM losses are limited to unreversed inclusions of PFIC income and unreversed inclusions are reduced to zero at the conclusion of the OVDI period. In other words, the taxpayer can't claim a benefit for MTM losses that are in excess of MTM gains recognized during OVDI and MTM losses can't be claimed in years subsequent to OVDI without first establishing additional unreversed inclusions outside of the program.

Penalties and Interest effect:
Please note that while the net MTM taxes will be the same no matter which approach is used, the penalties and interest will be affected. Carrying forward a MTM loss from an interim period, will have the ability to offset potential penalties in the subsequent year, similar to that of an NOL carryforward. The reverse is true for a carryback. So if a 2008 RIT is carried forward (method 2 or 3 above) to 2009 and offsets MTM tax in that year, then the understatement and potential penalty is reduced. If the loss was carried back (method 1 above), then the RIT would act more like a payment that generated on the date the RIT tax return was filed, and would not reduce the potential penalty in the prior year. On this note, there are also interest effects when deciding between the methods. If the RIT is carried forward, the payment effect of a carryback will not occur, which would help to minimize interest assessments for these older periods. So in essence, method one acts to reduce older assessments and its interest accruals, while methods 2 and 3 reduce penalties and subsequent interest.

Correct Method:
Based on prior guidance, the correct method is method #3 listed above. However, method #2 should produce the same result and be less complex to compute. Method #2 avoids making basis adjustments during interim years to individual funds and simply discloses that the total unallowed RIT and associated gross losses are being suspended, and offsetting the subsequent year bottom line figures. At the end of the disclosure period, both net MTM taxes paid and ending adjusted basis should be the same no matter if method 2 or 3 is employed, while unreversed inclusions revert back to $0.

If the net effect of this RIT carryforward and/or final year figures results in an overall RIT for the final year, carryback procedures will then be utilized in the normal manner to absorb tax in prior years where there is positive tax. Both MTM tax and qualifying non-MTM tax could be offset with the carryback. Qualifying non-MTM taxes are all other taxes with the exception of Self-Employment Taxes.

Please also keep in mind that carrying forward RITs and losses in general are easier administratively to handle then to carry back. Carrybacks require technical services to perform special restricted interest computations. When carrying back from the final year of the OVDI look back period, the goal is always to pick a single year which can fully absorb the RIT, if available. This will limit the use of IRS resources and should not affect the taxpayer, regardless if you carry back to 2003 or 2009. This is due to the restricted interest nature of NOL carrybacks.

Example Conclusion:
Assume the same initial facts presented previously. Also assume 2009 shows a MTM loss of ($15,000) and tax exclusive of PFIC of $1,000. 2010 shows a MTM gain of $5,000 and tax exclusive of PFIC of $3,000, but the carryforward of the MTM RIT credits from the previous years causes the 2010 year to be reflected as a loss since the accumulated RIT that was previously not recognized is shown on the 906 for the last year. Consider the calculations below that result from this treatment when populating the amounts on the 906:

Remaining MTM loss and resulting RIT credit:

2008	($40,000)*	($8,000)**

*Determined by taking the realized MTM loss of $95,000 minus the recognized MTM loss of $55,000. ($95,000 - $55,000 = $40,000).

**Determined by taking the realized RIT of 19,000 minus the recognized RIT of $11,000. ($19,000 - $11,000 = $8,000)

2009	($10,000)^	($2,000)^^

^Determined by taking the realized MTM loss of $15,000 minus the recognized MTM loss of $5,000 since the resulting RIT is limited to the amount of regular tax for 2009 ($1,000).

^^Detrermined by taking the realized RIT of $3,000 (MTM loss of $15,000 x 20%) minus the recognized RIT of $1,000.

2010 Form 906 computation:

2010 MTM gain	$ 5,000
2008 “carryforward” loss	($40,000)*
2009 “carryforward” loss	($10,000)^
2010 Total	($45,000)
Resulting PFIC Tax	($ 9,000)
Amount absorbed in 2010	($ 3,000) Tax exclusive of PFIC in 2010
Carryback to 2007	($ 6,000)

Note: The carryback could go to any OVDI year before 2008 as long as there are taxes to absorb it. 2008 and 2009 have no taxes left that are able to absorb in this example.

Form 906 Closing Agreement Presentation:

3. In addition to the unreported income and deductions in paragraph 1**,** the following amounts represent additional income and deductions related to the PFIC investments:

	2003	2004	2005	2006	2007	2008	2009	2010
PFIC Income	$125,000	$125,000	$125,000	$125,000	$125,000	($55,000)	($5,000)	($45,000)

The tax on the income from the PFIC investments, including PFIC interest, is as follows:

	2003	2004	2005	2006	2007	2008	2009	2010
PFIC Tax	$25,000	$25,000	$25,000	$25,000	$25,000	($11,000)	($1,000)	($9,000)

The tax on the PFIC investments (including PFIC interest) is in addition to the income tax to be calculated on the remainder of the unreported income in paragraph 1, above.

As of the end of taxable year 2010, there are no unreversed inclusions as defined by I.R.C. section 1296(d) with respect to the PFIC investments.

4. Of the $9,000 PFIC reduction in tax (RIT) in the 2010 year as stated in paragraph 3, $6,000 is not fully absorbed in that year. The amount not absorbed will be carried back to prior years. The underpayment in the year to which the unabsorbed reduction in tax is carried back will be subject to penalties as described in paragraph 5 ***without regard to the carryback,*** and interest described in paragraph 7 will be calculated under the provisions of IRC section 6611(f)(1). The 2010 unabsorbed reduction in tax will be carried back to the following years in the following amounts:

	2003	2004	2005	2006	2007	2008	2009
Carryback of unabsorbed RIT	$0	$0	$0	$0	($6,000)	$0	$0