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tax notes international

Volume 42, Number 2 ■ April 10, 2006

A Survey of Current U.S. Outbound International Tax Developments

by William M. Sharp, Sr. and Sherwin P. Simmons, II

Reprinted from *Tax Notes Int'l*, April 10, 2006, p. 157

Special Reports

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This article is based on a presentation by William M. Sharp, Sr. for the 24th Annual International Tax Conference held on January 26-27, 2006, which was organized by the Florida Bar and Florida Institute of Certified Public Accountants.

I. Developments in Specific Code Sections

A. Section 23: Adoption Credit for Foreign-Born Adoptions

IRS Announcement 2005-45[1] and Rev. Procs. 2005-31 and 2005-26[2] contain guidelines for individuals who claim the adoption tax credit or exclusion for qualified adoption expenses for an adopted child born outside the United States. The announcement adopts an earlier proposal to accelerate the date on which credit may be claimed for a foreign-targeted adoption based on the date when the foreign originating jurisdiction issues a decree of adoption (as opposed to recognizing the adoption when the United States issues an "immediate relative" visa through the U.S. State Department).[3]

1. Practitioner's Comment: Foreign-targeted adoptions have become increasingly popular in the United States, with many Americans adopting children from Asia and even the Middle East. This rule will allow a taxpayer that adopts foreign qualifying children to claim the credit when the foreign originating jurisdiction issues the adoption decree, as opposed to waiting for the red tape to work its way through the U.S. State Department.

B. Section 162: Deductibility of Insurance Premiums Paid to Special-Purpose Insurers

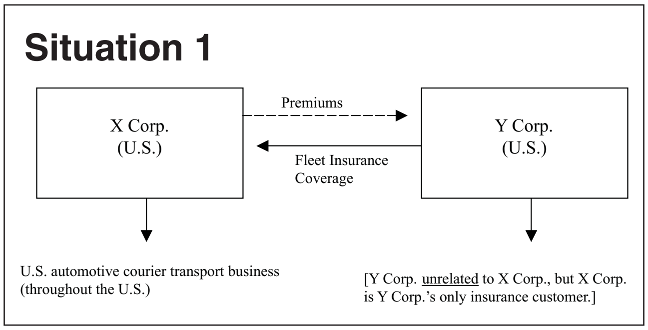
In Rev. Rul. 2005-40,[4] the issue was whether the proposed arrangements constituted insurance for federal tax purposes and, assuming the arrangements constituted insurance, if the premiums were deductible. The ruling addresses the judicially adopted requirements of risk shifting and risk distribution and the requirement that the risk transferred be a true economic risk of loss. The ruling

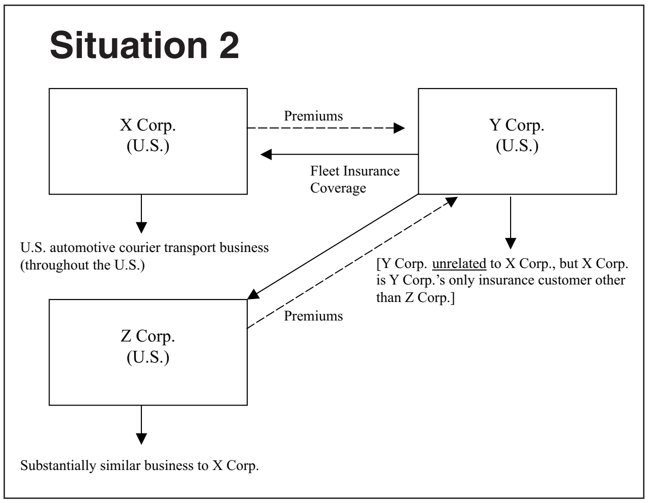
[1]IRB 2005-26.

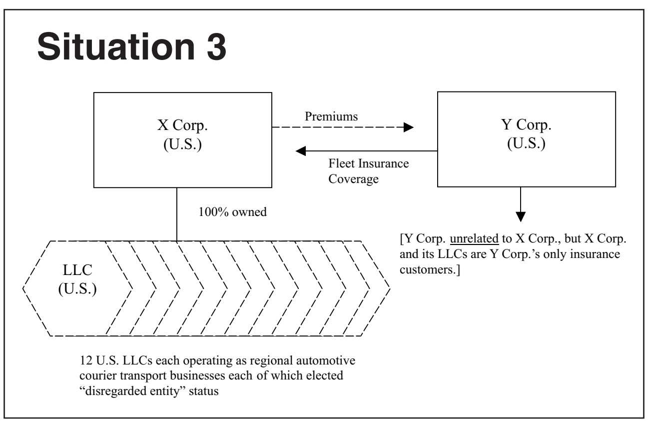
[2]IRB 1374.

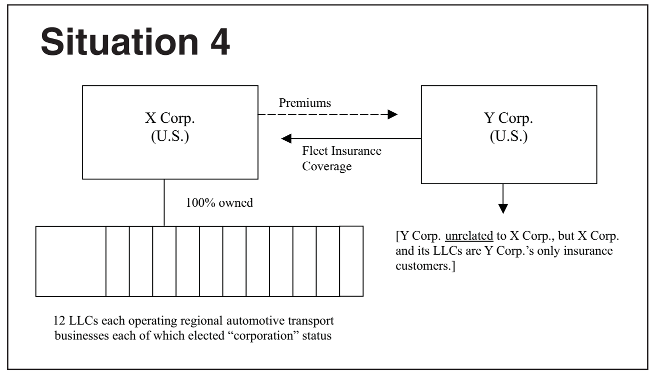
[3]*See 2005 WTD 118-9* or *Doc 2005-12951*.

[4]2005-27 IRB 4.









explains that risk distribution involves the insurance principle or statistical norm known as the law of large numbers. By engaging in risk distribution, an insurer spreads out the likelihood of a single costly liability claim over a substantial number of insureds. Above are illustrations of the four situations addressed by the ruling.

Rev. Rul. 2005-40 holds that situations 1 through 3 above do not constitute insurance for federal tax purposes because of an insufficient pooling of other premiums to distribute X Corp.'s risk (in situation 2, the presence of the unrelated Z Corp. was not enough to cause that distribution threshold to be met). In contrast, in situation 4, the 12 limited liability companies are treated as corporations (and separate legal entities) for federal tax purposes; thus the arrangement constitutes insurance for federal income tax purposes.

1. Practitioner's Comment: The IRS has noted that it will continue to focus and monitor "captive type" insurance arrangements, particularly when the insured and the insurer are related parties. The most unusual aspects of the ruling are that the insured and the insurer are unrelated parties, and the insurer insures no other insureds except as noted above. The ruling applies only to insurance arrangements between an insured and an insurer and appears to be targeted toward special-purpose insurance companies. The ruling addresses domestic insurance companies, but it could also be applicable to a foreign insurance company situation. Because the ruling applies to insured-insurer arrangements, arguably it should not apply to reinsurance arrangements, or even to foreign insurance arrangements. In the context of unrelated foreign reinsurance arrangements, the IRS would presumably rely on its traditional statutory authorizations to review reinsurance agreements, such as section 845(a), which allows the IRS to allocate and make adjustments to any reinsurance arrangement involving two or more related persons. Section 845(b) also allows the IRS to make proper adjustments and allocations even if the reinsurer and insurance group are unrelated parties if the insurance contract has the significant tax avoidance effect.

C. Section 199: Proposed Regs for Income Attributable to Domestic Production Activities

Under section 199, some companies may claim a deduction equal to 3 percent of income attributable to certain domestic production activities for 2005 and 2006. That amount increases to 9 percent by

2010. The IRS issued proposed regulations to address comprehensive rules, definitions, and examples for the section 199 deduction. Those proposed regulations are a follow-up to Notice 2005-14[5]; many of the public comments have been incorporated in the proposed regulations. A discussion of those proposed regulations is beyond the scope of this article; however, the practitioner should be aware of them in connection with any domestic production claim under section 199.[6]

As a general rule, as noted above, starting in 2010, section 199(a) allows a deduction in an amount equal to 9 percent of the lesser of the qualified production activities income of the taxpayer for the tax year or taxable income (determined without regard to section 199(a) for the tax year). Under section 199(a)(2), the percentage of that benefit is phased in, with 3 percent for 2005 and 2006 and 6 percent for 2007, 2008, and 2009. Also, section 199(b) provides some limitations for the section 199(a) deduction based on wages of the taxpayer.

Notice 2005-14 provides detailed guidance on the meaning of qualified production activities income in section 199(c), as well as other conditions and defined terms in the statute.[7]

D. Section 269B: Final Regs for Stapled Entities

In T.D. 9216, the IRS issued final regulations (Treas. reg. section 1.269B(b)-1) under section 269B, addressing the definition and tax treatment of certain stapled foreign corporation transactions, which corporations are generally treated as domestic corporations under section 269B. The final regulations by and large adopt the changes proposed in the September 2004 proposed regulations, including the rule that treats a stapled foreign corporation as a domestic corporation under section 269B but, for section 1504(b) purposes, treats it as a foreign corporation. Accordingly, a stapled entity will not be treated as an includable corporation for section 1501 consolidation return filing purposes. Interestingly, however, the IRS included no commentary on so-called dual-listed corporations because of the business nontax motivation for use of those companies.[8]

E. Section 269B: Transfer of Corporate Seat to Unstaple Shares

In PLR 200507009 (Nov. 15, 2004), Diagram A illustrates the fact pattern.

Because the taxpayer (the private limited liability company organized under the laws of country A) constituted a section 269B stapled entity, it did not qualify as an includable member for U.S. consolidated return filing purposes; thus, the taxpayer filed a separate U.S. corporation income tax return.[9]

Under a plan of reorganization, the taxpayer transferred 100 percent of the issued and outstanding shares of foreign entity B to foreign entity A as a contribution to capital in a transaction qualifying for nonrecognition treatment under section 351. The taxpayer represented that it would file a gain recognition agreement under Treas. reg. section 1.367(a)-8 to preserve section 351 nonrecognition treatment.

> ***The court's decision in Black & Decker confirmed the use of the contingent liability structure involving affiliated parties.***

The taxpayer proposed to transfer its statutory seat from country A to state C, the same state under which corporation 1 was incorporated and to which the taxpayer was stapled. The taxpayer argued that the corporate seat relocation would constitute a section 368(a)(1)(F) reorganization and the transaction should be entitled to nonrecognition treatment. The taxpayer requested a ruling that the F reorganization would not trigger the foreign entity B gain recognition agreement; thus, no gain recognition would occur under section 367(a).

The issue in the ruling was whether the taxpayer, as a U.S. transferor participating in the F reorganization, remained in existence to continue to be subject to the terms of the gain recognition treatment on the section 351 share transfer of foreign entity B, and specifically the five-year holding period required by Treas. reg. section 1.367(a)-8(g). Because the taxpayer was treated as the same corporation immediately after the reincorporation as a result of the F reorganization, the taxpayer argued that it should not be required to enter into a new gain recognition agreement.

The IRS ruled that instead of entering into a new gain recognition agreement, the taxpayer (through corporation 1) should provide a statement certifying that it continues to be the same taxpayer after this proposed transaction for gain recognition agreement purposes and that the statement must be signed

[5]2005-7 IRB 498.

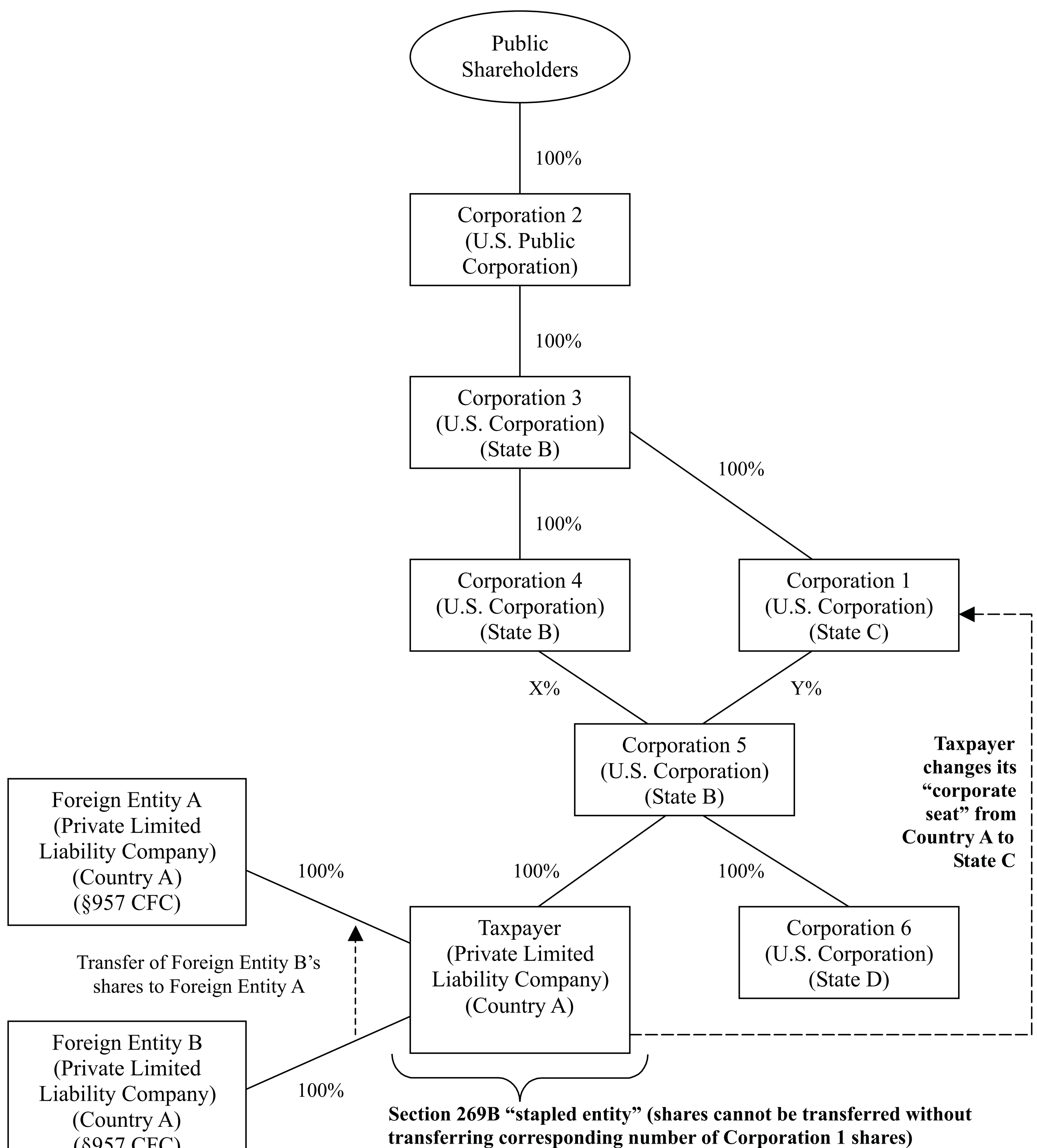
[6]*See 2005 WTD 14-16* or *Doc 2005-1241*.

[7]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Feb. 7, 2005, p. 517.

[8]*See 2005 WTD 145-14* or *Doc 2005-16181*.

[9]*See* Notice 89-94, 1989-2 C.B. 416 (because section 269B treats a stapled entity as a domestic corporation).

Diagram A


Public Shareholders
100%
Corporation 2 (U.S. Public Corporation)
100%
Corporation 3 (U.S. Corporation) (State B)
100%
100%
Corporation 4 (U.S. Corporation) (State B)
Corporation 1 (U.S. Corporation) (State C)
X%
Y%
Corporation 5 (U.S. Corporation) (State B)
Taxpayer changes its "corporate seat" from Country A to State C
Foreign Entity A (Private Limited Liability Company) (Country A) (§957 CFC)
100%
100%
100%
Transfer of Foreign Entity B's shares to Foreign Entity A
Taxpayer (Private Limited Liability Company) (Country A)
Corporation 6 (U.S. Corporation) (State D)
Foreign Entity B (Private Limited Liability Company) (Country A) (§957 CFC)
100%
Section 269B "stapled entity" (shares cannot be transferred without transferring corresponding number of Corporation 1 shares)

under the penalties of perjury by a responsible officer of the taxpayer under Treas. reg. section 1.367(a)-8(a)(3).

1. Practitioner's Comment: From a practical perspective, section 269B stapled entities are not very common; however, the above set of facts and the rulings issued help shed light on other outbound cross-border issues, which are of a more practical nature. Here, the taxpayer, a foreign private LLC, agreed to transfer its statutory seat to a U.S. state and thereupon terminate its charter in the foreign jurisdiction under which it was organized. That was probably accomplished by an inbound merger under applicable corporate law. The ruling provides comfort to the practitioner who is considering "domesticating" a foreign incorporated entity in a tax-deferred manner (F-type reorganization), so that when the dust settles the entity is no longer treated as a foreign entity, but as a domestic entity. That, under the facts of the ruling, was important for consolidated return filing purposes. The other comforting point here is that some significant potential tax problems of the merged foreign entity, such as triggering a gain recognition agreement, will not occur so long as certain conditions are satisfied.

F. Section 332: Proposed Regs on No Net Value Transactions

The general rule is that section 332 applies only if the distributee corporation receives at least partial payment for each class of stock that the distributee corporation holds in the distributor/liquidating corporation (known as the net value requirement). The preamble to the proposed regulations (prop. Treas. reg. section 1.332-2) explains that the taxpayer should be able to recognize a loss when no consideration or net value is received in a liquidation of a subsidiary. Accordingly, in worthless payment subsidiary liquidations, section 332 can be avoided, and, under section 865(g), the distributee corporation may be entitled to a worthless security deduction.[10]

G. Sections 337(d) and 1502: Loss Limitation Rules Final Regs

The IRS issued final regulations under sections 337(d) and 1502 to address the loss limitation rules for some corporations filing consolidated tax returns under Treas. reg. sections 1.337(d)-2(g), 1.1502-20(i), and 1.1502-32(b). Those regulations disallow some losses recognized on sales of subsidiary stock by members of a consolidated group. In more practical terms, the purpose of those final regulations is to implement the repeal of the *General Utilities* doctrine in the consolidated return context as mandated by section 337(d). They also follow up on Notice 2004-58,[11] which describes the basis disconformity method and announces that the IRS will accept that method for determining whether a subsidiary stock loss is disallowed and subsidiary stock basis is reduced under Treas. reg. section 1.337(d)-2T (now replaced by these final regulations). Treasury and the IRS adopted the proposed rules of Treas. reg. section 1.337(d)-2T, in effect on March 2, 2005, as the final regulation version set forth in Treas. reg. section 1.337(d)-2, without substantive change. Accordingly, the IRS will accept the basis disconformity method to determine whether subsidiary stock loss is disallowed and subsidiary stock basis is reduced under that final regulation.[12]

1. Practitioner's Comment: Those final regulations go hand in hand with newly enacted section 362(e) ("Limitation on Built-In Loss Issues") (see discussion below of Notice 2005-70) and the legislative push to ensure that high-basis, low-value assets do not generate unwarranted tax benefits. These section 337 and section 1502 regulations address a number of technical issues in the consolidated return context. The examples are worth revisiting whenever the practitioner is faced with a complex (or, for that matter, simple) consolidated return group in which an affiliate is sold via a stock sale. The practitioner must also be careful to ensure that the applicable purchase and acquisition documentation properly covers not only this issue, but also various elections available under section 338.

H. Sections 355, 368(a)(1)(D), 7701: U.S.-Canadian Reorganization

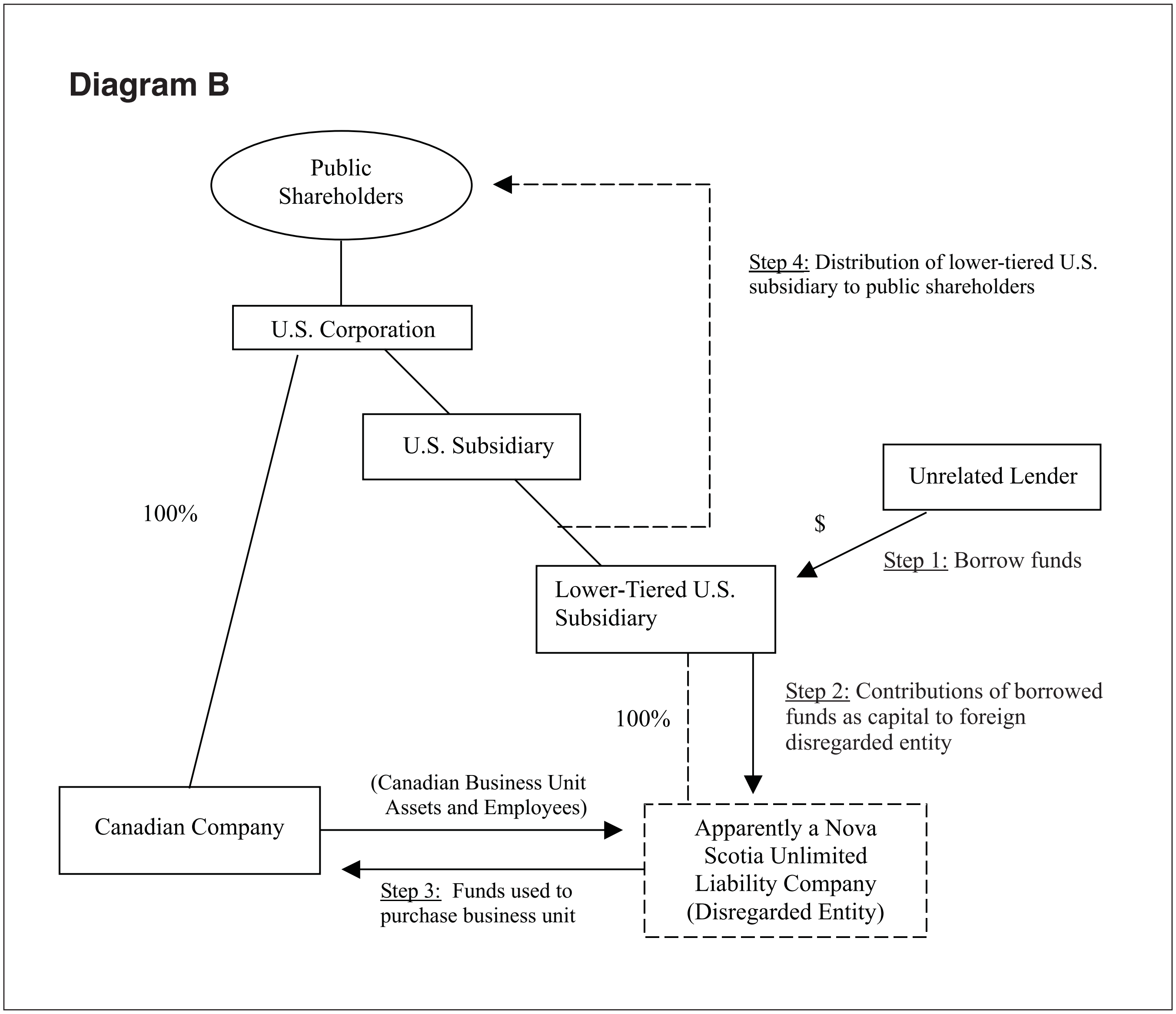
In PLR 200453003 (issued Sept. 15, 2004, released Dec. 31, 2004), Diagram B illustrates the four-step transaction that featured an affiliated asset purchase followed by a distribution of the acquiring corporation's shares:

Based on Diagram B (more simplified than the actual facts of the ruling), the IRS ruled that the U.S. lower-tiered acquiring subsidiary was treated as the entity conducting the businesses previously conducted by the apparent Canadian company. A financing vehicle was set up, apparently under Nova Scotia law, to structure the borrowed proceeds (from an unrelated lender) as a capital contribution from the U.S. lower-tiered subsidiary, which vehicle in turn was used to purchase the assets and hire employees from an affiliated Canadian company. Because the Nova Scotia unlimited liability company made a disregarded entity election, the IRS ruled that the purchased Canadian business unit

[10]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Mar. 28, 2005, p. 1179.

[11]2004-39 IRB 520.

[12]*See 2005 WTD 42-11* or *Doc 2005-4227.*



was treated as being conducted by the U.S. lower-tiered subsidiary. After the completion of those transactions, the U.S. subsidiary distributed the shares of the U.S. lower-tiered acquiring subsidiary to the U.S. corporation's public shareholders.

The IRS ruled that the contribution transaction described above followed by the distribution of the shares of the U.S. lower-tiered subsidiary constituted a tax-deferred reorganization under section 368(a)(1)(D). Accordingly, no gain or loss was recognized at the shareholder level of the distribution corporation upon receipt of the distributed shares under section 355(a)(1). Most importantly, the purchase of the Canadian company's business unit as illustrated above did not prevent the transaction from satisfying the five-year active trade or business requirement under section 355(b).[13]

1. Practitioner's Comment: The rulings appear to be consistent with the tax-deferred reorganization rules of section 355 and section 368(a)(1)(D). Interestingly, the IRS integrated the various acquisition, contribution, and distribution transactions to treat them as a section 368(a)(1)(D) reorganization. The IRS treated the distributing corporation and the acquired controlled corporation each as a party to a reorganization under section 368(b). That is the

[13]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Feb. 7, 2005, p. 521.

correct federal tax interpretation of this multistep transaction based on the section 368 regulations and several published rulings issued on that point.

From a check-the-box tax planning perspective, the ruling also solidifies the legal principle that assets and activities of a disregarded entity will be deemed owned by and operated under the entity sitting on top of the disregarded entity. Accordingly, the five-year active trade or business requirement of section 355(b) was deemed satisfied.

Even though the ruling dealt with a publicly traded company, its legal principles directly apply to a privately owned U.S. C corporation with multiple U.S. and foreign entities. In particular, the ruling provides an excellent blueprint of structuring a tax-deferred reorganization and spinoff. As mentioned above, the ruling gives further guidance to the use of the disregarded entity element of the check-the-box regulations.

I. Section 355(e): IRS Final Regs

Although without a direct impact on the international arena, Treas. reg. section 1.355-7,[14] issued effective April 19, 2005, addresses whether a distribution and acquisition constitute a part of the same plan. That determination is based on all facts and circumstances, including other than a public offering, if a distribution and postdistribution acquisition are linked by an agreement, understanding, or arrangement, or a substantial negotiation on the follow-up acquisition at some time during a defined two-year period ending on the date of the initial distribution. The regulation underscores the importance in the international arena of ensuring that separate steps that should not be treated as a part of the whole transaction must be separated both in time and in a legal manner.[15]

J. Section 357: Fourth Circuit Court of Appeals Reversal in *Black & Decker* on Economic Substance

Although not an international case, the Fourth Circuit Court of Appeals recently reversed a lower court's decision in *Black & Decker Corp. v. United States.*[16] The appellate court ruled that the lower court's determination on the appropriate interpretation of section 357(c)(3) was appropriate, because the contingent liabilities that were transferred to an affiliated subsidiary in the case would have given rise to a deduction in the hands of the transferor. Therefore, the transferor was not treated as receiving any money in connection with the transaction (thus losing basis in the subsidiary whose stock was later sold, thereby generating a substantial capital loss). However, the court ruled that the district court did not properly interpret both prongs of the sham transaction doctrine — the business-purpose prong and the economic substance prong. In particular, the court ruled that the district court did not address whether a reasonable possibility of profit from the transaction existed as required by the economic substance doctrine and that the lower court should have reviewed some expert witness reports on that reasonable expectation of profit issue. Although the court's decision is something of a setback for the taxpayer, it also confirmed the use of the contingent liability structure involving affiliated parties.[17]

K. Section 362(e): Termination of Built-In Losses — Notice 2005-70

In Notice 2005-70,[18] the IRS addressed some procedural and technical aspects of section 362(e), an important legislative provision included in the American Jobs Creation Act of 2004, P.L. 108-357 (the Jobs Act). Under section 362(e), if property is transferred to a corporation as a capital contribution or in a section 351 exchange and the aggregate basis of the transferred property exceeds its aggregate value immediately after the transaction, the transferee corporation will suffer a basis adjustment so that its transferred basis will not exceed the fair market value of the property.

The new provision states, however, that the transferor shareholder and the transferee corporation are allowed to make a joint election to reduce the transferor's section 358 basis in the stock received to its fair market value (thereby taking the downward adjustment at this shareholder level) and retaining the increased basis in the property at the corporate transferee's level (under section 362, a straight carryover basis without any adjustment).

Notice 2005-70 provides procedural guidance on that election. If the transferor is not a controlled foreign corporation, the section 362(e)(2)(C) election may be made by including a certification with the transferor's tax return filed by the due date (including extensions) for filing its original return for the tax year in which the transaction occurred.

Notice 2005-70 provides that for a CFC transferor, the defined controlling U.S. shareholders (see Treas. reg. section 1.964-1(c)(5)) may make the election by including a certification with their tax returns in the same manner described above. In either

[14]T.D. 9198.

[15]*See 2005 WTD 75-14* or *Doc 2005-8069*.

[16]340 F. Supp. 2d 621 (D. Md. 2004), *rev'd*, 2006-1 U.S. Tax Cas. (CCH) PSO, 142 (4th Cir. 2005).

[17]*See 2006 TNT 24-2* or *Doc 2006-2252*.

[18]2005-41 IRB 694.

of those cases, the transferor corporation is not required to make any filing.

1. Practitioner's Comment: The new basis adjustment rule in section 362(e) represents a huge trap for the unwary. The practitioner must be well aware of that provision in any restructuring transaction. The classic situation is one in which the transferors of a corporate group want to transfer low-value but high-basis property to an affiliated company. If no section 362(e)(2)(c) election is made, the property will suffer a write-down upon consummation of the transfer to the transferee corporation. The practitioner should be aware of the challenges of determining the fair market value of that property. In the absence of specific regulatory guidance, most practitioners believe the general case law on valuation standards will apply to section 362(e) challenges.

L. Sections 367 and 304: Proposed Regs on Cross-Border Section 367 and Section 304 Transactions

The proposed regulations address the interrelationship between sections 367 and 304 and refer back to Rev. Rul. 91-5,[19] which held that with a deemed contribution to capital of target corporation shares, section 367 was fully applicable because under prior law section 367(c)(2) caused the stock transfer to constitute a section 351 transfer. Under the proposed regulations, sections 367(a) and 367(b) will not be applicable to a deemed section 351 exchange attributable to or flowing from a section 304(a)(1) transaction.[20]

M. Section 368: Demerger and Merger Transactions

PLR 200452002 (issued August 27, 2004, released December 24, 2004) involved a complicated fact pattern in which a U.S. parent corporation restructured two separate foreign business units, A and B, into two separately incorporated foreign corporations organized under the same laws of the countries in which the businesses were previously conducted. Diagram C illustrates the three-step transaction:

The IRS ruled that the subject transactions would be treated as C and D reorganizations, as well as a tax-deferred section 351 transfer. Under that approach, the IRS explained that the first two steps would be treated as transfers by the four subsidiaries (including foreign subsidiary 4) of their assets and liabilities to Newco 1. The IRS further explained that immediately after those transfers, subsidiaries 1 through 4 would be deemed liquidated into Newco 1. Thereafter, the business B assets would be treated as being dropped down by Newco 1 into Newco 2. The IRS issued no rulings on whether it would require the taxpayer to enter into a gain recognition treatment. That agreement might be appropriate under this Treas. reg. section 1.367(a)-3(d) because of the indirect stock transfer rules and their interrelationship in a section 351 nonrecognition transaction.[21]

1. Practitioner's Comment: This ruling illustrates the application of an asset reorganization under section 368(a)(1)(C) to the combination of foreign Subsidiary 1, 2, and 3's business units into foreign Subsidiary 4. Also, the demerger transaction was ruled to constitute a section 368(a)(1)(D) tax-deferred reorganization. Finally, the contribution of the Newco 2 shares into Newco 1 was treated as a tax-deferred exchange. The various steps all involve transactions under the laws of country C and ultimately resulted in separation of two business units, A and B, into two separate C country corporations. It is likely that the use of foreign Subsidiary 4 for the merger and subsequent demerger transaction was done to comply with local requirements.

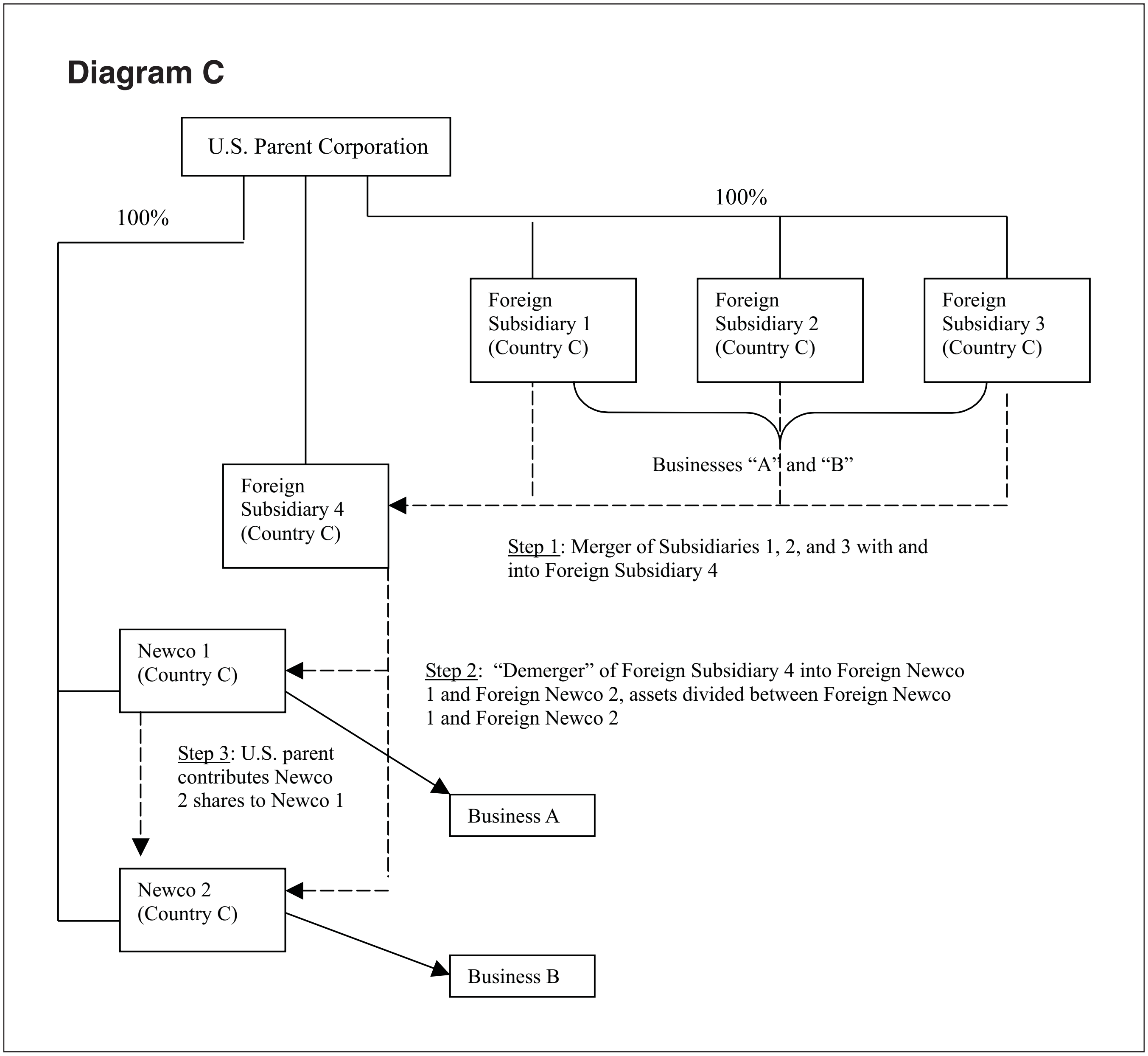
N. Section 368(a)(1)(A): Final Regs on Corporate Mergers and Consolidations Effected Under Foreign Law

Under Treas. reg. section 1.368-2(b)(1)(ii), for a merger or consolidation to be treated as a tax-deferred transaction under section 368(a)(1)(A), it must be effected under the laws of the United States, a state, or the District of Columbia. The recently proposed regulations (see prop. Treas. reg. section 1.368-2; REG-117969-00) were released with the objective to replace that language with language stating that those transactions must be "effected pursuant to the statute or statutes necessary to effect the merger or consolidation." According to the language in the preamble of the proposed regulations, merger or consolidation transactions structured under the laws of U.S. possessions may also qualify under that generalized language. Proposed regulations would also make conforming changes to applicable regulations under sections 367, 884, and 6038B. However, those new rules will apply only to

[19]1991-1 C.B. 114.

[20]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* June 27, 2005, p. 1187. For REG-127740-04, see *2005 WTD 99-15* or *Doc 2005-11340*. For another section 367 development, see Notice 2005-6, 2005-5 IRB 448, and H. Klumpp and R. Wearing, "IRS Issues New International Reorg Guidance," *Tax Notes Int'l,* Jan. 17, 2005, p. 238.

[21]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Feb. 7, 2005, p. 520.



transactions occurring after the regulations were published in final form[22] — that is, January 23, 2006.

1. Practitioner's Comment: Practitioners have welcomed the issuance of the final regulations, which put the U.S. on an equal footing with its foreign counterparts to enable tax-deferred merger treatment in the merger of entities organized outside the United States with and into entities organized under U.S. law.

O. Section 368(a)(1)(E), (F): Final Regs on Some E- and F-Type Reorganizations

In Treas. reg. section 1.368-1(b) (T.D. 9182), the 2004 proposed regulations were adopted in final form. Under the final version, the continuity of interest and continuity of business enterprise requirements will no longer be required for a transaction to qualify as a type E recapitalization or a type F mere change in form reorganization.

[22] *See* H. Klumpp and R. Wearing, "IRS Issues New International Reorg Guidance," *Tax Notes Int'l,* Jan. 17, 2005, p. 238.

The final regulations address a foreign-to-foreign country reorganization in which some shares of stock of the applicable foreign corporation are held by nominee shareholders. They provide that holding those nominee shares will not preclude application of a type F mere change in form reorganization.[23]

P. Section 382: Sibling Attributions in Some NOL-Affected Transactions

In *Garber Industries Holding Co., Inc. v. Commissioner*[24] (January 25, 2005), the Tax Court held that section 382 applies to a transaction in which change of ownership occurred because of the sale of shares in the corporation from one sibling to another. The court did not accept the IRS's argument that a change of ownership was because the brother's parents or grandparents were not alive during the testing period before the stock sale transaction. Instead the court determined that Congress intended the family aggregation rule to apply only to individuals who are actual shareholders of the corporation claiming the loss before the potential applicability of section 382. The court did not require an analysis of the brother's descendents, but simply held that the brothers are not subject to attribution under the applicable provisions of section 318. In holding that one brother's sale of stock to another triggered an ownership change under section 382(g), Judge Halpern explained that sibling shareholders are not aggregated under section 382(l)(3)(A)(i).[25]

> ***The new basis adjustment rule in section 362(e) represents a huge trap for the unwary.***

On appeal, the Fifth Circuit Court of Appeals ruled that the Tax Court properly interpreted section 382 in a sale of stock between two shareholder brothers when no parent or grandparent was a shareholder of the loss corporation. The court amplified Judge Halpern's opinion by reiterating that section 318 incorporates a limited family description for attribution involving spouse, parents, children, and grandchildren, and it limited the relatives of a shareholder whose stock aggregated with that of a shareholder in question; that clearly does not include siblings.[26]

1. *Practitioner's Comment:* Although *Garber Industries* is a domestic case, it has significant international repercussions. Although the taxpayer lost in *Garber Industries* in his effort to avoid section 382 "haircutting" of the relevant NOL, the case could be used in other outbound planning areas, particularly subpart F, to avoid family attribution under subpart F and other outbound rules. The case also illustrates that the court will strictly follow the statutory and regulatory mandates on attribution rules, which provides some certainty to taxpayers attempting to properly structure international transactions around the potential problems that would otherwise occur if attribution were triggered.

Q. Section 482: Proposed Cost-Sharing Regs and Related Developments

Addressing one of the most technical areas of section 482 and the regulations promulgated thereunder, the IRS and Treasury issued proposed cost-sharing regulations (see prop. Treas. reg. section 1.482-7). Based on conventional section 482 principles, specifically Treas. reg. section 1.482-1(b)(1), the proposed regulations' preamble states that the cost-sharing arrangement guidance is intended to provide the same results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. The proposed regulations provide guidance on several defined terms, methods for addressing the cost-sharing challenge, and a number of helpful examples. A discussion of that complex set of proposed regulations is beyond the scope of this outline, but this development, along with the recent cost-sharing checklist released by the IRS (discussed immediately below), should be carefully reviewed by practitioners.

In the technical world of section 482 cost-sharing, the IRS released its cost-sharing checklist to provide an interesting glimpse of useful cost-sharing agreements and eight separate sections referred to as "document sets." It also provides assistance to international examiners in evaluating cost-sharing agreements. For anyone involved in the highly technical world of cost-sharing agreements, the cost-sharing checklist is a must-read. The checklist also cites several background releases, including several technical advice memorandums and field service advice.

Also, a recent Tax Court decision illustrates the importance of sticking with the core principles of the section 482 regulations, in particular Treas. reg. section 1.482-1(b)(1) ("The standard to be applied in every case is that of a taxpayer dealing in arm's length with an uncontrolled taxpayer"). In *Xilinx v.*

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[23] *See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Mar. 28, 2005, p. 1180.

[24] 124 T.C. 1 (No. 10871-01).

[25] *See 2005 TNT 16-8* or *Doc 2005-1549*.

[26] *Garber Industries, Inc. v. Commissioner,* No. 05-60142 (5th Cir. 2006); *see also 2006 TNT 7-7* or *Doc 2006-552*.

Commissioner,[27] the Tax Court rejected the IRS's argument that the express terms of Treas. reg. section 1.482-7 (involving tax years before the 2003 cost-sharing regulations and, of course, the recently proposed cost-sharing regulations) do not automatically produce an arm's-length result, and the taxpayer's evidence of what controlled taxpayers would have allocated some stock options, spreads, or grants carried the day. The IRS has appealed the decision.

R. Section 482: The Nexus Between Partnership Allocations and Section 482

Under prop. Treas. reg. section 1.704-1(b), Example 29, the practitioner should be aware of what happens when a plan has become overly zealous in the engineering of special allocations. The upshot of that regulation and Example 29 is that special allocations may pass muster for section 704 purposes, but if those allocations result in the evasion of tax or if they do not clearly reflect income under section 482, the allocation may not be respected.

S. Section 861: Final Regs on Source of Compensation for Personal Services

In T.D. 9212, the IRS issued final regulations[28] for determining the source of income from personal services performed partly within and partly outside the United States. Those regulations are effective July 14, 2005, and retain the two-pronged sourcing approach in the proposed regulations.

The final regulations retain the facts and circumstances basis as the general rule for determining the source of compensation for labor or personal services performed partly within and partly without the United States received by persons other than individuals (for example, a U.S. corporation performing services in the United States and abroad) and by individuals who are not employees (for example, consultants who are independent contractors). For individuals who receive compensation as employees for labor or personal services, the final regulations provide two general methods for determining the proper source of compensation.

For those individual employees, under Treas. reg. section 1.861-4(b)(2)(ii)(A), an individual employee earning nonfringe benefit compensation will source compensation on a time basis. With fringe benefit compensation, the general approach is to source that compensation geographically.[29]

1. Practitioner's Comment: For a nonindividual or individual independent contractor, such as a U.S. domestic corporation performing services under a contract that calls for work to be performed in the United States and multiple foreign countries, the regulations use a facts and circumstances test to determine the source of the services performed. In one example given in the regulations, that facts and circumstances test could be based on a comparison of the relative payroll costs of the services performed hourly in the United States versus outside the United States. Under that example, the analysis would be based on payroll costs as opposed to hours, because the costs of performing the services in the United States are more significant because of the sophisticated nature of the services performed in the United States. For the performance of services by an individual who is not an employee, the regulations provide that apportionment on a time basis is probably the best standard. That same standard is also used for employees performing services within and outside the United States. Although those rules hold a great deal of logic, because services typically would be sourced on the basis of payroll costs or time spent, it is crucial for the practitioner to advise clients to set up the proper system for adopting and administering to determine and track the source of services.

T. Section 863: Proposed Space, Ocean, and Communications Regs

The IRS has reproposed regulations[30] on the source of income from space, ocean, and communications activities as covered by section 863. The reproposed regulations take into account several comments that have been made in light of substantial technological changes in the space, ocean, and communications activities. A discussion of those regulations is beyond the scope of this outline; however, the reproposed regulations provide for a liberalization of the earlier proposed version, which tended to skew everything toward U.S.-source income as opposed to using a split-source approach.[31]

U. Section 901: Determining Who Is Liable for the Foreign Tax

In ILM 200532044 (Aug. 12, 2005), the IRS addressed Treas. reg. section 1.904-2(e)(5), which allows a foreign tax payment to be creditable only if that payment is a "compulsory payment" to the foreign government. The issue in that memorandum was whether a subsidiary treated as a dual resident company under the applicable provisions of the bilateral tax treaty between the United States and the foreign country had to seek competent authority guidance to resolve by mutual agreement whether the subsidiary was treated solely as a resident of

[27]125 T.C. No. 4 (2005).

[28]Treas. reg. section 1.861-4.

[29]*See 2005 WTD 134-12* or *Doc 2005-14913*.

[30]Prop. Treas. reg. section 1.863-3.

[31]*See 2005 WTD 180-11* or *Doc 2005-19099*.

either the foreign country or the United States. If the foreign subsidiary was not treated as a resident of the applicable foreign country, as called for under the bilateral tax treaty, the subsidiary's payment of tax to that country would not be deemed a compulsory payment under that regulation.

Financially, the issue centered on the subsidiary's interest earnings from a bank located in the foreign country. However, the country to which the tax was paid was not the country of organization of the bank, but another country. (In other words, a third-country foreign bank had an operation in the treaty country and the subsidiary earned interest from the third-country banking operation branch in the treaty country; the tax was paid to the treaty country, which was probably a withholding tax.)

For anyone involved in the highly technical world of cost-sharing agreements, the cost-sharing checklist is a must-read.

In interpreting Treas. reg. section 1.904-2(e)(5) rather restrictively, the internal legal memorandum holds that the foreign subsidiary is obligated to request competent authority review to resolve the residency issue to demonstrate that the foreign subsidiary exhausted all remedies and took all measures to reduce its foreign country tax liability as required by the section 901 regulations. Apparently, the applicable bilateral treaty contained a standard "other income" provision, which allows the treaty country of residence to impose taxation on a given income item. In that case, if the competent authority agreement determined that the foreign subsidiary was solely a U.S. resident for treaty purposes, failure to seek the ruling would cause the foreign subsidiary not to comply with the "exhaust all remedies" requirements of Treas. reg. section 1.904-2(e)(5).

The internal legal memorandum raised another interesting foreign tax credit issue because the foreign subsidiary's parent corporation was a disregarded entity formed under the same laws of the foreign subsidiary, and that foreign parent corporation issued a hybrid instrument that generated imputation credits that could be viewed as subsidies under section 901. The issue was whether those imputation payments would preclude the foreign subsidiaries' payments of tax to the foreign treaty jurisdiction as constituting a true income tax paid or accrued for foreign tax credit limitation purposes.

The internal legal memorandum holds that if the payments made by the foreign subsidiary were compulsory (as addressed above), then the imputation credits allowed by the foreign treaty country to holders (presumably third-party unrelated holders) of the disregarded entity or foreign corporation parent's issued hybrid instruments would not constitute a section 901(i) subsidy.

V. Sections 901 and 6511(d): Limitations Expiration for FTC Carryforward

In *Chrysler Corporation v. Commissioner,*[32] the Sixth Circuit Court of Appeals affirmed a Tax Court decision holding that the 10-year statute of limitations precluded the taxpayer from electing a foreign tax credit carryover. The court also dealt with issues of deductions for some warranty liabilities and a stock redemption transaction. The case involved a complicated fact pattern on use of the foreign tax credit. In more simplistic terms, the taxpayer, Chrysler Corp., ran up huge losses in the late 1970s through the early 1980s, but during that U.S. loss period, it paid substantial foreign taxes. Accordingly, when the taxpayer filed its consolidated tax return, it elected to deduct instead of claiming a credit for all foreign taxes paid during the U.S. loss years. After claiming those foreign tax credit deductions, the IRS asserted tax deficiencies against the taxpayer for some of the earlier loss years — that is, for 1984 and 1985. As a result, the taxpayer filed amended tax returns for earlier years to change the claimed deduction treatment for foreign tax payments to credit treatment to carry over those credits to the 1984 and 1985 deficiencies. Relying on section 6511(d), which provides that the statute of limitations begins to run from the year the credit is claimed, the court ruled that the 10-year limitations period for making a foreign tax credit election had expired. Specifically, the court cited section 6511(d)(3)(A), which prescribes a 10-year window within which the taxpayer must claim a credit "for the year with respect to which the claim is made." The court interpreted that to mean that the reference year must be the year in which the taxpayer first elected whether to claim a foreign tax credit. The court noted that the touchstone for triggering the statute of limitations remains the original year of election. Here the taxpayer missed the 10-year window and thus was barred from claiming a credit carryover under sections 901 and 904.

W. Sections 901 and 7701: *Guardian Industries Corp. v. United States*

In *Guardian Industries Corp. v. United States*,[33] a U.S. C corporation wholly owned a Luxembourg corporation that was an SARL under Luxembourg law but was treated as an entity disregarded from its owner for U.S. federal tax purposes. The wholly

[32] 2006 Fed App. (0050P) (6th Cir. 2006).

[33] 65 Fed. CL 50, No. 02-1936 T (Mar. 31, 2005).

owned Luxembourg subsidiary/disregarded entity in turn owned several Luxembourg subsidiaries, and the group filed a consolidated tax return under Luxembourg law. The issue was whether Luxembourg tax paid by the Luxembourg subsidiary/ disregarded entity is treated as paid by that entity or if the tax must be allocated among the members of the Luxembourg consolidated group in accordance with Treas. reg. sections 1.901-2(f)(1) and 1.901-2(f)(3).

Treas. reg. section 1.901-2(f)(3) provides that foreign law must be analyzed to determine the allocation of foreign tax liabilities in the context of a foreign affiliated group when the members are jointly and severally liable for income tax under foreign law. In this case, the taxpayer successfully argued that the Luxembourg subsidiary/disregarded entity was in and of itself legally liable for all group Luxembourg corporation income tax liabilities and that the other members of the consolidated Luxembourg return bore no liability. The court concluded that the consolidated members had no joint or several liability for any members' share or, for that matter, all of the consolidated tax liability, and that ultimate liability hinged on the Luxembourg subsidiary/disregarded entity.[34]

1. Practitioner's Comment: The taxpayer's successful argument that the Luxembourg subsidiary/ disregarded entity was legally liable for all Luxembourg corporation income tax imposed on the Luxembourg consolidated group was the result of providing strong evidence to that effect. The emphasis by the court was on an analysis of Luxembourg law, to establish which entity was saddled with the legal liability for the foreign income tax.

Neither the taxpayer nor the IRS spared any expense in preparing their expert reports. The taxpayer submitted reports from a leading Luxembourg law firm, a Big Four accounting firm, and the deputy tax director of Luxembourg (in connection with the letter submitted by the director). The U.S. government presented a report from a leading Luxembourg lawyer, as well as a letter from the Luxembourg deputy tax director to the U.S. IRS deputy tax attaché based in Paris.

The court concluded that the consolidated members had no joint or several liability for any members' share or for all of the consolidated tax liability and that ultimate liability hinged on the Luxembourg subsidiary/disregarded entity.

Practitioners should keep in mind that when working with check-the-box elections with foreign entities, it is crucial to consult foreign tax counsel to sort out all relevant issues and to resolve how they play out in important U.S. tax contexts, such as the foreign tax credit. The practitioner should also ensure that all foreign legal and tax matters are sorted out as a part of that process. A check-the-box election has no impact on the application of foreign law; however, foreign law must be taken into account to resolve the applicable U.S. tax ramifications of making that election.

X. Section 901: Iraq and Libya Tax Credit and Earned Income Restrictions Lifted

In Rev. Rul. 2005-3,[35] the IRS issued additional guidance on tax credit limitations under section 901(j) in connection with Libya. The ruling also provides additional guidance on the section 911(d)(8) restriction for both Libya and Iraq. Because of improving diplomatic relationships, the section 901(j)(1) and section 954(a)(5) limitations do not apply to Libya after December 9, 2004. The same applies for Iraq after June 27, 2004. The section 911(d)(8) restrictions have been lifted for Iraq after July 29, 2004, and for Libya after December 20, 2004.[36]

Y. Sections 901, 902: Substantiation of Claimed FTCs

In ILM 200514010 (April 8, 2005), the IRS Office of Chief Counsel concluded that the taxpayer had inadequately substantiated its claim for foreign tax credits because the foreign subsidiary at issue was not legally liable for the tax as required by Treas. reg. section 1.901-2(f).

The facts of the ruling involve an interesting and complex financing transaction. The taxpayer claimed U.S. foreign tax credit treatment for taxes imposed by a foreign country in connection with proceeds received by the taxpayer upon redemption of some notes because of the taxpayer's acquisition of participation interests relating to the notes approximately three weeks before the redemption date. On the redemption transaction, the foreign jurisdiction withheld tax from the redemption proceeds at a 15 percent rate. That rate applied whether or not the holders of the notes were residents or nonresidents of the foreign jurisdiction.

The law and analysis portion of the ILM is thorough and technical. It relies heavily on the section 901 regulations and related case law. The memorandum demonstrates the burden of proof on the taxpayer to substantiate the payment of foreign taxes

[34] *See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Apr. 25, 2005, p. 323.

[35] 2005-3 IRB 334.

[36] *See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Feb. 7, 2005, p. 521.

and addresses the strict conditions under Treas. reg. section 1.901-2(f)(1) to show payment of a foreign tax.[37]

Z. Section 911: Denial of Foreign Earned Income Exclusion for Antarctica

The U.S. Tax Court has ruled that the section 911 exclusion for earned income does not apply for services rendered in Antarctica.[38] In reaching that conclusion, the Tax Court in *Arnett v. Commissioner*[39] determined that Antarctica was not a foreign country and that therefore section 911 does not apply. Although there had been previous cases that determined that Antarctica was a foreign country, the Tax Court found them not to be controlling factors because the cases dealt with statutes other than the Internal Revenue Code. U.S. employees working in Antarctica are fully taxed on their income but cannot adhere to the benefits.

AA. Section 936: Termination of Section 936 Treatment

Notice 2005-21[40] provides that termination of a section 936 company will result in the company being included in its parent corporation's consolidated return group, assuming the termination date of the section 936 company occurs at the end of 2005. The notice contains many other technical rules on termination of section 936 companies, including applicability of the "separate return limitation year" rules and many section 382 issues.[41]

BB. Section 937: Possessions Residency and Source Developments

On April 11, 2005, the IRS and Treasury issued temporary and proposed regulations, then on February 26, 2006, the IRS and Treasury issued final regulations (which added section 1937-1 and replaced temporary and proposed regulation section 1.937-1T), providing guidance on several section 937 matters, including the determination of whether an individual is a bona fide resident of some U.S. possessions (American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands).[42] The regulations also provide guidance on determining whether income is derived from sources within a U.S. possession (as opposed to U.S. sources) and whether some income is effectively connected with the conduct of the trade of business within a U.S. possession (as opposed to the United States).

On the bona fide residency determination, subject to exceptions, the effective date prescribed by the regulations is for tax periods beginning on or after January 1, 2006. The proposed and temporary regulations apply for the tax years ending after October 22, 2004, until tax years beginning on or after January 1, 2006. That represented a significant relaxation from what many expected given the October 2004 Jobs Act enactment date of section 937.

Further, most of the controversy on the regulations focus on the U.S. Virgin Islands because of the so-called economic development commission regime, under which qualifying businesses established in the U.S. Virgin Islands will be entitled to up to a 90 percent U.S. Virgin Islands tax break while also avoiding U.S. federal income taxation on economic development commission earnings.

Under section 932(c), so long as a bona fide resident of the U.S. Virgin Islands files an income tax return with the U.S. Virgin Islands tax authorities (the Bureau of Internal Revenue or BIR), income reported on the U.S. Virgin Islands filing is excluded from gross income for U.S. federal income tax purposes. Under section 932(a), a U.S. citizen and resident alien individual who does not otherwise qualify as a U.S. Virgin Islands bona fide resident, but who has sources from within the U.S. Virgin Islands, must file both a USVI BIR tax return and a follow-up U.S. IRS tax return. Any taxes paid to the former would be claimed as a credit for the tax return filed with the latter.

Perhaps most controversial, in the wake of the Jobs Act passage of section 937, the IRS has begun dozens of income tax examinations on what constitutes a bona fide resident of the U.S. Virgin Islands (or other possessions).

Section 937(a) provides a strict definition to determine whether an individual is a bona fide resident of a possession. Three hurdles must be passed: The individual must be physically present in the possession for 183 days or more during the tax year; the individual must not have a tax home (as defined under section 911(d)(3)) outside the possession during the tax year; and the individual must not have a closer connection (determined under section 7701(b)(3)(B)(ii)) to the United States or a foreign country than to the possession. Those three tests are known as the physical presence test, the tax home test, and the closer connection test, respectively.

The legislative history to section 937 specified that Congress delegated authority to the IRS and Treasury to carve out exceptions to the bona fide residency test specified above for reasons other than tax avoidance. The legislative history specifically refers to individuals who are military personnel or

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[37]*See 2005 WTD 69-15* or *Doc 2005-7260*, and J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Apr. 25, 2005, p. 334.

[38]*See Tax Notes Int'l,* Feb. 13, 2006, p. 535.

[39]126 T.C. No. 5 (2006).

[40]2005-11 IRB 727 (Mar. 14, 2005).

[41]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Mar. 28, 2005, p. 1181.

[42]*See* T.D. 9194.

fishery trade workers and those who are retired and living in a possession but travel outside of the possession for personal reasons.

The regulations provide for exceptions to the section 937(a) general residency rule, including a safe haven for any individual who spends no more than 90 days in the United States during the tax year. Because section 937(a) provides that an individual must be present in the possession for 183 days or more during the tax year, this special 90-day rule is intended to help individuals who travel between and among other possessions and also other foreign countries and who limit their amount of time spent in the U.S. mainland.

Another regulatory exception to the physical presence requirement under section 937(a) calls for an individual who spends more days in the possession in comparison to the United States, so long as the individual has no earned income in the United States during the tax year. Under that special exception, an individual who spends four months a year in St. Thomas could spend just under four months in the U.S. mainland and the rest of the time visiting foreign countries, and still qualify as a bona fide resident of a U.S. possession.

The regulations also provide that an individual will be treated as a bona fide foreign resident of a U.S. possession if the individual has no permanent connection to the United States. The regulations provide that a permanent connection means any permanent residence and a spouse or a dependent with a principal place of abode in the United States. Under that exception, an individual residing in a U.S. possession will not be concerned with counting the number of days, but will instead be required to sever all ties to the United States and to ensure that his or her spouse and dependents live with that person in the U.S. possession. That will enable the individual to spend substantial amounts of time in the U.S. mainland, whether for vacation, personal, medical, or business needs.

An important area that is covered by the temporary and proposed regulations concerns section 937(b)(2). That provides that income will not be derived from possession sources (or effectively connected with the conduct of a trade or business within a possession) if the income constitutes income from U.S. sources or is treated as effectively connected with the conduct of a trade or business in the United States based on sections 861-865. Based on the language of section 937(b), which provides for Treasury and the IRS to promulgate exceptions to the general source rule of section 937(b)(2) as guided by the legislative history to section 937(b)(2), the temporary and proposed regulations contain several exceptions to this sourcing rule. Similar to the residency rule, and subject to exceptions, the new rules apply only to income generated after December 31, 2004. In this section, the temporary and proposed regulations included several antiavoidance rules. The temporary and proposed regulations preserved the existing treatment of income for the sale of goods manufactured in a possession. Finally, the temporary and proposed regulations contain several other rules addressing many technical issues on source and effectively connected matters.

The IRS issued technical corrections to the temporary regulations on the bona fide foreign residency rule for some U.S. possessions on June 3, 2005, in T.D. 9194.[43]

1. Practitioner's Comment: The Jobs Act together with the April 2005 temporary and proposed regulations and the February 2006 final regulations effectively override the U.S. Virgin Island's economic development commission regime. Effective in 2005, the new rules will preclude many U.S. persons living in the Virgin Islands from claiming economic development commission benefits. As noted above, the IRS has launched numerous examinations on the administration of these new provisions, as well as examinations of the pre-Jobs Act residency rules (for 2004 and earlier years). In many cases, the IRS has teamed up with the BIR to conduct joint examinations for 2004 and prior years. The IRS has yet to formally or informally indicate its settlement profiles for resolving the hundreds (if not thousands) of residency cases that have already begun or will begin. At the July 21, 2005, hearings in Washington, most testified that the bona fide residency rules are still too restrictive. Many have advocated adoption of the section 7701(b) substantial presence test.

CC. Section 951: Final U.S. Shareholder Allocation of Subpart F Income Regs

The proposed regulations under section 951 that provided guidance on how a U.S. shareholder of a CFC allocated income to various types of subpart F income were recently finalized in T.D. 9222 and, by and large, adopted the proposed regulations with some minor modifications. See Treas. reg. section 1.951-1(e). Some of the more important modifications are highlighted below:

- Based on the suggestions of various commentators, the final section 951 regulations include no references to section 956 inclusions. Instead, a new regulations project is being considered to determine the pro rata amount of section 956 income that must be allocated among U.S. shareholders. Because of the statutory amendments made to section 956 back in 1993, the pro rata rules included in section 951(a) are no

[43]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Apr. 25, 2005, p. 330, and *2005 WTD 107-14* or *Doc 2005-12124*.

longer determinative in determining a U.S. shareholder's section 956 pickup amount.

- The final regulations clarify that for determining earnings and profits in connection with the calculation of each U.S. shareholder's pro rata share of the corporation's subpart F income for the tax year, assuming we are talking about one class of stock, the definition of E&P for that purpose means E&P unreduced by distributions made during the year.
- The final regulations retain the general rule for allocation of subpart F income for multiple or varying classes of CFC stock based on a hypothetical calculation that is determined by reference to the distributions that would be made in connection with each class of stock if the CFC's E&P for the year were distributed on the last day of the tax year of the CFC. That could present a hardship to a preferred shareholder with noncumulative dividend preferences, because it is not clear whether the dividends will actually be paid during the current tax year. However, based on the hypothetical distribution rule, the allocation is made on the assumption that the full noncumulative dividend preference payment will be made. The final regulations retained that rule even though, as one commentator suggested, it could be a hardship to the preferred shareholder if the dividends are never paid and the shareholder has been allocated too much E&P because of this hypothetical distribution that is never made. It is better to negotiate cumulative, and not noncumulative, provisions.
- For mandatorily redeemable preferred stock with cumulative dividend rights, the final regulations have special provisions that deal with potential antiabuse transactions whereby shareholder-level agreements provide for some sort of reallocation that could be inconsistent with the economic terms of the underlying stock.
- Despite objections from many commentators on the value-based allocation requirement for two or more classes of stock whose rights and privileges depend on the exercise of discretion by the board of directors (or other governing body) of the CFC, the final regulations contain the value-based allocation rule.
- The final regulations also adopt the effective date of the regulations for CFCs with tax years beginning on or after January 1, 2005.

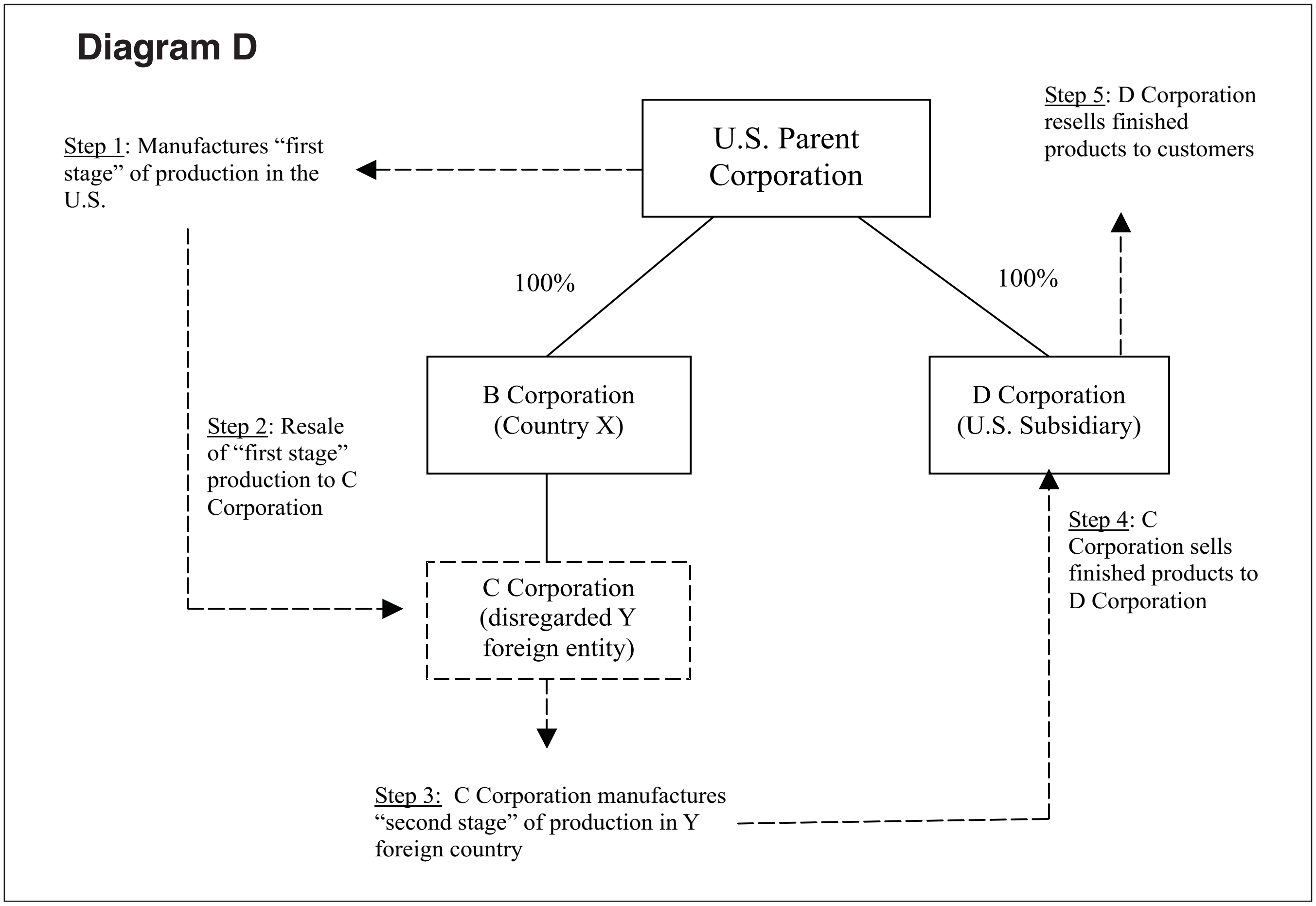
The final section 951 regulations attracted many comments that in and of themselves prodded the IRS and Treasury to propose additional section 951 regulations, including more guidance on allocation of E&P to a CFC with one more class of stock (Treas. reg. section 1.951-1(e)(3)(5)), as well as on some additional allocation issues.

1. Practitioner's Comment: The final regulations provide detailed guidance on the new millennium's CFC capital structuring transactions. However, in doing so the regulations adopt a value-based formula for two or more classes of stock whose rights and privileges depend on the exercise of discretion by the company's managing body. Those types of equity instruments are becoming more common in the international arena, so it will be crucial for shareholder agreements or other similar agreements to provide the method for determining and addressing the value-based allocation requirements of the final regulations. The value-based allocation requirements could also indirectly affect other areas, including the valuation of shares of a CFC for U.S. estate tax purposes and other transfer tax purposes. In view of the hypothetical distribution rule, the practitioner should counsel clients to avoid noncumulative or similar instruments, which may never yield a dividend payment. From a business perspective, those value-based regulations could also benefit or hurt business filings associated with the foreign operation, such as financial disclosures made to banks and financial institutions.

DD. Section 954(i): FPHCI Status of CFC Partnership Income Distributive Share

On January 17, 2006, the IRS published final and temporary regulations to determine whether a CFC distributive share of partnership income is excluded under section 954(i) from the definition of foreign personal holding company income.[44] Treas. reg. section 1.954-2(a)(5)(ii)(C) addresses the section 954(i) exception for income derived in the conduct of an insurance business. The interesting twist is that investment income excluded from insurance income as section 953(e) exempt insurance income may still be treated for subpart F purposes as subpart F income if that income constitutes foreign personal holding company income under section 954(c) and the section 954(i) exception is not applicable. For clarification, the regulations provide that a CFC's distributive share of partnership income will qualify for the section 954(i) exception if the CFC is a qualifying insurance company and the income of the partnership would have been qualified insurance income under section 954(i) if it had been directly received by the CFC. Under that approach, the CFC's distributive share is not determined at the partnership level, but at the CFC partner level, by testing the partner's qualification as an insurance company under the applicable rules described above.

[44]REG-106418-05, see *2006 WTD 10-12* or *Doc 2006-891*.



EE. Section 956: Avoiding 956 Inclusions, Plus Section 881 Withholding Tax

Following is an illustration of the fact pattern of PLR 200519005 (May 30, 2005):

Based on Diagram D, the ruling states that D Corporation (the U.S. subsidiary) for business reasons is required to maintain a more significant supply of finished goods in its U.S. warehouse (because of the intricate and delicate nature of the manufacturing process and the uniqueness of the final product and long lead times to prevent interruption in supply). To protect its market share and ensure a continuation of supply of the finished products, D Corporation proposes to purchase more significant levels of the finished products from C Corporation, but defer payment for those purchased products until they are actually sold by D Corporation to customers.

D Corporation requested a ruling that the obligation held by C Corporation (a foreign disregarded entity owned by another foreign corporation that appears to be a CFC) did not constitute a section 956 investment in U.S. property (if that obligation did not exceed the monthly amounts of inventory held in the United States and is not outstanding for greater than an undisclosed number of months). D Corporation further requested a ruling that the section 881(a) 30 percent tax on interest paid by D Corporation to C Corporation would not be subject to withholding under section 1442. The IRS relied on the "ordinary and necessary to carry on the trade of business" language of section 956(c)(2) to grant relief to the taxpayer by ruling that the extended payment terms would be treated as ordinary and necessary in the businesses of both C Corporation and D Corporation. Accordingly, the extended payment arrangement did not trigger subpart F income under section 956.

Further, the IRS ruled that the extended payment terms were exempt from section 1442 withholding treatment and were not subject to tax under section 881 because of the short-term exception rule in section 871(g)(1)(B). The IRS noted that the obligation by D Corporation to pay C Corporation would be treated as an original issue discount obligation under section 1273(a), but that the carveout for "any obligation payable 183 days or less from the date of original issue" would relieve D Corporation from withholding the 30 percent tax.[45]

1. Practitioner's Comment: Section 956 is one of the most significant hidden hazards in tax planning. Unlike many other provisions of subpart F (except for perhaps the "previously taxed income" rules of section 959), the section 956 rules are in many instances highly technical as well as counterintuitive; the rules must be fully addressed not only in connection with complex restructurings, but also in the context of ordinary commercial buy and sell transactions such as the above fact pattern. The ruling also illustrates the need to consider both the outbound world of tax planning and the inbound world of tax planning. For example, the payment of interest by D Corporation to its foreign supplier (C Corporation) could have triggered a section 1442 withholding tax; however, the taxpayer structured the relationship in accordance with the original issue discount obligation exception on any obligation payable 183 days or less from the date of original issue. Again, practitioners should be well aware of both outbound and inbound tax rules even in a fact pattern that appears to be purely outbound.

FF. Section 956: Rerelease of FSA 200216022

In the November 2005 rerelease of FSA 200216022 (April 19, 2002), several CFCs indirectly guaranteed a bank loan to a U.S. parent corporation/borrower. Although not entirely clear, the advice implies that a section 956 inclusion can occur for each CFC guarantee to the extent that each CFC's E&P is less than the principal amount of the U.S. parent corporation's bank loan. The rerelease says that "this rule could produce strange results." In summary, the field service advice concludes that the "best answer" for determination of the section 956 inclusion issue on those facts is to prorate the amount of loans indirectly guaranteed among the CFCs that are involved in the guarantee transaction.

1. Practitioner's Comment: This rereleased field service advice certainly underscores the complexity of section 956 and potential income pickups by the U.S. shareholder group. Whenever we are talking about a U.S. parent corporation that is borrowing from the lender in which underlying CFCs are providing guarantees, red flags should appear to warn the practitioner that we may be talking about inadvertent section 956 inclusions as a result of the structured transaction. It is crucial to carefully review the tax ramifications of those guarantee transactions, which may make perfect sense from a commercial banking viewpoint, but could be disastrous from a federal tax perspective.

GG. Section 965: Guidance for Temporary Dividends Received Deduction

Enacted as a part of the Jobs Act, section 965 allows U.S. companies to claim a temporary 5.25 percent tax rate in connection with some qualifying repatriations from foreign affiliates so long as the international earnings are redeployed to domestic activities, including workforce hiring and training, infrastructure and capital investment, research and development, debt repayment and qualified benefit payments, corporate acquisitions, advertising and marketing, and intangible property purchases.

> ***When working with check-the-box elections with foreign entities, it is crucial to consult foreign tax counsel.***

Notice 2005-10[46] provides new guidelines for that redeployment of foreign-source distributions and provides guidance on prohibited activities, such as using the repatriated proceeds to pay down outstanding tax liabilities, executive compensation arrangements, some intercompany transactions, shareholder dividends and other distributions to shareholders, some portfolio investments, debt instrument purchases, and stock redemptions. Under Notice 2005-10, a five-year safe harbor window is allowed for any company that encountered difficulties in its reinvestment plan but wishes to remain in compliance by avoiding paying the otherwise applicable 35 percent corporate income tax rate.

The notice provides detailed guidance on what constitutes qualifying dividends for section 965 purposes and specifies that dividend pickups under sections 1248, 78, or, in some instances, 367 will not qualify under the ordinary definition of sections 301, 302, and 304. Notice 2005-10 also provides detailed guidelines for what qualifies as a domestic reinvestment plan and expenditures that qualify under section 965(b)(4).

Notice 2005-38[47] provides guidance on the section 965(b)(1)-(3) limitations on the amount of dividends that a U.S. shareholder/corporation may claim as eligible for dividends received deduction treatment under section 965. A discussion of the details of that notice are beyond the scope of this outline, but any

[45]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* May 30, 2005, p. 806.

[46]2005-6 IRB 1.

[47]2005-22 IRB 1100.

tax practitioner involved in a section 965 repatriation should pay close attention to it, as well as to Notice 2005-10.

In August 2005 Notice 2005-64[48] was published to provide guidance on the use of Form 8895 to identify cash dividends and rules for determining ineligible distributions for section 965 purposes. The notice also provides guidance on the adjustment to the distributing corporation's E&P and tackles the thorny topic of how currency translation adjustments are made in the context of the CFC receiving a distribution in a functional currency. It contains several helpful examples and goes into detail on the determination of allocable expenses for section 965 purposes.[49]

HH. Section 965: PFIC Issues on Inbound Repatriations

In PLR 200604020 (issued October 21, 2005, released January 27, 2006),[50] the IRS ruled that a taxpayer must take into account section 965 in deciding whether a foreign corporation's disposition of shares in a foreign subsidiary causes the foreign corporation to be treated as a passive foreign investment company (PFIC). The issue is whether the foreign corporation's sale of the subsidiary's stock constituted passive income under section 1297(b)(1) or whether this determination depended on treating the selling foreign corporation as disposing of its proportionate share of underlying assets of the foreign subsidiary, of which the selling foreign corporation indirectly owned at least 25 percent. In this case, the selling foreign corporation sold stock in its 25 percent-owned foreign subsidiaries before becoming a CFC. The underlying U.S. corporate owner of the selling foreign corporation planned to repatriate the foreign corporation's E&P within the deadlines of section 965 to claim an 85 percent dividends received deduction for cash dividends from CFCs if the cash is properly reinvested in the United States. For testing whether the selling foreign corporation was a PFIC under section 1297(a), the IRS ruled that the selling foreign corporation must treat the sale of the underlying foreign corporation's stock as if the selling foreign corporation sold its proportionate share of the underlying assets of the subsidiary foreign corporation of which the selling foreign corporation owns (by value) at least 25 percent.

II. Section 985: Amendment to DASTM Method of Accounts

Notice 2005-27[51] sets forth guidance on the proper exchange rate in connection with the determination of the dollar approximate separate transaction method (DASTM) gain or loss on the translation of current and historic accounts on asset transfers from a qualified business unit (QBU) to the QBU's U.S. home office.[52]

JJ. Section 1001: No Taxable Gain on Currency Swap

Consistent with the Fifth Circuit's earlier decision in *G.M. Trading Corp. v. Commissioner*,[53] the federal district court in *Kohler Co. v. United States*[54] found that, in connection with a debt-for-pesos swap transaction, the taxpayer realized no gain because the restricted pesos account at issue lacked an ascertainable value. The court applied *Davis* gain legal principles in reaching its conclusion. See *United States v. Davis.*[55]

KK. Section 1031: Beware of Transient, Intermediary Parties

In *Teruya Brothers, Ltd. and Subsidiaries v. Commissioner*,[56] the Tax Court ruled that the taxpayer could not claim section 1031 deferred gain recognition treatment on properties exchanged through an intermediary in light of section 1031(f)(4) (no tax-deferred treatment for any "transaction (or series of transactions) structured to avoid the purposes of this subsection"). The court ruled that the transactions at issue were economically equivalent direct exchanges coupled by a sale of the subject properties to some unrelated third parties and that the use of the intermediary was an attempt to circumvent the section 1031(f)(1) limitation that would otherwise have applied if the exchanges involved related parties. The taxpayer failed to prove that it did not have tax avoidance as a principal purpose under section 1031(f)(2)(C).

1. Practitioner's Comment: Although this is not an international case, it has significant international overtones. The case illustrates that the Tax Court will not tolerate technical compliance for the applicable statutory provisions when the big picture of the transaction involves a tax avoidance motive,

[48]2005-36 IRB 471.

[49]*See* W. Rojas, "U.S. Treasury Fleshes Out Earnings Repatriation Framework," *Tax Notes Int'l,* Jan. 24, 2005, p. 291; J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Feb. 7, 2005, p. 510; and J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* May 30, 2005, p. 794.

[50]*See 2006 WTD 20-14* or *Doc 2006-1630*.

[51]2005-13 IRB 1.

[52]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Mar. 28, 2005, p. 1183.

[53]121 F.3d 977 (5th Cir. 1997).

[54]387 F. Supp. 2d 921 (E.D. Wisc. 2005).

[55]370 U.S. 65 (1962).

[56]124 T.C. No. 4 (No. 17955-03, Feb. 9, 2005).

such as the use of intermediaries to circumvent the application of an otherwise statutory prohibition.

LL. Sections 1297 and 1298: Guidance on PFIC Purging Elections

On December 8, 2005, the IRS and Treasury issued temporary regulations that provide some elections for taxpayers that continue to be subject to the PFIC excess distribution regime as set forth in section 1291, even though the foreign corporation in which they own stock is no longer treated as a PFIC under either section 1297(a) or section 1297(e). The temporary regulations provide detailed guidance on removing the PFIC taint for those foreign corporations.[57] On December 8, 2005, the IRS and Treasury also issued final regulations (and removed the temporary regulation version) to provide specific elections that grant relief to some U.S. persons that continue to be subject to the PFIC excess distribution regime of section 1291 even though the foreign corporation in which they hold stock no longer satisfies the definition of a PFIC under section 1297(a).[58]

1. Practitioner's Comment: For foreign corporations that are PFICs under the "once a PFIC, always a PFIC" rules, these new regulations may allow another opportunity to remove the PFIC taint, albeit at a tax cost on a deemed sale or repatriation of E&P, plus interest.

MM. Section 1374: Use of Valuation Reports in Built-In Gain Cases

Although it was not an international case, the Tax Court in *Van Der AA Investments, Inc., a Dissolved Delaware Corporation, Terry L. Van Der AA, Trustee, et al. v. Commissioner*[59] ruled that an Arthur Andersen evaluation report prepared on behalf of the taxpayer on a subchapter S conversion from a C corporation in 1995 was inadmissible. The issue in that case was the tax effect of the electing C corporation's 1999 net built-in gain tax liability in excess of US $60 million. The taxpayer sought to admit the report as a "business record." The court rejected that argument and ruled that the report would be admissible only if the professional who prepared the report testified at trial as an expert.[60]

1. Practitioner's Comment: In the international context, this issue is important because, since the 1996 tax law changes to the S corporation rules — in particular to section 1361(b) — S corporations may own 80 percent or more of C corporations, including foreign C corporations. (Remember the old days when an S corporation would be disqualified if it owned 80 percent or more of a C corporation?) However, when converting from a C corporation (that owns one or more foreign C corporations) to an S corporation, the section 1374 built-in gain issue must be proactively and carefully addressed, and a third-party evaluation of the net built-in gain exposure should be included. Of course, if the electing corporation does not engage in an asset sale or other defined triggering transaction within 10 years from the date of the S election, the section 1374 issue is moot.

NN. Section 1441: New Proposed Withholding Regs

The IRS and Treasury issued new proposed regulations on March 14, 2006,[61] that would materially amend and clarify the final section 1441 regulations that were issued in 1997. In Notice 2001-4, 2001-1 C.B. 267, 2001-2 IRB 267 (and Rev. Proc. 2003-64, 2003-32 IRB 306), detailed guidance is provided on the requirements of taxpayer identification numbers in the context of accounts held with a qualified intermediary. The rules become particularly complex in the context of foreign simple trusts or foreign grantor trusts holding an account with a qualified intermediary and the appropriate taxpayer information number requirements, and about whether and to what extent a Form W-8IMY would be required. The taxpayer identification number requirement rule in Treas. reg. section 1.1441-1(e)(4)(vii)(G) indicates that a withholding certificate that was finalized on or after January 1, 2001 (whether by a qualified intermediary or other withholding agent), by an individual representing to be a foreign grantor trust up to five grantors, is not required to provide a taxpayer identification number with the withholding certificate in order for the withholding certificate to be valid.

OO. Section 1446: Final Withholding Regs

Section 1446 addresses a partnership's tax withholding obligations on effectively connected income allocable to a foreign partner. Although at first, section 1446 and the regulations promulgated thereunder would appear to be an inbound tax matter, some partnerships subject to section 1441 may have outbound elements. For example, a U.S. partnership may include both U.S. and non-U.S. partners and might have different varieties of ECI. Arguably, section 1446 could be looked upon as an outbound provision to the extent the applicable partnership that has ECI has income from foreign sources or owns foreign (outbound) business operations,

[57]Temp. Treas. reg. section 1.1297-3T(f), 1.1298-3T(f).

[58]Treas. reg. section 1.1291-9, et al.

[59]125 T.C. No. 1 (No. 21342-03) (July 6, 2005).

[60]*See 2005 TNT 129-6* or *Doc 2005-14499*.

[61]T.D. 9253.

whether through a branch, corporation, partnership, or other lower-tiered entity. For those reasons, this outline briefly addresses the regulations that were finalized under section 1446 and were first proposed on September 3, 2003.[62]

The final and temporary regulations under section 1446 become effective for partnerships with tax years beginning after May 18, 2005 (although the regulation contains a special election to retroactively apply the new regulations to partnership tax years beginning after December 31, 2004). The final and temporary regulations, which begin at Treas. reg. section 1.1446-1, contain myriad rules addressing several topics, such as termination of the status of foreign partners, the appropriate Form W-8 to file, the impact of a section 871(d) or section 882(d) election, the interrelationship with section 1443 on section 512 income and the determination of unrelated business taxable income, cancellation of indebtedness income at the partnership level, withholding and payment of taxes under section 1446, and domestic and foreign trusts and estates.

Those regulations also contain a set of temporary and proposed regulations that address the new certification procedure, under which a partnership otherwise subject to section 1446 may consider the deductions and losses of a foreign partner is reasonably expected to reduce the partner's ultimate U.S. income tax liability on that partner's allocable share of ECI or gain.[63]

PP. Section 1503(d): Proposed DCL Regs

The IRS and Treasury released proposed regulations (Prop. Treas. reg. section 1.1503(d)-1 through section 1.1503(d)-6) that if finalized, would overhaul the current section 1503(d) regulations. The preamble to the proposed regulations notes several reasons for the proposed regulations, including the concern that the current regulations do not prohibit "double dip" benefits that are otherwise intended to be denied by section 1503(d). The proposed regulations also address several unresolved issues, including complexities from the check-the-box regulations. The proposed regulations try to implement a more administratively efficient system, which includes streamlining several provisions and narrowing the certification period to seven years.

The proposed section 1503(d) regulations are lengthy and complex, but well organized. The first section addresses definitional matters and some special rules; the second section explains the applicable operating rules; the third section addresses dual consolidated loss (DCL) situations; the fourth section sets forth several exceptions to the general rule prohibiting domestic use of a dual consolidated loss transaction; the fifth section provides numerous helpful examples; and the sixth section calls up the effective date rules for the proposed regulations. In general, the proposed regulations will apply to dual-consolidated loss matters occurring in tax years beginning after the date of publication of the final regulations.[64]

The IRS published Notice 2006-13[65] in February 2006 (effective March 23, 2006), which allows taxpayers to use the reasonable cause procedures of the proposed section 1503(d) regulations, when the taxpayers fail to file all documents under section 1503(d) in a timely manner. Taxpayers must demonstrate to the director of field operations, Large and Mid-Size Business Division, having jurisdiction over the return for the tax year that the return was not timely filed. The director will notify the taxpayer within 120 days if reasonable cause was accepted or if more time is needed for a determination.

Taxpayers who file a late request for a closing agreement must continue to follow the section 9100 regulations.

QQ. Section 6081: Automatic Six-Month Extension Regs

Although this is not directly an international issue, the recently issued final and temporary regulations[66] simplify automatic filing extension rules for most businesses and individuals to allow them to obtain a full six-month extension without providing a signature or an explanation. Those regulations are effective November 7, 2005, and thus are applicable to all 2005 tax returns due in 2006. In finalizing the regulation, the old two-step extension request process for most individuals is made inapplicable.[67]

RR. Section 6103: Report on History of IRS Criminal Investigation

The IRS on July 18, 2005, erroneously released an unedited and unredacted report on the historical development of the Criminal Investigation Division, titled "75 Years of IRS Criminal Investigation History (1919-1994)." The report is about 200 pages long and has an excellent historical review of the who's who of alleged tax evaders. It describes in detail how criminal investigation operatives brought many evaders to justice. It features historical cases, such

[62]T.D. 9200.

[63]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* May 30, 2005, p. 773, at 791.

[64]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* May 30, 2005, p. 773.

[65]2006-13 IRB 496 (Feb. 21, 2006).

[66]T.D. 9229.

[67]*See 2005 TNT 214-4* or *Doc 2005-22606*.

as IRS criminal investigation involvement in the Lindberg kidnapping and the prosecution and conviction of hotel heiress Leona M. Helmsley.[68]

SS. Section 6501(a): Equitable Tolling Principle Held Inapplicable

In *John Doe 1 and John Doe 2 v. KPMG, LLP*,[69] the Fifth Circuit Court of Appeals held that equitable tolling could not be used to extend the otherwise applicable three-year limitation period under section 6501(a) for assessing tax against John Doe taxpayers engaged in litigation (to prevent KPMG from revealing their identities and participation in possible tax shelter transactions). The background of the case is interesting and provides a glimpse of how the litigation strategy played out. It also sheds light on some of the procedural and substantive law aspects.

The new rules will preclude many U.S. persons living in the Virgin Islands from claiming economic development commission benefits.

Under section 6112(b)(2), the IRS published Notice 2000-44[70] in September 2000, which requires organizers and promoters of some tax shelters to maintain lists of participants and to provide those lists to the IRS upon request. Notice 2000-44 further states that the described shelter transactions are "potentially abusive." In December 2000 John Doe 1 and John Doe 2 (collectively referred to by the Fifth Circuit as the taxpayers) purchased from KPMG the so-called SOS shelter, also known as the short option strategy shelter, to reduce their tax liabilities for 2000 and 2001.

The IRS investigated KPMG's compliance with the Notice 2000-44 registration requirements and issued 25 summonses. In July 2002 the IRS brought an action in the U.S. District Court for the District of Columbia to enforce nine of the summonses sent to KPMG, seeking the names of clients to whom KPMG had sold particular tax shelters.

In December 2002 the district court ordered KPMG to comply with the summonses by revealing the requested names and transactional information to a special master in charge. By August 2003 KPMG had turned over information about the SOS shelter transactions to the IRS, but omitted taxpayer names and identifying information from the submitted documentation. The taxpayers asserted the so-called tax practitioner privilege under section 7525 and instructed KPMG to take no action that would otherwise waive the privilege.

Shortly thereafter, John Doe 1 and John Doe 2 instituted legal action in federal court against KPMG, seeking declaratory and injunctive relief to prevent KPMG from disclosing the identities required by the earlier summonses. KPMG agreed to abide by the taxpayers' stipulation and agreed order to prevent KPMG from disclosing their identities or any relevant documents until the court should enter a final judgment on the merits. (However, the Fifth Circuit noted that KPMG argued that the taxpayers' identifies were not protected by the tax practitioner privilege.)

As a result of those developments, the IRS became concerned about applicability of the three-year statute of limitations under section 6501(a), which would otherwise expire while the current lawsuit was pending. On March 19, 2004, the IRS asked the taxpayers to sign a consent agreement to extend the statute of limitations during the current litigation; however, the taxpayers refused. The IRS then filed an emergency motion to intervene under Federal Rule of Civil Procedure 24(a) to protect its interests and the public fisc.

The district court granted the government's motion and ordered the parties to take all necessary steps to prevent the statute of limitations from expiring. The taxpayers refused to sign the consent, and the IRS sought an order to show cause why they should not be held in contempt. The taxpayers argued, and the district court agreed, that consent to toll the statute of limitations must be voluntary. However, the district court issued an order in the government's favor equitably tolling the statute of limitations under section 6503(a)(1) and other equitable principles.

The Fifth Circuit Court of Appeals rejected the government's argument that section 7402(a) in a broad sense allows the district court's implied authority to use equitable tolling to enforce the revenue code. The court explained that the government failed to cite any authority to support that argument. The court relied on case law for the proposition that courts may not invoke equitable tolling to alter the plain language of the statute at issue. Further, the court noted that under the Jobs Act, Congress legislatively changed that result to extend the time for assessment of taxes and penalties when

[68]A copy of the report can be found on the following Web site: http://www.thememoryhole.org. *See also 2005 TNT 133-27* or *Doc 2005-14885*; *see also 2005 TNT 136-1* or *Doc 2005-15082*.

[69]U.S. Court of Appeals, 5th Circuit (No. 04-10470)(398 F.3d 686, Jan. 26, 2005) *reversing* 2004-1 USTC para. 50, 2070 (DC-Texas).

[70]2000-36 IRB 255 (Sept. 5, 2000).

the taxpayer fails to include required information on a return or statement about a listed transaction.[71]

TT. Section 6501(c)(10): Statute of Limitations Extension for Listed Transactions

In Rev. Proc. 2005-26,[72] the IRS provided guidance on the newly enacted section 6501(c)(10) (enacted by the Jobs Act), which extends the ordinarily applicable three-year limitations period on tax and penalty assessments for any failure to disclose a section 6707A(c)(2) listed transaction. That new provision applies to any assessment period that has not expired before October 22, 2004, and goes hand in hand with section 6501(c)(8) on a similar exception to the three-year statute of limitations rule for failure to file some foreign-related tax returns, such as Forms 5471 and 8865.[73]

1. Practitioner's Comment: The addition of section 6501(c)(10), along with its earlier counterpart in section 6501(c)(8) (the latter of which primarily affects international related nondisclosures), reflects the growing inclination of Congress to legislatively grant more time to the IRS to review transactions that have not been properly reported. The IRS in its examination efforts has focused heavily also on compliance issues regarding Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts), including the assessment of significant penalties, particularly in light of the recent increase in penalties under the Jobs Act (to either US $10,000 in nonwillful cases, and up to the greater of US $100,000 or half the balance in the account for willful violations). There is no question that the IRS is using these procedural tools as an important weapon in cracking down not only on abusive tax shelter transactions, but also on inadvertent civil law violations. A practical point to keep in mind is that even if those special section 6501(c) extensions of the statute of limitations do not apply, if a willful attempt in any manner to defeat or evade tax exists, we would also have an open statute based on the civil fraud exception in section 6501(c)(2).

UU. Section 6662(h): Economic Substance on Lease-Strip Transactions

In *CMA Consolidated Inc. v. Commissioner*,[74] the Tax Court ruled that some lease strip transactions using "tax indifferent" parties lacked both economic substance and a profit motive aside from tax benefits, and all claimed rental expense deductions were disallowed. Further, some losses associated with note dispositions were disallowed because the notes did not represent valid indebtedness and lacked economic substance. Applying the economic substance doctrine, the court disregarded the purported debt instruments and treated them as equity. It also did not find that a fee split agreement or joint venture of any form existed. The court hit the taxpayer with a 20 percent penalty on the underpayment of tax and a 40 percent accuracy-related penalty on the claimed losses from the note disposition transactions that were disallowed.

1. Practitioner's Comment: This case is good reading for an updated primer on the economic substance doctrine, as well as on what constitutes an adequate profit motive. It also serves as an excellent blueprint for the type of tax planning conduct tax practitioners should never allow. The detailed facts of the subject lease-stripping transactions are complex, but from a "smell test" perspective, whenever one engages in a purported joint venture with a tax-indifferent party like the Iowa Tribe of Oklahoma — an Indian tribe recognized by the Bureau of Indian Affairs of the U.S. Department of the Interior as exempt from federal income tax — the practitioner should know that the plan will be difficult to carry out. The Iowa Tribe of Oklahoma received only a very modest investment return for its 99 percent limited partnership interest in the partnership. Following is a list of other hazards that the practitioner should consider whenever engaging in a tax planning transaction that could rise to the level of this case:

- Do the underlying transactions have economic substance?
- Did the taxpayer have a nontax business purpose for entering into the transaction?
- What was the subject transaction's economic profit potential aside from tax benefits?
- When advances are made to a business entity and the advances are written off, are the advances debt or equity, and are the losses allowable?
- How would the advance be characterized under the 11-factor test: (1) What is the name given to the document?; (2) Does the document have a fixed maturity date?; (3) What is the source of repayment?; (4) What are the right-to-enforce payments?; (5) What level of participation in management exists?; (6) What is the status relative to other creditors?; (7) What is the intent of the parties?; (8) Does the entity have thin or adequate capitalization?; (9) Is interest identified?; (10) Is interest payable only out of the dividend flow?; and (11) Can the entity obtain outside lending?

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[71] *See 2005 TNT 17-11* or *Doc 2005-1652*.

[72] 2005-17 IRB l.

[73] *See 2005 WTD 69-12* or *Doc 2005-7334*.

[74] T.C. Memo. 2005-16 (No. 12746-01, Jan. 31, 2005).

- Does the subject transaction involve an assignment of income?
- Does the transaction involve fee splitting, and if so, how is the fee splitting determined?
- Did the promoters rely on outside and independent tax advisers for advice for entering into the transaction, and was the advice from a disinterested, objective, and independent adviser?

VV. Section 6663 Fraud Penalty: FBAR Ramifications

Worldwide Tax Daily on January 24, 2006, reported that a partially redacted IRS legal memorandum had been released on September 1, 2005. The memorandum addressed several issues in the foreign bank and financial accounts report (FBAR) penalty in section 5321(a)(5) of Title 31 of the U.S. Code in the context of willful violations stemming from the IRS's offshore credit card program and last-chance compliance initiative cases.[75] This partially redacted memorandum provides excellent insight into the IRS's thinking on this important penalty area in the context of the OCCP and LCCI cases. The memorandum addresses three issues: the proper interpretation of the willful standard, a redacted issue, and offshore credit card accounts that are not associated directly with bank accounts for deposits and the impact of the penalty.

On the first issue and the willfulness standard, the memorandum draws an analogy of willfulness under both the civil penalty in 31 U.S.C. section 5321 and the criminal penalty in 31 U.S.C. section 5322. The memorandum acknowledges that no case law exists on how to construe the willful standard in the civil penalty context, although case law does address that issue in the context of a criminal violation. It concludes that this proper standard is a "voluntary intentional violation of a known legal duty." The memorandum states that the government must prove that a defendant acted with knowledge that his conduct was unlawful; this level of proof ties into the voluntary intentional violation of a known legal duty threshold. The memorandum concludes that to impose the FBAR penalty, the account holder would simply have to have knowledge that he had a duty to file the FBAR. As a corollary, there would be no willfulness if the account holder had no knowledge of the duty to file the FBAR.

The memorandum also covers whether the criteria for assertion of the civil FBAR penalty are the same as the burden of proof that the IRS must demonstrate when asserting this civil fraud penalty under section 6663. The memorandum concludes that even though no case law addresses that issue, the IRS expects the answer to be yes. The memorandum states that the IRS expects that the courts will find the burden of proof in civil FBAR cases to be that of providing clear and convincing evidence instead of the lower evidentiary standard of preponderance of evidence. Interestingly, the memorandum states that the "higher standard of clear and convincing evidence offers some protection for an individual who may be wrongfully accused of fraud."

Even more interesting, the memorandum reviews the legal principle that the burden of proof of the IRS for civil tax fraud penalties represents an exception to the general presumption of correctness judicially afforded to tax assessments in the interest of the government's ability to officially collect taxes. The memorandum states that the FBAR penalty is not a tax or a tax penalty; therefore, the presumption of correctness of tax assessments would not apply to the FBAR penalty assessment for a willful violation. That is another reason, according to the memorandum, for why the IRS will need to meet the higher standard of clear and convincing evidence.

> ***PLR 200519005 illustrates the need to consider both the outbound world of tax planning and the inbound world of tax planning.***

As mentioned above, the second issue of the memorandum has been redacted, so the specifics of it are not clear. However, in the text of the memorandum, the LCCI standard offer letter is reviewed, with a focus on the possibility of asserting the civil fraud penalty for only one major year. The memorandum acknowledges that both the FBAR penalty and the civil fraud penalty may be abated or reduced depending on the facts and circumstances of each LCCI case. This section of the memorandum also asks whether it is possible to shift the burden of proof for willfulness to an uncooperative or unresponsive taxpayer. The memorandum states that the answer to this is, "unfortunately, no." Further, the memorandum notes that failure to cooperate could be a factor in supporting other circumstantial evidence in favor of imposing an FBAR penalty.

In another interesting item concerning the second issue, the memorandum addresses when the amount of the unreported bank accounts is still unknown and states that the penalty may be assessed for willful violations occurring after October 21, 2004, up to US $100,000. But the memorandum does not address when evidence shows that the amounts are substantially in excess of US $100,000, how the greater of 50 percent of the account balance or the US $100,000 threshold would play out.

[75]*See 2006 WTD 15-9* or *Doc 2006-1196*.

The memorandum's third issue addresses whether a secured offshore credit card account or an advanced payment offshore credit card account can be treated as a financial account for FBAR purposes. It concludes that a credit card with a deposit account would clearly be a financial account for FBAR purposes. The same conclusion is reached for a debit card account. If the agreement calls for advanced payments to be made to cover anticipated charges, the card is treated as a debit card, not a credit card; as such, the debit card would be treated as a financial account for FBAR purposes.

The memorandum also addresses whether the credit card account itself would be treated as a financial account for FBAR purposes. The memorandum concludes that, in the absence of special circumstances, a credit card account would not be treated as a financial account. Those special circumstances would include making advanced payments by the cardholder using the credit card account as a debit card or as a checking account. In that case, an argument can be made, depending on the facts and circumstances, that the account relationship is in substance a financial account.

WW. Section 6700 Investigations: Transferee Liability, Privilege, Summons Enforcement

During 2005, the U.S. government was very successful in its summons enforcement program, including in its defenses to a taxpayer's motions to quash a third-party summons. For example, in *Estate of Kenneth H. Reiserer et al. v. United States*,[76] an attorney who specialized in rendering tax planning services, including marketing an offshore employee leasing scheme (labeled by the court as an abusive tax arrangement), and who later died after the summons was issued, was subject to a section 6700 investigation for promotion of abusive tax shelters. The attorney's estate opposed the enforcement of the summons, arguing that the cause of action abated with the death of the attorney. That argument was rejected because of the transferee liability rules under sections 6700 and 6702, which were deemed not to be penal in nature.

The court also rejected the estate's argument that the documents were protected by the attorney-client privilege. It emphasized that although the summons would reveal the identities of several of the attorney's clients and how much was paid in fees to the attorney, the court held that information — including client identities — is not protected by the attorney-client privilege. Relying on section 6700, the court held that the attorney's clients' identities were relative to the government's investigation because of the penalty amounts specified in section 6700(a), because the assessment of those penalties is based on the number of illegal schemes the attorney sold or organized.[77]

1. Practitioner's Comment: The court's ruling in *Estate of Kenneth H. Reiserer et al.* denying the motion to quash the third-party summons is not surprising given the applicable judicially created legal standards for summons enforcement. What is interesting about that case is the context in which the summons arose. The case involved an investigation under section 6700, which is labeled "PROMOTING ABUSIVE TAX SHELTERS, ETC." The IRS is increasingly relying on section 6700 to conduct its investigations. Those investigations invariably morph into not only examinations of the alleged promoter under investigation, but also into tax examinations of many of the promoter's contacts, partners, business associates, and underlying customers and clients. Further, the penalty exposure under section 6700 is extensive, because for each defined violation, a penalty of US $1,000 (in some cases less) is imposed on the person promoting each of those activities. For the penalty to be imposed, the IRS must demonstrate that the promoter either made a statement on the tax treatment of the matter that the promoter knows or has reason to know is false or fraudulent as to any material matter or engaged in a gross evaluation overstatement of any material matter (section 6700(a)(2)(A), (B)).

XX. Section 7701: When Business Contracts Become Tax Entities

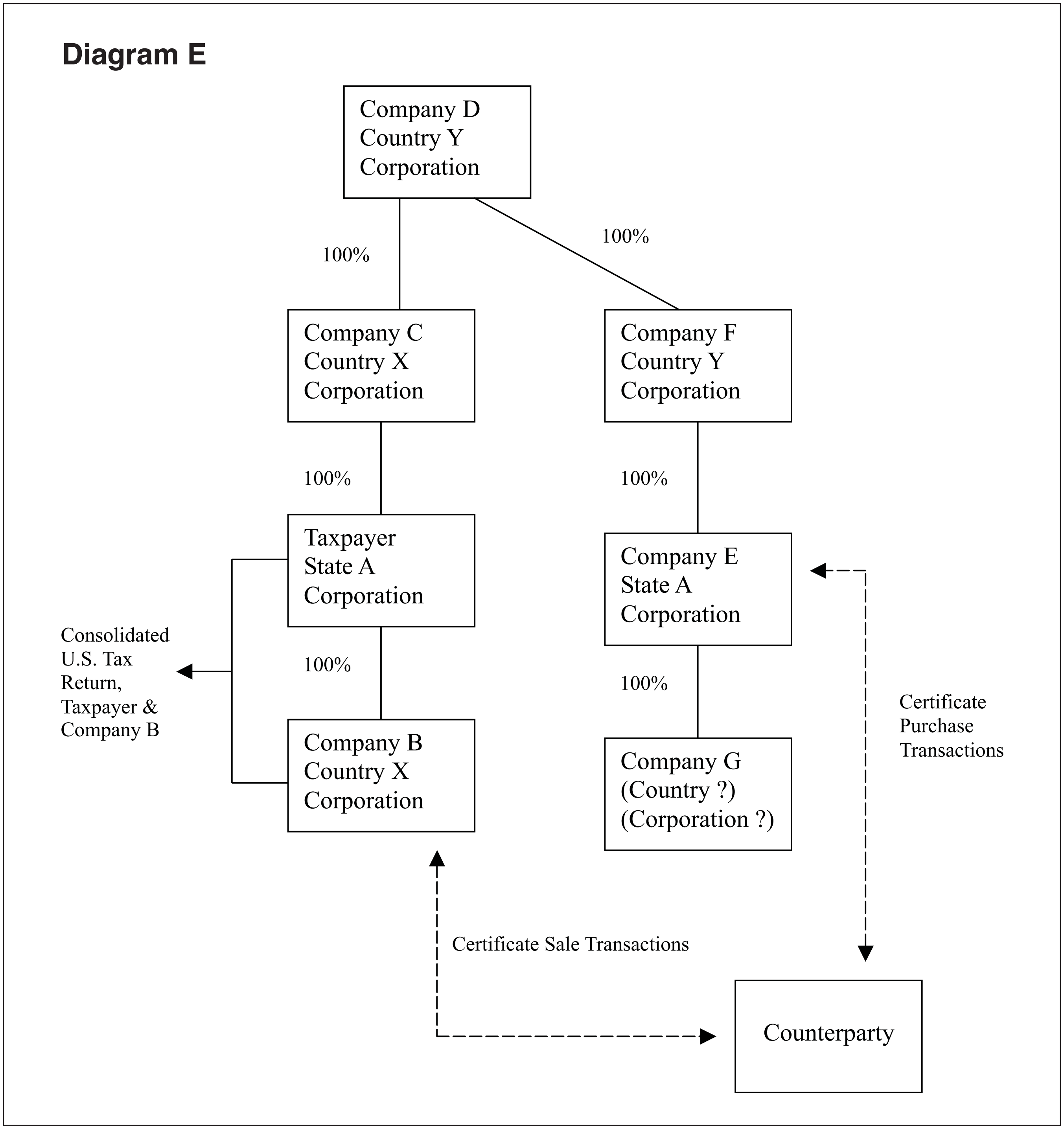
In TAM 200540010 (February 25, 2005), certain contracts were entered into by a U.S. corporation's controlled foreign subsidiary. Through the various contractual relationships, a business entity was created. Based on the application of Rev. Rul. 99-5, 1999-1 C.B. 434, a single-member LLC was initially disregarded, but once a new owner came into being, the disregarded entity transferred into a partnership. Diagram E illustrates the "complex corporate structure" (in the words of the TAM) involved:

Taxpayer, a state A corporation, filed a consolidated income tax return with company B, organized under the laws of country X (presumably either Mexico or Canada to file that consolidated return).

In a complicated financing transaction, company E approached the counterparty with an offer to buy and sell some financial products. The counterparty owned certificates maturing in the future. Under that transaction, company E would purchase the certificates from the counterparty; simultaneously,

[76]No. C04-0967 (May 25, 2005).

[77]*See 2005 WTD 103-8* or *Doc 2005-11579*.



the counterparty would purchase from company B (an affiliate of company E) newly created certificates that matured at approximately the same time. The assets underlying both sets of certificates were money market mutual fund shares.

Under the terms of the arrangement, company B paid company E a fee for structuring the transaction. Company B also paid a fee to the counterparty by reducing the sales price of its certificates. The memorandum describes the financing, exchange, and trading vehicles established under a contractual arrangement through various financing parties associated with the transactions.

When the dust settled, company B completed the counterparty transactions and reported dividend income from the four money market mutual funds.

It also deducted a short-term capital loss, with the short-term capital loss being calculated by subtracting company B's entire basis in the underlying money market mutual fund shares as further described in the prospectus. The memorandum addressed the following federal tax issues:

- Issue 1: On whether the contractual arrangement resulted in a full and complete transfer in the ownership of the underlying money market mutual fund shares for federal tax purposes, the IRS determined that the contractual arrangement did result in a full and complete transfer. In distinguishing various assignment of income cases, including *Helvering v. Horst*,[78] the IRS ruled that the taxpayer's assignment of future income without a transfer of any rights in underlying assets did not allow the taxpayer to allocate some bases to various certificates.
- Issue 2: On whether the contractual arrangement created an entity separate from company B, the IRS determined that the contractual arrangements did not result in a mere co-ownership of interest in the underlying money market mutual fund shares, but resulted in a formation of a separate entity in accordance with Treas. reg. section 301.7701-1(a)(2).
- Issue 3: On whether that separate entity created multiple classes of ownership in the assets of the contractual arrangement so that the contractual arrangement should be classified as a business entity under Treas. reg. section 301.7701-2, the IRS determined that the arrangement should be classified as a business entity under that regulation with the existence of multiple classes of ownership interests.
- Issue 4: On the consequences of treating the contractual arrangement as a business entity under Treas. reg. section 301.7701-4(c)(1), the IRS ruled that initially the arrangement would be treated as a disregarded entity, but later would convert into a partnership as a result of the transfer by company B of some certificates to the counterparty.

1. Practitioner's Comment: This overly complex TAM certainly demonstrates the complexity involved in not only cross-border financing transactions, but also the associated federal tax results. In this case, the taxpayer started with an unduly complex structure and ended up with an even more unduly complex tax result. Any practitioner involved in a cross-border financing or money-market-driven transaction should carefully review the ruling to make sure that the subject transaction does not rise to the level of inadvertently forming an entity for federal tax purposes and triggering potential disregarded status, partnership status, or other status for federal tax purposes. The memorandum in issue 4 includes a thorough discussion of the default classification rules under Treas. reg. section 301.7701-3(b)(1). The memorandum also relies on Rev. Rul. 99-5 in the analysis of what happens for federal tax purposes when a single-member LLC that is disregarded becomes an entity with more than one owner that is then classified as a partnership.

YY. Section 7701: Check-the-Box Regs — Per Se Corporation Updates

The IRS has issued final and temporary regulations to amend the check-the-box regulations at Treas. reg. section 301.7701-2 by including some European business entities on the commonly referred to per se corporations list. Those regulations are effective October 7, 2004, and primarily focus on the *Societas Europaea*, a type of company under the EU rules that effectively functions as a public LLC and will be treated as a per se corporation.[79]

ZZ. Section 7701: Check-the-Box Regs — Abolition of Per Se List?

In the outbound planning context, as well as in the inbound planning arena, the check-the-box rules have been well received by practitioners since they were finalized in December 1997. One of the recent topics of discussion is whether the per se list should be abolished. According to Hal Hicks, former IRS associate chief counsel (international), and now Treasury's international tax counsel, who spoke at the American Bar Association Section of Taxation meeting in Washington on May 20, 2005, the answer is no. Hicks noted that some at the IRS believe the check-the-box rules are problematic from an enforcement standpoint, so we will continue to see close monitoring of those rules. [80]

AAA. Section 7701: Check-the-Box Regs — Clarification of Procedural Matters

In Treas. reg. sections 1.856-9(a), 1.1361-4(a)(6)(iii), and 301.7701-2(e) (T.D. 9183), the IRS issued final regulations to clarify that some single-owner eligible entities that are disregarded as entities separate from their owners are treated as separate entities for some other federal tax liability purposes. The regulations are effective April 1, 2004, and adopted the earlier proposed regulations with relatively few changes. Under the final regulations,

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[78]311 U.S. 112 (1940).

[79]T.D. 9235 (Dec. 16, 2005). *See 2005 WTD 241-12* or *Doc 2005-25257*.

[80]*See* C. Scott, "ABA Tax Section Meeting: IRS Official Outlines International Guidance," *Tax Notes Int'l,* May 30, 2005, p. 752.

as expected, in appropriate circumstances, a disregarded entity may be the target of an assessment and may be subject to lien and levy. And, in appropriate circumstances, a disregarded entity may file a consent to extend the applicable period of limitations on assessment.

Some at the IRS believe the check-the-box rules are problematic from an enforcement standpoint, so we will continue to see close monitoring of those rules.

The final regulations do not discuss the circumstances under which a disregarded entity is either liable for federal taxes or entitled to a refund or credit. However, regulations note that, assuming a disregarded entity is entitled to a tax refund or credit, the entity will be treated as separate from its owner for purposes of that specific refund or credit.[81]

BBB. Section 7701: Check-the-Box Regs — *Littreillo v. United States*

Under the Treas. reg. section 301.7701-3 check-the-box regulations, the IRS and Treasury have generally taken the position that a disregarded entity is still treated as regarded by local law or foreign law even though the entity is disregarded as an entity separate from its owner for federal tax purposes. That position is solidified in Rev. Rul. 2004-88, 2004-32 IRB 165, as well as in other IRS releases and the relevant case law.

In *Littreillo v. United States*,[82] the U.S. federal district court upheld the validity of the check-the-box regulations and ruled that the LLC that made a disregarded entity election but had unpaid state employment taxes would be subject to liability and collection at the sole member level. The taxpayer argued that as a member of a Kentucky-formed LLC, he was not subject to liability for the LLC's debt under state law. The U.S argued that the LLC's member was subject to liability for the unpaid employment taxes because the LLC was disregarded for federal tax purposes.[83]

In an interesting "Hail Mary" legal move, the taxpayer's counsel filed a motion to reconsider the trial decision in *Littriello v. United States*, which earlier held that the check-the-box regulations were valid (invalidating either a legislative or an interpretive regulation is no easy task). The taxpayer argued that the check-the-box regulations improperly overruled the Supreme Court's decision in *Morrissey v. Commissioner*,[84] which the court rejected.

1. Practitioner's Comment: This is not an international case, but it has international repercussions. Although the government's argument seems contrary to other authorities, such as Rev. Rul. 2004-88, 2004-32 IRB 165, a contrary argument can also be made that the government's view is consistent with recent regulations concerning the statute of limitations for entities that have undergone a check-the-box election (that is, responsibility is borne at the member level for entity-level issues). The paramount question emanating from this case is when is a disregarded entity truly disregarded versus being regarded. Here, because the liability for unpaid state employment taxes was the crucial issue, the court upheld the validity of the check-the-box regulations. It disagreed with the taxpayer's argument that the sole member of the state law LLC should not be liable because of state law (which regards the member as a person separate from the LLC). Under that line of reasoning, one should compare Rev. Rul. 2004-88, 2004-32 IRB 165, in which a disregarded entity general partner is treated as the tax matters partner by reason of the partner's right and power to enter into binding commitments on behalf of the partnership under state law. But also compare prop. Treas. reg. section 1.704-1(b)(2)(iii)(2). In practical terms, whether a disregarded entity should be regarded or disregarded will often boil down to protecting the fisc, whether at the federal or state level — that is, a disregarded entity will not be fully disregarded if it jeopardizes the fisc.

CCC. Section 7701: Check-the-Box Regs — Disregarded Entity Consents to Extend Limitations Period

In Treas. reg. section 301.7701-3 (T.D. 9182), the IRS clarified that for a successor entity that is a disregarded entity, the successor entity is the appropriate party to sign a consent to extend the applicable statute of limitations, even though that entity is treated as disregarded. Although the regulations illustrate this rule in the context of a domestic corporation that merges into a domestic LLC wholly owned by another presumably domestic corporation, this procedural rule could equally apply in the context of an international transaction. It also illustrates that a disregarded entity is not fully disregarded for federal tax purposes inasmuch as the

[81]*See 2005 TNT 37-6* or *Doc 2005-3745*.

[82]2005 U.S. Dist. Lexis 9813 (W.D. Kentucky 2005).

[83]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* June 27, 2005, p. 1188.

[84]296 U.S. 344 (1935).

disregarded entity is treated as the proper legal entity to sign the statute of limitations extension.[85]

DDD. Dually Chartered Entities Final Regs

The August 12, 2004, temporary regulations on dually chartered entities were published on January 30, 2006.[86] Similar to the temporary regulations, the final regulations provide for definitions of corporation and domestic in the context of an entity organized or created in several jurisdictions. The final regulations adopt the earlier temporary regulation rule that any entity may be subject to the final regulations at the earliest date of August 12, 2004. However, the regulations contain a transition rule that could apply the final regulations as of May 1, 2006, for dually chartered entities organized and existing on the earlier regulations date of August 12, 2004.

EEE. Section 7874: Proposed Regs to Deter Corporate Inversions

On December 28, 2005, the IRS released proposed regulations to address the scope of the affiliate-owned stock rule when determining whether a corporation is a surrogate foreign corporation for section 7874 purposes. A detailed discussion of these intricate regulations is beyond the scope of this outline; however, they provide significant guidance to the already detailed statutory provisions in section 7874.

II. Legislative Developments

A. H.R. 4297: International Tax Proposals

Section 203 of H.R. 4297 proposes to amend section 954(c) (on the foreign personal holding company income rules) by providing a blanket look-through treatment of some payments between related CFCs. Dividends, interest, rents, and royalties received or accrued from a CFC that is a related person shall not be treated as foreign personal holding income to the extent attributable or properly allocable to income of a related person, which is not subpart F income. The amendment specifically provides that factoring income would also be included.

Also, section 303 of H.R. 4297, titled "Capital Gains and Dividends Rates," appears to extend the section 1(h)(11) 15 percent rate December 31, 2008, expiration date to December 31, 2010.

B. S. 2020 (Tax Relief Act of 2005): International Tax Proposals

The most important international provisions of this pending legislation include: (1) proposals for FIRPTA reform; (2) qualified investment entities; (3) modification of the expatriation rules on imposing a mark-to-market series of rules; (4) proposed changes to the foreign tax credit rules for some oil companies; and (5) some technical modifications for rules for entities that have undergone expatriation transactions.

III. Other Developments

A. IRS Circular 230

Circular 230 was adopted on June 20, 2005, and addresses several ethical and practice matters, including the new opinion standard rules. However, since the circular's adoption, the debate has continued on whether and to what extent tax practitioners must provide generic warnings to clients as well as taking other action. At the time of this outline's due date, many law firms have adopted an automatic affixing of the "no penalty production legend" to all e-mail and related correspondence generated not only from tax departments, but also corporate law, real estate law, and even other practice areas. However, many major law firms and specialized boutique firms have not used such a broad-based approach. The general belief for adopting the generalized "no penalty protection" legend on all e-mail correspondence is that most major firms are reluctant to spend lawyer time determining whether and to what extent communications should contain the legend. Both government attorneys and the private sector have publicly addressed the complexities of Circular 230; however, several areas are still unanswered. For example, many commentators have stated that until the IRS modifies penalty regulations that continue to allow taxpayers to reasonably rely on the advice of professionals and also determine whether reliance is reasonable depending on the diligence and sophistication of the taxpayer, including the legend on e-mails tends to imply that tax counsel is providing erroneous advice to clients on penalty avoidance regulations.[87]

B. Rev. Proc. 2005-7: Annual No-Ruling International Checklist Updated

In Rev. Proc. 2006-7,[88] the IRS released its updated and annual list of subject matters under the jurisdiction of the associate chief counsel (international), in which the IRS will not issue advanced letter rulings or determination letters. Major changes to the 2006 version of Rev. Proc. 2005-7[89] pertain to some section 892 and section 893 issues.

[85]*See 2005 WTD 38-15* or *Doc 2005-3752*, and J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Mar. 28, 2005, p. 1180.

[86]T.D. 9246.

[87]*See 2005 TNT 116-4* or *Doc 2005-13145*.

[88]2006-1 IRB 242; *see also 2006 WTD 3-14* or *Doc 2006-108*.

[89]2005-1 C.B. 240.

C. Ann. 2005-80: IRS Settlement Offer on Abusive Transactions

On October 27, 2005, IRS Commissioner Mark Everson offered what he termed a "quick, quiet and cost-effective" method for taxpayers to settle some transactions the IRS considers abusive. Those transactions include 21 separate tax abusive items listed in Announcement 2005-80.[90] The IRS claims it has identified more than 4,000 taxpayers involved in those forms of arrangements. If taxpayers voluntarily disclose and settle their involvement in the identified transactions, they will pay 100 percent of any tax deficiencies, along with interest. However, the penalties will be reduced to either one-quarter to one-half of the normal penalty the IRS would typically impose. Also, complete penalty abatement is available in a voluntary disclosure if the taxpayer can demonstrate that he received a legal opinion from an independent tax adviser (as opposed to a promoter of the specified transaction) and if the opinion elicits a "more likely than not" opinion conclusion on the significant tax issues being resolved in favor of the taxpayer.[91]

The IRS is using procedural tools as an important weapon in cracking down not only on abusive tax shelter transactions, but also on inadvertent civil law violations.

1. Practitioner's Comment: One of the interesting aspects of Announcement 2005-80 is Everson's comment that the IRS has identified more than 4,000 taxpayers involved in the arrangements described in the announcement. It is unclear how the IRS arrived at that number; it is also unclear whether it is a high or low number. Has the IRS simply reported on the tip of the iceberg? Another interesting aspect of the announcement is the list of eligible transactions in section 3. That list includes transactions involving inflated basis, use of intermediary transactions as tax shelter arrangements, lease strips and other stripping transactions, straddle tax shelters, and a variety of other structures. Each of those listed eligible transactions has its appropriate accuracy-related penalty stated next to the described item.

D. *Jade Trading LLC v. United States*: Son-of-BOSS Update

In a son-of-BOSS case litigated in the Court of Federal Claims (in Atlanta) in September 2005, *Jade Trading LLC v. United States*, some notes of an attorney working with the IRS Office of Chief Counsel said the underlying legal rationale of the son-of-BOSS transactions was "good law" and that to reverse that result, new regulations would be needed to treat an option as generating a liability. The case trial concluded on September 23, 2005. A final decision has not been rendered.

The primary defense in the son-of-BOSS transactions is reliance on *Helmer v. Commissioner*,[92] standing for the proposition that an option does not create a partnership liability. Most participants litigating their involvement in the son-of-BOSS transactions have argued that a written (or sold) call option contributed to a partnership simultaneously with an approximate offsetting purchase call option should not create a partnership liability; therefore, the partner should not suffer a reduction in basis in his partnership interests.[93]

E. Offshore Trusts: Court-Ordered Repatriation of Offshore Assets

In *United States v. Raymond Grant et ux.*,[94] we see a good example of the jurisdictional powers of the U.S. judiciary to order the repatriation of offshore assets. In this case, a U.S. magistrate judge recommended to the court that the taxpayer's assets held in two offshore trusts be repatriated to the U.S. to satisfy an IRS tax lien. The magistrate explained that the purpose of the trust is not distinguishable from a directly held foreign financial account.[95]

1. Practitioner's Comment: The magistrate's report provides a useful summary of the power of the U.S. district courts to order repatriation of offshore assets, whether held as a direct financial account or through some types of trusts, to satisfy a tax lien in favor of the U.S. government under section 6321. In this case, the taxpayer had over US $36 million in unpaid taxes. The United States sought an order to repatriate the funds held in a Bermuda trust and a Jersey, Channel Islands, trust established in 1983 and 1984, respectively. Under the terms of the trust, the U.S. settlors had unreviewable discretion to change the trustees and unreviewable authority over discharge and appointment of the trustees. Based on those and other elements of control, the magistrate determined that the U.S. settlor actually controlled the corpus of each trust. The magistrate cited section 7402(g), which provides the necessary authority for the government to collect unpaid federal tax liabilities, including the issuance of orders of repatriation for funds held in foreign countries.

[90] 2005-46 IRB 967.

[91] *See 2005 WTD 209-4* or *Doc 2005-21869*.

[92] T.C. Memo. 1975-160.

[93] *See 2005 WTD 199-5* or *Doc 2005-20856*.

[94] No. 00-8986-CIV, U.S.D.C. N.Y., Sept. 2, 2005.

[95] *See 2005 WTD 190-15* or *Doc 2005-19927*.

The main wrinkle in this case is what happens when the funds are held through a foreign trust. Because the magistrate concluded that the U.S. settlors actually controlled the trust, for reasons mentioned above, the magistrate recommended that the government's motion for repatriation of assets be granted, and that either the U.S. settlor repatriate the assets held in the Bermuda and Jersey trusts or appoint a trustee in the United States for the Bermuda and Jersey trusts.

F. Freedom of Information Act Not Applicable to Tax Court

In *Alec J. Megibow v. Clerk of the United States Tax Court*,[96] the Second Circuit Court of Appeals affirmed a lower court decision finding that the U.S. Tax Court is a court for purposes of the Freedom of Information Act; therefore, the Freedom of Information Act does not apply to the Tax Court.

G. Indictment of Professionals for Participation in Illegal Tax Shelters

From 1996 to 2003, a leading accounting firm along with a major law firm developed and promoted four illegal tax shelters, known as FLIP, OPIS, BLIPS, and SOS. On October 30, 2005, the U.S. government announced the indictment of nine tax professionals for conspiring with KPMG LLP to commit tax shelter fraud. The government announced a deferred prosecution agreement with KPMG (calling for the payment of US $456 million and admission of criminal wrongdoing). Those actions resulted from the Bush administration's Corporate Fraud Task Force and reflected the zero-tolerance policy for corporate fraud, according to U.S. Attorney General Alberto R. Gonzales. The indictment reflects the ongoing government attack on abusive tax shelters. In addition to the nine original tax professionals charged by the U.S. government, the government later expanded its indictment to include 10 new defendants in the KPMG tax shelter case.[97] (For related coverage, see p. 113.)

Additionally, the government announced a deferred prosecution agreement with the German bank HVB (calling for the payment of almost US $30 million and admission of conspiracy to commit tax fraud). HVB assisted taxpayers in evading taxes on capital gain and ordinary income over US $1.8 billion by participating in BLIPS between 1996 through 2003. The agreement with HVB comes six months after the former head of HVB's financial engineering group plead guilty to fraud, conspiracy, and tax evasion charges.[98]

H. Disgruntled Tax Shelter Investors in Arbitration, Not Federal Court

In the ongoing litigation in the U.S. government crackdown on abusive tax shelters that boomed in the late 1990s, the Second Circuit Court of Appeals issued an opinion vacating a lower court ruling in which BDO Seidman was denied its motion to compel arbitration of some claims filed by disgruntled investors in the tax strategy labeled "COBRA."

Several investors in the COBRA tax strategy brought suit in *Thomas Denney et al. v. Jenkens & Gilchrist et al.*[99] to recover damages as a result of advice by a law firm, an accounting firm, and a banking institution that promoted the COBRA tax strategy. The lawsuit against the law firm was settled, and the settlement was approved by the U.S. District Court for the Southern District of New York in a record settlement amount of US $81.5 million.

However, during the pendency of the law firm settlement negotiations, the accounting firm and bank sought to dismiss the same lawsuit to compel the plaintiffs to move their disputes into arbitration under arbitration clauses that were included in the underlying professional contracts. The Second Circuit reversed the lower court decision because the underlying consulting agreements provided for a broad arbitration provision.[100]

I. Tax Administration: The IRS Budget Increase

On February 1, 2005, the Bush administration requested a US $500 million increase in the IRS budget for enforcement in 2006. That add-on would increase the IRS's enforcement budget to US $6.9 billion, up from US $6.4 billion in 2005. Most of those funds will be devoted to increased income tax return examinations, collections, and investigations of cases involving tax avoidance.[101]

J. Criminal Exposure: *Pasquantino v. United States*

Suppose your client, a U.S.-based electronics manufacturing company, wants to establish an assembly and sales operation in "Uzieland." Your client has informed you through your Uzieland special counsel that the tax laws of Uzieland are unclear, that the tax administration procedures fall far below U.S. notions of fair play and due process, and that

[96] 94 A.F.T. R. 2d (RIA) 5804 (S.D. N.Y. 2004), *aff'd* 432 F.3d 387 (2d Cir. 2005).

[97] *See 2005 TNT 167-22* or *Doc 2005-17962*; and *Tax Notes Int'l*, Sept. 5, 2005, p. 893.

[98] *See Tax Notes Int'l*, Feb. 20, 2006, p. 616-617.

[99] 340 F. Supp. 2d 338 (S.D. N.Y. 2004).

[100] *See 2005 WTD 116-8* or *Doc 2005-13040*.

[101] *See 2005 TNT 21-3* or *Doc 2005-2063*.

even some corruption is suspected in the tax administration system in Uzieland. You have also been told that by filing full Uzieland tax returns and reporting all income in Uzieland, you could endanger the welfare and well-being of your Uzieland employees (because of the rampant increase in kidnappings, extortion, and similar activities).

Accordingly, you engage in what would normally be viewed as routine U.S.-foreign tax planning to structure what would normally be viewed as acceptable base erosion planning to reasonably move in-country income and deductions back to the United States. The months go by, and you receive a notice from the Uzieland government stating that your Uzieland company has illegally avoided foreign taxes and that alleged activities in the foreign tax plan would constitute a criminal violation under Uzieland law. How concerned should you be about this development? Considering the recent U.S. Supreme Court case adjudicated on April 26, 2005, you should have some concerns.

The Supreme Court in *Pasquantino v. United States*[102] ruled that 18 U.S.C. section 1343, the federal wire fraud statute, could apply to a fraudulent scheme to smuggle liquor into Canada to evade Canadian excise tax laws. In so ruling, the Court determined that the U.S. criminal prosecution under the wire fraud statute did not violate the long-standing common law revenue rule, which ordinarily prohibits U.S. courts from assisting a foreign sovereign jurisdiction in connection with the collection of taxes owed to that sovereign jurisdiction.

The important issue was whether avoiding foreign tax laws would constitute a scheme to defraud, which in turn would give rise to U.S. criminal liability. The Court's opinion on that crucial point is brief (only a couple of paragraphs address the issue) and unclear. A broad reading of the language would indicate that criminal prosecution might be warranted for any conduct that would constitute a criminal violation of a foreign tax law, but only if the applicable foreign government could demonstrate fraudulent concealment in the subject conduct. In a more restrictive interpretation, arguably a dual criminality standard must be met before a U.S. criminal prosecution would be warranted. That means the conduct would constitute a criminal violation under foreign law, and if that same conduct were to occur in the United States, it would also constitute a criminal violation under U.S. law.

Another important legal principle of *Pasquantino* is when a U.S. court will apply the revenue rule to prohibit a U.S. court from enforcing the tax obligations of a foreign sovereign jurisdiction. *Pasquantino* certainly shed some doubt on the Second Circuit Court of Appeals decision in *Attorney General of Canada v. R.J. Reynolds Tobacco Holdings Inc.*, in which the revenue rule barred a civil antiracketeering claim asserted by a foreign sovereign jurisdiction in a U.S. court for customs law violations. In addition to questioning the result of *R.J. Reynolds*, the Court has recently requested that the Second Circuit revisit the revenue rule issue by vacating and remanding the decision in *European Community*.[103]

In practical terms, whether a disregarded entity should be regarded or disregarded will often boil down to protecting the fisc.

1. Practitioner's Comment: From the practitioner's perspective, perhaps the *Pasquantino* case raises more questions than it answers. First and foremost, is the result of *Pasquantino* at odds with the applicable provisions of the Canada-U.S. income tax treaty? What about all of that U.S. case law that stands for the proposition that tax planning to reduce a foreign tax constitutes a good business purpose for U.S. federal tax purposes? Perhaps there is even more confusion when one considers the U.S. attorney general's August 10, 2005, release in which the U.S. government agreed not to prosecute Tommy Hilfiger for apparently alleged underpayments of Hong Kong taxes by a foreign affiliate of Hilfiger, presumably based on an apparent fraud conducted on the Hong Kong tax administrators, if the transfer pricing was modified (from 10 percent to 7.5 percent) and if the taxpayer agreed to a 36-month period within which the U.S. attorney's office could monitor the pricing practices. Again, we are dealing with section 482 pricing issues. These apparently are on the fringe of a potential criminal prosecution. What is the line between valid and legitimate tax planning versus potential criminal tax violations?

K. International Tax Shelters: Son-of-BOSS Settlement Status

In March 2005 the IRS announced that about two-thirds of the so-called son-of-BOSS participants

[102]125 S. Ct. 1766 (2005).

[103]*See* "*Pasquantino* Case Raises International Tax Planning Concerns," *Tax Notes Int'l,* May 30, 2005, p. 735; *Pasquantino v. United States*, 161 L. Ed. 2d 619, 125 S. Ct. 1766 (2005); *Attorney General of Canada v. R.J. Reynolds Tobacco Holdings Inc.*, 268 F.3d 103 (2nd Cir. 2001), *cert. denied*, 537 U.S 1000 (2002); *European Community v. RJR Nabisco*, 150 F. Supp. 2d 456 (E.D. N.Y. 2001), *aff'd by* 355 F.3d 123 (2nd Cir. 2004), *vacated by, remanded by, cert. granted*, 125 S. Ct. 1968 (2005), *reinstated by* 424 F.3d 175 (2005), *cert. denied* 126 S. Ct. 1045 (2006).

had remitted approximately US $3.2 billion. The IRS has identified 1,165 participants in that tax shelter. The general settlement conditions include disallowance of 100 percent of the claimed tax losses and payment of up to 20 percent in penalties, plus interest thereon. The IRS announced that those who did not participate in the settlement initiative could pay at least double the penalty amount. About 200 investors were barred from participation in the initiative because of alleged promoter ties.[104]

L. Taxpayer Advocate Services Report

On July 8, 2005, National Taxpayer Advocate Nina Olson issued a report to Congress in which she expressed concern about Everson's "enforcement-heavy agenda" for the IRS and noted that approach conflicts with the IRS mission set forth in the Internal Revenue Service Restructuring and Reform Act of 1998. Olson criticized the IRS for focusing too much on enforcement and not enough on serving all taxpayers. The Office of the Taxpayer Advocate is required to report to Congress twice each year.[105]

M. Civil Proceedings Subsequent to Criminal Tax Convictions

In Chief Counsel Notice CC-2005-012, the IRS provides a useful discussion of how the doctrine of collateral estoppel may be invoked to narrow issues for trial in the follow-up Tax Court proceeding level subsequent to a taxpayer's conviction for tax evasion and willful failure to file a return or filing a false return in the earlier tax evasion trial. Again, although it is not strictly an international issue, practitioners are seeing more civil, and in some cases criminal, tax proceedings involving U.S. citizens with noncompliant offshore holdings. This chief counsel notice underscores the harmful nature of a criminal tax conviction on the follow-up civil fraud case proceeding.[106]

N. Supreme Court Reversal in *Arthur Andersen LLP v. United States*

In a unanimous decision (No. 04-368), the U.S. Supreme Court held that improper jury instructions were given in the lower court; therefore, the lower court decision, and the Fifth Circuit Court of Appeals affirmation, were overturned. The lower court decision resulted in a jury conviction under 18 U.S.C. section 1512(b)(2) (corruptly persuading employees to withhold, alter, destroy, or conceal documents — that is, obstruction of justice). In summary, the lower court failed to elaborate on the proper meaning of the terms "knowingly" and "corruptly." Thus the level of evidence needed to generate a conviction under 18 U.S.C. section 1512(b)(2) was much lower than it should have been.[107]

O. *Survivor* Winner Convicted for Tax Evasion

The conviction of television star Richard Hatch on January 25, 2006, demonstrates the IRS's resolve to enforce U.S. tax laws.[108] TV watchers may recall that Hatch was the first "survivor" on the hit television series. Despite Hatch's claims that he was the world's worst bookkeeper and after six hours of deliberations, Hatch was convicted on two counts of tax evasion and one count of filing a false tax return, although he was acquitted on several counts of wire, mail, and bank fraud. The three tax convictions combined carry up to a US $600,000 fine and five years of incarceration.

P. Canada-U.S. Memorandum of Understanding

In Announcement 2005-47,[109] the IRS announced the signing on June 3, 2005, of a memorandum of understanding between the United States and Canada to establish a mutual agreement procedure (MAP) for resolving double taxation disputes under the 1980 Canada-U.S. income tax treaty. The announcement was released on July 11, 2005, and states that the fundamental purpose of the mutual agreement procedure is to try to resolve double taxation or taxation results contrary to the treaty. Once a MAP request is filed, the competent authorities must reach an agreement within six months of the commencement of negotiations. If that deadline is not met, the competent authorities must refer the case to a joint panel comprising tax administration officials chosen by the chief of appeals for the IRS and the assistant commissioner of appeals for the Canada Revenue Agency.

The memorandum states that the competent authorities must accept a transaction as structured by the taxpayer. Only in exceptional cases should the competent authorities disregard or restructure a transaction. No guidance is given as to what is meant by "exceptional cases."

A tiebreaker system is established if the arbitration panel does not work out and a compromise isn't reached. The CRA's director general of the International Tax Directorate and the IRS's director-international of the Large and Midsize Business Division will agree to meet, or agree to have their subordinates meet, to resolve the case. However,

[104]*See 2005 WTD 58-3* or *Doc 2005-6197*.

[105]*See 2005 TNT 131-2* or *Doc 2005-14501*.

[106]*See 2005 TNT 111-4* or *Doc 2005-12606*.

[107]*See 2005 TNT 104-3* or *Doc 2005-11951*.

[108]*See 2006 TNT 17-6* or *Doc 2006-1481*.

[109]2005-28 IRB 71.

nothing is said about what happens if these two directors (or their designees) do not reach an agreement.

The competent authorities are directed by the memorandum to follow the OECD's transfer pricing guidelines for multinational enterprises and tax administrations.

The memorandum of understanding presents a list of areas that may not be resolved under the treaty, including: (1) arm's-length compensation for consignment manufacturing; (2) whether a given set of facts constitutes a permanent establishment; (3) the profit attributable to the permanent establishment; and (4) what happens when the source in the resident's country's laws are in conflict.[110]

Q. Ann. 2006-8: Treatment of Fiscally Transparent Entities Under the Mexico-U.S. Tax Treaty

On January 23, 2006, the IRS issued Announcement 2006-8,[111] which contains a mutual understanding between the United States and Mexico to address the treatment of fiscally transparent entities under the Mexico-U.S. income tax treaty.

The announcement addresses the eligibility of fiscally transparent entities for treaty benefits. Under paragraph 2(b) of the protocol, a provision is included to clarify that, for purposes of paragraph 1 of article 4, a partnership, estate, or trust is a resident of a contracting state only to the extent that the income it derives is subject to tax in that state as the income of a resident, either in the hands of the partnership, estate, or trust, or in the hands of its partners or beneficiaries. Announcement 2006-8 supersedes and clarifies the Competent Authority Mutual Agreement entered into on August 26, 2005.[112] The newly released agreement provides that for Mexican tax purposes, a fiscally transparent entity organized in the United States, such as a U.S. LLC that has elected to be treated as a partnership for federal tax purposes, will be treated as a U.S. resident under the above provision; thus, it will be entitled to claim treaty benefits to the extent the fiscally transparent LLC derives income subject to tax in the hands of the U.S. residents who are members, owners, or partners. The same rules will apply to other types of U.S. flow-through vehicles, such as a U.S. subchapter S corporation or a U.S. LLC that has filed an election to be treated as a disregarded entity separate from its owner, or even a U.S. grantor trust. This announcement also contains special U.S. residency certification procedures for fiscally transparent entities, involving filing with the withholding agent a Form 6166 certifying U.S. residency status for treaty purposes.

R. France-U.S. Tax Treaty Protocol

The United States and France entered into a protocol to address partnerships and similar passthrough entities, as well as estates and trusts. The protocol was signed on December 8, 2004, and provides that a partnership or similar passthrough entity (including an estate and a trust) will qualify as a treaty resident if the income derived by the partnership or similar entity is treated for taxation purposes in that contracting state as income of a resident, either in the hands of the partnership or other entity or in the hands of its partners or other participants (such as beneficiaries or grantors).

> ***The important issue in Pasquantino was whether avoiding foreign tax laws would constitute a scheme to defraud, which in turn would give rise to U.S. criminal liability.***

This new rule applies even if the partnership or similar passthrough entity, estate, or trust is not organized or managed in one of the contracting states. In the latter case, treaty benefits will not be allowed for the passthrough entity's income or gains derived from or arising in France unless four conditions are satisfied: (1) the third-country jurisdiction (presumably where the passthrough entity is organized or managed) must have no contrary provisions in a double tax treaty with France; (2) the partnership or other passthrough entity (or estate or trust) may not be treated as a "body corporate for tax purposes" or otherwise be liable to tax on French-source income at the passthrough or participant level; (3) a partner's or other participant's share income or gain of the partnership or other passthrough entity must be taxed at the partner level in the same manner as at the entity level as if the income or gain had been derived directly (other than variances due to different accounting methods); and (4) the third-country foreign jurisdiction must include an appropriate exchange of information provision in its double tax treaty with France.

The effective date of the protocol for the flow-through provisions discussed above is not effective after ratification of the protocol, but instead the effective date goes back to January 1, 1996.[113]

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[110]*See 2005 WTD 132-10* or *Doc 2005-14611*.

[111]2006-4 IRB 344.

[112]*See* Ann. 2005-72, IRB 2005-41.

[113]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* Dec. 20, 2004, p. 1025.

S. Swiss Update: Bank Secrecy Survives, but at a Tax Cost

In a historic settlement of a long and bitter dispute between Switzerland and the European Union, on June 24, 2005, the Swiss Federal Department of Finance announced a bilateral savings tax agreement with the European Union, which entered into force on July 1, 2005. Under the terms of the agreement, Switzerland will withhold tax on interest paid to any EU resident based in an EU member state. However, the Swiss Federal Department of Finance said in its press release that "fiscal banking secrecy concerning income tax which is anchored in the Swiss legal system is upheld." Another important feature of the agreement calls for a complete exoneration of any taxation from an EU member state source from which dividends, interest, and royalty payments are made from those subsidiaries to a Swiss headquarters company.[114]

The United States and France entered into a protocol to address partnerships and similar passthrough entities, as well as estates and trusts.

The Swiss Federal Tax Administration on June 22, 2005, announced the revocation of the firmly entrenched "50/50" and "80/20" tax practices, effective July 1, 2005. Because of pressure from the OECD, which claimed that the 50/50 and 80/20 tax practices did not conform with arm's-length standard transfer pricing, these shorthanded methods for determining the Swiss tax liabilities for a reinvoicing center or an intellectual property center have been scrapped. Despite that major change, Switzerland remains a viable alternative for a European-based or even global-based holding company, both because of its internal laws on the use of holding companies as well as its vast tax treaty network, including the income tax treaty it has with the United States.[115]

T. Tax Amnesty in Brazil and Other Countries

Many countries are emulating the United States and other industrial countries that have promulgated various types of partial amnesty and amnesty programs for noncompliant taxpayers. In Rev. Proc. 2003-11[116] the IRS published the well-known offshore voluntary compliance initiative, which expired April 15, 2003. As a follow-up to that initiative, the IRS has been leveraging on its treasure trove of potential noncompliant taxpayers (obtained through the various credit card summons programs, as well as through other administrative examinations of potentially abusive tax shelters). As a result of those initiatives, it has been issuing thousands of "last chance compliance initiative" letters. Many countries, such as Italy and France, have developed and completed tax amnesty programs.

More recently, we are seeing that trend extend to developing countries, such as Brazil. For example, the Brazilian legislature on May 27, 2005, reviewed and approved, subject to further legislative input, a law that would grant tax amnesty for Brazilian taxpayers who hold undeclared funds offshore. To benefit from the amnesty proposal, Brazilian individuals and companies would have to remit the funds back to Brazil and would be subject to an income tax rate of 3 percent or 6 percent, depending on the facts and circumstances. The law also provides that those who declare offshore funds and remit them to Brazil would not be criminally prosecuted. However, to take advantage of that program, the repatriation of funds must take place within six months after the date of publication of the law in Brazil's official gazette.[117]

U. Foreign Tax Evasion: U.S. Fund Official, Others to Face Tax Inquiry in R.O.K.

In an example of foreign jurisdictions attacking potential tax evasion transactions, the Republic of Korea National Tax Service charged four foreign fund officials — including a U.S.-based investment fund — with tax evasion. The matter has been referred to state prosecutors in South Korea, but as of this writing no further news has been published. This is a good example of the aggressiveness of foreign jurisdictions in cracking down on alleged tax evasion and abusive tax transactions.[118] (For related coverage, see p. 110.)

V. Foreign Tax Evasion: China

During the past year, the People's Republic of China has made news because of its surging economy, Chinese-U.S. trade discussions (disputes), the booming real estate market in Shanghai, Guangzhou, not to mention Hong Kong, and the revaluation of the renminbi. But perhaps one of the most important developments during the past year in China as far as U.S. outbound operations are concerned is the increased federal and state effort in China to fight tax evasion.

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[114]*See 2005 WTD 123-7* or *Doc 2005-13952*.

[115]*See Tax Notes Int'l*, July 4, 2005, p. 7.

[116]2003-4 IRB 311.

[117]*See Tax Notes Int'l*, June 6, 2005, p. 872.

[118]*See Tax Notes Int'l*, Oct. 17, 2005, p. 244.

A report released in the past year by the Chinese Academy of Social Sciences determined that tax evasion is one of the main reasons for the gap between rich and poor, with the richest 10 percent of all families in urban areas earning eight times more than approximately 60 percent of the urban population. Because many of the foreign direct investment manufacturing operations pay little or no Chinese federal and state tax under the "tax holiday" system (whether to continue the system is a matter of debate), most investors in China are expected to pay their fair share. For example, real estate investors who purchase and resell commodity housing investments are typically subject to a state sales tax as well as a personal income tax. However, those taxes are commonly evaded, merely because most private real estate investments have been initiated from sources outside China, such as Hong Kong, the Republic of China, and Singapore.

China already has the electronic infrastructure to strengthen its tax administration.

Many states are trying to improve the collection of the capital gains tax, which is commonly evaded. For example, in Guangzhou, the Land and House Office implemented a new regime to collect all capital gains taxes on secondary property transactions. However, even under the stepped-up regime, sellers who purchase and hold housing for more than five years will avoid all taxes.

To provide more tax revenue to China and eliminate the discrepancy between the poor and the rich, many politicians are advocating a 5 percent export duty, which would raise between US $30 billion to US $42 billion per year. Unlike other countries that have tried to step up tax reform, such as Mexico and many Latin American neighbors, China already has the electronic infrastructure to strengthen its tax administration. In 2000 the so-called Golden Computer Project was introduced by Premier Zhu Rongji, requiring every business entity in China to dedicate a computer for sole use for transactions with each applicable state tax office. It would not take much effort to implement the 5 percent export duty and have it administered through the Golden Computer Project network.[119]

W. U.S. Shareholders of French Dividend-Paying Companies

Effective December 31, 2004, U.S. shareholders and any other non-French residence shareholders will no longer use the *avoir* refund system. Under that system, shareholders that receive dividends from French companies under some conditions could claim a tax refund based on the relationship to the underlying corporate-level tax paid by the French company.

For dividends received on or after January 1, 2005, U.S. individual shareholders and non-French individual resident shareholders who benefit from an applicable tax treaty that specifies for the transfer of the otherwise applicable *avoir fiscal* account would be eligible for a tax credit equal to 50 percent of the declared distribution, subject to a nominal ceiling of €115 or €230.

Under French domestic rules, dividends paid to non-French shareholders generally are subject to a 25 percent French withholding tax. But under most applicable tax treaties, withholding tax rates on dividends are reduced to 15 percent or 5 percent for French company dividends paid to corporate shareholders depending on the level of ownership by the corporate shareholders in the paying French companies.

To make French companies more attractive to foreign investors, the *avoir fiscal* regime has been repealed and a new limited credit system has been put into place. On February 5, 2005, the French tax authorities published a withholding tax relief procedure simplifying the manner in which nonresident shareholders benefit from the reduced withholding tax rate available under an applicable tax treaty.

Under that procedure, nonresidents eligible for the new reduced withholding tax system must provide the French tax authorities with a certificate of residence that must be stamped by the nonresident shareholder's state of residence before the dividend payment is made. However, for U.S. tax residents, the French tax authorities will not require the certificate to be stamped by the U.S. tax governing regime. Instead, U.S. financial institutions will be permitted to certify the U.S. tax residents of the applicable securities account shareholders.[120]

X. Tax Credits: Impact of Foreign Judicial Rulings

The Netherlands Supreme Court upheld an earlier Dutch tax court ruling to confirm that the applicable provisions of the Netherlands-U.S. tax treaty are intended to address situations involving double taxation. In effect, under Article 43(b) if a taxpayer is subject to a net U.S. tax on Dutch-source income, that net U.S. tax is not otherwise creditable or deductible in the Netherlands.

[119] *See* L. Lipsher, "Asian Tax Review," *Tax Notes Int'l,* May 9, 2005, p. 507.

[120] *See* E. Bérengier, "France Amends Treatment of Dividend Distributions," *Tax Notes Int'l,* May 9, 2005, p. 467.

In this case, the taxpayer was a U.S. citizen who resided in the Netherlands. The taxpayer received employment income along with book royalties; however, the Dutch government treated the book royalties as income from employment. The taxpayer reported his worldwide income to the United States for the 2000 tax year and obtained a credit in the United States on the Dutch tax imposed on his income. The overall U.S. effective tax rate was higher than the total Dutch tax rate; thus, the taxpayer argued that he should be allowed to subtract the residual U.S. tax from his Dutch taxable income as deductible expenses. As explained above, the Dutch Supreme Court rejected that argument.[121]

Y. India: Withholding Tax Issues for Indian-Source Fees

India is second to China in Asia as a place for more cost-efficient manufacturing, pharmaceutical development, and high technology. During the past year India's fiscal system has become increasingly focused on the administration of foreign investment transactions by: (1) curtailing tax-free export oriented unit benefits; (2) asserting withholding taxes on fees earned by non-Indian service providers; (3) asserting that some income constitutes taxable short-term capital gains as opposed to nontaxable business profits (because of the absence of a permanent establishment); and (4) assertion of withholding tax on some other Indian-source foreign targeted payments.

India is an excellent example of a former common-law jurisdiction whose revenue system is based on U.S. tax principles. But it also has many variances that should be taken into account and reviewed by Indian tax counsel.

The Indian judicial system recently ruled that customary outsourcing by a non-Indian principal to an Indian business processing organization would not constitute a permanent establishment under most Indian tax treaties. That is a shift in a positive direction because for several months Indian tax authorities were attempting to apply permanent establishment status to those foreign principals. Also, the Indian government has recently announced plans to provide more tax benefits to software exporters under the Software Technology Park of India scheme to bring those benefits in line with those offered in some special economic zones. The 100 percent tax exemption for software exporters was scheduled to sunset in March 2010; however, actions are being taken to extend those benefits consistent with the special economic zone program that offers tax benefits for 15 years.[122]

Z. India: Indian Tax Exams of Outsourcing Companies

On February 8, 2006, *Worldwide Tax Daily* reported that the Indian Income Tax Department has undertaken examinations of foreign companies involved in outsourcing businesses with Indian affiliates. The central issue in the examinations is whether and to what extent the foreign principles maintain permanent establishments in India, and whether tax returns must be filed and tax paid on those permanent establishments. Those examinations apparently are based on Central Board of Direct Taxes and Ministry of Finance actions issuance of a circular in 2004 noting that business process outsourcing could trigger permanent establishment status on behalf of foreign principles and could thus require the payment of tax and filing of Indian tax returns. The official 2004 circular indicates that determination of permanent establishment status in India will depend on the guidelines of the applicable double tax avoidance agreement with the country in question. Under Indian internal law, a foreign company that maintains a fixed place of business on behalf of that company in India or operates through a dependent agent will trigger permanent establishment status in India. That is an issue that should be closely monitored by non-Indian companies outsourcing to India, not only in the business processing area, but also in all other business areas. ◆

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[121]*See* M. Vrouwenvelder, "No Deduction for U.S. Tax in Netherlands, Supreme Court Says," *Tax Notes Int'l*, Sept. 19, 2005, p. 1079.

[122]*See 2006 WTD 1-6* or *Doc 2006-57*.