Special Reports

A Survey of Current U.S. International Tax Developments

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I. Outbound Developments in Specific Code Sections

A. Section[1] 1(h)(11): Distributions by Former Foreign Personal Holding Company

In LTR 200543002 (July 22, 2005) and LTR 200606021 (Nov. 3, 2005), an LLC organized under the laws of a foreign jurisdiction maintained an office in the U.S. and intended to pay dividends to its presumably U.S. shareholders, as illustrated in Figure 1.

Company X was a foreign personal holding company (FPHC) before the repeal of the FPHC provisions (sections 551-558) by the American Jobs Creation Act of 2004.[2] In addition to repealing the FPHC rules, the Jobs Act also amended the qualified foreign corporation dividend rules — specifically section 1(h)(11)(C)(iii) — that previously prohibited qualified foreign corporation dividend treatment for foreign corporations that constituted FPHCs or foreign investment companies.

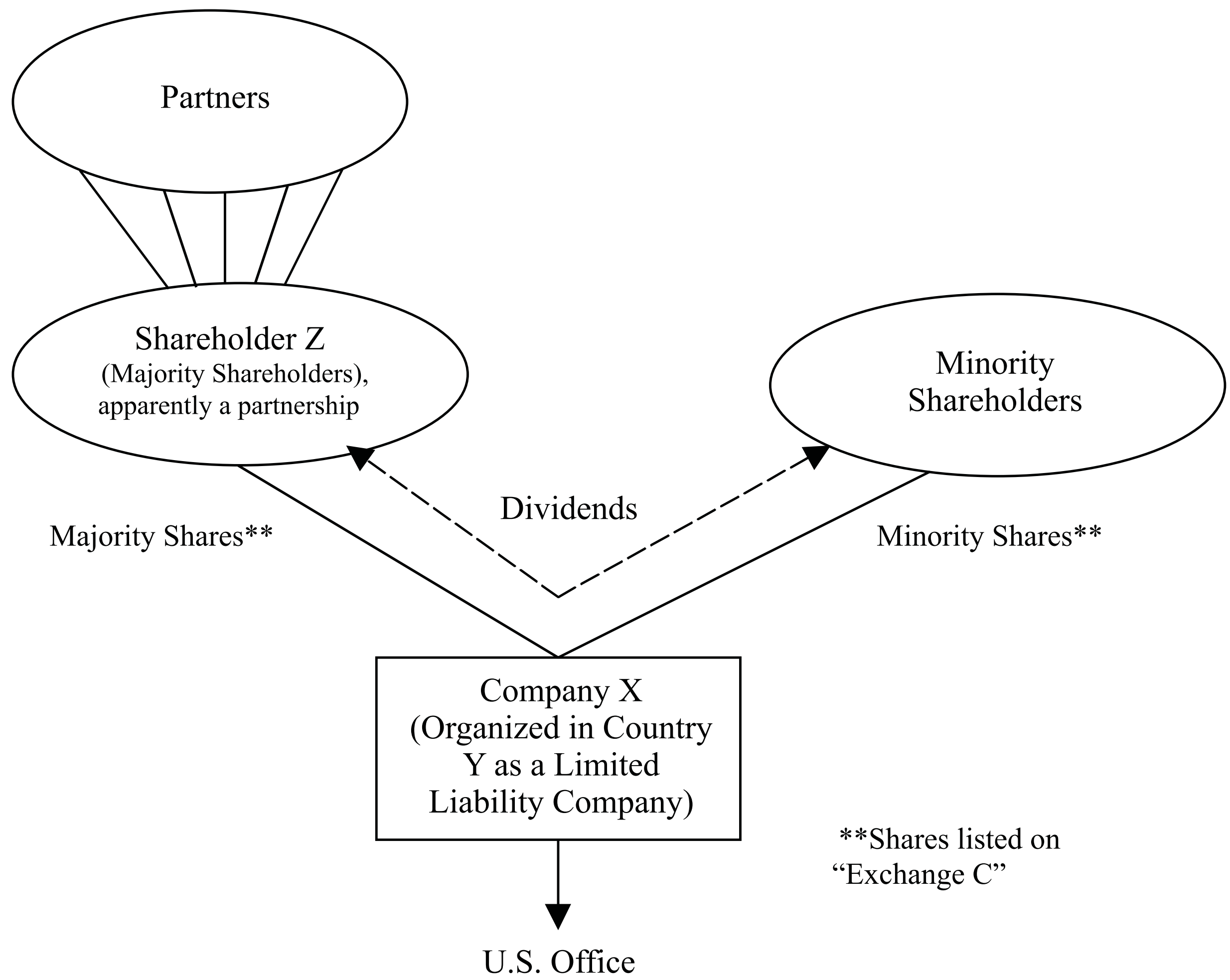
LTR 200543002 held that because the Jobs Act repealed the FPHC provisions and Company X did not constitute a passive foreign investment company (PFIC) as defined in section 1297, any distribution made by Company X to a qualifying shareholder would receive qualified dividend income treatment under section 1(h)(11).

In LTR 200606021, the IRS noted that Company X was not incorporated in a U.S. possession, nor is it eligible for the benefits of a comprehensive income tax treaty with the U.S. that was determined to be satisfactory for section 1(h)(11)(C)(i)(II) purposes. However, the IRS noted that the company shares

[1]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986 as amended, and all reg. section references are to U.S. Treasury regulations promulgated under the code.

[2]Pub. L. No. 108-357.

Figure 1



were listed on Exchange C and are Company X's only class of stock. The majority shareholder, Shareholder Z, filed a registration statement on Securities and Exchange Commission Form S-3 for certain shares Z owned. As a result of the registration, Shareholder Z was allowed to sell up to a specific number of Company X's common shares on the open market. However, the remainder of Shareholder Z's shares was not registered under the Securities Act of 1933, so Z planned to distribute them to its partners as restricted shares. The IRS noted that the unregistered shares may be sold in accordance with Rule 144 of the Securities Act of 1983, which permits limited sales of restricted shares of a publicly traded company subject to some restrictions.

To be eligible for qualified foreign corporation dividend treatment, Company X was required to satisfy the section 1(h)(11)(C)(ii) requirement for its stock to be treated as readily tradable on an established securities market in the United States. Under Notice 2003-71,[3] stock is considered readily tradable on an established securities market if it is listed on a national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934[4] or on the NASDAQ Stock Market. These securities must also be registered under the Securities Act of 1933.

In summary, the IRS ruled that the portion of the Company X common shares that were registered properly met the readily tradable standard; however, the unregistered Company X shares would not

[3]2003-43 IRB 922 (Oct. 27, 2003).

[4]15 U.S.C. section 78f.

be treated as meeting the standard. Dividends paid for Shareholder Z's qualified shares would be eligible for 15 percent qualified foreign corporation dividend treatment, but the remaining unregistered shares would not qualify for the treatment.[5]

Practitioner's Comment: First, this is a somewhat unique fact pattern because the LLC was based in a foreign jurisdiction, maintained an office in the U.S., and filed its tax returns using the accrual method of accounting. Because the ruling sought refuge under section 1(h)(11), this entity was a C corporation and not a flow-through vehicle. Also, the foreign corporation at issue constituted an FPHC before 2004 and by statute it must have had five or fewer shareholders and generated at least 60 percent of its gross income from passive sources. Under this fact pattern, it is possible that the foreign corporation accumulated profits in a nontreaty foreign jurisdiction, engaged in business outside the U.S. (perhaps in a low-rate or tax-favorable manner), and hoped that when the dividend repatriations were made, they would qualify under section 1(h)(11). For the foreign corporation at issue to qualify for section 1(h)(11)'s favorable 15 percent tax treatment, the corporation must be a qualified foreign corporation. As the second ruling discusses, to be a qualified foreign corporation, the foreign corporation must:

- be a corporation formed in a possession of the U.S.; or
- be a corporation that is eligible for the benefits of a comprehensive income tax treaty with the U.S.; and
- the applicable treaty must be certified as a satisfactory treaty for exchange of information purposes.[6]

However, if a foreign corporation does not qualify under either of those tests, it still may qualify for qualified foreign corporation status if the dividend paid by the corporation pertains to stock that is readily tradable under an established securities market in the United States. Because the foreign corporation at issue was formed as an LLC under foreign law (and thus most likely made an entity classification election under Treas. reg. section 301.7701-3(a) to be treated as an association taxable as a corporation), it is possible that the jurisdiction in question provided for more favorable tax treatment because of this LLC status. Note, however, that in most foreign jurisdictions, a foreign LLC is not taxed on a flow-through basis but rather on a company-level income tax.

[5]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l*, Nov. 28, 2005, p. 817.

[6]*See* section 1(h)(11)(C)(i).

B. Section 1(h)(11): Expansion of Eligible Countries for Preferential Treatment

In Notice 2006-101,[7] the IRS updated its list of countries that maintain a satisfactory U.S. income tax treaty under section 1(h)(11)(C)(i)(II). The new countries include Sri Lanka, Barbados, and Bangladesh; and in light of Notice 2003-69,[8] the IRS has designated 55 countries that comply with this rule. It is interesting that the U.S. income tax treaties with Bermuda, the Netherlands Antilles, and several former members of the Soviet Union have not been included on the "satisfactory" list.[9]

Practitioner's Comment: The section 1(h)(11) qualified foreign corporation dividend repatriation planning is an important element to any international business plan. The practitioner must keep in mind that the 15 percent benefit expires on December 31, 2010. Accordingly, it is crucial that all repatriations made under the 15 percent favorable rate be completed and paid on or before that sunset date.

C. Section 199: Reallocations of Interest and Research and Experimentation Expenses

Given the importance of the section 199 domestic production activities deduction, Rev. Proc. 2006-42[10] grants automatic consent to a change of accounting method that converts allocation methods for some expenses such as interest and research and experimentation.[11]

Practitioner's Comment: The practitioner should review Notice 2005-14[12] and the proposed regulations that were issued under section 199.[13] Practitioners should also bear in mind that section 199(a) allows a deduction calculated as a percentage of income attributable to specific domestic production activities based on a phase-in rate. During 2006 the rate is 3 percent; this rate increases to 6 percent for 2007 to 2009, and to 9 percent in 2010.

D. Sections 199 and 954(f): Domestic Production and Subpart F Manufacturing Exception

Section 199 was added by section 102 of the Jobs Act. In late 2005 the IRS and Treasury issued prop.

[7]2006-47 IRB 930 (Oct. 30, 2006).

[8]2003-2 C.B. 851 (Oct. 20, 2003).

[9]*See* "IRS Adds to List of Countries Eligible for Reduced Foreign Dividend Tax Rate," *Standard Federal Tax Reports — Taxes on Parade*, Nov. 2, 2006, p. 4.

[10]2006-47 IRB 931 (Oct. 17, 2006).

[11]*See* "IRS Allows Automatic Reallocations of Interest and R&E Expense in Computing Code Sec. 199 Deduction," *Standard Federal Tax Reports — Taxes on Parade*, Oct. 19, 2006, p. 3.

[12]2005-7 IRB 498 (Nov. 4, 2005).

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

reg. section 1.199-3,[14] which provides that a tax deduction may be available for taxpayers that derive income from selling, exchanging, leasing, or licensing property that is manufactured in whole or in significant part within the United States. The regulations specifically address contract manufacturing and provide that property will satisfy the requirements so long as the manufacturing activity is substantial in nature and also qualifies under a safe harbor test. The substantiality requirement is satisfied if the conversion cost to the taxpayer, within the United States, accounts for 20 percent or more of the taxpayer's costs of goods sold.[15] These regulations further provide that the taxpayer will be considered as being engaged in the manufacture of property when another person under a contract manufacturing arrangement handles the production or manufacturing functions and the taxpayer has the benefits and burden of ownership while the manufacturing activity occurs.[16]

The preamble to the proposed regulations states that these rules are to be used only in connection with determining which taxpayer receives the section 199 benefits for the same activities, and thus do not necessarily apply to subpart F.

Practitioner's Comment: One could argue by analogy that these regulations add regulatory support to attribute the activities of contract manufacturer from that entity to a controlled foreign corporation for purposes of qualifying for the manufacturing exception under Treas. reg. section 1.954-3(a)(4), despite the recent IRS reversal of its policy.[17] Note that the IRS and Treasury issued proposed regulations in 1998 requiring a CFC to directly conduct manufacturing activities to qualify for the manufacturing exception, but these regulations were later withdrawn. Also, the IRS's position has traditionally been that the activities of some contracting manufacturing entities would be attributed to their principal for subpart F purposes.[18]

E. Section 267: Deductions Denied for Transfer of Securities

Although not an international tax pronouncement, Chief Counsel Advice 200617036 (Jan. 12, 2006) has significant international repercussions. The IRS held that section 267(f) applied, preventing a corporate transferor from recognizing a loss from the transfer of some high bases and low fair market value securities to a corporation in a transaction that did not constitute a tax-deferred contribution under section 351(a) (because the transferor did not control the transferee immediately after the transfer). Note that the loss was disallowed even though the transferor and the transferee were not members of the same control group immediately after the transaction, a requirement that section 267(f) and associated regulations mandates.

Practitioner's Comment: Although the loss was disallowed, under section 267(f)(2), the loss is deferred until such time if, as, and when the property is transferred outside of the control group, and thereupon a recognition event would be allowed. However, note that the interpretation of the "immediately after" requirement underlying section 267(f) appears to have been amiss.[19]

F. Section 304: An Intricate Tax Trap Worth Reviewing

LTR 200611004 (Nov. 30, 2005) addresses a complex international restructuring ruling request involving multiple corporate affiliates. A discussion of this ruling and its intricate fact pattern is beyond the scope of this article. However, it is worth noting that for some related-party transactions (including the contribution of business assets and stock from one affiliate to another) and the sale of stock by one affiliate to another, section 304 was held to be applicable. It treated those transactions as deemed distributions, which constituted dividends (to the extent of earnings and profits) for U.S. federal income tax purposes.

Practitioner's Comment: Even though section 304 can represent a latent tax trap for domestic restructurings as well as cross-border reorganizations, in some instances, section 304 treatment is desired, for example, when pulling up foreign-source dividends to use foreign tax credits. The practitioner should be cautious about whether and to what extent transactions may be structured to activate section 304 to achieve proactive tax planning objectives.

G. Section 362: Revocation of 'Zero-Basis' Ruling

In Rev. Rul. 2006-2,[20] the IRS revoked Rev. Rul. 74-503,[21] in which a corporation transferred its treasury stock to an unrelated corporation in exchange for newly issued shares of the transferee corporation, as illustrated in Figure 2.

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[14]70 *Fed. Reg.* 67220 (Nov. 4, 2005).

[15]Prop. Treas. reg. section 1.199-3(f)(3).

[16]Prop. Treas. reg. section 1.199-3(e)(1).

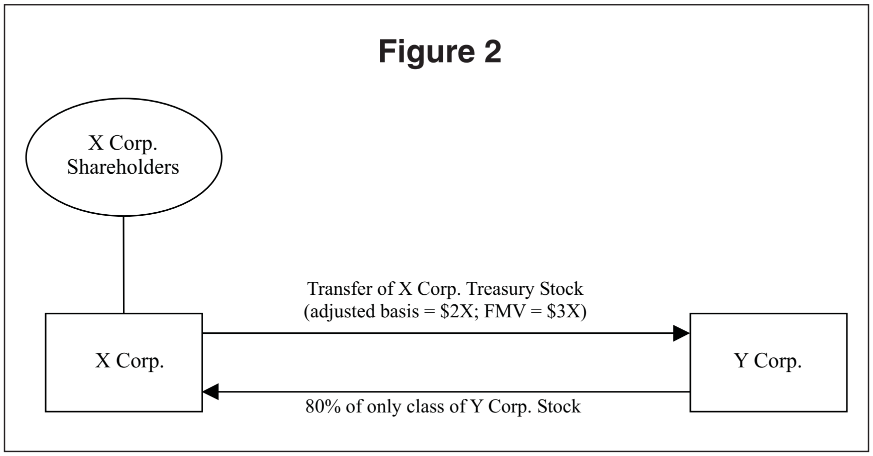
[17]Rev. Rul. 97-48, 1997-2 C.B. 89 (July 1997).

[18]*See* Rev. Rul. 75-7, 1975-1 C.B. 244 (Jan. 1975).

[19]*See* J. Rubinger, "IRS Misses the Mark on Disallowing Loss in a Busted Section 351 Transaction," *Journal of Taxation,* July 2006, p. 49.

[20]2006-2 IRB 261 (Jan. 9, 2006).

[21]1974-2 C.B. 117 (July 1974).



The transferred treasury stock had a cost basis of $2X and a fair market value of $3X, and the stock issued by the transferee had a fair market value of $3X. As a result of the transfer of the treasury stock, the transferor corporation obtained an 80 percent controlling interest in the transferee corporation and the transfer was treated as a tax-deferred transfer under section 351. In Rev. Rul. 74-503, the IRS ruled that the basis of the previously unissued treasury stock was zero, so based on section 362(a), the newly issued transferee stock also would be zero. In Rev. Rul. 2006-2, the IRS ruled that it is incorrect to use section 362(a) to determine the basis of newly issued shares of the transferee corporation received by the transferor.[22]

Practitioner's Comment: Although Rev. Rul. 2006-2 is not an international ruling, it has international repercussions for any tax-deferred restructuring or reorganization involving foreign entities. What is also interesting about this ruling is that the IRS not only rules that section 362(a) is not the appropriate provision to determine the tax basis of the treasury stock contributed by X Corp. to Y Corp., but it also says the issue is "under study." Assuming the transaction constitutes a section 351 transfer, the operative provisions of sections 358 and 362 should apply to determine the basis of property contributed to the transferee corporation and the basis of shares issued by the transferee corporation to the transferor. However, the IRS is further reviewing this issue to determine the appropriate tax treatment of this phantom transaction. When the dust settles, the transferor corporation ends up with full control of the transferee corporation, which is not unlike a regular section 351 transaction, but when using appreciated treasury shares, it could result in a federal tax conclusion outside of section 351.

H. Section 362(e)(2): Proposed Regs Issued

The IRS and Treasury have published proposed regulations to provide guidance when determining the basis of assets, stock transfers, and some nonrecognition transactions under section 362(e)(2).[23] Note that the new provision limits the ability of taxpayers to duplicate net built-in loss in certain defined nonrecognition transactions.

The proposed regulations provide much-needed guidance on the application of section 362(e)(2) to asset transfers outside of the U.S. tax system, reorganizations, transfers in exchange for securities, and some section 351 transactions treated as subject to tax under section 304. To understand these regulations, it is important to review the background of section 362 and the basis limitation provisions.

In 1999 Congress enacted section 362(d) to prevent the basis of assets transferred to a corporation from being increased above those assets' aggregate fair market value as a result of a liability assumption. As follow-on legislation, section 358(h) was enacted in 2000 to reduce the basis of stock received in some nonrecognition transactions, but not below fair market value, by the amount of any liabilities assumed in the transaction. Despite the passage of sections 362(d) and 358(h), Congress remained concerned that taxpayers were trying to take more than one tax deduction for a single economic loss. Congress passed section 362(e), which limits the ability of taxpayers to duplicate net built-in loss of certain defined nonrecognition transactions.

Section 362(e) overrides the general carryover basis rule of section 362(a) by providing that the basis of some built-in loss property acquired in a section 362(a) or 362(b) transaction shall be its fair market value immediately after the transaction. Section 362(e)(1)(C) provides that an importation of a built-in loss occurs if the transferee's aggregate adjusted basis in the property would exceed the aggregate fair market value of that property immediately after the transaction. In summary, section 362(e) steps down the adjusted basis of transferred built-in loss property to its lower fair market value.

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[22]*See* "IRS Revokes Ruling Setting Zero Basis From Treasury Stock Used in Tax-Free Incorporation," *Standard Federal Tax Reports — Taxes on Parade*, Dec. 29, 2005, p. 5.

[23]Prop. Treas. reg. section 1.362-4, 71 *Fed. Reg.* 62,067 (Oct. 23, 2006).

The proposed regulations clarify that for transfers that are wholly outside the U.S. tax system, section 362(e)(2) in theory applies, but it does not have relevance unless and until the assets are transferred or until stock received in the exchange enter the U.S. tax system. Relevance is triggered if the underlying owner becomes a U.S. person or if the assets or stock in question are transferred to a CFC. The proposed regulation's commentary indicates that the IRS and Treasury recognize that if the transferor anticipates the transfer becoming relevant for U.S. tax purposes, it is not likely to undertake the valuation and record keeping that section 362(e)(2) would generally require. Moreover, if circumstances change at a later date, the administrative burden of reconstructing the appropriate records may be substantial.

The proposed regulations provide that when transactions are consummated with no plan or intention to enter the U.S. tax system, section 362(e)(2) will have no relevance. If assets are transferred in a transaction that potentially could be subject to section 362(e)(2) more than two years before entering the U.S. tax system, the proposed regulations generally presume that the aggregate fair market value of the transferred assets equals the aggregate adjusted basis of the transferee immediately after the transfer — so long as the original transfer was not undertaken with the view of reducing U.S. tax liabilities. However, if the transfer occurs within a two-year period, the fair market value presumption does not apply, and section 362(e)(2) applies to the original transfer.

Practitioner's Comment: This important rule change needs to be included in the checklist for preresidency planning and cross-border restructuring transactions. Similar to other code sections and regulatory provisions, a non-U.S. person who later becomes a U.S. person might encounter an adverse basis step-down under this special provision even though the underlying asset transfers occur a year or even two years before becoming a U.S. person. This also needs to be considered for a foreign corporation that does not constitute a CFC but later has a change in ownership and becomes a CFC. In complicated corporate acquisitions and mergers, the practitioner should carefully review the historical adjusted basis and fair market values of the relevant assets to properly conduct due diligence under section 362(e) and the proposed regulations.

I. Section 367: Notice 2005-74 Tax Trap

The IRS and Treasury announced in Notice 2005-74[24] that the section 367(a) regulations will be amended for the gain recognition agreement rules set forth in Treas. reg. section 1.367(a)-8. The new rule would become effective for exchanges of stock or securities in connection with some asset reorganizations occurring on or after September 8, 2005.

The current gain recognition agreement regulations provide that in specific domestic-to-domestic asset transactions, imbedded income associated with the gain recognition agreement is not recognized if the domestic-to-domestic transaction involves a U.S. surviving party. A modified or successor gain recognition agreement is not even required.[25] Most domestic-to-domestic restructuring transactions are only for business or shareholder value reasons and have little to do with economizing or avoiding U.S. income tax.

According to Notice 2005-74, if the original U.S. transferor transfers all or a portion of its stock of the transferee foreign corporation to a successor U.S. acquiring corporation under an asset reorganization during the gain recognition agreement period a more onerous rule applies. The stock or securities exchanged in accordance with the reorganization will trigger the imbedded income described in the gain recognition agreement. Notice 2005-74 includes an exception for a related-party scenario in which the U.S. transferor was a member of a preexisting consolidated group, the common parent of the consolidated group entered into the gain recognition agreement, and the successor U.S. transferor is a member of the original consolidated group. However, even in this case, a new gain recognition agreement must be adopted.[26]

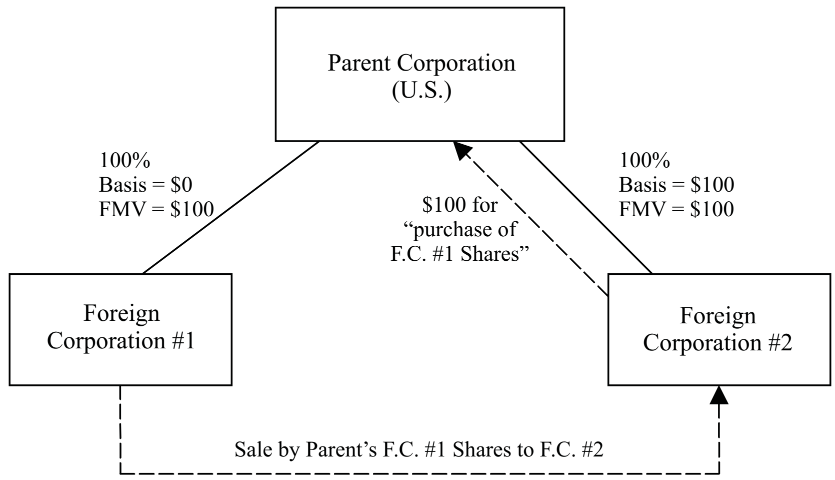
Practitioner's Comment: Notice 2005-74 expands the circumstances under which a U.S. transferor or shareholder group participating in an otherwise tax-deferred reorganization with a successor U.S. acquiring group will be subject to U.S. income taxation for shares transferred in connection with the reorganization. The only exception deals with the internal consolidated group and provides little relief for those shareholders that will experience a significant increase in value by participating in the reorganization. At the same time, they will be required to incur U.S. income tax on an exchange of shares with no resulting cash to pay the tax. Forthcoming section 367(a) regulations should not be amended to tamper with the already appropriate gain recognition agreement rules for domestic acquiring transactions. The practitioner must be cautious when reviewing proposals for a client who wants to participate in these forms of reorganizations, and must

[24]2005-42 IRB 726 (Oct. 17, 2005).

[25]Treas. reg. section 1.367(a)-8(g).

[26]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l*, Oct. 31, 2005, p. 455.

Figure 3



carefully review the underlying documentation to make sure that the end result will be tax-deferred status.

J. Section 367(a): Override of Section 304 Avoids Double Inclusion of Income

Figure 3 is an illustration of a potential tax trap — the double inclusion of income that occurs when a U.S. corporation, which controls separate brother-sister foreign subsidiaries, sells or engages in a deemed transfer of the shares of one foreign subsidiary to another foreign subsidiary. Under this example, Parent Corporation sells all of the issued and outstanding shares it owns in Foreign Corporation #1 to Foreign Corporation #2 for $100, which represents the true fair market value of Foreign Corporation #1.

Section 304 attacks certain defined related-party transactions by recharacterizing some sale or exchange transactions as a dividend rather than as a gain or loss from the sale of a capital asset. Under section 304(a), Parent Corporation's receipt of the $100 is treated as a redemption of Foreign Corporation #2's stock and is treated as a dividend to the extent of Foreign Corporation #2's earnings and profits. To the extent the distribution is not covered by earnings and profits, it would be applied against and reduce the adjusted basis of stock under section 301(c)(2). Section 304 recharacterizes the above "sale" transaction as a nontaxable section 351 transfer of Foreign Corporation #1's shares to Foreign Corporation #2, followed by a redemption by Foreign Corporation #2 of its own stock that is deemed to have been issued.

Section 367(a) overrides section 351 for the transfer of appreciative property to a foreign corporation unless a gain recognition agreement is entered into under Treas. reg. section 1.367(a)-3 and the taxpayer agrees to pick up the gain at a later date. Here, Parent Corporation may be deemed to have engaged in both a taxable section 367 transaction as well as a taxable section 304 transaction. The new Treas. reg. section 1.367(a)-3[27] provides that this transaction will *not* be treated as being taxable under section 367, but rather section 304(a) will govern the transaction and any taxable event will be covered by the deemed dividend rule. The final regulations allow corporations to retroactively apply this avoidance of double inclusion of income for any open years.[28]

K. Section 367(b): Final Regs on Carryover of Tax Attributes

In Treas. reg. section 1.367(b)-7,[29] the IRS and Treasury issued final regulations on the carryover of some tax attributes and nonrecognition transactions involving foreign corporations. The regs provide guidance on the carryover of earnings and profits of a foreign corporation and foreign income taxes in some tax-free corporate asset acquisitions and generally adopt subchapter C principles. However, the regulations indicate that some subchapter C principles are modified to make them as consistent as possible with international tax policies and to prevent material distortions of income. The final regs also address some inbound nonrecognition transactions and apply the hovering deficit rule on a basket-by-basket basis. The regulations also retain the general zipping rule for specific pooling purposes. These regulations are highly complex and technical and must be carefully reviewed for any type of section 367(b) transaction.[30]

L. Section 367(b): Notice 2006-85 and 'Killer B' Reorganization

In Notice 2006-85,[31] the IRS announced that forthcoming regulations under section 367(b) would

[27]T.D. 9250, 71 *Fed. Reg.* 8802 (Feb. 21, 2006).

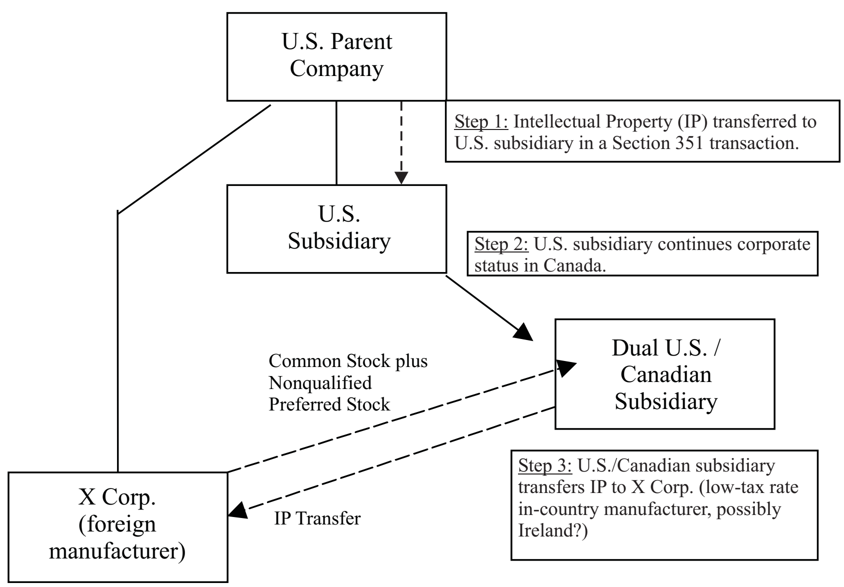
[28]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l*, Mar. 27, 2006, p. 1067.

[29]T.D. 9273, 71 *Fed. Reg.* 44,887 (Aug. 8, 2006).

[30]*See* L. Nadal, "Few Surprises in Killer B Guidance, Practitioners Say," *Tax Notes Int'l*, Oct. 2, 2006, p. 32.

[31]2006-41 IRB 677 (Sept. 25, 2006).

Figure 4



address tax avoidance transactions known as "Killer Bs," which are viewed by the IRS and Treasury as abusive. The effective date for Killer B reorganizations is for transactions occurring after September 21, 2006. Although the final regulations[32] address the treatment of many section 367(b) triangular reorganizations, Notice 2006-85 foreshadows that the new regulations would attack transactions designed to avoid U.S. income tax.

Under the typical Killer B triangular reorganization, a subsidiary purchases its parent's stock for property and transfers the stock in exchange for stock and assets of a corporation (according to the section 368(a)(2)(E) triangular reorganization rules). The parent corporation, under section 1032, recognizes no gain or loss on the issuance of its stock to its subsidiary for cash or a note. The subsidiary acquires a cost basis in the parent's shares under section 1012, and the subsidiary recognizes no gain under Treas. reg. section 1.1032-2(c) on the transfer of the parent's shares immediately afterwards. No amount realized is generated because of the equivalence of the tax basis in the shares and the fair market value of those shares. The bottom line is that the cash or note used by the subsidiary to purchase the parent's stock does not constitute a section 301 distribution.

In practical terms, assuming the subsidiary is a foreign corporation in a low-tax jurisdiction, the Killer B triangular reorganization results in the subsidiary distributing its foreign earnings to the parent without a commensurate dividend pickup at the corporate parent level, thus avoiding U.S. income tax. Alternatively, if the parent corporation is a foreign entity and the subsidiary is a domestic corporation, by avoiding section 301 treatment, the subsidiary would effectively repatriate its U.S. earnings to its foreign parent to avoid U.S. withholding tax. Finally, assuming there is both a foreign parent and a foreign subsidiary otherwise controlled by U.S. shareholders, the transaction would in effect avoid a subpart F pickup. Under Notice 2006-85 and the forthcoming section 367(b) regulations, taxpayers will be required to include the property in the parent's gross income (as opposed to being sheltered from taxation under Section 1032). There will be a corresponding reduction in the parent's basis in the subsidiary stock and a recognition of gain by the parent corporation for the disposition or exchange of property.[33]

M. Sections 367(d) and 351(b): Section 367 Overrides Section 351(b) in Corporate Restructuring

In IRS Legal Memorandum 200610019 (Mar. 10, 2006), a U.S. parent corporation restructured the holding of its intellectual property (IP) for use outside of the U.S. through a three-step U.S.-Canadian restructuring plan as illustrated in Figure 4.

Under the above plan, after the intellectual property (IP) was dropped into the U.S. subsidiary under section 351, the U.S. subsidiary restructured under Canadian law to become a dual U.S.-Canadian subsidiary. Thereafter, the dual company transferred the IP to a foreign affiliate, presumably a manufacturer based in a low-tax jurisdiction such as Ireland. The dual company received stock that would otherwise qualify under section 351(a), as well as nonqualified preferred stock[34] under section 351(g).

[32]Treas. reg. section 1.367(b), T.D. 9243, 71 *Fed. Reg.* 4276 (Jan. 26, 2006).

[33]*See* "Regs Will Crack Down on 'Killer B' Reorganizations," *Journal of Taxation*, Oct. 2006, p. 195.

[34]Nonqualified preferred stock is defined as preferred stock that is: (i) stock for which the holder has the right to require the issuer to redeem or purchase the stock, the issuer

(Footnote continued on next page.)

In this structure, the taxpayer maintained that under the applicable provisions of the Canada-U.S. income tax treaty, the U.S. was precluded from taxing the gain on the IP transfer to X Corp. Under a previous TAM, the IRS concluded that the benefits of the Canada-U.S. income tax treaty do not apply to the transaction.

The central issue was whether section 351(g) applied and, if so, whether section 351(b) applied to the tax part of the exchange. Alternatively, the question was whether section 367(d) applied and, if so, was the U.S. transferor required to follow the super royalty rule under section 367(d) by taking into account annual amounts based on the use, productivity, or disposition of the IP.

The IRS used the step transaction doctrine to collapse the issuance of the nonqualified preferred stock and its subsequent redemption as if the IP contributed to X Corp. was done in exchange for the cash received. The technical advice memorandum expresses concern that if sections 351(b) and 367(d) applied, the "boot" would conceivably be taxed twice. The TAM acknowledges that Congress did not intend to tax the transfer of the IP twice.

The TAM referenced the rule of construction that when two statutes are in conflict and one of the statutory provisions addresses the issue in more specific terms, the more specific statute controls. Accordingly, the TAM concluded that Congress intended section 367(d) to override section 351(b), so only section 367(d) triggered a tax. The TAM also discussed the alternative of concluding that section 351(b) took precedence over the super royalty rule and noted several practical and technical problems. Section 351(b) gain does not have a commensurate-with-income requirement similar to section 367(d), so no guidance exists on how to adjust the section 367(d) payments based on the application of section 351(b).

Practitioner's Comment: From a practical perspective, the result of the TAM is not surprising, because applying the super royalty rule under section 367(d) will undoubtedly yield a more substantial tax because of the annual imputed value of the use of IP. Under this structure, the taxpayer attempted to crystallize the maximum gain, based on the IP's fair market value, on the date of the transfer by the dual U.S.-Canadian subsidiary to the foreign manufacturing operation. It is likely that the foreign manufacturing operation was based in a tax-favorable jurisdiction like Ireland or a country in Asia. This is an excellent pronouncement to illustrate how the IRS analyzes the conflicting provisions of two separate code sections. From the fundamental legal perspective, the linchpin was to use the classic common-law rule of construction: A statutory provision that is more specific and detailed will always govern any less definitive statutory provision.

is required to redeem or purchase the stock, and as of issue date, it is more likely that such right will be exercised; or (ii) stock for which the dividend rate on such stock varies in whole or in part with reference to interest rates, commodity prices, or other indices.

N. Section 368(a)(1)(D): Acquisitive Transactions Are Reorganizations

On December 18, 2006, the IRS released temporary regulations at temp. Treas. reg. section 1.368-2T,[35] which provide the circumstances under which the distribution requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are deemed satisfied, even though no stock or securities are actually issued in a transaction under section 368(a)(1)(D). Under the temporary regulations, when the same person owns, directly or indirectly, identical proportions of stock in the transferor and transferee corporations, the distribution requirements under sections 368 and 354 will be treated as satisfied.

To determine whether a person owns stock of the transferor or transferee corporations in identical proportions, the constructive ownership rules of section 318 will be determinative, without regard to the 50 percent limitation under section 318(a)(2)(C). In addition, an individual and all family members described in section 318(a)(1) shall be treated as one individual. The temporary regulations contain a de minimis provision in which the same person will be treated as owning, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions despite a de minimis variation in shareholder identity or proportionality of ownership. Although the regs do not define de minimis, example 4 shows that ownership of 1 percent of the stock of a corporation will be considered de minimis.

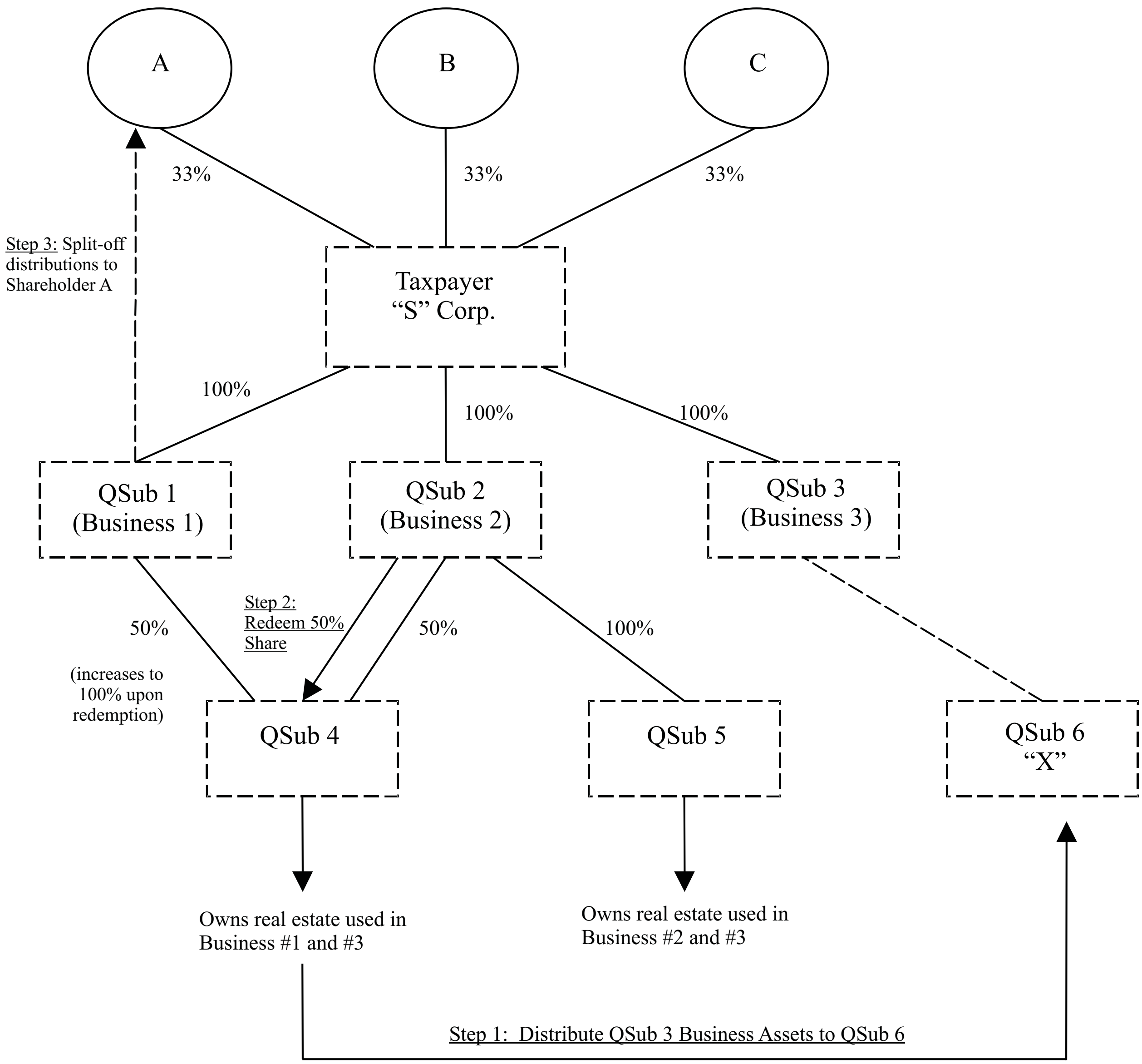
Although not an international regulation per se, these temporary regulations will have international significance for reorganizations that involve foreign entities.

O. Section 368(a)(1)(D): Split-Off of QSubs — New C Corporation Emerges

In LTR 200645003 (Aug. 2, 2006), the IRS ruled that an S corporation may split off one of its qualified subchapter S subsidiaries (QSub) to a shareholder as a tax-free reorganization under section 368(a)(1)(D), and the transaction would not trigger adverse section 1361 consequences. Although this ruling involves a domestic fact pattern, it has significant international ramifications. Here, the taxpayer was a domestic subchapter S corporation

[35]T.D. 9303, 71 *Fed. Reg.* 75879-75882.

Figure 5



using the accrual method of accounting and was engaged in various businesses in three separate geographical locations through the QSubs for more than five years. The taxpayer was owned by three separate individuals, shareholders A, B, and C, each of whom owned one-third of the taxpayer's voting stock, which was the only stock issued and outstanding. Taxpayer owned all the stock of QSub 1, QSub 2, and QSub 3; QSub 1 and QSub 2 each owned one-half of QSub 4; and QSub 2 owned all of QSub 5, as illustrated in Figure 5.

Under the plan of reorganization, QSub 4 would distribute its assets leased to and used in QSub 3 to a new corporation (X), which would become QSub 6 of QSub 3. In the second step, QSub 2 would contribute 50 percent of the QSub 4 stock to QSub 4, which would then retire the stock, leaving QSub 1 as the sole stockholder of QSub 4. In the third step, the taxpayer would distribute all of the stock of QSub 1 to shareholder A in exchange for all of shareholder A's stock of the taxpayer (the split-off). As a result of the fourth step, ownership of the stock of the split-off

QSub 1 by shareholder A would result in a disqualification of QSub 1 and its subsidiary, QSub 4, and result in a deemed contribution of those entities' assets and liabilities to a new corporation.

The ruling explained that this split-off was carried out to retain management of Business 1 and QSub 4, attract new business management to Business 1, and avoid operational and business issues caused by the admission of new owners within the same S corporation group.

The IRS ruled that the transaction summarized above constituted a reorganization within the meaning of section 368(a)(1)(D), and thus appropriate results occurred under sections 357(a), 361(a), 1032(a), related provisions regarding the split-off, and especially section 355(a)(1). Note also that the IRS ruled[36] that this split-off would cause immediate termination of the QSub election and the split-off entity would be treated as a new corporation, receiving all of its assets and assuming all of its liabilities immediately before the termination.

Practitioner's Comment: This ruling could significantly affect privately held U.S.-controlled S corporations that own a QSub operating in the U.S. and non-U.S. entities operating abroad. In connection with a proposed split-off of a foreign affiliate, appropriate attention would need to be devoted to the section 367 inbound toll charge rules as well as sections 904, 1248, and other international sections. However, under the appropriate circumstances, tax-deferred treatment may be attainable.

P. Section 368(a)(1)(F): Reorganization to Reduce Foreign Tax Burden Approved

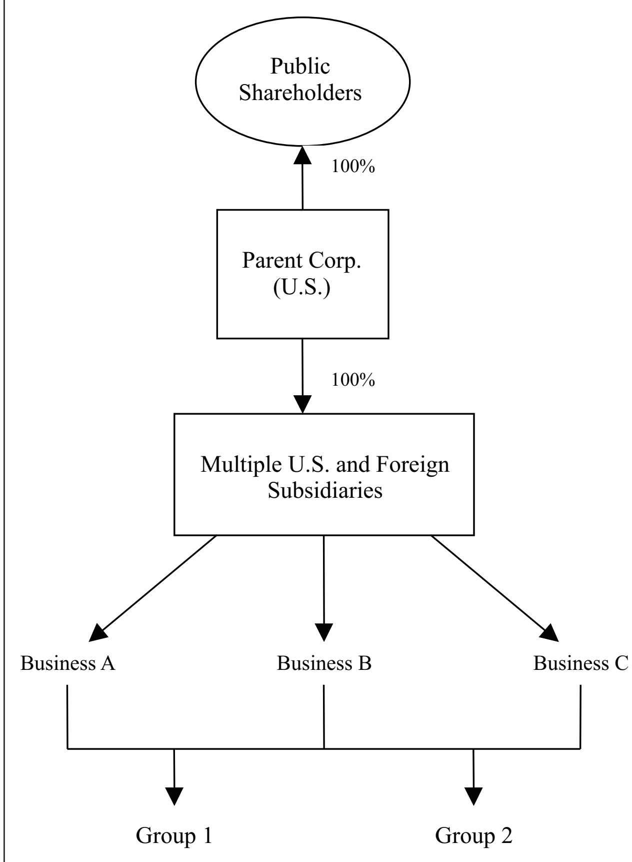
In LTR 200626037 (Mar. 24, 2006), the IRS ruled that the transfer of assets from one foreign corporation in exchange for stock in a newly formed foreign corporation with the principal purpose to achieve foreign tax savings constituted a section 368(a)(1)(F) reorganization.

Practitioner's Comment: It is interesting that the IRS will accept as a good business purpose the attainment of foreign tax savings for a section 368 reorganization. In this ruling, achieving foreign tax savings seemed to be the only business purpose to the restructuring transaction. In contrast, much of the recent tax shelter litigation described in this article focuses on the legal principle that U.S. tax savings in and of itself without an economic purpose will not be sufficient to uphold the structure.

Q. Section 368(a)(1)(F): Tax-Free 'F' Reorganizations

In LTR 200645015 (Aug. 1, 2006), the IRS ruled that restructuring a parent corporation to create two separate series of common shares, designed to track the performance of two separate operational groups, qualified as a tax-free reorganization under section 368(a)(1)(F). While not an international tax ruling per se, this ruling has significant international tax repercussions. The IRS issued its ruling despite the "no ruling" position on most F-type reorganizations,[37] because it determined that this fact pattern raised a significant issue that merited ruling treatment. Figure 6 is a diagram of the corporate structure of this ruling.

Figure 6



As Figure 6 illustrates, Parent Corporation owned several U.S. and foreign subsidiaries through which businesses A, B, and C were conducted within the U.S. and internationally. The ruling does not identify the number or type of U.S. and foreign subsidiaries, nor does it specify the nature and extent of the international operation. However, one could infer from the language of the ruling that the

[36]Treas. reg. section 1.1361-5(b)(1).

[37]*See* Rev. Proc. 2006-3, 2006-1 IRB 122 (Jan. 3, 2006).

international operation was a more than nominal contributor to the overall business operation.

Parent Corporation underwent a restructuring to create separate series of common stock that were intended to track the economic performance of the two operational groups (Group 1 and Group 2). It is unclear from the ruling whether businesses A, B, and C are each involved in one or both of the two specified operational groups.

According to the ruling, the restructuring was completed to:

- enable investors and analysts to better focus on the assets and businesses of each group;
- facilitate greater market recognition of the value in each group of assets and the parent as a whole;
- provide greater future flexibility in raising capital in responding to strategic opportunities, including acquisitions; and
- allow investors to invest in either or both series of stock based on their particular investment objectives.

To restructure, the parent corporation organized two domestic subsidiaries — New Parent and Merger Sub. Thereafter, Merger Sub then merged into Parent Corp., with Parent Corp. as the surviving corporation. In connection with this merger, Parent Corp. issued the newly created "tracking" stock, which included the tracking stock issued by New Parent. Immediately following the merger, Parent Corp. converted into a single-member domestic LLC by filing a certificate of conversion under the applicable Limited Liability Act. As a result, New Parent held all of the membership interests in the newly formed LLC, and this was disregarded as separate from its owner under Treas. reg. section 301.7701-3(b)(1)(ii). Figure 7 illustrates this transaction.

In ruling that the restructuring plan qualified as a reorganization under section 368(a)(1)(F), the IRS noted that Parent Corp. and New Parent Corp. each constituted a party to the reorganization under section 368(b). The shareholders of Parent Corp. did not recognize any gain or loss upon their exchange of Parent Corp. stock for New Parent Corp. common stock under section 354(a). Furthermore, Parent Corp. did not recognize any gain or loss under the restructuring based on sections 361(a) and 357(a), nor did New Parent recognize any gain or loss based on section 1032(a). This ruling also tracks classic reorganization-based tax bases, holding periods, and tax years, as well as related section 381 continuations of corporate characteristics.[38]

Practitioner's Comment: Even though this letter ruling involved a publicly traded corporation, the ruling could have significant relevance to closely held corporate planning involving U.S. and international business operations. What is most interesting is that the parent corporation was able to restructure its shares in a tax-deferred reorganization (a type-F reorganization) so that its shareholders exchanged their traditional common shares for the series of tracking shares. This enables the shareholders to participate in the value of the corporate group on the basis of specific business lines as opposed to the corporation as a whole, which provides greater market recognition of the value of each operational group. From a closely held planning perspective, this could enable a company to conduct a subsequent buyout of tracking shares. The shareholders would not have a direct operational interest or a financial interest, but could still retain the tracking shares attributable to operational units in which the shareholders have a continuing role, subject to some limitations under the section 302 redemption rules.

R. Section 482: 2005 APA Updates

In Ann. 2006-22,[39] the IRS released a report regarding advance pricing agreements for the 2005 calendar year. The IRS reported that 53 APAs were signed, 16 were renewed, and 1 was amended. It is interesting that the report commented that the average time needed to complete these agreements was 34.3 months. The IRS also provided a helpful background discussion of APAs, as well as the current model draft for the agreements.[40]

S. Section 482: Cross-Licensing Structures

In Notice 2006-34,[41] the IRS requested information to address cross-licensing structures and transactions to better determine their tax treatment. The notice raises several important issues, including the circumstances under which companies determine whether to engage in licensing or cross-licensing of intellectual property. The IRS requests information on the nature and extent of cross-license arrangements, not only for patents but also for know-how, trademarks, and trade secrets. The IRS acknowledges in the notice that the tax treatment of cross-license arrangements depends on the characterization, for U.S. federal tax purposes, of the underlying

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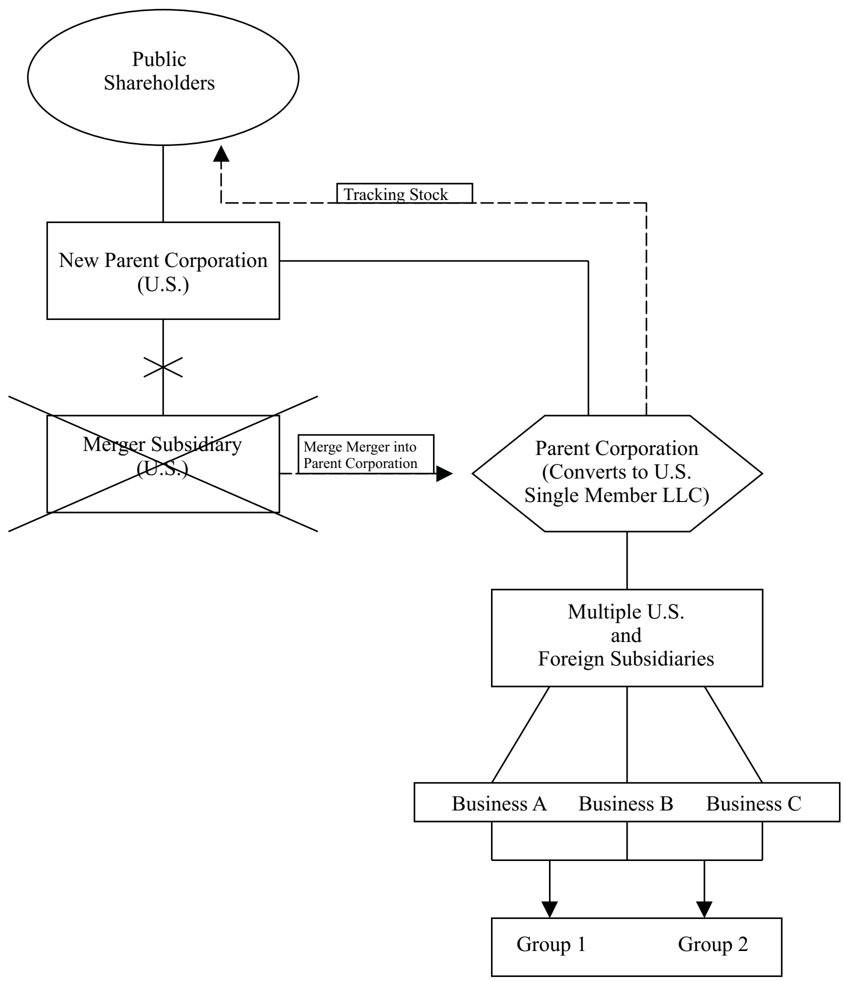
[38]*See 2006 WTD 220-19* or *Doc 2006-22965*.

[39]2006-16 IRB 779 (Mar. 31, 2006).

[40]*See 2006 WTD 63-8* or *Doc 2006-6279*.

[41]2006-14 IRB 705 (Apr. 3, 2006).

Figure 7



transactions. The notice describes three fundamental theories for characterizing a cross license, including a two-way license of IP rights, a reciprocal agreement to refrain from asserting claims of infringement, and the more traditional sale or exchange of property.

T. Section 482: Regulations for Low-Margin Services

The IRS and Treasury released temporary and proposed transfer pricing service regulations[42] that are intended to provide significant relief to multinational corporations dealing with the section 482 transfer pricing regulations applicable to low-margin services. The regulations were to be effective for tax years beginning after December 31, 2006. However, according to Notice 2007-5,[43] the effective date of the regulations, insofar as they pertain to the identification of controlled services, has been moved back one year and will apply to tax years beginning after December 31, 2007. Regarding the business judgment rule, the effective date remains for tax years beginning after December 31, 2006. Although the regulations represent a significant improvement over the 2003 proposed regulations, which would have required significant diagnostic analysis and burdensome documentation, the newly released set of regulations are still complex and require extensive documentation. Many commentators have stated that the new regulations will represent a significant compliance burden.

Under the temporary regulations, the simplified cost-based method proposed in 2003 would be replaced with the new services cost method (SCM). Under the proposed SCM, the key is determining an arm's-length price based on total service costs with no markup. So long as the pricing method conditions are met, the regulations consider it the best transfer pricing method. However, the regulations specify that to qualify, the low-margin services may not contribute significantly to the competitiveness, core capabilities, or fundamental success of the business.

Ann. 2006-50[44] prescribes a list of 21 categories and 48 services that taxpayers may rely on as being eligible for the SCM. In principle, the list of services covers the full range of typical back-office services. Taxpayers must maintain documentation of a statement of intention to use the SCM, costs of covered services, and the allocation of those costs.[45] On December 20, 2006, the IRS released Rev. Proc.

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[42]Temp. Treas. reg. section 1.482, T.D. 9278, 71 *Fed. Reg.* 44,466 (Aug. 4, 2006).

[43]2007 IRB LEXIS 5 (Dec. 21, 2006).

[44]2006-34 IRB 321 (Aug. 21, 2006).

[45]*See* A. Nutt, "Practitioners, Tax Officials Discuss Improving New Services Regs," *Tax Notes Int'l*, Oct. 30, 2006, p. 341.

2007-13,[46] which almost doubles the number of eligible services and includes the provision "other similar activities" for each category.

Another category of covered services in the low-margin area includes services for which the median comparable arm's-length markup is 7 percent or less. Assuming the 7 percent test is met, the services can be charged at cost with no markup. The purpose of this second category of covered services is to provide a backup position for taxpayers having services that may not qualify for SCM treatment because they are not described in the announcement and revenue procedure.

On September 6, 2006, the IRS released informative commentary regarding these regulations. The IRS developed the SCM to take a large number of services off the table. The idea behind specified covered services is to create a rebuttable presumption that those services should be valued at cost. Furthermore, the specified covered services are subject to the business judgment rule, enabling the IRS to identify specified covered services more robustly.

IRS commentary also has clarified that the SCM is elective; therefore, taxpayers may choose to use the traditional method. The new regulations are unclear about whether the SCM is considered the best method. Many practitioners have commented that the IRS's best-method stance seems to contradict the IRS position that the SCM is elective; however, the IRS commented that the preamble in the regulations clearly states that a taxpayer has the leeway to choose. It is likely that the technical language in the regulation will be revised to comport with the preamble, which states that the SCM is elective.

Under the proposed regulations' shared service arrangements (SSAs), a controlled group should be able to allocate costs for numerous low-margin services to multiple group users. The IRS commented that SSAs are designed to provide a more flexible approach for allocating costs among multiple members based on each member's reasonably anticipated benefits.[47]

U. Section 704(b): Anti-'Splitter' Regulations

On October 18, 2006, the IRS and Treasury promulgated final regulations[48] effective for partnership tax years beginning on or after October 19, 2006. Under the classic splitter transaction, a U.S. corporation owned two brother-sister CFC's, CFC 1 and CFC 2, and CFC 1 and CFC 2 in turn were the sole partners in a foreign hybrid, treated as a company under foreign law but as a partnership for U.S. federal tax purposes. In this structure, CFC 1 allocated only a small percentage of the foreign taxes of the hybrid (a low-tax pool) and CFC 2 allocated the lion's share of the foreign taxes incurred by the hybrid (the high-tax pool). The hybrid was subject to foreign tax and its taxes would qualify for foreign tax credit treatment primarily through CFC 2. The underlying income was still trapped in the foreign hybrid.

The 2004 temporary regulations[49] provided that these foreign tax credit allocations did not have substantial economic effect and had to be allocated according to the partner's interest in the partnership. This is subject to the safe haven provision that requires the partnership allocations to have economic effect and the tax allocations to be allocated according to foreign income.

The final regulations apply to creditable foreign tax expenditures, and to determine the appropriate allocation, one must review the "related" taxes — the foreign tax must be related to the underlying foreign income. Accordingly, creditable foreign tax expenditures are now allocated in proportion to related foreign income. Unlike the temporary regulations, the final regulations do not require capital accounts to be maintained or liquidated for this special allocation.

Practitioner's Comment: From a practical international business perspective, these new rules will greatly facilitate the structuring of joint ventures between U.S. and foreign partners. Assuming the in-country entity is treated as a partnership for federal income tax purposes, practitioners will not be required to explain the idiosyncrasies of special allocations to a foreign partner. Instead, each U.S. CFC participant will take into account the creditable foreign tax expenditure based on a tracking of those expenditures to related foreign income. In practical terms, such joint venture agreements will not be required to adhere to substantial economic effect nuances.

V. Section 752: Allocating Partnership Liabilities to Underlying Owners of Disregarded Entities

In Treas. reg. section 1.752-2,[50] the IRS and Treasury provided guidance for allocating partnership liabilities when a partnership interest is owned through a disregarded entity and when a partner may be treated as bearing the economic risk of loss

[46]2007 IRB LEXIS 4 (Dec. 21, 2006).

[47]*See* A. Nutt, "U.S. Practitioners Air Canvas on Service Regs," *Tax Notes Int'l*, Nov. 6, 2006, p. 418.

[48]Treas. reg. section 1.704-1, T.D. 9292, 71 *Fed. Reg.* 61,648 (Oct. 19, 2006).

[49]Temp. Treas. reg. section 1.704-IT, T.D. 9121, 69 *Fed. Reg.* 21,405 (Apr. 21, 2004).

[50]T.D. 9289, 71 *Fed. Reg.* 59,669 (Oct. 11, 2006).

for the partnership liabilities. In the final regs, payment obligations of a disregarded entity that owns a partnership interest are taken into account only to the extent of the net value of the disregarded entity as of the date the partner's share of the partnership liabilities are determined. The regulations cover disregarded entities, including a QSub, a real estate investment trust, and entities that have elected to be classified as a corporation (single-member LLC). As many commentators have stated, the new rules will require that the disregarded entity be valued.

W. Section 882: Determining Interest Expense Deduction for Foreign Corporations With U.S. Branches

The IRS and the Treasury issued temporary and proposed regulations[51] designed to simplify the 1996 final interest expense allocation expense regulations for determining the interest expense deduction of foreign corporations with U.S. branches. The 1996 regulations[52] became obsolete with the override provisions of the U.K.-U.S. and Japan-U.S. income tax treaties that were modified after the issuance of the regulations. Under the treaties, taxpayers are allowed to use risk-waiting as an alternative to the 1996 regulations' three-step method set forth in Treas. reg. section 1.882-5. The regulations required that this method be the exclusive calculation for allocating branch interest.

Practitioner's Comment: Although the temporary and proposed regulations do not extend the risk-waiting method used in these treaties for all banks, we are likely to see substantial commentary from the international banking sector advocating that the regulations should allow risk-waiting as the best method for allocation of interest. The rationale is that the levels of equity capital required for an asset depend substantially on the type of asset and the level of risk associated with that asset.

X. Section 901: Multistep Transactions Lacked Business Purpose

In ILM 200620022 (Jan. 30, 2006), the IRS concluded that a U.S. financial services corporation was not entitled to claim foreign tax credit benefits regarding a multistep transaction involving put and call operations with unrelated parties because the multistep transactions lacked a business purpose and had no reasonable profit expectation except for the generation of the foreign tax credit benefits.

Under the multistep series of transactions, the corporate taxpayer entered into a series of transactions with a U.S. financial services corporation that served as the seller to the transaction. The corporate taxpayer acquired title to some disregarded entities and then caused the disregarded entities to sell some foreign share holdings to the seller, triggering foreign tax on the stock dispositions. As a result, the corporate taxpayer claimed a foreign tax credit benefit for the foreign taxes.

In disallowing the foreign tax credit benefits, the IRS determined that the corporate taxpayer had no real potential for profit from the various transactions. The IRS relied on *Compaq Computer Corp. v. Commissioner*,[53] which held that a taxpayer may not deduct expected foreign taxes from a structured transaction in which economic substance is lacking. Also, the IRS relied on *Long Term Capital Holdings LP et al. v. United States*,[54] which held that the transaction must be subjected to an economic substance analysis in which both the subjective business purposes and objective economic substance are reviewed. Also, the step transaction doctrine must be taken into account in this analysis.

Y. Section 901: Foreign Tax Credits Disallowed Where Economic Substance Lacks

In CCA 2006-20-022 (January 30, 2006), the IRS Chief Counsel analyzed a transaction designed to generate foreign tax credits and concluded that based on economic substance and step transaction doctrine principles, the intended foreign tax credit benefits would not be allowed.

Figure 8 illustrates the two primary steps that took place in this particular transaction.

Following the closing of the sale of the country X corporation shares, the 17 disregarded entities paid applicable foreign taxes levied on the sale. The taxpayer claimed the foreign tax credit relief for payment of those country X taxes (that is, the payment of those taxes by the disregarded entities as a matter of federal tax law was treated as direct tax payments by the taxpayer).

The IRS Chief Counsel concluded that this two-step transaction should be disregarded because of the lack of business purpose and the lack of a reasonable expectation of profit from the transaction. The sole objective of the two-step transaction was to generate foreign tax credit benefits. Using the economic substance doctrine, the Chief Counsel concluded that a rational investor would not have engaged in this form of transaction, because the potential loss on the

[51]Temp. Treas. reg. section 1.882-5T, T.D. 9281, 71 *Fed. Reg.* 47,443 (Aug. 17, 2006).

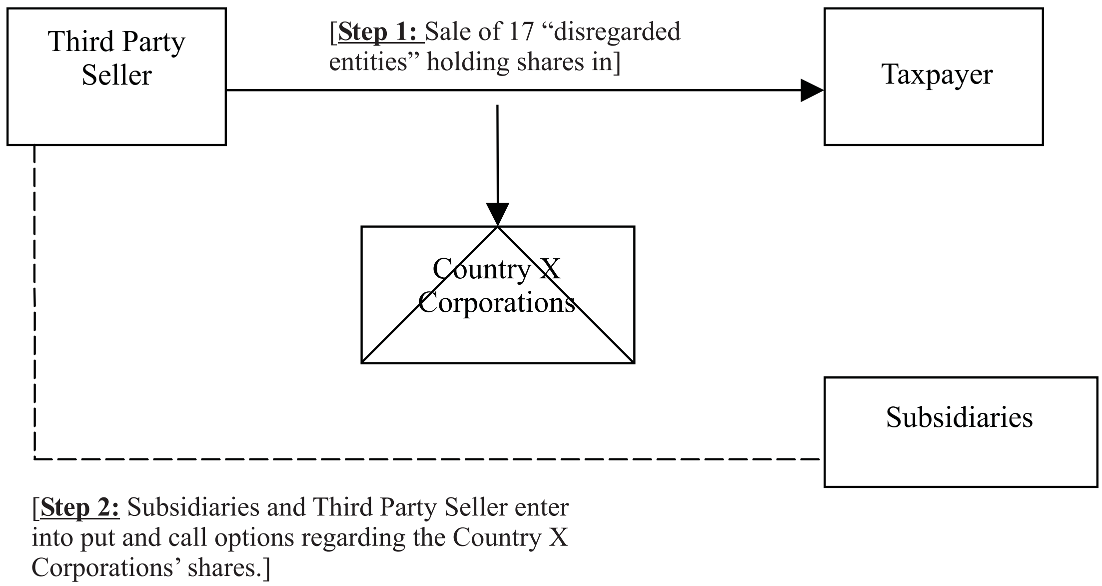
[52]Treas. reg. section 1.882-5, T.D. 8658, 61 *Fed. Reg.* 93,261 (Mar. 8, 1996).

[53]277 F.3d 778 (5th Cir. 2001).

[54]330 F. Supp. 2d (D. Conn. 2004).

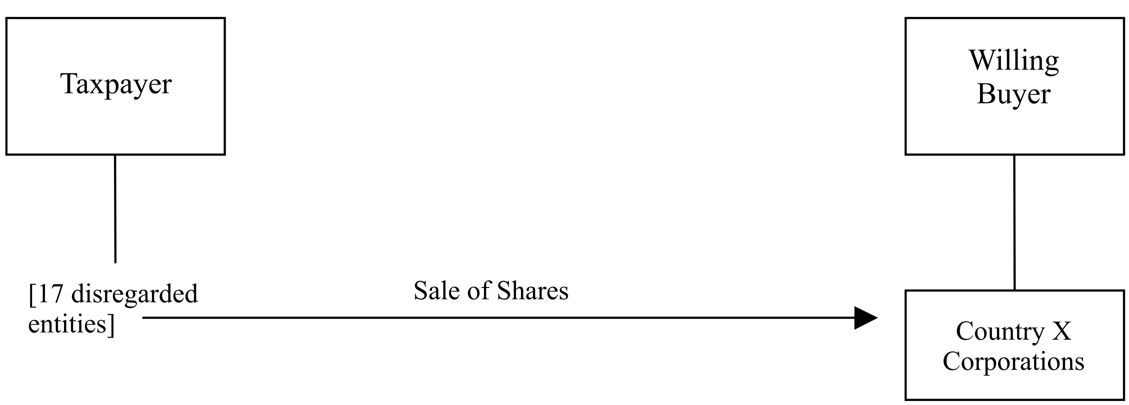
Figure 8

At Closing:



Two Months Later:

Third Party Seller locates willing buyer to purchase Country X Corporations’ shares, Taxpayer “accepted” price as to the value of the shares to settle call option, which the willing buyer exercised:



transaction was four times greater than the possible upside. What might have been the most damaging was the taxpayer's concession that from the beginning of this two-step transaction, it intended to sell the shares to a third party when the call option was either exercised or expired.[55]

Practitioner's Comment: This two-step transaction is very similar to one of the listed transactions in Notice 2004-20.[56] It involved a prearranged sale of stock in a foreign corporation to a domestic corporation, which in turn sold the foreign corporation's assets to a third party. This generated a taxable gain for foreign tax purposes, but not for U.S. tax purposes — enabling the domestic corporation to claim foreign tax credit benefits. CCA 2006-20-022 presents an interesting and somewhat rare insight on the IRS Chief Counsel's consideration of exotic international structured transactions. Perhaps the lesson to be learned is that whenever a taxpayer is asked whether it would have entered into the transaction if it could not have claimed foreign tax benefits, the response should not be "it may be that the transaction would not have met the required return."

Z. Section 901 and 903: Proposed Regulations on Allocation of Foreign Taxes

In prop. Treas. reg. section 1.901-2,[57] the IRS issued proposed guidance on determining the allocation of foreign taxes under sections 901 and 903. The proposed regulations also include rules for foreign consolidated groups, reverse hybrids, and hybrid entities. The proposed regulations clarify that foreign law is generally reviewed to determine whether legal liability is imposed for income tax on the specific taxpayer required to include such income for foreign tax purposes, and that this standard applies even if another person has the sole obligation to pay the tax. Foreign law is often controlling when determining whether tax is imposed on a base other than income, and the legal liability for the tax on the owner for the tax base for foreign tax purposes.

To overrule *Guardian Industries v. United States*,[58] the proposed regulations provide detailed guidance on how to treat taxes paid on combined income of two or more persons in the context of foreign consolidated-type groups whose members are not jointly and severally liable for the group's tax. In this case, the foreign tax apportioned among all group members will be done on a pro rata basis based on the relative amounts of each member's net income. It should be noted that the IRS has filed a notice of appeal for *Guardian Industries*, which is pending. The IRS commentary explains that if a U.S. taxpayer is allowed to claim a foreign tax credit but the associated income is not subject to U.S. taxation, where is the double taxation abuse?[59]

Practitioner's Comment: When dealing with foreign tax credits, two fundamental issues need to be addressed. First, is the foreign tax payment a creditable tax? Second, assuming we are dealing with a creditable tax, who is the bona fide taxpayer who bears the cost of the foreign tax? The proposed regulations attempt to address the complex issue of what IRS officials describe as an inappropriate separation of taxes from the underlying foreign-source income.

AA. Section 901(l): Minimum Holding Period for Withholding Taxes on Gain and Income Other Than Dividends

Notice 2005-90[60] provides detailed guidance on section 901(l), which generally disallows a foreign tax credit for any withholding tax on items of income or gain for any property that is held by the recipient of the income item for 15 days before the date on which the right to receive payment of that item arises or to the extent the recipient of the item is under obligation (whether under a short sale or otherwise) to make related payments for positions in substantially similar related property.

Although this notice sounds highly technical if not esoteric, it has practical application to many common international business arrangements, including back-to-back computer programming licensing arrangements as illustrated in Figure 9.

Under this arrangement, a U.S. licensor corporation enters into a master license agreement with the U.S. licensee corporation, which in turn sublicenses (as permitted under the master license) the right to use the licensor's computer program with its various domestic and foreign subsidiaries. The domestic and foreign subsidiaries in turn reproduce and distribute the licensor's computer programs on various items of high-tech equipment, and receive license fees from their underlying customers. The domestic and foreign subsidiaries then make sublicense payments to the U.S. licensee corporation, which makes master license payments to the U.S. licensor corporation.

[55]*See* "Prearranged Sale Nixes Taxpayer's Claim to Foreign Tax Credits," *Standard Federal Tax Reports — Taxes on Parade*, May 25, 2006, p. 2.

[56]2004-11 IRB 608 (Mar. 15, 2004).

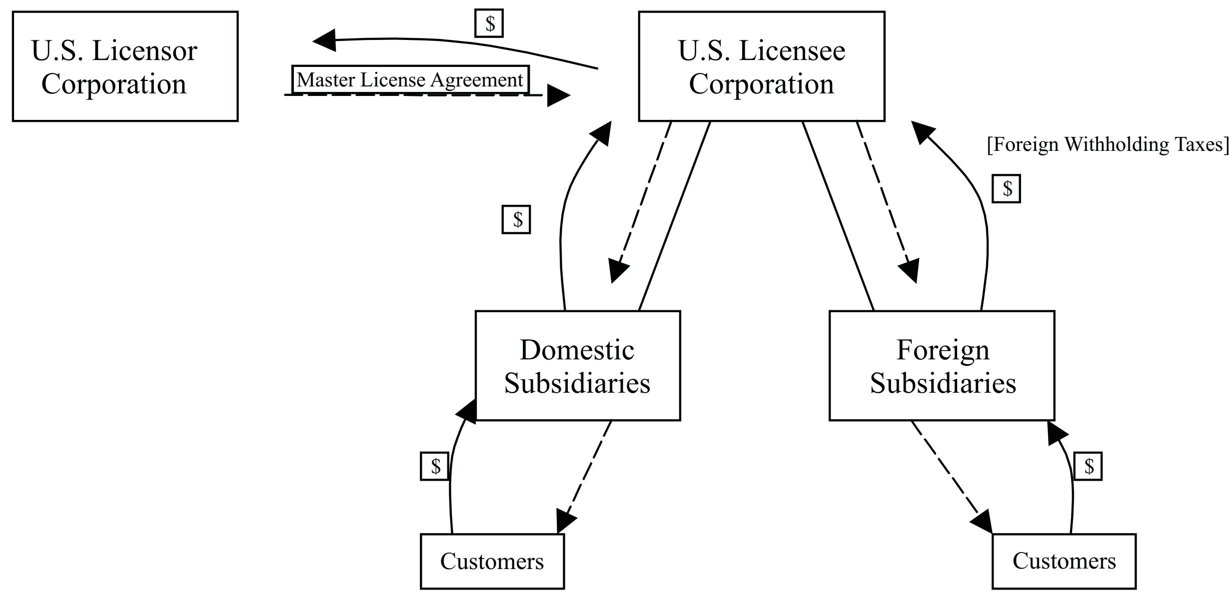
[57]71 *Fed. Reg.* 44,240 (Aug. 4, 2006).

[58]65 Fed. Cl. 50 (2005).

[59]*See* J. Calianno and J.M. Cornett, "Guardian Revisited: Proposed Regs Attack Guardian and Reverse Hybrids," *Tax Notes Int'l*, Oct. 23, 2006, p. 305.

[60]2005-51 IRB 1163 (Dec. 19, 2005).

Figure 9



Foreign gross-basis withholding taxes are imposed on the payments made by the foreign subsidiaries to the U.S. licensee.

Notice 2005-90 carves out back-to-back computer licensing structures that are operated in the ordinary course of the licensor's and licensee's trades or businesses because they do not constitute a tax avoidance intention to which section 901(l) is directed.

Practitioner's Comment: Although at first blush Notice 2005-90 appears to be virtually irrelevant to the regular international business operation, this notice must be carefully reviewed to ensure that underlying foreign tax credits in the form of gross foreign withholding taxes are not disallowed. Note that in a back-to-back license arrangement, these types of arrangements are typical because the U.S. licensor or master licensor has to deal with one customer as opposed to dozens of second-tier subsidiaries. This minimizes the licensor's credit risk and the currency risk to the licensee's foreign affiliates.

BB. Section 911: Foreign-Earned Income Exclusion Update

U.S. citizens meeting some qualifying rules may claim a U.S. foreign-earned income exclusion for wages, salaries, and other fees earned outside of the United States. Any exclusion includes qualifying earnings of up to US $80,000, which is inflation-adjusted beginning in 2005 according to section 515 of the Tax Increase Prevention and Reconciliation Act of 2005[61] (TIPRA). In addition, a qualifying individual may exclude a defined housing cost amount, including housing expenses as well as rent, in excess of 16 percent of the US $80,000 inflation-adjusted limit, but generally not more than 35 percent of the limit, as prescribed by TIPRA. It is crucial to make a timely election on Form 2555 for claiming section 911 benefits, because as a general rule, elections filed on a dilatory basis are not permitted for any returns filed more than one year after the filing deadline.[62] Rev. Proc. 2006-51[63] raised the exclusion amount to US $82,400 to account for inflation.

In Notice 2006-87,[64] the IRS targeted more than 250 high-cost international cities from the onerous housing exclusion amount legislatively adopted by TIPRA. This list is retroactive to January 1, 2006, and raises the meager US $24,720 housing cost amount allowance in most developed countries abroad; however, many significant financial centers, such as Beijing, are not included on the list. It is also interesting that the applicable amount for the 2006 U.S. housing amount is US $24,720, and from this

[61]Pub. L. No. 109-222.

[62]*See* J. Bernstein and P. Sczudlo, "A Guide to Taxation for U.S. Citizens Living in Canada," *Tax Notes Int'l*, Aug. 7, 2006, p. 507.

[63]2006-47 IRB 945 (June 19, 2006).

[64]2006 IRB LEXIS 567 (Oct. 6, 2006).

amount the more than 150 high-cost cities located abroad raised their annual rate. The city highest on the list was Hong Kong at US $114,300 per year. Other cities of interest include London at US $72,100 and Tokyo at US $85,700.

In Notice 2006-84,[65] the IRS clarified that U.S. citizens working at the Guantanamo Bay, Cuba, U.S. Naval Base may claim the foreign earned income exclusion under section 911. Note that in 2006, U.S. citizens working abroad who otherwise qualified under section 911 may exclude the first US $82,400 of qualifying income earned from foreign sources. Because section 911(d) denies the exclusion for any foreign country to which travel is forbidden by U.S. government regulations, it was not clear whether U.S. citizens working in Guantanamo Bay would qualify for section 911 treatment.[66]

CC. Section 932(c)(4): U.S. Citizen's Filing U.S.V.I. Tax Return

In CCA 2006-24-002 (Feb. 16, 2006), the IRS Chief Counsel determined that a U.S. citizen filing a U.S. Virgin Islands tax return also must file a U.S. federal income tax return. The only exception would be if the U.S. citizen satisfies all of the conditions set forth in section 932(c)(4).

To qualify under section 932(c)(4), an individual must:

- be a bona fide resident of the Virgin Islands during the entire tax year;
- file his income tax return with the Virgin Islands reporting all sources of income; and
- fully pay his tax liability to the Virgin Islands.

If these conditions are met, the individual, for purposes of calculating his U.S. income tax liability, does not include the income in his U.S. gross income and would not be required to file a U.S. tax return.[67]

Practitioner's Comment: In connection with the ongoing U.S.V.I.-IRS joint examinations, the IRS is asserting that individuals who claim residency status in the Virgin Islands before and after the enactment of the Jobs Act may also be required to file a U.S. tax return for the years at issue. Because the residency issue will not be determined for several months — if not years, in specific cases — most U.S. citizens proclaiming Virgin Islands residency status for prior years have been filing "protective" tax returns with the IRS. This preserves any refund opportunities should the taxpayers' status as a bona fide resident of the Virgin Islands not be accepted and would enable the taxpayers to obtain a refund for taxes paid to the Virgin Islands government with respect to the federal tax filings.

DD. Section 937: IRS's Hunting License for Tax Abuses in the U.S.V.I.

On September 26, 2006, Donna M. Christensen, the newly elected delegate of the U.S.V.I., indicated that the IRS has exploited the subjective residency standard of the U.S.V.I. (before it was changed by the Jobs Act under section 937) as a "hunting license" to conduct abusive tax shelter audits. Christensen testified before the House Ways and Means Select Revenues Subcommittee and explained that the IRS is using the residency standard to unfairly target and audit residents who claimed economic development tax incentives.

Christensen also criticized the IRS for applying its policy that the statute of limitations for IRS examinations never tolls for U.S.V.I. taxpayers, and a bona fide U.S.V.I. resident who underpays his tax by even one dollar (even if due to a good-faith error) may now be subject to full taxation in the U.S. without being given any credit for payments made to the U.S.V.I. Christensen also criticized the IRS for challenging a congressionally sanctioned economic development program. She said participation in the program does not create a rebuttable presumption that the taxpayer is not a bona fide U.S.V.I. resident and that the taxpayer engaged in fraud or unlawfully participated in a tax shelter.[68]

EE. Section 937: Alternative 'Presence' Test

On November 14, 2006, the IRS published an addition to the final regulations at Treas. reg. section 1.937-1.[69] The new addition supplements the final regulations that were published on January 31, 2006.[70] It incorporates a new alternative to the "presence" test, which requires that the individual must be present in the relevant territory for an average of 183 days per year to be considered a resident, provided that a minimum of 60 days per year is spent in the relevant territory. An individual will satisfy the presence test if he is present in the relevant territory for a minimum of 549 days during the three-year testing period, assuming the annual 60-day minimum is met. Further, an example illustrating the 183-day unweighted average test is included in the regulations. Other than the addition of the 183-day average test, the final regulations have not made any substantive changes to the section 937 regulations.

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[65] 2006-41 IRB 677 (Sept. 21, 2006).

[66] *See 2006 WTD 187-2* or *Doc 2006-20118*.

[67] *See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l,* July 31, 2006, p. 427.

[68] *See 2006 TNT 187-5* or *Doc 2006-20162*.

[69] T.D. 9297, 71 *Fed. Reg.* 66,232 (Nov. 14, 2006).

[70] T.D. 9248, 71 *Fed. Reg.* 4,996 (Jan. 31, 2006).

The first residency rule involves physical presence in the possession for 183 days or more during a tax year, not having a tax home outside of the possession during the tax year, and not having a "closer connection" to the U.S. or foreign country other than the possession. The combination of these three tests make it difficult for any U.S. citizen to qualify as a bona fide foreign resident in a possession.

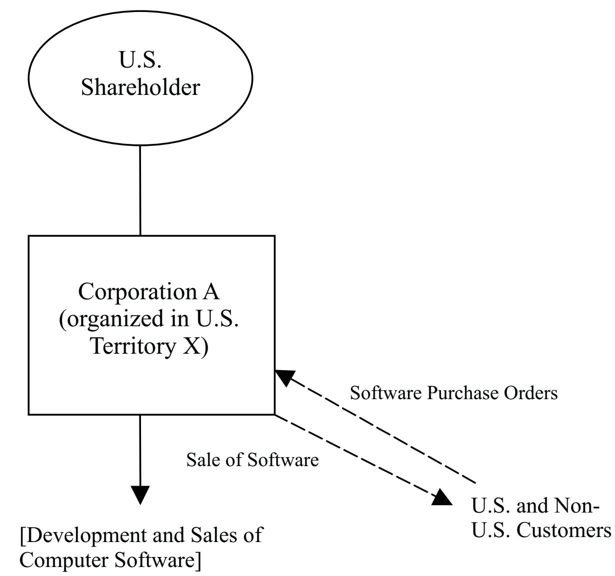
Other exceptions pertain to an individual who does not spend more than 90 days in the U.S. during the tax year and to an individual who spends more days in the possession in comparison with days spent in the U.S., so long as the individual has no earned income in the U.S. during the tax year. Finally, the proposed regulations contain a rule that would require a person to be treated as a bona fide resident of a U.S. possession if the individual had no "permanent connection" to the U.S. — that is, no permanent residence, spouse, or dependent with a principal place of abode in the U.S. This rule would require a severing of all ties with the mainland U.S. Under this approach, an individual could spend substantial amounts of time in the U.S. mainland for vacation, personal, medical, or business needs.[71]

Practitioner's Comment: Under the final regulatory rule's unweighted average test, U.S. citizens can now qualify for bona fide residency status in the U.S. possession by testing the physical presence status over a 36-month period, so long as at least 60 days are spent per year in relevant territory. Mathematically, this means that a person could qualify for bona fide residency status by loading up a substantial number of days in one of those three years in order to meet the 549-day threshold. For example, if in year one a U.S. citizen spends 60 days in the possession and 124 days in year two, he would qualify as a bona fide resident under this test if he spent all 365 days of year three in the relevant territory (assuming the tax home and closer connection tests are satisfied).[72]

FF. Section 937(b): Determination of Sources

Notice 2006-76[73] expressly focuses on section 937(b) and temp. Treas. reg. section 1.937-2T, -3T,[74] and it expressly disclaims that no other issues are addressed, including determining a taxpayer's trade or business status within the U.S. under section 864. Notice 2006-76 provides several helpful examples, the first of which is illustrated in Figure 10.

Figure 10



Based on the above diagram, Corporation A receives and reviews purchase orders from U.S. and non-U.S. customers. Assuming the purchase orders are accepted, the software is either loaded onto compact discs at Corporation A's territory headquarters and shipped via common carrier, or the software is downloaded from Corporation A's server located in territory X. The example assumes that Corporation A is not engaged in the conduct of a trade or business in the U.S. It also assumes that because the sales contract provides that all right, title, and interest in the software passes from Corporation A to the customer at Corporation A's headquarters in territory X or on Corporation A's server located in territory X (if electronically downloaded), each transaction is classified as a sale of a copyrighted article in accordance with Treas. reg. section 1.861-18(c)(1)(ii) and (f)(2).

Notice 2006-76 reviews temp. Treas. reg. section 1.937-2T(b), and in light of section 863(a) principles, assumes that Corporation A's income attributable to the software sales is sourced in territory X. The notice also determines that Corporation A's income is effectively connected with the conduct of a trade or business in territory X based on section 864(c)(3) principles as related to temp. Treas. reg. section 1.937-3T(b). The premise of these rulings is that Corporation A passes the right, title, and interest to

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[71]*See* "Final Regs Revise Residency Rules for U.S. Possessions Tax Breaks," *Standard Federal Tax Reports — Taxes on Parade*, Feb. 19, 2006, p. 5.

[72]*See* Kevin E. Packman and Andrew H. Weinstein, "Establishing Residency in the U.S. Virgin Islands — A Look at Section 937's Reach," *Journal of Taxation*, July 2006, p. 33.

[73]2006-38 IRB 1 (Aug. 29, 2006).

[74]T.D. 9194, 70 *Fed. Reg.* 18,920 (Apr. 11, 2005).

the copyrighted articles in territory X and not elsewhere. As a result, section 937(b)(2) allows Corporation A's software sales income to be sourced in the territory, not in the U.S.

In contrast to the above example, Notice 2006-76 also reviews a fact pattern involving an application service provider. Under this example, Corporation B is assumed not to be conducting a trade or business in the U.S. Employees of Corporation B develop and maintain software on Corporation B's server located in territory X. In a slight twist on the sales example discussed above, Corporation B's non-U.S. and U.S. customers provide detailed information about their customers to Corporation B's server and electronic storage facility located in territory X. Those customers pay a monthly service fee under a subscription agreement, which allows the customers to use the application software from their customer-based locations.

Again using section 861(a)(3) principles and in reference to temp. Treas. reg. section 1.937-2T(b), the services performed by Corporation B in territory X are deemed compensation for services to be sourced in territory X. These services are also treated as being effectively connected with the conduct of a trade or business in territory X.[75]

Practitioner's Comment: The examples contained in Notice 2006-76 provide a blueprint for practitioners to properly establish a possessions-based operation or any other business operation so long as the source rules are properly followed. In the case of the U.S.V.I., if the economic development program is properly put into place and the U.S. citizen becomes a bona fide resident of the U.S.V.I., significant and permanent U.S. federal tax savings may be generated.

GG. Sections 953(d) and 7874: Sole Agent Status

The IRS and Treasury issued final and temporary regulations at temp. Treas. reg. section 1.1502-77T.[76] These regulations address the situation in which the foreign entity is deemed the common parent corporation under the anti-inversion rules of section 7874 or the special domestic insurance election under section 953(d). Under the new rules, if a foreign entity is treated under section 7874 as a domestic corporation or if a foreign insurance company makes a section 953(d) election to be treated as a domestic entity, the foreign entity could be considered a common parent of a subsidiary group. The common parent for the consolidated return year is generally the sole agent for the group.[77]

HH. Section 954(c)(1)(A): Exclusion of Foreign Leasing Income

The Jobs Act overhauled subpart F in the foreign base company shipping income rules. The act allows income earned by a CFC from the leasing of ships and aircraft to be excluded from subpart F income if the income is attributable to active trade or business income. In Notice 2006-43[78] and Notice 2006-48,[79] the IRS provides guidance on excluding some shipping income from subpart F treatment. To qualify for the active trade or business classification, the operations must be substantial, which — in the context of leasing expenses — means that leasing expenses must be 10 percent or more of the profit from the lease. Additional guidance is given on the requirement that the aircraft or ship must operate in foreign commerce at least to the extent of more than 50 percent of the vessel's operations (compared with the 70 percent requirement under the existing regulations).[80]

II. Section 954(c)(6): Subpart F Look-Through Rule

Section 954(c)(6) (enacted as a part of TIPRA) provides that certain defined dividends, interests, rents, and royalties received or accrued by a CFC from a CFC that is a related person will not, under ordinary circumstances, be treated as a foreign personal holding income.

During the past year, several interpretation issues have emerged, including:

- whether an interest expense can be attributable to the payer's CFC subpart F income (by theoretically tracing such interest expense to the subpart F income); or
- whether such an allocation is even relevant for section 954(c)(6) purposes.[81]

Clarifying guidance is anticipated to be issued in early 2007 to address these issues.

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[75]*See* L. Nadal, "IRS Clarifies Use of U.S. Possessions Tax Benefits," *Tax Notes Int'l*, Sept. 18, 2006, p. 961.

[76]T.D. 9255, 71 *Fed. Reg.* 13,001 (Mar. 14, 2006).

[77]*See 2006 WTD 48-6* or *Doc 2006-4706*.

[78]2006-21 IRB 921 (May 22, 2005).

[79]2006-21 IRB 922 (May 22, 2005).

[80]*See* "Foreign Shipping Income May Satisfy New Tests to Qualify for Exclusion," *Standard Federal Tax Reports — Taxes on Parade*, May 11, 2006, p. 6.

[81]*See* J. Calianno and M. Collins, "The CFC Look-Through Rule: U.S. Congress Changes Landscape of Subpart F," *Tax Notes Int'l*, July 10, 2006, p. 141; J. Fuller, "U.S. Tax Review," *Tax Notes Int'l*, July 31, 2006, p. 427; and L. Yoder, "Technical Corrections in House Bill to the section 954(c)(6) Look-Thru Exception," *Tax Management Int'l Journal*, Oct. 13, 2006, p. 528.

JJ. Section 956: Bar Association Commentary on CFC and Loan Transactions

In response to the proposed regulations issued under section 954(i), which requested comments regarding the application of section 956 in the case of a loan by a CFC to a foreign partnership, in which one or more partners are U.S. shareholders of the CFC, the New York State Bar Association (NYSBA) Tax Section issued an extensive report.[82] Because section 956 is a tax trap for the practitioner, and because its taxability results are not always intuitive given the proliferation of foreign flow-through entities that are structured in connection with a CFC operation, attention should be given to these recommendations.

NYSBA concluded that a loan by a CFC to a related domestic partnership should continue to be treated as a section 956 investment in U.S. property regardless of what the loan proceeds were used for or whether the partners in the partnership were U.S. or foreign persons.

However, a loan by a CFC to a related foreign partnership should not be treated as a section 956 investment in U.S. property (again, without regard to whether the partners in the foreign partnership are U.S. or foreign partners), so long as the loan proceeds are not invested in U.S. property (or distributed to U.S. partners).

As a general exception, NYSBA commented that a loan by a CFC to a foreign partnership should be treated as a section 956 reinvestment if the loan would be treated under U.S. federal tax principles as made to a U.S. partner of the foreign partnership who is also a U.S. shareholder of the same CFC. It should be noted that the federal tax principles referenced in this comment pertain to well-established case law that would treat a thinly capitalized entity that issues debt guaranteed by its shareholder to be treated for federal tax purposes as debt being issued by the shareholder-guarantor.[83]

NYSBA recommended that Treas. reg. section 1.956-1T be amended to build in a new "principle purpose of tax avoidance" test for certain defined loan transactions, such as when the loan proceeds are distributed to a U.S. partner of the foreign partnership.

KK. Section 959: Previously Taxed Income

The IRS and Treasury have issued proposed regulations at prop. Treas. reg. section 1.959-1, -2, -3 and prop. Treas. reg. section 1.961-1, -2, -3, -4.[84] Fortunately, these regulations provide much-needed guidance in this highly technical area. In general, the regs address the maintenance of shareholder-level accounts for previously taxed income (PTI) and earnings and profits at the foreign-corporation level in PTI and non-PTI categories. Note also that the proposed regulations call for maintenance of the section 959(c) PTI and non-PTI categories on an aggregate basis by reference to all issued and outstanding shares of the foreign corporation. A detailed review of these regulations is beyond the scope of this article; however, several points are worth reviewing.

Section 959 is intended to prevent double taxation of income that has been previously included in a U.S. shareholder's gross income. Accordingly, distributions by a CFC of its E&P to a covered shareholder are excluded from gross income to the extent of the previously taxed E&P, commonly referred to as a PTI account. However, upon making the distribution, the U.S. shareholder's PTI account is reduced.

For shareholder-level exclusion under section 959, prop. Treas. reg. section 1.959-1(d)(1) requires that a PTI account for each share (or block of shares so long as the PTI attributable to each share is the same) in a foreign corporation be maintained by each covered shareholder. Note that shareholder status is determined under section 958(a) as either direct or indirect ownership. The regulations provide a detailed definition of a covered shareholder. A covered shareholder would be a U.S. person who has previously had a section 951(a) inclusion for his stock in the CFC, alternatively, qualifies under the "successor-in-interest" rules (see below), or finally, corporations that own stock in a foreign corporation that falls under one of the above definitions.

The proposed regulations provide for detailed disclosure and information reporting requirements for a transferee shareholder that constitutes a "successor-in-interest." Under prop. Treas. reg. section 1.959-1(d)(2)(i), the transferee of stock in a foreign corporation not only acquires the shares in the foreign corporation but also inherits the PTI account of the transferor and is eligible to exclude distributions of PTI from gross income. However, the regulations provide that the transferee must be a U.S. person and must substantiate its right to claim the "inherited" PTI exclusion. In addition to this section 959(a) shareholder-level exclusion, the proposed regulations provide under section 959(b) that a CFC's E&P attributable to amounts that are or have been included in the gross income of a U.S.

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[82] *See* NYSBA Tax Section, "Controlled Foreign Corporations and Foreign Partnership Loan Transactions," *Tax Notes Int'l*, Sept. 11, 2006, p. 915.

[83] See *Plantation Patterns v. U.S.*, 462 F.2d 712 (5th Cir. 1972).

[84] 71 *Fed. Reg.* 51,155 (Aug. 29, 2006).

shareholder under section 951(a) will not, when distributed through a chain of ownership, be included in the gross income of the CFC receiving the distribution. Prop. Treas. reg. section 1.959-2 provides detailed guidance on these rules and adopts Rev. Rul. 82-16.[85]

In addition to covering the shareholder- and corporate-level adjustments, the proposed regulations also provide detailed guidance on the appropriate adjustments in the basis of the foreign corporation stock and the shareholder-level PTI account. The regulations provide guidance on computing foreign currency gain or loss in basis adjustments for a taxpayer that elects to treat distributions as being made from a single pool of post-PTI for this purpose.

The effective date of the proposed regulations will be for the tax years of foreign corporations beginning on or after the promulgation date of the final regulations, and also to the U.S. shareholders in their tax years ending within those tax years of the foreign corporations.[86]

LL. Section 987: Proposed Regulations for Branch Currency Transactions

To more effectively calculate the section 987 qualified business unit's foreign currency gain and loss, the IRS and Treasury released prop. Treas. reg. section 1.987-1 through -11,[87] and withdrew the 1991 proposed regulations.[88] The new proposed regs seek to use a foreign exchange exposure pool method to minimize (if not eliminate) the realization of *noneconomic* foreign currency gain and loss. Though the proposed regs are highly technical and complex by using the foreign exchange exposure pool method to determine qualified business gain and loss, a balance sheet approach is used to determine exchange gain or loss and recognized on a remittance. Under this approach, the regulations distinguish between items whose value fluctuates with changes in the functional currency and those that do not. The proposed regulations are intended to incorporate profit and loss principles as well as net worth method principles, which under the old regulations were alternative methods. The proposed regulations generally become effective a year after the regulations are finalized and do not apply to financial institutions, including insurance companies and some trust companies. The IRS intends to issue separate guidance for those industries.[89]

Practitioner's Comment: The purpose of the branch currency transaction regulations, according to IRS and Treasury officials, is to arrive at the right economic answer regarding the determination of currency gains and losses. IRS officials have taken the position that the new regulations are intended to be neutral and not pro-government, and everyone seems to acknowledge that too much noneconomic gain or loss under the prior regulations was taken into account. For example, when the 1991 regulations were put into place, the U.S. dollar was in a very weak position. As the dollar appreciated over time, this resulted in significant foreign exchange gain exposure on which U.S. taxpayers paid significant U.S. income taxes, even though the underlying economics of the business did not truly trigger a tax. The new rules appropriately segregate financial and economically driven assets from those nonfinancial and economically driven assets.

MM. Section 1248: Tracking Earnings and Profits

In prop. Treas. reg. section 1.1248-8,[90] the IRS and Treasury address attribution of E&P associated with certain defined nonrecognition transactions. The proposed regulations also address the section 1248 aspects of the disposition of stock of a CFC by a foreign partnership. According to the comments in the proposed regulations, on the sale of the stock of a CFC, the partnership is viewed under the aggregate theory, and thus each partner is deemed to have sold its pro rata share of the underlying CFC.[91]

Practitioner's Comment: These proposed regulations will not become effective until they are issued in final format. As noted above, when a foreign partnership sells stock of a CFC, the proposed regulations determine that for section 1248 purposes, the taxpayer uses the aggregate approach for determining the bringing up of the dividends and the associated tax burden.

NN. Section 1291: Excess Distribution Elections

The IRS and Treasury adopted final regulations at Treas. reg. section 1.1291-9[92] to enable U.S. persons that continued to be subject to PFIC excess

[85]1982-1 C.B. 106 (Jan. 1982).

[86]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l*, Sept. 25, 2006, p. 1071.

[87]*See 2006 WTD 173-10* or *Doc 2006-18640*.

[88]Prop. Treas. reg. section 1.987-1,-2,-3, 56 *Fed. Reg.* 48,457 (Sept. 25, 1991).

[89]*See supra* note 86.

[90]*See 2006 WTD 107-8* or *Doc 2006-10534*.

[91]*See* N. Bress, C. Ocasal, and C. Markham, "Tracking the Proposed Changes to the § 1248 Regulations," *Tax Management Int'l Journal*, Oct. 13, 2006, p. 491.

[92]T.D. 9231, 70 *Fed. Reg.* 72,914 (Dec. 8, 2005).

distribution rules under section 1291 to make certain defined remedial elections. To purge PFIC taint, a shareholder must make the appropriate deemed sale or dividend election for the tax year that includes the termination date on the shareholder's original or amended return. When filing an amended return, the shareholder must make the deemed sale or dividend election within three years of the due date of the original return for the election year. The regulations define the termination date as the last day of the last tax year of the applicable foreign corporation in which the corporation constituted a PFIC as defined by section 1297(a).

In 1988 the IRS and Treasury issued temporary and proposed regulations that allowed a shareholder of a former PFIC to purge the PFIC taint through the deemed sale election procedure. The 1998 temporary and proposed regulations provided that in the case of a former PFIC that also constituted a CFC during the last relevant PFIC year, a shareholder may use the section 1291(d)(2)(B) deemed dividend election procedure to purge the PFIC taint. Furthermore, as mandated by section 7805(e)(2), these temporary regulations expired on January 2, 2001, even though a former PFIC no longer satisfies either the PFIC income test or the asset test. Under the old adage that an entity is "once a PFIC, always a PFIC," ongoing PFIC issues are attributable to shareholders of a former PFIC. The new final regulations will provide relief for tax years in that scenario.[93]

Practitioner's Comment: Since passage of the PFIC regime in 1986, the IRS and Treasury have periodically implemented regulations that would ameliorate the reporting and sometimes underlying tax burdens of a foreign corporation qualifying as a PFIC. From a practitioner's perspective, no one imagined that over 20 years ago when the PFIC regime was passed that it would wreak such havoc in international tax planning and cause so many unintended and unfair results. Because of the "once a PFIC, always a PFIC" rule, it is crucial for the IRS and Treasury to provide this type of remedial relief, particularly because many taxpayers have no idea they hold shares in a PFIC because of the lack of corporate information.

OO. Section 1361(b)(1)(D): Second Class of Stock

In LTR 200548021 (Aug. 23, 2005), the IRS ruled that a state law corporation that converted into an LLC and later made an election to be treated as an association taxable as a corporation would retain its S corporation status. The IRS determined that the entity would not be deemed through the restructuring to have created a second class of stock under section 1361(b)(1)(D), so long as the LLC governing documents, once executed, would not cause the entity to have a second class of stock. Figure 11 is an illustration.

Under the facts of the ruling, an entity incorporated under state law and elected to be treated as an S corporation (Step 1). For valid business reasons, the entity converted from a state law corporation to an LLC in the same state. The conversion was determined by the IRS to be a section 368(a)(1)(F) reorganization in LTR 200528021 (Apr. 8, 2005) (Step 2). The entity then made an election under Treas. reg. section 301.7701-3 to be treated as an association taxable as a corporation and then filed an S election (Step 3). The IRS explained that because the LLC governing documents only called for a single class of membership interest, the entity would not be treated as having a second class of stock. Once executed, the governing documents would be a binding agreement that defined each member's rights and obligations, including distributions and liquidation rights.

Practitioner's Comment: This sequential planning structure avoids a gain recognition event because of its F-type reorganization status and maintains a flow-through structure because of the favorable ruling regarding the S corporation result. Separate from the tax planning aspects, this structure also enables the operating entity to function as an LLC under state law but as an S corporation under federal law. One of the main advantages of this structure is that if the underlying owners encounter problems and creditors obtain a judgment, under most state laws, it is not permissible for the judgment creditor to levy and sell the member's interest in the LLC. The creditor can only obtain, via appropriate creditors' rights, distributions in respect to the member's interests in the LLC. Furthermore, for federal tax planning purposes, this structure enables the member group to take advantage of any S corporation tax rules that might not otherwise be available under subchapter K's partnership taxation rules.

PP. Section 1503(d): Dual Consolidated Loss Late-Filing Relief

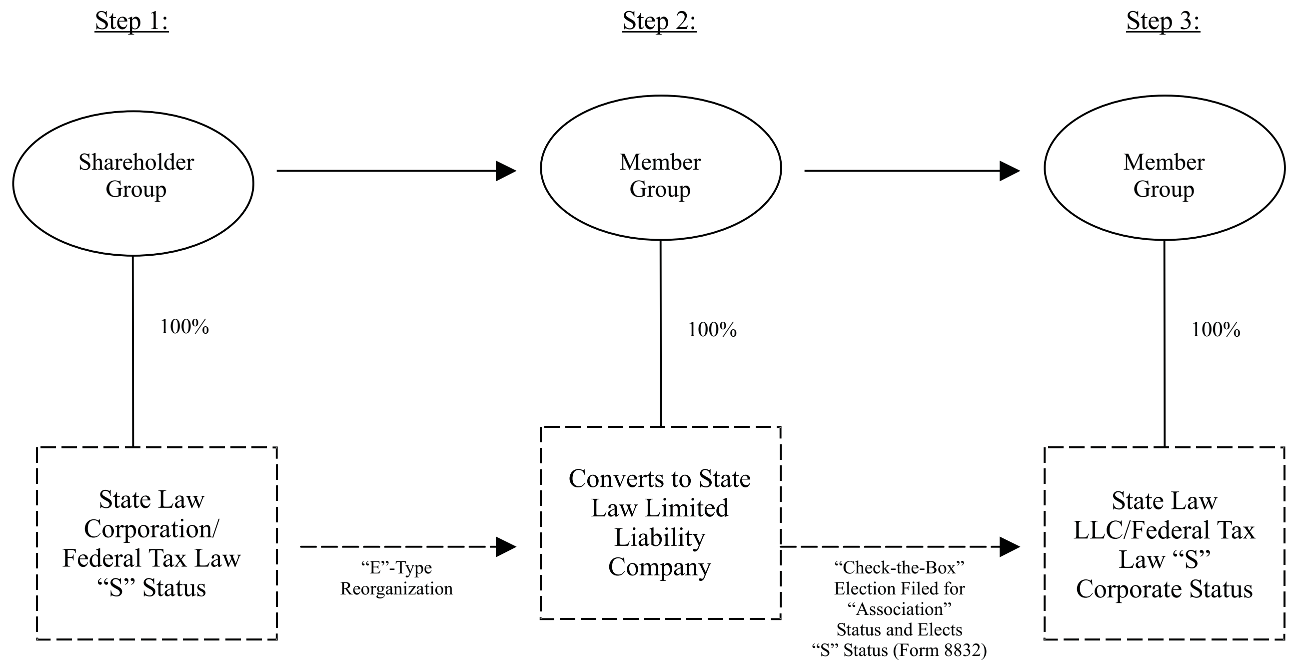
In Notice 2006-13,[94] the IRS announced that taxpayers that file agreements, statements, or other information under the dual consolidated loss provisions of section 1503(d), may rely on the reasonable cause standard set forth in the pending prop. Treas. reg. 1.1503(d)-1(c)(1)[95] rather than filing for relief under Treas. reg. section 301.9101-1. The notice

[93]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l*, Dec. 26, 2005, p. 1184.

[94]2006-8 IRB 496 (Feb. 21, 2006).

[95]70 *Fed. Reg.* 29,868 (May 24, 2005).

Figure 11



clarifies that the taxpayers that seek relief may still use the Treas. reg. section 301.9100-1 ruling process or use the proposed regulation's reasonable cause standard. In any event, the closing agreement requirement included in the existing regulations would be eliminated.[96]

QQ. Section 6011: Proposed Regs Targeting 'Transactions of Interest'

Under section 6011, certain defined disclosures must be filed by taxpayers who participate in a "reportable transaction," including listed transactions, confidential transactions, transactions with certain defined contractual protections, loss transactions, and transactions involving transitory or a very brief asset account period. As of December 8, 2006, the IRS has already targeted more than 35 listed transactions as abusive tax shelters.

Under prop. Treas. reg. section 1.6011-4(b),[97] taxpayers involved in reportable transactions are subject to new reporting obligations for a new category of reportable transactions known as "transactions of interest." In summary, transactions of interest are those transactions that the IRS has insufficient information to determine whether they are abusive. Once the information is obtained, the IRS has several choices, including elimination of the transaction from being reportable, designating the transaction as a listed transaction, or even identifying a new category of reportable transaction.

It is interesting that the proposed regulations include an expression of concern by the IRS regarding the recent trend to patent tax advice, tax analysis, and tax strategies. The IRS requests commentary on whether another new category of reportable transactions should be created or whether it should be dealt with in other ways. The proposed regulations also contain guidance on some confidential lease transactions and reporting by material advisers.[98]

RR. Section 6038 and Section 6679(A)(1): Reasonable Cause and Form 5471

In ILM 200645023 (June 20, 2006), the IRS determined that a U.S. corporation did not have "reasonable cause" for its failure to complete Form 5471,

[96]*See 2006 WTD 21-14* or *Doc 2006-1506*.

[97]T.D. 9295 (Nov. 1, 2006).

[98]*See* "Investors, Advisors Must Comply With Stricter Tax Shelter Disclosure Regs, Including New 'Transactions of Interest' Reports," *Standard Federal Tax Reports — Taxes on Parade*, Nov. 9, 2006, p. 3.

"Information Return on U.S. Persons With Respect to Certain Foreign Corporations." In the legal memorandum, the taxpayer acquired a foreign company, which in turn held various non-U.S. subsidiaries. The taxpayer corporation timely filed Form 5471 but did not attach Schedule O, and it also failed to prepare, translate, and report the form in U.S. dollars, in accordance with U.S. generally accepted accounting principles.

The IRS concluded that the taxpayer was not entitled to "reasonable cause" relief because it did not substantiate a reasonable reliance based on a belief that a filing was not required. In fact, the death knell of this case was that the corporation's tax adviser stated that a Form 5471 should be filed. The result of this legal memorandum is not surprising, especially since the taxpayer's tax professional advised that Form 5471 should be filed, and the taxpayer filed many Forms 5471 incompletely.[99]

Practitioner's Comment: The taxpayer's argument that it reasonably believed that it was not required to file Forms 5471 did not overcome the tax advice rendered by the tax professional. The IRS determined that the Forms 5471 that were filed were not substantially complete. The IRS held that the taxpayer's situation did not involve an excessive or unreasonable cost factor or any other grounds for undue hardship.

SS. Section 6048: Penalty Rules Apply to Gratuitous Transfers to Foreign Trusts

In Field Attorney Advice 20062701F (May 1, 2006), the IRS determined that an original owner and transferor of assets to a foreign trust was required to file section 6048(a) and 6048(b) information returns because the multiple gratuitous transfers made to the foreign trust in question constituted reportable transactions. Failure to file appropriate reports subjects the taxpayer to penalties under section 6677(a). In reviewing the facts of this release, it is interesting that the taxpayer, who served as the president and chairman of the board of the U.S. company in question, entered into a tax avoidance arrangement designed to save taxes and transfer assets offshore. Settling two separate foreign trusts, one of the ideas was to create an offshore-deferred compensation arrangement.

Section 6048(a) requires U.S. persons to report gratuitous transfers to foreign trusts on Form 3520. The failure to do so triggers a section 6677(a) reporting penalty equal to 35 percent of the gross value of the transferred property. The IRS took into account all of the taxpayer's transfers, including premium payments for an insurance policy under the trust arrangement, some stock from a U.S. company of which the taxpayer was president, and funds from a U.S. company that settled the foreign country's account. Further, under section 6048(b), the specific 5 percent penalty for failure to report information on the trust is computed each year based on the gross value of the trust assets that are treated as owned by the taxpayer at the end of the applicable tax year.

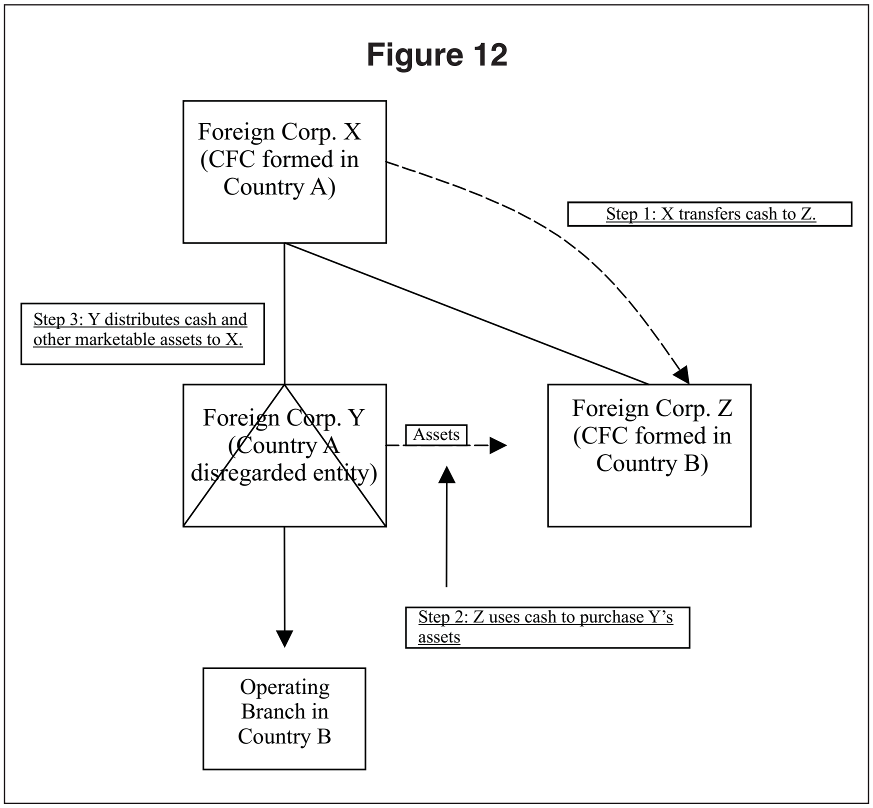
The section 6677(a) penalty is measured based on all of the life insurance premium payments, the fair market value of the described service recipient corporation stock that was sold to the foreign annuity entity, and the transfers to the foreign entity company accounts via the offshore leaving company. In addition to the 35 percent Form 3520 penalty, the IRS assessed penalties under Form 3520-A for failure to file the annual reporting forms (and thus subject to a penalty of 5 percent of the gross value of the foreign trust for each year of nonfiling).

The IRS also assessed a penalty under section 6038(a)(1) for failure to file a Form 5471 because the taxpayer continued to control the underlying entities within the meaning of Treas. reg. section 1.6038-2(b) (reviewing the more than 50 percent voting power rule and taking into account the section 318(a) constructive ownership rules). The section 6038(a)(1) penalty for failure to file for each entity is $10,000 for each year, with a surcharge of $10,000 for each 30-day period, capped at $50,000 if the failure continues for more than 90 days after the IRS issues written notice to the taxpayer.

Practitioner's Comment: Based on a closer view of this field attorney advice, practitioners should have a jump start on avoiding potential abusive transactions similar to the complicated fact pattern described in this pronouncement. First, the type of transaction described in the field attorney advice was included as a listed transaction in Notice 2003-22.[100] The domestic entity continued to claim significant section 162 deductions for compensation paid to its president while at the same time it structured the compensation package through a complicated offshore structure to avoid reporting the compensation as income and paying tax on it. This set of facts involved in this field attorney advice appears to be even more abusive given the apparent forgery of a Form 3520. The IRS concluded that the taxpayer failed to file a Form 3520 and was liable for the 35 percent penalty as prescribed by section 6677(a). Note that the field attorney advice addresses several income tax issues and related penalties but does not take into account any potential U.S. gift tax exposure. One explanation is that the IRS concluded that the described domestic trust constituted a grantor

[99]*See 2006 WTD 220-15* or *Doc 2006-22973*.

[100]2003-1 C.B. 851 (Jan. 2003).



trust — but based on the language of the trust as presented in the pronouncement, this is not totally clear. Very little commentary was noted regarding the foreign trust in which the taxpayer's wife and children were the sole beneficiaries.

TT. Section 7701: Addition to Per Se Corporation List

In Notice 2007-10,[101] the IRS supplemented the list of entities that are treated as per se corporations under Treas. reg. 301.7701-2(b)(8) by adding the Bulgarian *Attsionerno Druzhestvo* entity. Because Bulgaria became a full member of the European Union as of January 1, 2007, the IRS determined it appropriate to expand the list. Temporary and proposed regulations modifying the per se corporations list will be issued in early 2007.

UU. Section 7701: Circular Flow of Cash Treated as 351 Transfer

In LTR 200627022 (Apr. 13, 2006), the IRS ruled that the circular flow of cash (see Figure 12) should be disregarded and the transaction treated for U.S. federal income tax purposes as a section 351(a) transfer of assets from X to Z. X transferred cash to Z, Z used the cash to purchase the assets of Y (which operated a branch in country B), and Y distributed the cash and other marketable assets to X. Consistent with Treas. reg. section 301.7701-3 check-the-box regulations, the transactions in steps two and three involving Foreign Corp. Y were disregarded.[102]

Practitioner's Comment: This ruling supports the substance and form of Treas. reg. section 301.7701-3, the check-the-box regs. One of the most likely objectives of this plan was to move assets from Y to Z for purposes of country B taxation. It is likely that country A is a low tax or very modest tax jurisdiction, because this properly structured Y might have received the cash to avoid taxation in country B (thereby falling back on the low tax jurisdiction of country A).

VV. Section 7701: Rescission Transaction Recharacterization of Abandoned Initial Public Offering

In LTR 200613027 (Dec. 16, 2005), a domestic LLC was owned by two members and was treated as a partnership for U.S. federal tax purposes. To prepare for an anticipated public offering, the domestic LLC converted into a corporation under state law. However, because of the softening initial public offering market, the underwriting was abandoned. Under state law, the corporation was reconverted from a corporation to an LLC. The rescission transaction was implemented according to a rescission agreement. The IRS ruled that based on an earlier published ruling,[103] the entity at issue would be treated during the tax year as a partnership for federal tax purposes.[104]

Practitioner's Comment: Although this is not an international ruling, it could apply in the international arena, subject to special considerations such as sections 367 and 1248. The most important fact of the ruling is that all events occurred during the same tax year, that is, the calendar year. As noted above, this ruling is based on Rev. Rul. 80-58,

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[101]2007-4 IRB 1 (Dec. 22, 2006).

[102]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l*, Aug. 28, 2006, p. 775.

[103]Rev. Rul. 80-58, 1980-1 C.B. 181 (Jan. 1980).

[104]*See* J. Fuller, "U.S. Tax Review," *Tax Notes Int'l*, Apr. 24, 2006, p. 354.

commonly known as the IRS's "rescission ruling." Rescission is defined as an abrogation, canceling, or voiding of a contract that results in a releasing of the contracting parties from further obligations. More importantly, it restores the parties to the relative positions they would have occupied had no contract been made. This is commonly referred to as the "status quo" element. Also, the rescission action must take place in the same tax year to true-up any U.S. federal tax consequences of the initial transaction and its subsequent rescission. This enables the affected parties to treat the rescission transaction in a consistent manner during the annual accounting period. This is commonly referred to as the same-year-only element, which must be carefully considered. Although this ruling and Rev. Rul. 80-58 involve rescission relating to the sale of property, this ruling can be used in other types of business transactions, ranging from stock option grants, gift transactions, trust transactions, and even corporate reorganizations, distributions, and dividend transactions. In contrast to this specific fact pattern, LTR 200533002 (Apr. 28, 2005) also dealt with a rescission transaction in which an S corporation was reinstated after converting to a C corporation.

WW. Section 7874: Updated Anti-Inversion Regulations

The Jobs Act enacted the section 7874 anti-inversion statute that prohibits U.S.-controlled companies from restructuring to emerge as a foreign-owned company to enable the restructured company to escape U.S. corporate income tax with respect to non-U.S. operating source income. Inversion transactions have been structured for decades, and since the passage of section 367 in 1976, the general consensus was that the outbound toll charge rules would prohibit or limit the benefit by taxing the gain realized on the shares exchanged. However, in many cases, shareholders did not always realize a gain. In the end, the restructured foreign-controlled business operation would avoid U.S. corporate income tax for some foreign-structured business units of the inverted group.

On December 28, 2005, the IRS and Treasury introduced temp. Treas. reg. section 1.7874-IT[105] to provide guidance on the definition of an ownership determination for anti-inversion purposes. It also put the public on notice that forthcoming regulations may have a retroactive effect, particularly for some structures that have yet to be defined but nonetheless have the impact of avoiding section 7874. These temporary regulations also refer to potential abuses involving publicly traded partnerships and the need for regulations.[106]

On June 6, 2006, the IRS and Treasury released the second set of anti-inversion regulations, at temp. Treas. reg. section 1.7874- 2T.[107] These temporary regulations provide guidance on the substantial business test that may be subject to exempt treatment to the general anti-inversion rule, and also provided guidance for some transactions that would otherwise have the effect of inversion transactions. The effective date of the June temporary regulations is June 6, 2006; however, an exception exists for binding commitments that existed as of December 28, 2005.

The June regulations also address acquisitions of trade or business assets of a domestic partnership or stock of a domestic corporation by publicly traded foreign partnerships that would be treated as a corporation at any time within two years of the acquisition at issue but for the impact of section 7704(c). As a general rule, if the 80 percent overlap ownership threshold is applicable, the publicly traded foreign partnership is deemed to have converted to a domestic partnership before the acquisition.

According to IRS and Treasury officials, a third set of regulations should be issued in early 2007. These regulations will cover a variety of topics, including:

- providing guidance to the four-year window under section 7874;
- the treatment of stock that is sold at a public offering that is related to an acquisition; and
- the meaning of "substantially all" when a foreign entity is considered to acquire that threshold of property of a domestic business.[108]

Practitioner's Comment: It is interesting to note that all of the regulatory attention to treating publicly created partnerships as a target under the section 7874 anti-inversion rules can be attributed to a glitch in the 2004 tax legislation. Recall that the Jobs Act repealed sections 551-558 foreign personal holding company income provisions because Congress believed they were duplicative to the subpart F and PFIC anti-deferral provisions. However, this opened the door because removal of the FPHC attribution rule meant that in using a publicly

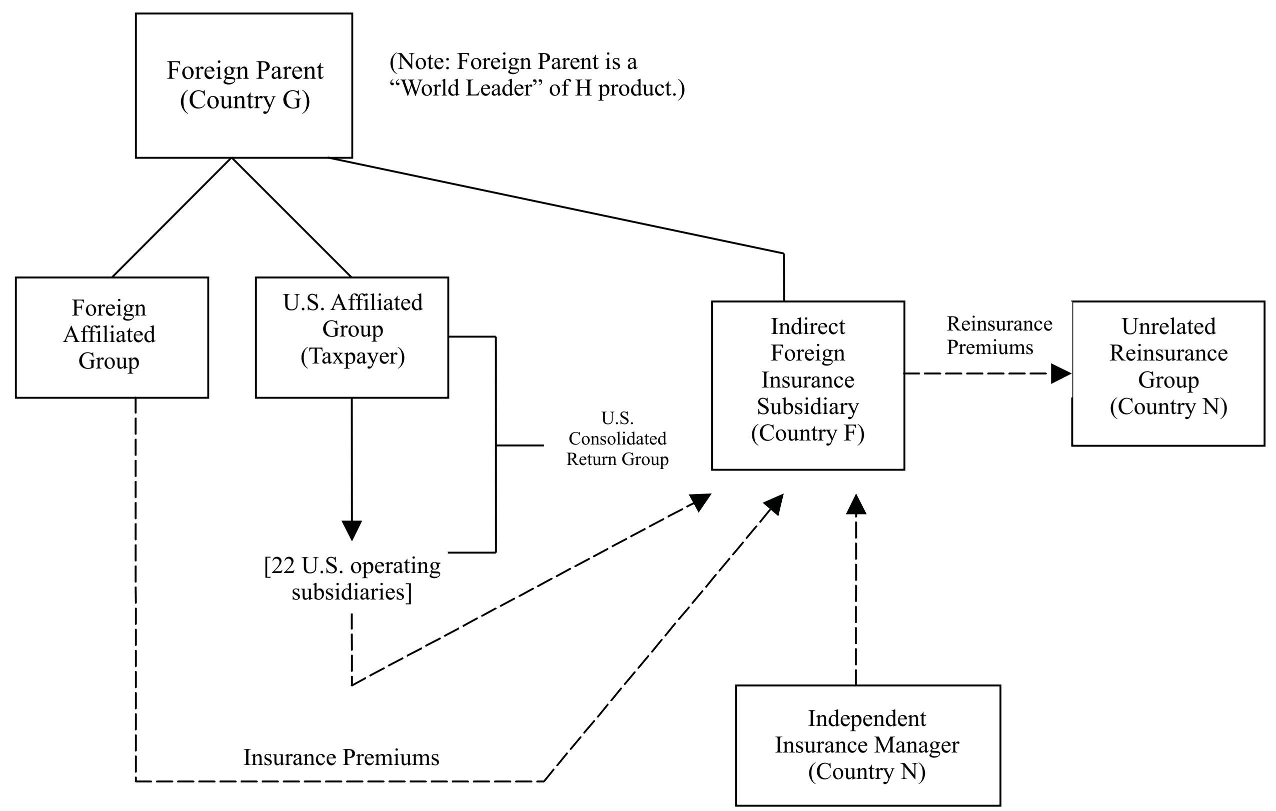
[105]T.D. 9238, 70 *Fed. Reg.* 76,685 (Dec. 28, 2005).

[106]*See* "Temporary Regs Exempt Certain Restructurings/Acquisitions From Corporate Inversion Rules," *Standard Federal Tax Reports — Taxes on Parade*, Jan. 5, 2006, p. 4.

[107]T.D. 9265, 71 *Fed. Reg.* 32,437 (June 6, 2006).

[108]*See* "Temp Regs Expand Curb on Foreign/Domestic Corporate Inversions; Create Safe Harbors," *Standard Federal Tax Reports — Taxes on Parade*, June 8, 2006, p. 6.

Figure 13



traded foreign partnership, relevant attribution rules were no longer available to cause a problem at the U.S. shareholder level. More important, because the goal of the section 7874 anti-inversion rules is to impose a corporate level tax on the surrogate foreign corporation, the use of a publicly traded foreign partnership seemingly escaped that rule.

II. Inbound Developments in Specific Code Sections

A. Section 11: Physical Data

According to the summer 2006 *Statistics of Income Bulletin*,[109] the IRS reported that only 1.1 percent of all U.S. corporate taxpayers consisted of foreign controlled domestic corporations. However, these entities accounted for 12.4 percent of corporate business receipts for 2003 and 11 percent of all corporate assets. For the 2003 tax year, foreign controlled domestic corporations filed 58,945 returns, reported $2.6 trillion in total receipts, and reported net profits of $32 billion (compared with $7.8 billion for 2002).

[109]News Release IR-2006-149 (Sept. 22, 2006).

B. Section 162: Subsidiary's Insurance Payments Constitute Insurance Premiums for Foreign Parent

In LTR 200636085 (May 30, 2006), the IRS ruled that amounts paid by a foreign parent corporation's wholly owned affiliated operating subsidiaries to an affiliated foreign insurance company constituted insurance premiums for section 162 business expense deduction purposes. Figure 13 shows the insurance and reinsurance structure.

Here, Foreign Parent's U.S. and foreign affiliated group members entered into insurance contracts with Foreign Insurance Subsidiary, which in turn entered into reinsurance contracts with Unrelated Reinsurance Group. The management of Indirect Foreign Insurance Subsidiary was conducted by Independent Insurance Manager, an independent group based in a separate country (but the same country in which Unrelated Insurance Group was based).

The taxpayer (one of the wholly owned subsidiaries of Foreign Parent) represented that:

- Indirect Foreign Insurance Subsidiary's obligations were not guaranteed by Foreign Parent or any subsidiary;
- Indirect Foreign Insurance Subsidiary was adequately capitalized in light of its risk exposure and reinsurance coverage;
- no one member of the group of insured companies had more than 15 percent of the total risk covered by Indirect Foreign Insurance Subsidiary; and
- the amount of premiums paid by the taxpayer and the other subsidiaries reflected commercial rates for the insurance involved.

Practitioner's Comment: The ruling provides an excellent overview of the applicable rules for claiming a deduction for insurance premiums paid within a related party group, including a thorough discussion of risk shifting and risk distribution. The IRS noted that Indirect Foreign Insurance Subsidiary distributed the excepted risk by accepting premiums from the multiple group members, determined at arm's length, and this arrangement constituted insurance for U.S. federal income tax purposes, citing Rev. Rul. 2002-90.[110] Although the IRS ruled that the arrangement constituted insurance, the IRS disclaimed that no opinion was expressed on whether the amount of premiums charged by Indirect Foreign Insurance Subsidiary was calculated correctly. The IRS also disclaimed a ruling on whether Indirect Foreign Insurance Subsidiary or Unrelated Reinsurance Group are treated as insurance companies for U.S. federal tax purposes.

C. Section 368(a)(1)(A): Reorganization of Separate Chains

In LTR 200644021 (July 28, 2006),[111] the IRS ruled that a foreign parent company could reorganize its separate chains of U.S. subsidiaries through a series of statutory mergers in which preexisting gains from intercompany transactions will continue to be deferred. Figure 14 illustrates the organizational structure.

Parent is a country X corporation that is the parent of a worldwide group of insurance and financial service corporations. FS 1 is a country X corporation whose common stock is wholly held by Parent and whose preferred stock is held by the public. FS 2 is a country X corporation wholly owned by FS 1. U.S. Parent 1 is a domestic LLC that operates as a holding company, has elected to be treated as a corporation for U.S. federal tax purposes, and is wholly owned by FS 2. Sub 1 is a domestic holding company wholly owned by Parent 1. Lifeco 1 is a domestic life insurance company wholly owned by Sub 1. Lifeco 2 and Lifeco 3 are country Y reinsurance companies that have elected to be taxed as domestic corporations. Lifeco 2 is wholly owned by Sub 1 and Lifeco 3 is wholly owned by Lifeco 2. Sub 1, Lifeco 1, Lifeco 2, and Lifeco 3 are members of the U.S. Parent 1 group.

U.S. Parent 2 is a domestic LLC, has elected to be treated as a corporation for U.S. federal tax purposes, and is wholly owned by Parent. Sub 2 is a domestic holding company wholly owned by U.S. Parent 2. Lifeco 4 is a domestic life insurance company that is wholly owned by Sub 2. Lifeco 5 is a country Y reinsurance company that has elected to be taxed as a domestic corporation and is wholly owned by Sub 2. Sub 2, Lifeco 4, and Lifeco 5 are members of the U.S. Parent 2 group.

Lifeco 2 reinsures life insurance businesses from affiliated and unrelated insurers and reinsurers. Lifeco 3 and Lifeco 5 reinsure life insurance business from affiliates. Lifeco 2, Lifeco 3, and Lifeco 5 conduct no other business activities. In previous years, members of the U.S. Parent 1 group sold or distributed property to other members of that group, which resulted in the deferral of gains by Lifeco 1 and Lifeco 2 under to Treas. reg. section 1.1502-13. Accordingly, these deferred items would be taken into account upon Sub 1, Lifeco 1, Lifeco 2, or Lifeco 3 ceasing to be a member of the U.S. Parent 1 group.

In a previous year, FS 1 restructured its U.S. operations. These transactions would have resulted in branch profits tax liability, which in the absence of rulings from the IRS requires FS 1 to agree to recognize some amounts in income for U.S. federal tax purposes.

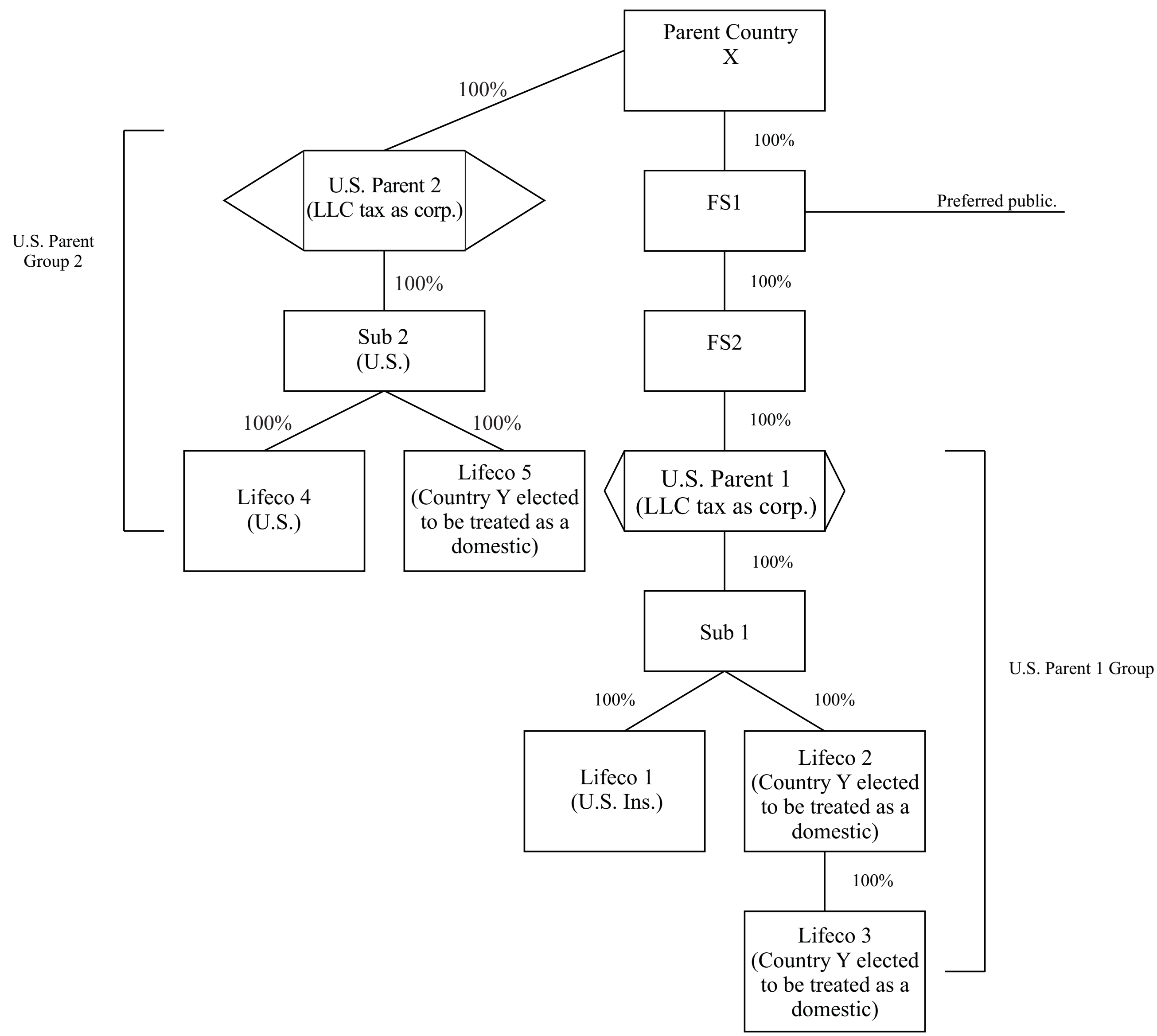
Parent now desires to combine the two U.S. Parent groups to minimize the inefficiencies and expenses of operating two separate U.S. groups. Parent proposes the following reorganization:

- FS 1 will distribute all the stock of FS 2 to Parent;
- Parent will contribute some or all of its interest in U.S. Parent 2 to FS 2;
- U.S. Parent 1 will merge into U.S. Parent 2 in a statutory merger that will not be a "reverse acquisition" of U.S. Parent 2 under Treas. reg. section 1.1502-75(d)(3);
- Sub 1 will merge into Sub 2 in a statutory merger in which Sub 2 will issue one additional share of its stock to U.S. Parent 2;
- Lifeco 1 will merge into Lifeco 4 in a statutory merger in which Lifeco 4 will issue one additional share of its stock to Sub 2;

[110] 2002-2 C.B. 985 (Dec. 30, 2002).

[111] *See 2006 WTD 215-15* or *Doc 2006-22471*.

Figure 14



- Lifeco 3 will transfer all of its assets to Lifeco 5;
- Lifeco 5 will assume all of the liabilities, rights, and obligations of Lifeco 3;
- Lifeco 3 will be liquidated;
- Lifeco 2 will transfer all of its assets to Lifeco 5;
- Lifeco 5 will assume all of the liabilities, rights, and obligations of Lifeco 2; and
- Lifeco 2 will be liquidated.

In reaching its ruling, the IRS specifically stated that it expressed no opinion regarding the branch profits tax liability resulting from the merger. However, it held that the U.S. Parent 2 group will be treated as terminating the U.S. Parent 1 group under Treas. reg. section 1.1502-13(j)(5). The successors to U.S. Parent 1, Sub 1, Lifeco 1, Lifeco 2, and Lifeco 3 will be treated as includable members of the U.S. Parent 2 group immediately after the proposed reorganization. Accordingly, the IRS stated that the

U.S. Parent 1 deferred income from the previous years intergroup transactions of the U.S. Parent 1 group would continue to be deferred following the reorganization.

D. Section 861: Foreign Taxpayer Gross Income Reduced

In TAM 200615034 (Feb. 3, 2005), the IRS determined that a foreign taxpayer's distributive share of gross income from a domestic partnership is reduced by the foreign taxpayer's allocable share of section 174 research and experimentation expenses in accordance with Treas. reg. section 1.861-17.

Although the facts to this TAM are somewhat complicated, in summary, the foreign taxpayer was a foreign corporation engaged in the research, development, manufacturing, and marketing business for a specified industry. The taxpayer's U.S. operations were conducted through a wholly owned U.S. subsidiary, as well as through an alliance with an unrelated U.S. company.

The foreign taxpayer organized a partnership in the U.S. that performed marketing and wholesale activities for products in the taxpayer's primary industry. The partnership also owned a manufacturing operation in the U.S. and licensed intangible property attributable to the taxpayer's worldwide research and experimentation activities. It is interesting that the taxpayer filed a protective election on Form 1120-F for its position on aggregation and allocation of the research and experimentation (R&E) activities based on whatever product categories were ultimately determined to be applicable for the partnership's income.[112]

Because the R&E expenses were related to the taxpayer's distributive share of the partnership income, the IRS, in applying Treas. reg. section 1.861-17, allocated and apportioned these expenses to the taxpayer's distributive share of income. In approving this apportionment and allocation, the IRS agreed that the aggregate approach (as opposed to the entity approach) justified the allocation and apportionment.

E. Section 861: Final Regulations on Alternative Tax Book Value Method

On January 31, 2006, the IRS and Treasury issued temp. Treas. reg. section 1.861-9T,[113] which substantially adopted the previously issued temporary and proposed regulations.[114] Under the final regulations, taxpayers may elect to apply an alternative method of valuing assets to apportion expenses under the tax book value method as prescribed by Treas. reg. section 1.861-9T. The preamble to the final regulations explains that the alternative method is intended to minimize basis disparities between foreign and domestic assets of some specified entities that could arise when those entities use adjusted tax basis to value assets under the tax book value method of expense apportionment. Note that if taxpayers elect to use the alternative tax book value method, they may change to use the fair market value method on the IRS's consent.[115]

F. Section 863: Space, Ocean, and International Communications

On December 26, 2006, the IRS published final regulations at Treas. reg. section 1.863-8,-9,[116] which govern the source of income from space, ocean, and international communications. In general, under section 863, any income derived by a U.S. person from a space or ocean activity is income from sources within the United States.[117] If a foreign person derives the income, the income is from sources without the United States.[118] An exception is that a U.S. person's space or ocean income will be considered from sources without the United States to the extent the income is attributable to functions performed, resources employed, or risks assumed in a foreign country. There are two exceptions for income derived by a foreign person. First, space or ocean income derived by a CFC will be considered U.S.-source income. Second, space or ocean income that is attributable to functions performed, resources employed, or risks assumed within the United States will be considered U.S.-source income.

International communications income of a U.S. person is sourced half within and half without the United States. A foreign person's international communications income is sourced outside the United States,[119] but if the income derived is attributable to an office or other fixed place of business in the United States, it is considered U.S.-source income. International communications income derived by a CFC is sourced half to the United States and half without the United States.

G. Section 871: Bonds Titled in Foreign Book-Entry Systems

In Notice 2006-99,[120] the IRS issued guidance on treating certain defined dematerialized bonds and

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[112]*See* Treas. reg. section 1.861-17(a)(2)(ii).

[113]T.D. 9247, 71 *Fed. Reg.* 4813 (Jan. 30, 2006).

[114]T.D. 9120, 69 *Fed. Reg.* 15,673 (Mar. 26, 2004).

[115]*See 2006 WTD 19-10* or *Doc 2006-1696*.

[116]T.D. 9305, 71 *Fed. Reg.* 77594.

[117]Section 863(d)(1)(A).

[118]Section 863(d)(1)(B).

[119]Section 863(e).

[120]2006-46 IRB 907 (Oct. 26, 2006).

whether they are to be treated as registered bonds or bearer bonds when held and ultimately transferred in a non-U.S. or foreign book-entry system. Most U.S. markets trade bonds in certified form, whereas in Europe and Asia, uncertified or dematerialized bond trading has become prevalent. Dematerialized bonds have no physical documentation, and ownership is governed by electronic records maintained by a foreign clearinghouse authorized under local law. In the notice, the IRS and Treasury acknowledged that dematerialized book-entry systems for trading bonds offer significant efficiencies for the securities markets. In some cases, dematerialized bonds will be treated as being in registered form, but some bonds in bearer form issued before January 1, 2007, need to be treated in bearer form to comply with Treas. reg. section 1.163-5(c)(2)(i)(D).[121]

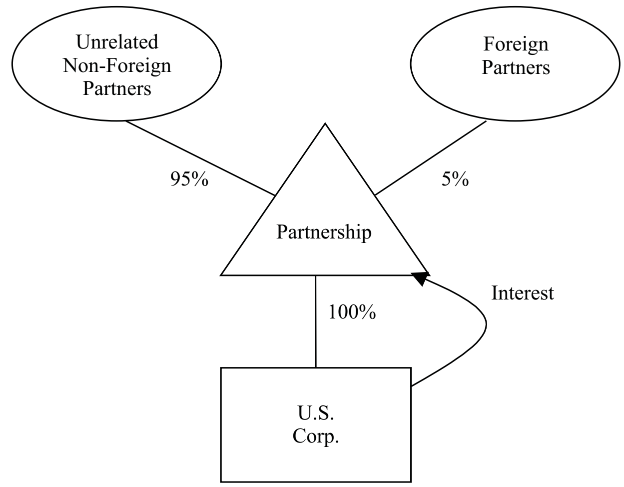
H. Section 871: Portfolio Interest Ownership Test

Under sections 871(h) and 881(c), the ordinarily applicable 30 percent withholding tax imposed on U.S.-source fixed or determinable annual or periodic income (FDAP) paid to a nonresident alien individual or foreign corporation that is not otherwise treated as effectively connected is tax free. An exception is when a nonresident alien individual or foreign corporation receives portfolio interest. However, portfolio interest does not include interest received by a significant stakeholder in a corporation that is the debtor for a loan transaction, including a 10 percent shareholder in such a debtor corporation.[122]

On June 12, 2006, the IRS and Treasury released prop. Treas. reg. section 1.871-14[123] to clarify the issue of whether portfolio interest earned by a partnership or trust for purposes of conducting the 10 percent ownership test is tested at the partnership level or the partner level. As illustrated in Figure 15, if a partnership interposed between a U.S. corporate borrower and a financing group has foreign and nonforeign partners, how would the portfolio interest rules work for the 5 percent foreign partner, who would be treated as an indirect 5 percent owner of the U.S. corporate borrower?

The proposed regulations provide that the 10 percent ownership test is conducted at the partner level for interest earned by a partnership. The regulations also provide that the timing for determining the 10 percent ownership status is the time

Figure 15



at which the withholding agent would otherwise be required to withhold tax and file withholding documentation for the interest at issue. The proposed regulations contain similar rules for interest received by a grantor or simple trust.[124]

Practitioner's Comment: Because of the crucial planning importance of the portfolio interest exemption, and given that many foreign lenders wear a lending cap and an equity investor cap, it is important to work through the rules for portfolio interest structures involving partnerships. Although the proposed regulations represent a welcome clarification to the 10 percent ownership test, at the same time, the approach taken by the regulations for determining the test at the time the withholding agent is required to withhold and remit the appropriate withholding tax places an unclear standard on the withholding agent. For example, does this rule mean that the withholding agent looks at the partnership and the underlying partners as of March of the year following the year in which the interest is paid and withholding discounts are issued (K-1, Form 1042)? Or does it mean that the withholding agent looks back to the actual status of each partner during that year? And what happens in the event a partner who owns 6 percent of a partnership interest during the relevant calendar year of the partnership becomes

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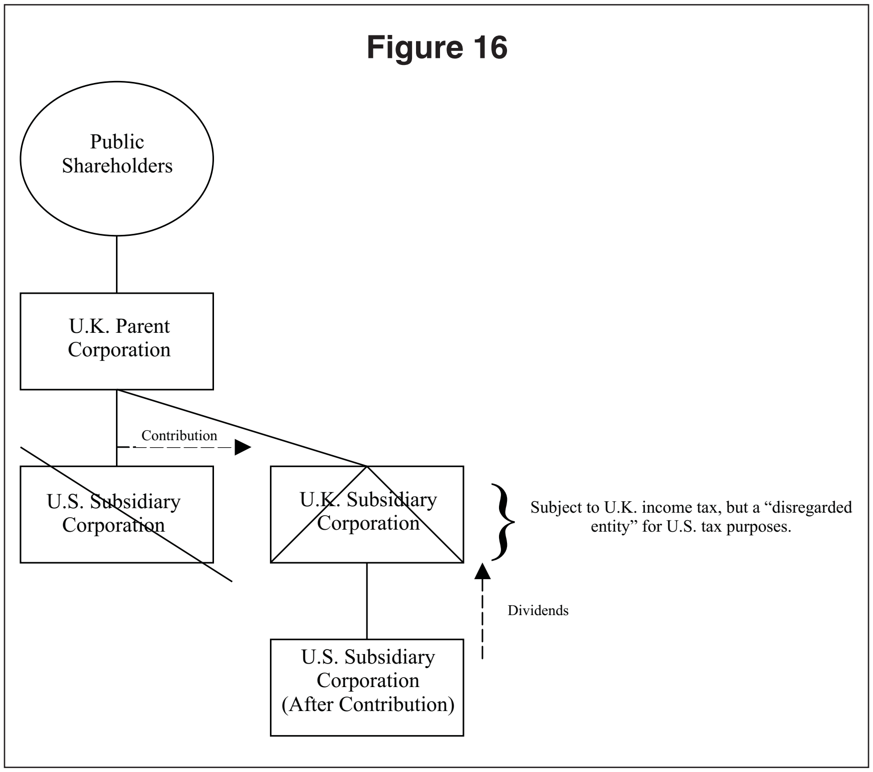
[121]*See*, J. Fuller, "U.S. Tax Review," *Tax Notes Int'l*, Nov. 27, 2006, p. 695.

[122]*See* sections 871(h)(3)(B) and 881(c)(3)(B).

[123]71 *Fed. Reg.* 34,047.

[124]*See* E. Tanenbaum, "Portfolio Interest and Foreign Partners — Aggregate or Entity," *Tax Management Int'l Journal*, Oct. 13, 2006, p. 527; and "IRS Extends Portfolio Interest Exception in Partnerships and Trusts," *Standard Federal Tax Reports — Taxes on Parade*, June 15, 2006, p. 3.



an 11 percent partner after that year but before March 31 of the following year? These are all questions that hopefully will be addressed in forthcoming regulatory guidance.

I. Section 894: Dividend Treatment Under U.K.-U.S. Treaty

In LTR 200626009 (Mar. 9, 2006), the IRS ruled that a distribution by a U.K. corporation of all of the issued and outstanding stock of its U.S. subsidiary to an affiliated U.K. company will not result in disqualifying a declared dividend under the U.K.-U.S. income tax treaty. The U.K. parent corporation was publicly traded on the London Stock Exchange. Figure 16 is an illustration.

Under one fact pattern, the U.S. subsidiary paid a dividend to its U.K. parent company and claimed that the dividend was eligible for an exemption from source taxation under article 10(3)(a) of the U.K.-U.S. income tax treaty. The U.K. parent had owned the shares of the U.S. subsidiary for more than 12 months when the dividend was declared and otherwise qualified for benefits under article 10(3) of the U.K.-U.S. income tax treaty.

The U.K. parent then contributed the U.S. subsidiary stock to a wholly owned U.K. company, and the transferee U.K. company filed an election under Treas. reg. section 301.7701-3 to be disregarded as an entity separate from its owner for U.S. federal tax purposes. The U.K. parent was still deemed to own the U.S. subsidiary, not the U.K. transferee corporation. The dividend declared on the third date mentioned in the ruling was less than 12 months after the transfer described above.

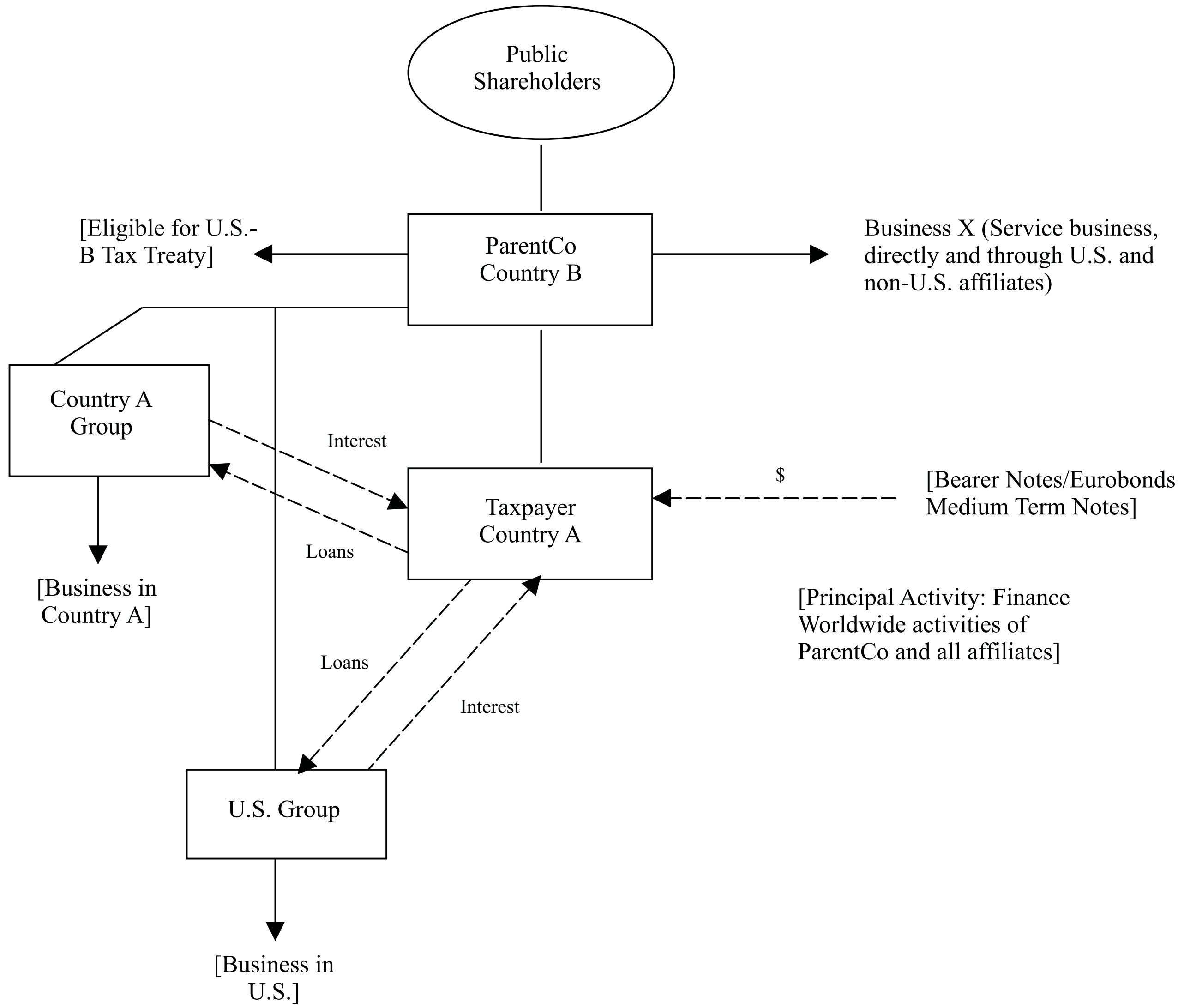
The taxpayer represented that:

- the U.K. transferee company was not an agent, nominee, intermediary, or conduit as determined under U.S. tax principles for the dividend declared;
- the U.K. transferee corporation was a tax resident of the U.K. for U.K. tax purposes (and otherwise subject to U.K. taxation with respect to the dividend); and
- the U.K. parent corporation as well as the U.K. transferee corporation met the requirements of article 10(3)(a)(ii) on the dividend declaration date at all times during the 12-month period ending on the date of the ruling.

The ruling provides a useful summary of the treaty dividend exemption rule. The dividend paid by the U.S. subsidiary must be derived by and beneficially owned by a resident of the U.K., and the beneficial owner must own 80 percent or more of the shares of the corporation paying the dividend for a 12-month period ending on the date the dividend is declared. The ruling notes that the U.K. transferee corporation is a disregarded entity from its owner, the U.K. parent, but it is liable to pay the taxes of the corporation under U.K. law. The dividend is treated for U.K. tax purposes as income, profit, or gain of a resident, and thus under article 1(8) of the U.K.-U.S. income tax treaty, the dividend is deemed to be derived by a resident of the U.K.

Even though the U.K. transferee corporation is a disregarded entity for U.S. federal tax purposes, for treaty purposes the IRS ruled that it is the beneficial owner of the dividend. The ruling further concludes that even though the U.K. transferee corporation did not hold the shares of the U.S. subsidiary for the entire 12-month holding period as required by article 10(3), the proper analysis is to take into account the aggregate days during which both the U.K. parent corporation and the U.K. transferee corporation (as the disregarded entity) owned shares representing 80 percent or more of the voting power of the U.S. subsidiary.

Figure 17



J. Section 894: Treaty Benefits Connected to a Trade or Business

In LTR 200620017 (Feb. 9, 2006), the IRS ruled that a foreign corporation that did not otherwise qualify for benefits under the applicable U.S. tax treaty may obtain treaty benefits on some items of income that are connected to a trade or business in the company's country of residence through indirect common ownership of related group. Figure 17 is an abbreviated illustration of the somewhat complicated fact pattern.

Under Figure 17, the taxpayer, organized under the laws of country A, served as the global financial group to ParentCo and its worldwide affiliates, including some U.S. affiliates. The taxpayer made loans to several components of the group, including about 15 percent to the U.S. affiliated group, which used the loan proceeds for capital expenditures and business operations.

The taxpayer raised the loan funding by issuing notes to the public in the U.S. and on international capital markets by the issuance of medium-term notes. The taxpayer also borrowed relatively smaller amounts from various banks. A portion of the notes were issued in bearer form as Eurobonds and medium-term notes, and the taxpayer issued the bearer notes under procedures that complied with sections 163(f)(2)(B), 871(h), and 881(c). The taxpayer received interest payments from members of the U.S. group, and these interest payments are the income of the taxpayer at issue.

During a series of acquisitions, ParentCo's affiliate purchased all of the issued and outstanding shares of country A group and its affiliates. The country A group consisted solely of the unspecified business activities related to Business X in country A (in fact, this was the third-largest participant in Business X in country A). Similarly, ParentCo (through various subsidiaries) owned all of the issued and outstanding stock of the U.S. group, whose activities consisted solely of Business X-related activities within the U.S. The U.S. group ranked as the fourth-largest participant in Business X activities in the U.S. In both cases, the taxpayer represented that the officers and directors of the companies constituting the country A group as well as the U.S. group exercised "substantial managerial control over business activities" over the country A group and the U.S. group, respectively. The ruling addresses four significant treaty issues.

First, could a country B corporation (ParentCo) be the indirect common owner for determining whether the taxpayer and the members of the country A group are connected under the treaty?

The resident of a contracting state must be engaged in the active conduct of a trade or business in its state of residence to be entitled to treaty benefits for an item of income derived from the other contracting state. The treaty also provides that for determining whether a resident of the contracting state is engaged in the active conduct of a trade or business in that state, the activities conducted by a partnership and activities conducted by persons connected to that person shall be deemed connected by such person.

Accordingly, as the taxpayer was a wholly owned subsidiary of ParentCo, and ParentCo indirectly owned the country A group through a chain of wholly owned country B entities, and because nothing in the treaty required the common owner to be a resident of country A, the IRS concluded that for determining whether the taxpayer and the members of the country A group are connected, ParentCo can be treated as the indirect common owner.

Second, was the taxpayer viewed as engaged in the active conduct of a trade or business to the extent that the taxpayer is engaged in the active conduct of a trade or business in country A?

The IRS explained that under the treaty, activities conducted by a person connected to that person would be deemed to be conducted by such person. Assuming that the taxpayer is a country A resident and is not actively engaged in the active conduct of a trade or business in country A, the taxpayer would be deemed to conduct activities conducted by connected country A corporations.

Third, how should the taxpayer determine whether the interest it derives from the U.S. group is derived in connection with an active conduct of a trade or business within country A?

Based on the assumption that the country A group members are connected to the taxpayer, the IRS ruled that it depends on whether the interest is attributable to income producing activities of a member of the U.S. group. The line of business of the group member must form a part of or be complementary to a trade or business treated as conducted by the taxpayer through the activities of members of country A group in country A.

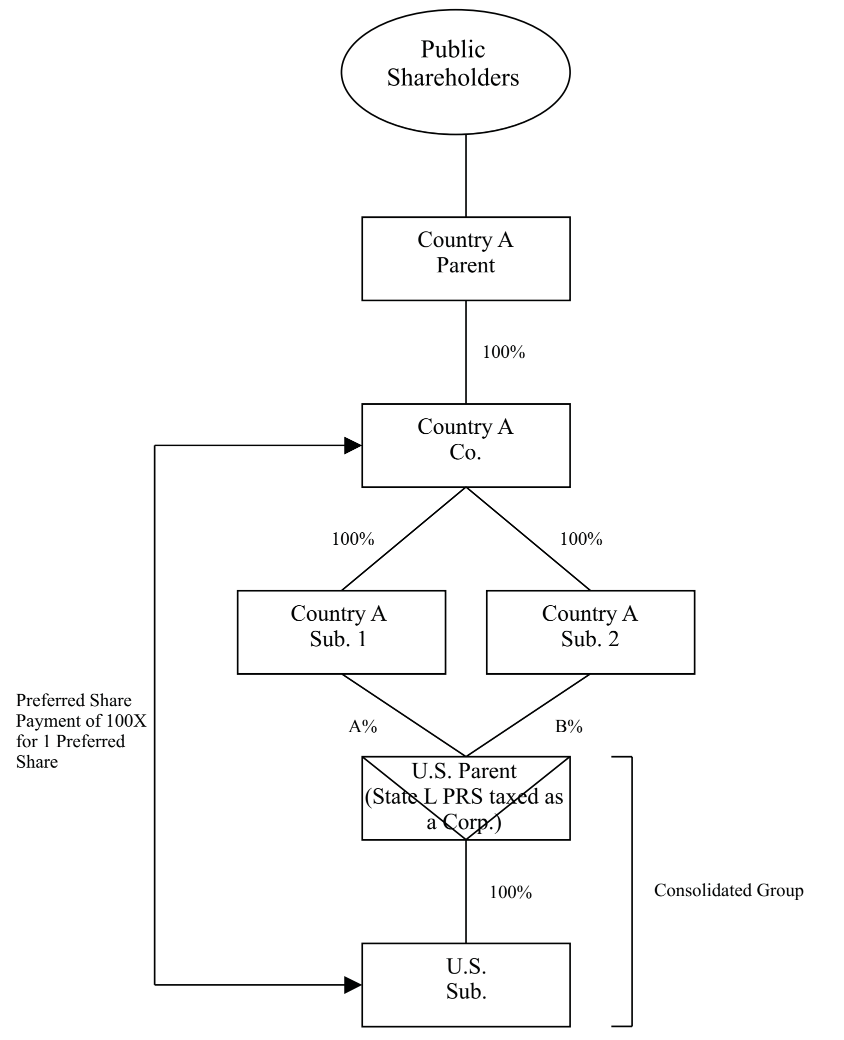
Fourth, how should the taxpayer determine whether the taxpayer's country A trade or business is substantial in relation to the U.S. trade or business that gives rise to an item of U.S.-source interest income?

The IRS noted that a country A resident is entitled to the benefits of the treaty for any item of U.S.-source income only if the country A residents trade or business is substantial in relationship to the U.S. trade or business that gives rise to the item of U.S.-source income. The IRS then relied on the memorandum of understanding (MOU) of the treaty. The MOU addresses the substantiality requirement, which is intended to prevent treaty-shopping abuses in which a company attempts to qualify for the benefits of the treaty by engaging in a de minimis connected business activity that might have little economic cost or effect. Under the MOU, determining whether a trade or business is substantial for trading purposes is based on a consideration of all facts and circumstances. This includes the comparative sizes of the trades or businesses, the nature of the activities performed, and the relative contributions made to that trade or business with due regard given to the relative sizes of the U.S. and country A economies.

The IRS concluded that they must compare the size and nature of the trade or business conducted by the members of the country A group in country A with the trade or business conducted in the U.S. by the member or members of the U.S. group that gives rise to the item of the income. In making this comparison, the IRS observed that the asset values, income, and payroll expenses of the taxpayer are not taken into account under the specific treaty provision because the taxpayer's own activities are merely financing activities and do not constitute active conduct of a trade or business.

Practitioner's Comment: This is an excellent ruling that serves as a primer for claiming eligible benefits. In this case, reduced interest withholding

Figure 18



(presumably 0 percent) for interest payments made to a related party within the same multinational group in which the portfolio interest exemption is not otherwise available.

K. Section 894: Domestic Reverse Hybrid Rules

In a July 11, 2006, chief counsel advice letter, the IRS recharacterized a deemed interest payment from a U.S. corporation to a foreign corporation as a section 301(a) dividend distribution based on the domestic reverse hybrid (DRH) entity rules under Treas. reg. section 1.894-1(d)(2)(ii)(B).[125] Figure 18 is an illustration of the transactions.

[125]*See 2007 WTD 1-14* or *Doc 2006-22968*.

Country A Parent is a country A public company traded on the country A exchange and the parent of a multinational group of entities engaged in the same business. Country A Parent wholly owns Country A Co., which in turn wholly owns Country A Sub 1 and Country A Sub 2. U.S. Parent is a domestic state partnership, which has elected under the check-the-box regulations to be taxed as a corporation for U.S. federal tax purposes. U.S. Parent is wholly owned by Country A Sub 1 and Country A Sub 2, in unequal proportions. U.S. Parent wholly owns U.S. Sub, a domestic corporation. U.S. Parent included U.S. Sub on its consolidated tax return for the years at issue.

U.S. Parent and U.S. Sub agreed that U.S. Parent would procure a purchaser willing to pay 100X for one share of U.S. Sub preferred stock. U.S. Sub and Country A Co. agreed that Country A Co. would pay 100X for one share of U.S. Sub preferred stock. The preferred share carries no voting rights and must be redeemed upon the tenth year from its issuance. Country A Co. granted U.S. Parent a call option for the preferred share, and U.S. Parent granted Country A Co. a put option for the preferred share. U.S. Parent and Country A Co. prepared a U.S. tax letter in which the parties agreed that:

- the transaction will be treated as a secured loan by Country A Co. and as secured borrowing by U.S. Parent;
- the U.S. Parent will be treated as the beneficial owner of the preferred share; and
- U.S. income tax returns will be filed consistent with the letter.

The parties intended the payments made by U.S. Sub to Country A Co. be treated as nondeductible dividend payments from U.S. Sub to U.S. Parent, followed by deductible interest payments from U.S. Parent to Country A Co. Critical to the IRS's analysis was:

- for country A tax purposes, the direct payments made by U.S. Sub to Country A Co. were taxable dividends;

- for U.S. tax purposes, the payments by U.S. Parent to Country A Co. were interest payments; and
- Country A Co. paid taxes to country A on the preferred share dividends.

Treas. reg. section 1.894-1(d)(2)(ii)(B) is important to the recharacterization. The section provides special rules that apply to payments made and received by a DRH. A DRH is a domestic entity that is treated as nontransparent for U.S. tax purposes but that is treated as a transparent entity under the laws of a foreign jurisdiction. Treas. reg. section 1.894-1(d)(2)(ii)(B)(1) applies when a domestic entity makes a payment to a related DRH, which is treated as a dividend under the laws of the jurisdiction of the related foreign interest holder, and the DRH makes a payment that is deductible for U.S. tax purposes to the related foreign interest holder, subject to some conditions.

In holding that the deemed interest payments should be treated as a dividend payment under Treas. reg. section 1.894-1(d)(2)(ii)(B), the IRS found that:

- the payments by the U.S. Sub to U.S. Parent were treated as dividends for U.S. federal tax purposes;
- U.S. Parent made payments, which were deductible interest payments for U.S. federal tax purposes to Country A Co.; and
- the amount of the payments from U.S. Parent to a Country A Co. did not exceed the amount of the payments from the U.S. Sub to U.S. Parent.

Therefore, Treas. reg. section 1.894-1(d)(2)(ii)(B) properly applied to recharacterize the interest payments as deemed dividends for all U.S. federal tax purposes.

L. Section 897: REMIC Allocable to Foreign Persons

The IRS issued prop. Treas. reg. section 1.860G-3, which mirrors the text of temp. Treas. reg. section 1.860G-3T,[126] to provide guidance on various U.S. tax principles, such as income recognition, income sources, and withholding obligations when a real estate mortgage investment conduit residual interest is allocated to foreign persons. The regulation also addresses foreign persons' participation in a REMIC through a domestic partnership.

M. Section 897: FIRPTA and Merger-Related U.S. Real Property Interests

In Notice 2006-46,[127] the IRS provided interim guidance in advance of final regulations under section 897(d) and (e) regarding the transfer of U.S. real property interests to reflect the newly finalized section 368(a)(1)(A) statutory merger regulations for foreign entities.[128] The notice states that the IRS and Treasury issued final regulations on January 23, 2006, regarding statutory mergers and consolidations described in section 368(a)(1)(A). These regulations provide guidance to the definition of the term "statutory merger or consolidation" to permit transactions under the statutes of a foreign jurisdiction or a U.S. possession to qualify as a statutory merger or consolidation. Under the notice, and also to be published in the final regulations, inbound statutory mergers and consolidations will be subject to the same rules under temp. Treas. reg. section 1.897-5T, along with related guidance that applies to other inbound asset reorganizations. The notice states that foreign-to-foreign statutory mergers or consolidations will be subject to the same rules currently under temp. Treas. reg. section 1.897-6T as applicable to foreign-to-foreign reorganizations, although two additional exceptions are included that provide a foreign corporation with nonrecognition treatment on its transfer of a U.S. real property interest to some foreign-to-foreign asset reorganizations. The effective date of the final regulations that will incorporate guidance on exchanges and statutory mergers and consolidations will apply to distributions, transfers, or exchanges beginning on or after January 23, 2006.

N. Section 1441: Final Withholding Tax Regulations Issued

The IRS and Treasury issued final withholding tax regulations at Treas. reg. section 1.1441-1, -3, and -6.[129] The new rules overhaul the existing rules for withholding of income tax on some U.S.-source income remitted to foreign persons, and they also provide revised rules regarding the collection, deposit, refund, and credits of withheld amounts. For foreign grantor trusts, the rules relax some taxpayer identification number requirements and provide guidance on reporting of treaty-based return provisions under section 6114.[130]

O. Section 1441: Principal Payments to a Foreign Distributor Are Foreign-Source Income

In LTR 200620016 (Feb. 8, 2006), A, a nonresident alien individual, owned and operated a sole proprietorship in country X, and the business imported

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[126] 71 *Fed. Reg.* 43,398 (Aug. 1, 2006).

[127] 2006-24 IRB 1044 (June 12, 2006).

[128] *See* Treas. reg. section 1.368-2.

[129] T.D. 9253, 71 *Fed. Reg.* 13,003 (Mar. 14, 2006).

[130] *See* "Regs Revise Withholding and Information Reporting on Foreign Persons Receiving U.S. Income," *Standard Federal Tax Reports — Taxes on Parade*, Mar. 16, 2006, p. 4.

sporting goods for sale and use solely in country X. All of the proprietorship's employees resided in country X, and the proprietorship never engaged in a U.S. trade or business.

Domestic Corporation C entered into a contract with A's sole proprietorship. The sole proprietorship was appointed the exclusive distributor of Corporation C's sporting equipment in country X. In the course of a four-year extension of the original distributorship contract, Corporation C's assets were acquired by Corporation D, a domestic corporation. Corporation D continued to supply A's proprietorship with sporting equipment and also entered into an agreement to manufacture some sporting equipment items for sale to the proprietorship.

Ultimately, Corporation D terminated the distributorship agreement, and the proprietorship brought suit in U.S. Federal District Court alleging that the termination of the distributorship was wrongful. Later, Corporation D filed a voluntary petition for relief under chapter 7 of the Bankruptcy Code. On behalf of the sole proprietorship, nonresident alien individual A filed a claim in the bankruptcy case for breach of contract and incorporated the claims and costs that had been asserted in the U.S. district court action.

Under a negotiated settlement agreement, the nonresident alien individual A agreed to receive, in satisfaction of all claims, a cash settlement from the former owners of Corporation D and the bankruptcy trustee. The issue was whether the payments under the bankruptcy settlement constituted income from non-U.S.-source income under section 862(a)(6) and thus no withholding was required under section 1441.

The ruling analyzes the 30 percent imposition of a withholding tax under section 871 and the applicable rules under section 1441(a). The ruling describes the determination of the source of payments made under the settlement agreement, and stated that the nature of an item for which the settlement payment is substituted controls the characterization of the payment. Relying on Rev. Rul. 83-177,[131] the IRS ruled that amounts paid under the settlement agreement representing principal for purposes of compensating services performed outside of the U.S. were not subject to tax under section 871(a), nor subject to withholding under section 1441(a). The IRS then noted that under section 862(a)(6), any gain, profit, and income derived from the purchase of inventory property (as defined by section 865) within the U.S. and its sale or exchange outside the U.S. shall be treated as income from sources outside the U.S.

Based on the above authorities, the IRS explained that for determining the source of the settlement payment, the amount of principal received under the settlement agreement depends on the nature of the item for which the bankruptcy claims were settled. In this case, the bankruptcy claims were settled for the alleged wrongful breach of contract with A's sole proprietorship in the form of a distributorship agreement to perform within country X. The purchase of supporting equipment within the U.S. for sale and use in country X would constitute foreign-source income under section 862(a)(6).

Practitioner's Comment: This ruling illustrates the importance of carefully analyzing any outbound payment made to a foreign person for their conduct. This includes analyzing and determining the nature and extent of the appropriate payments to be made to avoid an inadvertent failure to withhold the 30 percent withholding tax as prescribed by section 871. The other alternative course of action would have been for the payer in the ruling to withhold the 30 percent, and thereafter the foreign person could file for a refund using Form 1040NR, stating the basis on which the tax should not have been withheld.

P. Section 1445: Modifications to Withholding Agreement Request

In Rev. Proc. 2005-77,[132] the IRS addressed final withholding foreign partnership and withholding foreign trust agreements as originally addressed in Rev. Proc. 2003-64,[133] and provided guidance and procedures for applying for withholding agreements and withholding trust as described in Treas. reg. section 1.441-5(c)(2)(ii). In general, Rev. Proc. 2005-77 simplifies the documentation, reporting, and withholding procedures and eliminates the relatedness requirement. By eliminating the "relatedness" rule, withholding agents and withholding entities will be able to more readily comply with the IRS guidelines for obtaining withholding agreements. Note that the modifications in Rev. Proc. 2005-77 are effective as of July 10, 2003, which correlates to the effective date of Rev. Proc. 2003-64.

Q. Section 1446: Foreign Partner May Certify Deductions and Losses to Reduce Withholding

In temp. Treas. reg. section 1.1446-6T,[134] the withholding agent may take partner-level deductions into account when determining the amount of

[131]1983-2 C.B. 112 (July 1983) (also involving settlement of a legal action in which services were performed outside the U.S.).

[132]2005-51 IRB 1176 (Dec. 19, 2005).

[133]2003-32 IRB 306 (Aug. 11, 2003).

[134]T.D. 9200, 70 *Fed. Reg.* 28,702 (May 18, 2005).

withholding under section 1446. When a partnership engages in a U.S. trade or business, section 875(1) treats each foreign partner as being directly engaged in the same trade or business through an imputation legal principle for U.S. federal tax purposes. Even though the foreign partners involved may have little if any connection to the U.S., they are still treated as engaged in a trade or business in the U.S. and must file appropriate income tax returns. Section 1446 imposes a partner-level withholding tax for each foreign partner's tax burden on such partner's share of effectively connected income. Because of claims for many years that foreign partners are subject to overwithholding, the new rules allow a foreign partner to certify net operating loss carryovers attributable to prior years to reduce the withholding burden. However, current-year losses may not be certified to reduce the current-year withholding burden, even if the current-year loss is attributable to the partnership in question.[135]

III. Outbound Case Law Developments

A. Section 382: Brother Is Not Family

The Tax Court's decision in *Garber Industries Inc. v. Commissioner*[136] was affirmed by the Fifth Circuit Court of Appeals in 2006. Although not an international case, it has substantial international repercussions. In *Garber*, two brothers owned 19 percent and 65 percent, respectively, of a domestic C corporation that had a substantial net operating loss. In 1998 one brother sold all of his stock to the other brother, and his stock ownership increased from 19 percent to 84 percent. This was an increase of more than 50 percentage points for section 382 purposes. The IRS reviewed the 1998 tax return and made an adjustment to reduce the net operating loss carryforward from $809,000 to $121,000.

The corporation argued that under section 382, the brothers' shares in the corporation should be treated as the stock of one individual and thus aggregated because of section 318(a)(1) because they were members of the same family having the same parents and grandparents. The IRS argued that the family aggregation rule is limited to living individuals. Since the parents and grandparents had been deceased during the 36-month testing period under section 382, the aggregation rule under section 318(a)(1) could not be used.

The Fifth Circuit affirmed the Tax Court's ruling that one brother's stock could not be attributed to the other or vice versa. In a narrow reading of the statute, the Fifth Circuit agreed with the Tax Court's holding but with a slightly different rationale. The brothers were not considered brothers for the section 382 exception because the family aggregation rule applies only to individuals who are shareholders of a loss corporation. In the case of each individual shareholder's family, this consists only of his spouse, children, and grandchildren during the three-year testing period. Parents and grandparents would be taken into account if, in fact, they had been living during the testing period. To hold otherwise, the Fifth Circuit reasoned, would open the floodgates to unlimited and unclear aggregation among family members.[137]

Practitioner's Comment: For international tax planning, the practitioner should be mindful of the appropriate attribution as well as the direct and indirect ownership rules in making sure the intended results occur based on the specific structured plan.

B. Section 482: U.S. Government Appeals in *Xilinx*

On August 25, 2006, the U.S. government filed a notice of appeal in the Ninth Circuit Court of Appeals in response to the Tax Court opinion in *Xilinx v. Commissioner*.[138] In this decision, the court accepted the taxpayer's argument that it was not required to include stock-based compensation in a qualified cost-share agreement with its Irish subsidiary. At the time of the release of this announcement, it was unclear whether the U.S. government was going to pursue an appeal or was simply filing the notice to preserve appellate rights. The government's opening brief was due November 13, 2006, and no further developments have been reported.

C. Section 901: Amended Filing for Foreign Tax Credit Barred

In *Chrysler Corp. v. Commissioner*,[139] the Sixth Circuit Court of Appeals affirmed the Tax Court ruling that the 10-year statute of limitations expired and barred the taxpayer from electing a foreign tax credit carryover. Chrysler experienced large losses in the 1970s and early 1980s but was still subject to foreign taxes. Because of the absence of a U.S. income tax liability, Chrysler elected to deduct rather than claim a credit for foreign tax payments. However, in 1992 the IRS assessed tax deficiencies against Chrysler for 1984 and 1985. In response,

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[135] *See* R. Goulder, "U.S. Withholding for Foreign Partners," *Tax Notes Int'l,* Mar. 6, 2006, p. 765.

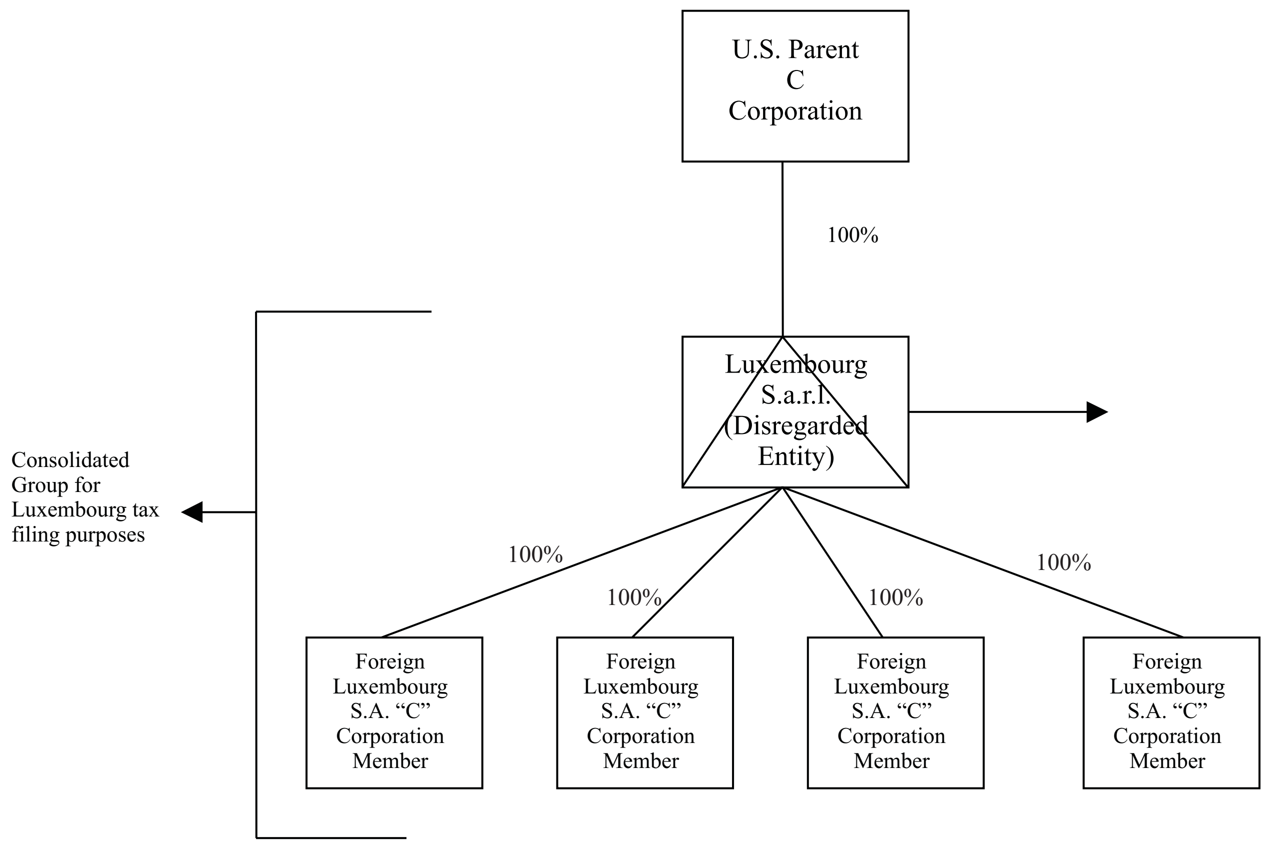
[136] 124 T.C. 1 (2005), *aff'g* 435 F.3d 555 (5th Cir. 2006).

[137] *See* "Fifth Circuit Rules Brothers Not 'Family' Under Code Sec. 382," *Standard Federal Tax Reports — Taxes on Parade*, Jan. 19, 2006, p. 7.

[138] 125 T.C. No. 4 (2005).

[139] 436 F.3d 644 (6th Cir. 2006).

Figure 19



Chrysler sought to amend its returns for 1980 through 1982, which it filed in 1995, to reverse the foreign tax payments from claimed deductions to credits, to carry forward to the 1984 through 1985 asserted deficiencies. The Sixth Circuit agreed with the Tax Court in holding that under section 6511(d), the applicable statute of limitations begins to run from the year the credit is claimed, and Chrysler missed the 10-year window because of the expiration of the statute of limitations.

D. Sections 901 and 7701: *Guardian Industries*

In *Guardian Industries Corp. v. United States*,[140] a U.S. C corporation wholly owned a Luxembourg corporation that was a *Societe a responsabilite limitee* (S.a.r.l.) under Luxembourg law, but was treated as an entity disregarded from its owner for U.S. federal tax purposes. This wholly owned Luxembourg subsidiary/disregarded entity in turn owned several Luxembourg subsidiaries, and the group filed a consolidated tax return under Luxembourg law as illustrated in Figure 19.

The issue was whether Luxembourg tax paid by the Luxembourg subsidiary/disregarded entity would be treated as paid by the disregarded entity or should the tax be allocated among the various 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 allocation of foreign tax liabilities in the context of a foreign affiliated group, where the members of the foreign affiliated group 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 legally liable for all group Luxembourg corporation income tax liabilities, and the other members of the consolidated Luxembourg group did not bear any liability. The court concluded that the consolidated members had no joint or several liability for any members'

[140] 65 Fed. Cl. 50 (2005).

share or any of the consolidated tax liability. Ultimate liability hinged on the Luxembourg subsidiary/disregarded entity.

The dispute in *Guardian Industries* is still far from over. On November 24, 2006, the taxpayer filed a brief arguing that the Court of Federal Claims was correct in granting the foreign tax credit for foreign income taxes imposed on the various subsidiaries of the Luxembourg parent entity. On appeal, the government conceded that its sole argument is whether Treas. reg. section 1.901-2(f)(1) requires the Luxembourg tax to be allocated among the members of the Luxembourg group in proportion to each member's share of the consolidated taxable income of the Luxembourg group. The taxpayer premised its appeal on the language of this regulation, which provides that the "person by whom tax is considered paid for purposes of Section 901 . . . is the person on whom foreign law imposes legal liability for such tax."

The taxpayer argued that the relevant portions of Luxembourg statutory and regulatory law established that the parent company of a Luxembourg consolidated group is solely liable for the Luxembourg tax on the income of the consolidated group. Here, the government argues that a domestic corporation chose to conduct its business through a foreign subsidiary. Therefore, it cannot claim a direct foreign tax credit for the foreign subsidiaries of foreign taxes unless the subsidiary makes an election to be treated as a disregarded entity pursuant to Treas. reg. section 301.7701-3(a). The Luxembourg S.a.r.l. made that election; however, the Luxembourg subsidiaries did not.

Practitioner's Comment: The briefs filed by the taxpayer and the government represent excellent summaries of the direct foreign tax credit rules and offer insightful discussions of Treas. reg. section 1.901-2(f)(3). It is not yet clear how this case will ultimately be resolved. It does provide a clear and unequivocal warning to the practitioner about relying on in-country consolidated groups featuring a disregarded entity parent corporation with foreign C corporate subsidiaries. This will be subject to review and potential challenge by the IRS in the event the ultimate U.S. owner claims a section 901 direct foreign tax credit for income earned by the underlying foreign C corporations. In theory, foreign tax credits should match income. To allow a U.S. multinational to claim a foreign tax credit for the foreign taxes treated as being owed by the foreign parent corporation that filed a check-the-box election to be treated as a disregarded entity is inherently inappropriate when the underlying taxable income is still lodged in the subsidiaries of that disregarded entity parent. Note also that the IRS and Treasury have introduced proposed regulations (discussed in Part I) that are designed to "fix" this regulatory loophole.

E. Section 1212: Capital Loss May Not Reduce a Previous Years' AMT

Although not an international case, *Merlo v. Commissioner*[141] confirms that under section 1212(a), noncorporate taxpayers may not carry back capital losses to offset prior years' capital gains. A capital loss arising in the current year may only be used to offset capital gains, plus an additional $3,000 of loss may be absorbed, and any excess must be carried forward to subsequent years. In comparison, section 1212(b) allows a corporate taxpayer to carry back capital losses to the three years immediately preceding the year in which the capital loss is generated.

The facts in *Merlo* illustrate the unfairness of the alternative minimum tax. In 1999 the taxpayer was granted stock options from his employer, which qualified as incentive stock options. After exercising the options on December 21, 2000, at a purchase price of 20 cents per share, the taxpayer reported taxable income of $548,729 and AMT income (AMTI) of $1,001,776. However, in November 2001 the issuer company declared its common stock worthless, so the taxpayer's exercised shares became worthless. Because the shares were not subject to a substantial risk of forfeiture, the court affirmed the IRS determination that the taxpayer had in excess of $1 million of AMTI based on the exercise date of December 21, 2000.

Practitioner's Comment: This case illustrates the huge pitfalls of stock options, especially in a fluctuating stock market. Although the IRS national taxpayer advocate has publicly stated the unfairness of the AMT, and, in fact, supports its repeal, Congress has yet to take any action on a potential repeal or modification of the AMT (except for the limited relief included in TIPRA).

F. Section 7121: Tax Court Stipulation and Closing Agreement Are Final

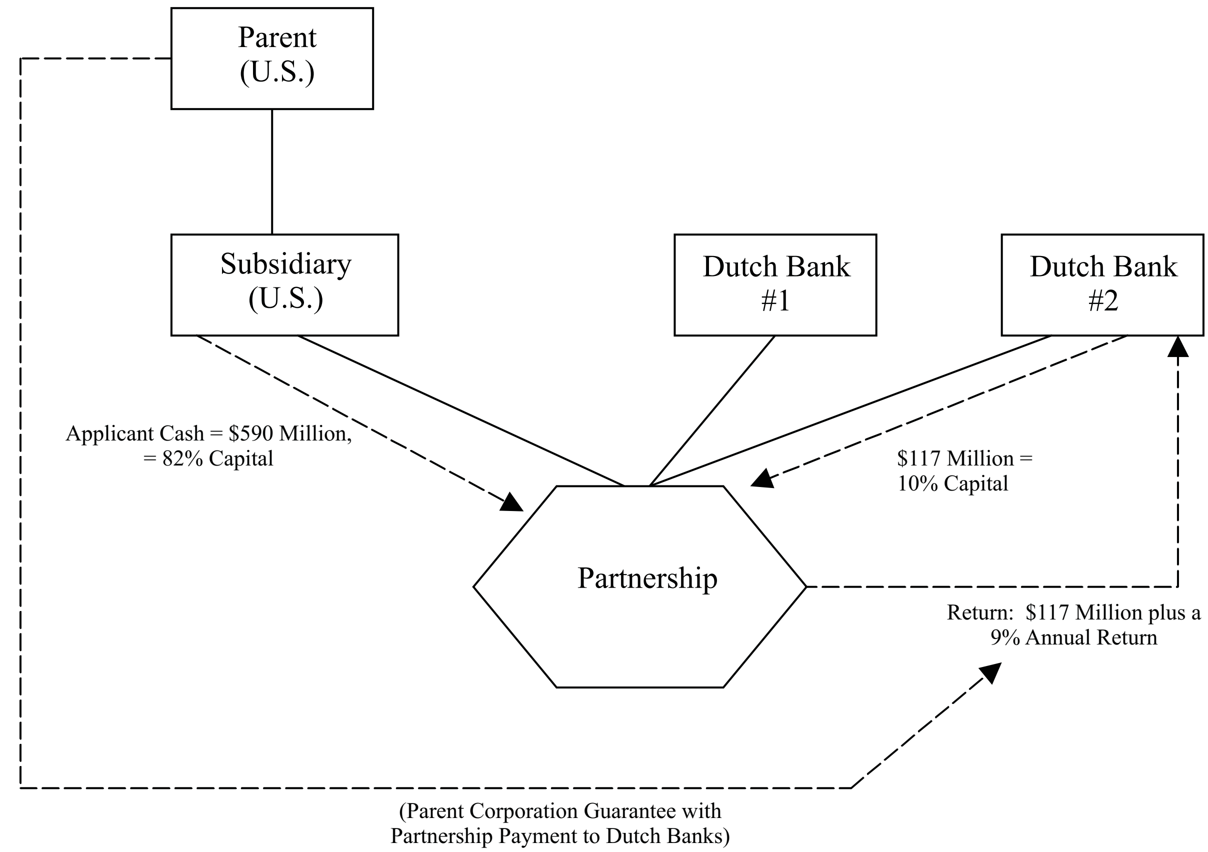
Although not an international case, *LaRosa's International Fuel Co., Inc. v. United States*[142] has significant repercussions in the international arena when international tax disputes are settled. The government's claim for additional interest was denied. The court found that amounts a company and its owner paid under a Form 906, "Closing Agreement,"[143] along with some Tax Court stipulations

[141] 126 T.C. 10 (2006).

[142] 73 Fed. Cl. 625 (2006).

[143] *See* section 7121.

Figure 20



included interest payments. Based on the four corners of the closing agreement and related documentation, the parties intended to end the dispute.

The case involved deficiencies in excess of $11 million and was settled with the entry of two stipulated decisions in the Tax Court in November 1990. Following entry of the stipulated decisions, the parties engaged in further settlement discussions and reached a final Form 906 Closing Agreement in March 1991. As a result of these actions, the taxpayers' IRS account transcripts were adjusted to reflect a zero balance. The taxpayers initiated this action to recover what they believed were excessive payments of interest, including amounts that were beyond what was called for in the agreement.

The court ruled that settlement agreements constitute binding contracts, and general contract law principles govern tax case settlements. The court went on to find that both parties conceded the existence of a binding contract regarding the Tax Court stipulations and the Form 906 Closing Agreement, so the contract in question was interpreted to include interest. Attempts to claim additional interest would not be appropriate.

G. Section 7121: Chief Counsel Clarification on Closing Agreement Procedures

In Chief Counsel Notice CC-2006-017 (Aug. 11, 2006), the IRS clarified the procedures for obtaining waivers of restrictions on assessment with reference to Form 906 Closing Agreements in light of the recent *Manko* decision.[144] The Tax Court held that the IRS may not collect a taxpayer couple's liability without having issued a deficiency notice, because entering into a closing agreement does not vitiate the obligation of the IRS to issue a notice of deficiency before assessing the underlying tax. To assess a deficiency associated with a closing agreement, either the taxpayer must properly waive restrictions on assessment or the agreement must determine that restrictions do not apply. Most closing agreements include a provision integrated in Form 906

[144] *Bernard F. Manko et ux. v. Comm'r,* 126 T.C. 9 (2006).

stating that the taxpayer agrees to waive restrictions on assessment. Sometimes a separate waiver form is included in the final package. Form 906 is not necessary to request a waiver if additional assessments are not required.

H. Section 7201: Plea Agreement in Largest-Ever Individual Tax Evasion Case

On September 8, 2006, the U.S. Department of Justice and the IRS announced that Walter Anderson pleaded guilty in federal district court on two counts of federal tax evasion and one count of defrauding the District of Columbia. Anderson was a telecommunications entrepreneur who failed to pay $200 million in federal and local taxes and did not report approximately $365 million of income on his 1998 and 1999 tax returns. In March 2005 federal prosecutors alleged that Anderson evaded paying U.S. federal income tax on $450 million he earned from 1995 to 1999 through a complicated offshore corporate and bank account scheme.

I. Section 7201: Tax Evasion Conviction Triggers Civil Fraud Penalty

In *Uscinski v. Comm'r,*[145] the Tax Court granted the IRS's motion for partial summary judgment for an individual who had been previously convicted for tax evasion as a matter of law and liable for the civil fraud penalty based on that conviction. However, the court noted that the taxpayer might challenge the amount of unreported income contained in the IRS Notice of Deficiency, even though he entered into a criminal plea agreement with the IRS.

J. Section 7201: Postponement of KPMG Criminal Tax Case

U.S. District Court Judge Louis Kaplan indefinitely adjourned the pending KPMG criminal tax case while the Second Circuit Court of Appeals hears a dispute between KPMG and its former partners over whether their dispute is subject to arbitration. Judge Kaplan has warned that a dismissal of the indictment may be appropriate if KPMG does not cover the defense costs of its former executives. In June 2006 Judge Kaplan ruled that KPMG violated the constitutional rights of the former executives by not paying their legal fees in exchange for avoiding criminal charges against the firm. Also, the former KPMG executives, as well as a banker and a lawyer, were indicted on conspiracy charges to defraud the IRS, tax evasion, and obstruction regarding promotion of allegedly fraudulent tax shelters. The government claims that the defendants enabled its clientele to claim $11 billion in phony tax losses and evade $2.5 billion in taxes.

[145]T.C. Memo. 2006-200 (Sept. 19, 2006).

K. Section 7201: *United States v. Stanley L. Wade*

During 2006 the Department of Justice scored many convictions for tax evasion, false subscription, and related tax crimes for attempts by taxpayers to use offshore vehicles to conceal income and avoid paying taxes. For example, in the *United States v. Stanley L. Wade*,[146] the Tenth Circuit affirmed the conviction of an individual for his role in transferring title to apartment complexes into sham business trusts to evade taxes.

Practitioner's Comment: The writing is clearly on the wall. The use of foreign and domestic trusts and offshore entities to hold U.S. investment assets and properties under the purported guise to avoid U.S. federal income tax and internal reporting is simply improper and illegal. It can result in criminal violations subject to incarceration as well as monetary penalties. Tax practitioners should steer clear of these types of transactions, and should they come along, they should decline representation and seek the input of criminal legal counsel.

L. Section 7602: Attorney-Client Privilege

In *United States v. Dale C. Landon*,[147] a federal court refused to enforce a portion of an IRS summons that sought disclosure of some correspondence and also sought compelled answers to questions regarding the documentation because the attorney-client privilege applied.[148]

M. Fast-Track Settlement Now Applicable to SB/SE

In Announcement 2006-61,[149] the well-accepted fast-track settlement program used by the IRS Large and Midsize Business Division (LMSB) is now being extended to the IRS Small Business/Self-Employed Division (SB/SE). The fast-track program procedures for SB/SE taxpayers will be based on the procedures described in Rev. Proc. 2003-40.[150]

N. Taxpayer Victory in *Castle Harbour* Reversed

In *TIFD III-E, Inc. v. U.S.* (commonly referred to as "Castle Harbour"),[151] the Second Circuit Court of Appeals reversed a district court ruling in favor of the taxpayer in connection with a tax shelter case involving Castle Harbour LLC.

[146]2006 U.S. App. LEXIS 27110 (10th Cir. 2006).

[147]No. C06-3734 (D. N.D.Cal. 2006).

[148]*See 2006 TNT 212-20* or *Doc 2006-22215*.

[149]2006-36 IRB 390 (Aug. 22, 2006).

[150]2003-25 IRB 1044 (Jan. 2003).

[151]459 F.3d 220 (2nd Cir. 2006).

Under the partnership arrangement illustrated in Figure 20, the Dutch banks were not subject to U.S. tax, were entitled to annual cash distributions to reimburse their $117 million investment, and could generate an annual return of 9 percent. The payments to the Dutch banks were guaranteed by the taxpayer's parent corporation and were not dependent on partnership earnings of any profits. Although the banks could earn a modest additional upside if the partnership experienced unexpected gains, this was capped at a 2.5 percent return on investment over the eight-year term of the partnership agreement.

In the lower court proceeding, the district court did not accept the IRS's argument that the partnership was a sham, and it concluded that the partnership had a bona fide purpose — to raise capital — although the court conceded the formation of the partnership was substantially tax motivated. The district court upheld the allocation of the partnership's taxable income.

The Second Circuit determined that the Dutch banks did not meaningfully share their risks of the enterprise conducted by the partnership and thus would not be treated as partners. The court determined that the banks' interest in the partnership had more of the character of debt or equity, and that it was almost to the level of a secured lender's interest because the banks had no stake in the partnership's success or failure. In determining that the Dutch banks would not be treated as equity partners, the IRS was permitted to reallocate $310 million in additional income to the taxpayer and to assess $62 million of additional tax, despite the allocation of 98 percent of partnership taxable income to the Dutch banks.

Practitioner's Comment: It is interesting how the Second Circuit reversed the lower court's decision. Appellate courts do not review and rewrite the factual findings of the lower court; however, as a matter of law, it found that the Dutch banks should not be treated as partners. The court placed great emphasis on the Dutch bank's lack of a meaningful participation in losses as a way of supporting its finding that the Dutch banks were not partners for U.S. federal tax purposes. The spillover effect of this case could move into other areas of federal tax practice as well as international tax planning, especially when the practitioner needs to evaluate whether an instrument is debt or equity. After *Castle Harbour*, tax advisers should carefully review all instruments issued by business entities, whether corporations, partnerships, or LLCs, to determine whether it may be possible to treat an equity instrument as debt, thereby creating entity-level deductions for interest expense.

O. *Black & Decker*: Achieving the Desired Tax Result

In *Black & Decker Corp. v. United States*,[152] the Fourth Circuit Court of Appeals reversed the district court's summary judgment in favor of the taxpayer and remanded for further proceedings. The circuit court stated that the district court failed to correctly apply the objective prong of the two-part test,[153] which looks at whether the transaction had any economic substance or if the realistic possibility of profit existed. The circuit court erred by focusing on the general business activities of the corporation instead of on the specific transactions that gave rise to the tax consequences in dispute. The circuit court held that based on the evidence presented to the district court, whether the transaction had a realistic possibility of profit was a question to be decided at trial.[154]

P. *Melnick v. Commissioner*: Lack of Economic Purpose

In *Melnick v. Comm'r*,[155] two U.S. citizens who were owners of a U.S. corporation decided to sell their stock to a foreign investment holding company held by two separate offshore trusts, which in turn issued private annuities for the benefit of the U.S. corporation's selling shareholders. Figure 21 is an illustration of the proposed plan.

The IRS challenged the transaction as lacking economic substance, and the Tax Court agreed. Relying on *Frank Lyon Co. v. U.S.*,[156] the court reviewed the business purpose and the reasonable possibility of generating a profit independent from tax considerations, while noting that the taxpayers had the burden of proof. The court found that the transactions lacked economic substance, and the IRS properly disregarded the structure when determining the gain from the sale of the stock of the company. The court was hard-pressed to identify a business reason on the basis that transferring stock to a foreign entity minimizes litigation exposure regarding a former spouse, noting that this was a personal rather than business-related motivation.

In summary, there was no evidence of business purpose or justification for use of the foreign structure, and the court determined the foreign structure

[152]436 F.3d 431 (4th Cir. 2006).

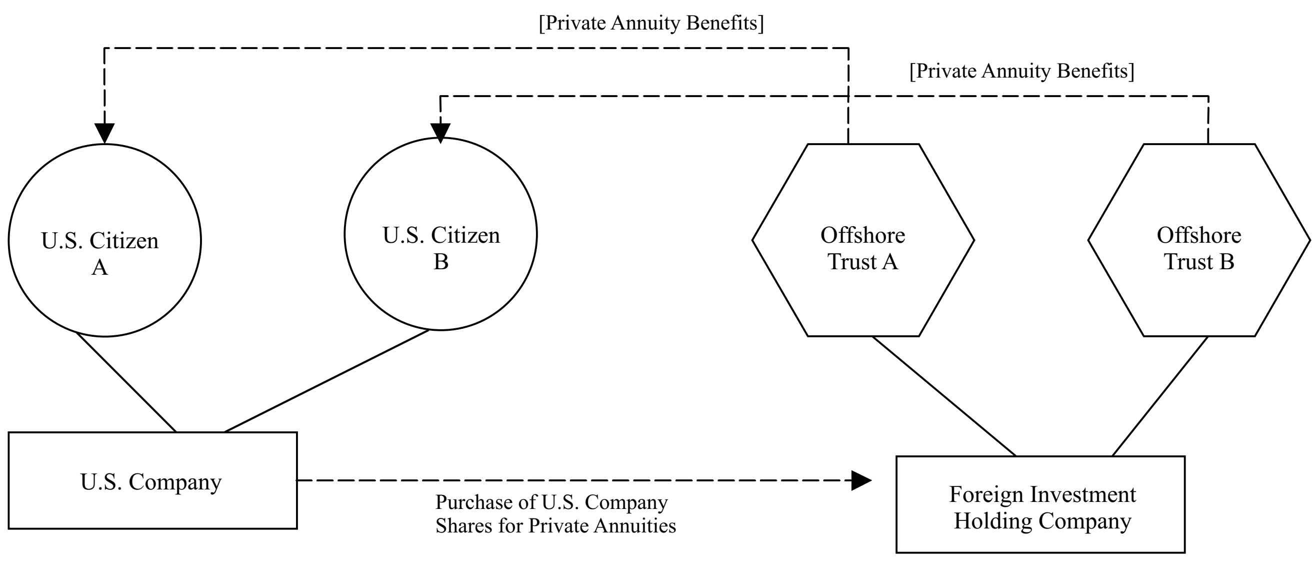
[153]*See Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 91 (4th Cir. 1985).

[154]*See* "Appeals Court Reverses Taxpayer's Summary Judgment in Contingent Liability Shelter Case," *Standard Federal Tax Reports — Taxes on Parade*, Feb. 9, 2006, p. 4.

[155]T.C. Memo. 2006-25.

[156]435 U.S. 561 (1978).

Figure 21



was a conduit. The IRS also asserted that in addition to the $2 million deficiency, the taxpayers were liable for the section 6662 accuracy-related penalty because of their negligence in failing to make a reasonable attempt to comply with the tax law or because of a substantial understatement of income. The court rejected this assertion, finding that the taxpayers acted reasonably in relying on the advice of legal counsel when establishing the transaction and thus the taxpayers acted in good faith.

Practitioner's Comment: This case illustrates that the use of offshore private annuities in which U.S. selling shareholders attempt to minimize legal exposure to former spouses (or to attain other personal objectives), and otherwise lack business purpose, will be rejected by the IRS. The IRS's rejection is virtually certain to be upheld by the courts. Furthermore, this case was based on pre-Circular 230 enhancements. It is possible that the legal advice rendered in this case would not pass scrutiny under the amended Circular 230 provisions that no longer allow the tendering of a casual reliance opinion without requiring a full-blown discussion of the issues and legal analysis.

Q. IRS Examination Activities — Withholding Tax Audits

On January 1, 2001, the IRS and Treasury completed a substantial overhaul of the section 1441 fixed, determinable, annual, and periodic (FDAP) withholding tax regulations. As a general rule, all payments of FDAP to non-U.S. persons are subject to a 30 percent withholding tax unless otherwise reduced or eliminated by tax treaty or statutory exemption. To qualify for treaty relief or a reduced withholding rate, the foreign person must submit the appropriate documentation to the withholding agent, such as foreign W-8 BEN (or other forms of the W-8 certifications) or Form 8833.

A couple of years ago, the IRS announced a 100 percent audit plan for all Form 1042 filers. The first focus was on the financial industry. As a result of this examination program, many shortfalls were detected. In September 2004 the IRS initiated the voluntary compliance program (VCP), which was completed in June 2006. The results of this program were remarkably successful because it induced the financial industry to conduct a self-audit of its own withholding practices. It resulted in the detection and collection of substantial previously underwithheld or nonwithheld taxes, and brought many companies into compliance. At the conclusion of the VCP, about two-thirds of the participants were from the financial community and about one-third were financial institution multinationals.

The IRS has continued to apply stringent examinations with tough audit standards, including strict liability interpretations on all of the Form W-8 BENs. Despite this aggressive examination program, the IRS will usually provide more favorable treatment to voluntary disclosures presented to withholding agents.

For nonfinancial institution multinationals, the IRS has begun examining Forms 5471 and 5472, and has established that thousands of multinationals are either not complying with appropriate withholding rules or comply only on a periodic basis.

According to IRS officials, the IRS intends to audit all Form 5471 and 5472 data pertaining to withholding matters. The IRS also has indicated that examination letters are being sent in batches because the problem is extensive.

One of the reasons cited for the multinational exposure for failure to withhold tax on FDAP payments is that many of these payments, such as interest and dividends, service payments, rents and royalties, are not typically handled by the tax department. Instead, they are handled by account receivables and account payables with little recognition to the tax considerations.

Practitioner's Comment: The IRS withholding tax program will not be confined to the multinationals but will spill over to the closely held corporation that operates abroad and files Form 5471. This is one area in which clients have not always synchronized tax planning and tax compliance advice on one hand and the practical accounting functions on the other. Given the recently promulgated section 482 service regulations, as well as a heightened U.S. cross-border compliance initiative, practitioner should meet with clients and make sure all material operational and reporting functions are in compliance. The exposure here could be substantial, including:

- The 30 percent withholding tax.
- The failure to file correct information returns under sections 6721 and 6722. If the failure to file was due to intentional disregard, then penalties may be assessed up to 10 percent of the amount required to be reported.
- A failure to deposit penalty.
- Possible section 6662 negligence or substantial understatement penalties.

The only good news in this area is that the IRS is backing away from the punitive interest provision contained in Treas. reg. section 1.482-8. Complicating matters, FIN 48 would require a company to make sure that it has a more likely than not position and that it fully documents this matter.

R. IRS Examination Focus on Offshore Financial Accounts

The IRS has increased its emphasis through SB/SE to examine U.S. individuals who have set up offshore corporations to invest in U.S. brokerage and portfolio accounts and failed to comply with appropriate tax reporting and tax payment rules. The classic scenario involves a U.S. individual who establishes a tax haven corporation, which in turn opens a U.S. account. The tax haven corporation furnishes the U.S. investment or brokerage house with a Form W-8 BEN, and the only tax exposure is for the 30 percent withholding tax on FDAP, but not taxes withheld on capital gains. Under the recently revised section 1441 withholding rules, a withholding agent is not required to look behind the tax haven company to the underlying owner to apply back-up withholding on capital gain proceeds or other FDAP payments, even though the U.S. broker or investment house probably has knowledge of the underlying U.S. owner because of Know Your Customer/PATRIOT Act documentation. The IRS has a wide range of tools for examining these offshore arrangements, including section 7602 summons authority, including the use of a John Doe summons.

IV. Inbound Case Law Developments

A. Section 267: Court of Appeals Affirms Use of Cash Method of Accounting

In *Square D Co. v. Comm'r*,[157] the Seventh Circuit Court of Appeals rejected the taxpayer's challenge to the validity of Treas. reg. section 1.267(a)-3. This reg mandates that taxpayers use the cash method of accounting when claiming a deduction for payments made to foreign-related parties. The court examined section 267(a)(3), which requires that the IRS use the matching principles of section 267(a)(2) to payments to related foreign persons. Also, under Treas. reg. section 1.267(a)-3, the cash method of accounting is required for claiming deductions for payments to such related persons. The court determined that the language of section 267(a)(3) was ambiguous; however, the court upheld the regulatory interpretation of section 267(a)(3) because to do otherwise would make this subsection redundant. Furthermore, Treas. reg. section 1.267(a)-3 was a reasonable interpretation based on prior case law challenging the validity of Treasury regulations. The court also rejected the taxpayer's argument that the nondiscrimination article of the France-U.S. tax treaty was violated by this regulation. Unlike the situation in which the U.S. subsidiary pays a U.S. parent corporation, using the cash method of accounting in a situation involving foreign ownership is appropriate because the method is only designed to affect payments made to a foreign related party.

B. Section 482: IRS Settles Transfer Pricing Dispute

On September 11, 2006, the IRS announced a $3.4 billion settlement agreement reached with GlaxoSmithKline for a transfer pricing dispute from 1989 through 2000. When Glaxo petitioned the Tax Court in 2004, it alleged that the IRS incorrectly applied section 482 by adjusting the U.S. income allocation to over 80 percent of its worldwide profits, limiting

[157]438 F.3d 739 (7th Cir. 2006).

its manufacturing market to 30 percent, and capping its U.K. parent company's royalties at 15 percent. The final settlement figure involves a net cash payment of $3.1 billion. Previously, Glaxo reserved $11.5 billion for the 1989 through 2005 tax years, so the final settlement should not affect its earnings and underlying stock price.

Practitioner's Comment: To understand and advise clients regarding section 482 transfer pricing matters, consider the following quote from IRS Commissioner Mark W. Everson: "We have consistently said that transfer pricing is one of the most significant challenges for us in the area of corporate tax administration."

C. Section 937: Injunctive Relief on Form 8898 Denied

In *Joel H. Holt v. United States*,[158] the United States District Court for the District of the Virgin Islands ruled that the taxpayer lacked standing under applicable judicial guidelines to request a court order to enjoin the required filing for Form 8898 with the IRS. Form 8898 requires that bona fide residents of the U.S.V.I. provide voluminous information regarding residency status, including:

- a list of social, cultural, religious, professional, and political organizations the taxpayer participated in;
- the location of each organization;
- a list of any charitable organizations to which the taxpayer made contributions during the tax year; and
- the locations of those charitable organizations.

The taxpayer raised several constitutional issues, including a question on Form 8898 that requires a list of social, cultural, and religious activities, as well as a list of charitable organizations. The taxpayer filed a motion for a temporary restraining order under Rule 65(b) of the Federal Rules of Civil Procedure, seeking that the IRS be enjoined from using Form 8898.

Section 937(c) provides that if for any tax year an individual became or ceases to be a bona fide resident of a possession, as described in section 937(a)(1), that individual shall file Form 8898 with the IRS. The instructions to Form 8898 help determine whether a taxpayer is required to file the form and provide information as to the nature and extent of the information required.

The government argued that the taxpayer lacked standing, because the taxpayer submitted a declaration stating that he was not currently planning to move from the U.S.V.I. and therefore could not show immediate injury. The taxpayer argued that because of the nature and extent of Form 8898, he suffered an immediate, concrete, and particularized injury that deterred him from joining or becoming involved in clubs or associations. The court held that the taxpayer failed to establish that he suffered a concrete, particularized, actual, or imminent injury in fact.

The IRS argued that the taxpayer's claims were barred for three reasons: a lack of standing, and therefore a lack of subject matter jurisdiction over the dispute; application of the Anti-Injunction Act;[159] and application of the Declaratory Judgment Act.[160] It is interesting that the taxpayer also filed an amended complaint alleging that the definition of a bona fide resident as described in section 937(a) violates Article IV of the U.S. Constitution.

The IRS filed a response to the taxpayer's supplemental memorandum to address the standing issue, and also filed a motion to dismiss under Rule 12(b)(1) of the Federal Rules of Civil Procedure.

Perhaps one of the most interesting and enlightening aspects of this case is at its first footnote. It cites IRS Notice 2006-73,[161] in which the IRS notified taxpayers that they should disregard the information requested on lines 17 and 29 (which served as the factual foundation and legal basis for the argument in *Holt*) until the Treasury Department revises the form. In the interim, information regarding lines 17 and 29 must be retained so it can be readily available for inspection upon examination.

D. Section 882: Non-U.S. Persons Filing a U.S. Tax Return Regulation Invalidated

Non-U.S. persons who are engaged in a trade or business in the U.S. are subject to U.S. income tax on all effectively connected income. Also, those persons are allowed to claim appropriate and allocable deductions and credits, but according to the regulations only if a U.S. tax return is filed in a timely manner (subject to certain limited exceptions). Treas. reg. sections 1.882-4(a) and 1.874-1(a) provide that in some circumstances, the IRS may waive this filing requirement so long as the non-U.S. taxpayer can demonstrate that he acted reasonably and in good faith. Also, a non-U.S. taxpayer is allowed to file a protective return to establish the position that the taxpayer is not engaged in a U.S. trade or business, thereby triggering the running of the statute of limitations.

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[158] 2006 U.S. Dist. LEXIS 82948 (D.V.I. 2006).

[159] 26 U.S.C. section 7421.

[160] 28 U.S.C. section 2201.

[161] 2006-35 IRB 339 (Aug. 28, 2006).

In *Swallows Holdings, Ltd. v. Comm'r*,[162] the Tax Court held that the foregoing regulations are invalid because the timeliness requirement is not in the underlying statute and thus the regulations are not a reasonable interpretation of the statute. Assuming the Third Circuit affirms *Swallows*, any non-U.S. person who is otherwise engaged in a trade or business in the U.S. will arguably have an unlimited time within which to file a tax return for the relevant tax years. To resolve this open filing, the Joint Committee on Taxation issued a letter to Senator Chuck Grassley, R-Iowa, asking him to sponsor legislation to fix the problem.

E. Section 6672: Employee Personally Liable for Not Withholding Tax

In *Cook v. United States*,[163] the U.S. District Court for the Southern District of Indiana sustained the government's motion for summary judgment in holding that a comptroller was liable for the employer's failure to pay backup withholding taxes on interest paid to a Chinese bank. Under section 6672(a), if a U.S. taxpayer or corporation fails to withhold the appropriate tax, the government may collect an equivalent sum directly from the individual who is responsible for collecting the tax. Under *Bowlen v. United States*,[164] for a person to be held civilly liable, he must first be found to be a "responsible person," and he must have "willfully failed to carry out the responsibilities that the tax code imposes on him."[165] A person is considered a responsible person if he "could have impeded the flow of business to the extent necessary to prevent the corporation from squandering the taxes it withheld."[166] A responsible person acts willfully when he permits funds to be paid to other parties, instead of to the United States, and he is aware that withholding taxes due to the government have not been withheld.[167]

In May 2000 the comptroller was the only employee in the U.S. corporation to have authority to sign checks. Further, the comptroller was responsible for generating a weekly report of the U.S. company's accounts payable, in order of priority. In some weeks, withholding taxes was listed as the priority, and in other weeks it was not. Based on these and other facts, the district court held that the comptroller was a responsible person who willfully did not withhold the taxes required under section 881(a).

[162]126 T.C. 6 (2006).

[163]2006 U.S. Dist. LEXIS 92634 (Dec. 21, 2006).

[164]956 F.2d 723, 727 (7th Cir. 1992).

[165]*Id.*

[166]*Thomas v. United States,* 41 F.3d 1109, 1113 (7th Cir. 1994).

[167]*United States v. Running,* 7 F.3d 1293, 1298 (7th Cir. 1993).

V. Other Developments

A. Section 11: Shifting Effective Tax Rates for U.S.-Based Multinationals

According to a recent Tax Analysts report[168] that examined 10 high-tax companies and studied their effective tax rates over the past several years, the average effective tax rate of those companies in 1994 was 31.8 percent. But by 2005 the rate dropped to 22.2 percent. A substantial portion of this rate reduction is due to the section 965 one-time repatriation provision enacted in the American Jobs Creation Act of 2004. More than $1 billion was repatriated under section 965. Although no hard and fast conclusions can be reached from this study, it suggests that U.S.-based multinationals are shifting profits from the U.S. to overseas through transfer pricing adjustments, as well as shifting income out of high-tax foreign countries to the U.S.

B. Section 482: New APA Procedure

In Rev. Proc. 2006-9,[169] the IRS updated the procedure for obtaining an advance pricing agreement, superseding Rev. Proc. 2004-40.[170] While discussing the procedures is beyond the scope of this article, note that several material changes were made to Rev. Proc. 2004-40, including procedures for reducing processing time, as well as increasing user fees. The new APA user fee is $50,000, a renewal request is $35,000, and for a small-business APA request, the fee is $22,500.

C. Section 6700: Injunctions Granted

During 2006 the IRS and Department of Justice were more active than ever in the section 6700 investigation area. This year the IRS was heavily involved in section 6700 proceedings. One of the offshoots of the section 6700 investigation is the obtaining of injunctions to enjoin further violations. For example, in *United States v. James Scott Sparkman*,[171] the court entered a stipulated final judgment to enjoin an individual and the businesses he operated from engaging in activities that promote abusive tax shelters, aiding in the understatement of tax liability, or impeding IRS law enforcement.

[168]*See Tax Notes Int'l*, Sept. 25, 2006, p. 1033.

[169]2006-2 IRB 278 (Jan. 9, 2006).

[170]2004-29 IRB 50 (May 17, 2004).

[171]No. 05-00555 (D. Haw. 2006).

D. Section 7201: Wesley Snipes Case Update

On October 17, 2006, actor Wesley Snipes was indicted in Tampa, Florida, on tax evasion charges involving at least $12 million in taxes. The indictment charged Snipes with conspiracy to defraud the IRS, presenting a fraudulent claim for payment to the IRS, and six counts of failing to file income tax returns. Snipes is charged with using the section 861 protester argument — that is, only foreign-source income is subject to U.S. income tax. One of Snipes's coconspirators surrendered to authorities on October 17, 2006, and another was detained in Panama and returned to the U.S. for a bond hearing set in November. According to various press reports, Snipes reached a settlement with the IRS — apparently a payment plan — in which he apparently would avoid incarceration and be able to continue to travel and work abroad. However, according to other sources, the case has not been settled and the government is continuing to pursue tax evasion charges.

E. IRS Updates No-Rule List

On January 2, 2007, the IRS released Rev. Proc. 2007-3,[172] which updates the list of areas on which the IRS will not issue letter rulings or determination letters. Rev. Proc. 2007-3 contains several additions and deletions to the list set out in Rev. Proc. 2006-3.[173] Rev. Proc. 2006-3 is superseded.

F. TIPRA

On May 18, 2006, President Bush signed into law the Tax Increase Prevention and Reconciliation Act of 2005,[174] which extends the section 1(h)(11) 15 percent tax rate for qualifying dividends and capital gains through December 31, 2010. The Jobs and Growth Tax Relief Reconciliation Act of 2003[175] reduced the capital gains tax rates from 20 percent to 15 percent, and in the case of qualifying dividends, reduced the rate from 35 percent to 15 percent. The 2003 legislation also allows taxpayers in the 10 percent to 15 percent tax brackets to enjoy a special 5 percent tax rate for these items of income. Perhaps the most important factor supporting the extension of the bill was one report showing that the capital gains tax paid in 2005 was almost $80 billion, compared with $49 billion paid in 2002. This indicates that the stock market has seen a substantial increase in trading activities as investors are willing to trade off the 15 percent capital gains tax for long-term capital gains in exchange for more trading activities.

[172]2007-1 IRB 108 (Jan. 2, 2007).

[173]2006-1 IRB 122 (Jan. 3, 2006).

[174]Pub. L. No. 109-222.

[175]Pub. L. No. 108-27.

One of the limited international provisions contained in TIPRA is the section 199 manufacturing deduction. Originally enacted in 2004, it was modified by TIPRA for the 50 percent wage limitation calculation used in determining a taxpayer's qualified production activities income. TIPRA also repeals grandfather protection for some foreign sales corporations and extraterritorial taxable income contracts that Congress enacted in 2004.

From a subpart F perspective, TIPRA extends the temporary exception from subpart F tax treatment on some active financing and insurance income activities. Equally important, the new law includes an exception to subpart F treatment for what was formerly foreign personal holding company income by allowing look-through treatment of qualifying dividends and interest, rents, and royalties. One of the most controversial provisions of TIPRA is the reduction of the housing cost allowance benefits under section 911.

G. ABA Criminal Tax Fraud Seminar Update

When IRS Commissioner Mark Everson took office in 2003, he stated that one of his fundamental objectives was to step up enforcement on the civil and criminal levels. During the past three years, significant increases occurred on the civil examination side of the IRS as well as the criminal investigation and enforcement side. During the recent 23rd American Bar Association National Institute on Criminal Tax Fraud 2006 Seminar, several interesting updates were shared:

- Twenty-three years ago, the IRS Criminal Investigation (CI) Division was spending most of its efforts on narcotic-related activities, but today it spends less than 10 percent of its resources in this area.
- In contrast to 23 years ago when very few, if any, grand juries were used for tax matters, today over 70 percent of all criminal tax cases are attributed to the grand jury.
- Twenty-three years ago, maybe only a dozen search warrants were used each year for criminal tax investigation matters. Now hundreds are used each year.
- Twenty-three years ago, U.S. taxpayers who chose to hide their resources in offshore tax havens such as the Cayman Islands and Switzerland were primarily safe. Today, there is no safety at all given the emergence of the mutual legal assistance treaties, tax treaty exchange of information provisions, and tax information exchange agreements.
- Twenty-three years ago, the sentencing of convicted tax felons was up to a judge's discretion. However, today's courts rely on the sentencing

guidelines that have markedly longer sentences for criminal tax violations.

- Twenty-three years ago, tax shelters were run by scam artists and dealt with timber, coal, artwork, or tape. Today, the abusive tax shelters are being handled by major law firms and accounting firms, resulting in serious backlash to professional advisors who involve themselves in tax shelters.
- CI has 4,400 employees, with 2,700 special agents worldwide. The focus today is no longer on drugs but rather on tax compliance, and CI maintains offices in several locations, including Hong Kong, Ottawa, Frankfurt, Germany, and the Middle East.
- Publicity has become important in IRS enforcement, and 75.6 percent of all cases receive publicity or press releases.
- Abusive tax schemes continue to represent the largest target of IRS civil and criminal investigation activities, and they are not only offshore but also domestic. Also important are high-income nonreporters, and one of the focus areas is in Las Vegas. The main area of focus is refund crimes, and these are usually very large cases.
- CI is the largest user of Bank Secrecy Act information.
- CI dedicates 3 percent of its time to counterterrorism activities both within and outside of the U.S., and has special agents in the Middle East.
- Of the 2,700 special agents, the IRS Office of Chief Counsel has 75 attorneys to advise agents.
- The most significant source of CI cases are fraud referrals from the IRS's civil examinations agents/group/office, and the biggest source of fraud referrals is the SB/SE Division. Even LMSB is now making fraud referrals.
- According to IRS officials, the government recognizes that there is not an absolute ban, but there are some limitations on whether materials and information obtained in a grand jury proceeding may be used in a civil case.
- The IRS has announced that "parallel investigations" are now the way CI and the civil examinations group are working together. In a typical referral, SB/SE will continue on the civil side.
- Less than 10 percent of all examinations may involve a parallel investigation. These are primarily related to nationwide fraud cases.
- In 2003, 63 tax fraud specialists were hired, trained, and assigned to SB/SE throughout the United States.
- Government officials believe the IRS has the absolute right to interview the person with the most firsthand knowledge — the taxpayer — and not the representative appointed by Form 2848. However, section 7521(c) specifically provides that the IRS may not require a taxpayer to accompany the Form 2848 representative in the absence of an administrative summons issued to the taxpayer.
- Circular 230, as recently revised, provides a delicate balance for the practitioner to walk. Under the revised circular, the practitioner has an obligation to assist the IRS in gathering information, but must respect the attorney-client privilege.

H. FIN 48: Addressing Uncertain Tax Positions

On July 13, 2006, the Financial Accounting Standards Board issued the final interpretation amending FASB Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." Of particular importance was FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48). The interpretations were published to address the uncertainty in accounting for income tax assets and liabilities. Previously, FASB No. 109 contained no guidance on accounting for income tax benefits and liabilities, which resulted in corporations taking inconsistent positions. FIN 48 attempts to reconcile the inconsistencies by prescribing a consistent recognition threshold and measurement of tax attributes and liabilities. It also gives practitioners a clearly defined set of criteria to use when recognizing, derecognizing, and measuring uncertain tax positions for financial statements, and it also requires additional disclosures regarding uncertainty.[176]

Under FIN 48, the evaluation of a tax position is based on a two-step process. The first step is *recognition*: The enterprise determines whether it is more likely than not (which is a 50 percent or greater likelihood) that a tax position would be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The second step is *measurement*: The tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize on financial statements.

In asserting the more-likely-than-not standard, all facts and circumstances are taken into account.

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[176]*See* P. Morrison, "The Multiple Meanings of 'More Likely Than Not,' " *Tax Management Int'l Journal*, Oct. 13, 2006, p. 524.

Additionally, the practitioner must presume that the tax position will be examined by the relevant taxing authority with full knowledge of all the other materials, technical merits of the relevant tax law, and their applicability to the facts and circumstances of the tax position. The practitioner may take into account any past administrative practices and precedents of the tax authority in its dealings with the corporation. Finally, each tax position must be evaluated without consideration of the possibility of offset or aggregation with other positions.

The appropriate timing of claiming the benefits of a tax position is when it becomes clear that the tax position has a more likely than not chance of being sustained. If a previously taken tax position does not meet the more-likely-than-not standard, it must be adjusted in the first period after the January 1, 2007, effective date of FIN 48.

A corporation must classify the liability associated with an unrecognized tax benefit as a current liability to the extent the enterprise anticipates payment of cash within one year or the operating cycle, if longer. The liability for an unrecognized tax benefit should not be combined with deferred tax liabilities or assets.

In addition to accounting for the benefit that a specific tax position will create for a particular corporation, interest and penalties must be computed along with the tax liability when the law requires the payment of interest or penalties on an underpayment of taxes. Tax liability will cease to be a liability during the first interim period in which any one of the following three conditions occurs:

- the more-likely-than-not recognition threshold is met by the reporting date;
- the tax matter is ultimately settled through negotiation or litigation; or
- the statute of limitations for the relevant taxing authority to examine has expired.

I. Senate Subcommittee Report on Tax Haven Abuses

The Senate Homeland Security and Governmental Affairs Committee's Permanent Subcommittee on Investigations issued an extensive report addressing abusive tax havens. This report is almost 75 pages long and covers the subcommittee's findings on control of offshore assets, tax haven secrecy, control and beneficial ownership, offshore tax haven abuses, anti-money-laundering abuses, securities abuses, stock option abuses, and hedge fund transfers. The subcommittee report makes recommendations on the presumption of control, disclosure of U.S. stockholdings, offshore entities as affiliates, 1099 reporting, real estate and personal property, hedge fund duties, stock option annuity swaps, and sanctions on uncooperative tax havens. This report is a must-read for any tax practitioner involved in international issues involving the IRS, whether on the examination, appeals, or the Tax Court level.

The report has several excellent factual summaries of specific targeted tax haven abuses and attempts to draw the line between nonabusive and abusive structures. The report claimed that offshore tax havens in offshore jurisdictions today hold trillions of dollars in assets and that Americans have an estimated one trillion in assets offshore and illegally evade between $40 billion and $70 billion in U.S. taxes each year through the use of offshore tax schemes. The following list gives other interesting facts and analyses contained in the report:

- The evidence is overwhelming that inaction in combating offshore abuses has resulted in them growing more widespread and reaching new levels of sophistication. For example, the report cites that in 2000, Enron Corp. had more than 441 offshore entities in the Cayman Islands.
- In 2003 the IRS estimated that 500,000 taxpayers had offshore bank accounts and were accessing funds through offshore credit cards.
- U.S. multinational corporations are increasingly attributing their profits to offshore jurisdictions, allocating $150 billion in 2002 profits to 18 offshore jurisdictions, up from $88 billion just three years earlier.

A 2005 study of high-net-worth individuals worldwide estimated that their offshore holdings now exceed $11.5 trillion. The report contains six case histories illustrating how U.S. citizens backed by an armada of professionals hide assets, shift income offshore, and use offshore entities to circumvent U.S. tax law.[177]

J. Overview of Important Treaty Developments During 2006

The U.S. was busy on several other fronts in adopting new treaties and modifying existing ones.[178] The U.S. entered into a protocol with Sweden, and the Bangladesh-U.S. income tax treaty has entered into force. The France-U.S. protocol addressing income tax and estate tax issues was approved by the U.S. Senate and is expected to be ratified in the near future.[179] The U.S. also signed

[177]*See* A. Kenney, "Senators Target Professional's Involvement in Tax Havens," *Tax Notes Int'l*, Aug. 7, 2006, p. 474.

[178]On Dec. 15, 2006, the Danish parliament ratified the May 2, 2006, protocol to the Denmark-U.S. income tax treaty. The protocol will enter into force after ratification by both countries.

[179]*See* P. Connors and S. Sabu, "New French Protocol Updates U.S.-France Income Tax Treaty," *Tax Management Int'l Journal*, July 14, 2006, p. 344.

protocols with Denmark and Finland. Treaty agreements have been reviewed and approved in principal with Belgium, Norway, and Iceland and are anticipated to be signed in the near future.

IRS and Treasury officials project that the protocol to the Canada-U.S. income tax treaty is anticipated to be completed in early 2007. The income tax treaty under discussion with Chile should be completed in the near future, as are the modifications to the Hungary-U.S. income tax treaty.[180]

Regarding treaty negotiations, the U.S. is in the process of either negotiating or conducting discussions with Brazil, Malta, Vietnam, Poland, Bulgaria, and Romania.

The U.S. adopted the 2006 model income tax treaty, replacing the 1996 version. It has several significant provisions, including a more sophisticated limitation on benefit provision, revised dividend withholding provisions (but no zero rate withholding), combination of the independent personal services article, and an updated interest provision. Interestingly enough, an arbitration provision was not included, a situation we are seeing in other treaties, such as the Germany-U.S. treaty protocol discussed below. Treasury's comments to the model treaty include an updated business profits discussion: Either Article VII or section 864 should be relied on, and there will be no mixing or cherry picking.

K. 1989 Germany-U.S. Income Tax Treaty Amended

On June 1, 2006, the United States and Germany signed a protocol amending the 1989 Germany-U.S. income tax treaty. The protocol made several significant amendments to the 1989 treaty, including:

- a full exemption from dividend withholding tax on some parent-subsidiary dividends and dividends paid to some pension funds;
- a redrafted limitation on benefits article;
- guidance on treating fiscally transparent entities;
- a mandatory binding arbitration protocol; and
- technical changes to the taxation of income from pensions and government services.

Perhaps most interesting is the arbitration provision, which is a first-time event for the U.S. tax treaty system. The arbitration is mandatory and binding. The protocol's arbitration provision replaces the treaty's voluntary arbitration system. This arbitration provision only applies when competent authorities are unable to resolve a treaty dispute within two years. Each country picks an arbitrator and then each arbitrator picks a third arbitrator who may not be a citizen of either of the contracting parties. The procedure of the arbitration is detailed in the protocol, but in summary, the arbitration board must choose between the proposed resolutions and render a decision within nine months from the date of the appointment of the chairman. The arbitration board's decision is binding with some exceptions. It is also interesting that the arbitration decision will not set precedent, and will include confidentiality provisions.[181]

L. Guernsey-U.S. TIEA Enters Into Force

On September 19, 2002, the U.S. and Guernsey signed a tax information exchange agreement that closely follows the previous TIEAs entered into between the U.S. and various jurisdictions such as the Cayman Islands, British Virgin Islands, Bahamas, Isle of Man, and Jersey. On April 27, 2006, the Treasury Department announced that the Guernsey TIEA entered into force on March 30, 2006.

M. Mexico-U.S. Protocol for Transparent Entities

The U.S. and Mexico entered into a competent authority agreement by way of protocol to the Mexico-U.S. income tax treaty to deal with emerging issues regarding fiscally transparent entities and eligibility to benefit under the treaty. In summary, paragraph 2(b) of the protocol provides that a transparent entity, such as a partnership, estate, or trust, will be treated as a resident of a contracting state only to the extent that the income derived by that entity is subject to tax in that contracting state. The theme of the protocol is that a transparent entity will be eligible for tax treaty benefits so long as any income received by the transparent entity will be subject to tax in one of the contracting states.

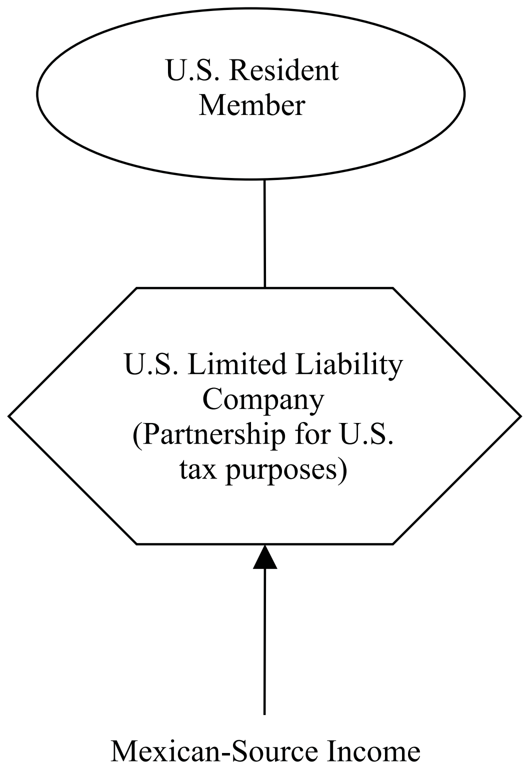
As Figure 22 illustrates, a U.S. resident member of a U.S. LLC that receives Mexican-source income will be entitled to treaty benefits so long as the income is treated as being subject to tax in the U.S.

The protocol notes that if and when Mexico introduces similar legislation to the U.S. fiscally transparent rules, the same treaty benefits will apply to a Mexican resident owning a Mexican fiscally transparent entity that invests in the U.S. For a U.S. fiscally transparent entity to be treated as an eligible beneficiary under the treaty, the entity must request and obtain a Certificate of Residency (Form 6166). Note that the processing time for a Form 6166

[180]*See* K. Bell, "Treasury Updates Model Tax Treaty," *Tax Notes Int'l*, Nov. 20, 2006, p. 607.

[181]*See* J. Libin, "The U.S.-German Arbitration Provision," *Tax Management Int'l Journal*, Nov. 10, 2006, p. 579.

Figure 22



is not less than 45 days, so this needs to be taken into account for any time-sensitive year-end payments.

N. Mexico: Amendment of Maquiladora Program

The Mexican government is expected to modify the existing maquiladora program and replace the PITEX (Temporary Import Program for Exporters) program with a new duty deferral program. The new program will consolidate other programs and will represent a consolidation of the Decree for the Promotion of the Manufactured Industry Maquiladora and Exportation Services (IMEX).

The overall objective of the new program is to streamline the administrative aspects of the maquiladora program, including:

- requiring less information when importing new goods;
- having fewer annual reporting requirements;
- introducing electronic filing;
- reducing the export threshold to temporarily import machinery and equipment (from 30 percent to 10 percent); and
- retaining current income tax benefits such as permanent establishment exemption, asset tax exemption, preferential transfer pricing rules, and the presidential decree tax credit.

The new IMEX program adopts the long-held requirement that a maquiladora operate on a consignment basis, so that the non-Mexican-related party must own the plant, property, and equipment, and all goods must be produced for export. To claim treaty benefits, the non-Mexican related party in the maquila contract must be resident in a jurisdiction with which Mexico maintains a treaty.

Another important Mexican legislative front affecting U.S. companies doing business in Mexico is that the Mexican government released a draft amendment to the Mexican Income Tax Law for comments by the public. The amendment limits the statutory permanent establishment exemption for maquiladoras to foreign companies that have no PE under a tax treaty with Mexico. This proposal could unintentionally harm U.S. companies with maquiladora operations in Mexico simply because the existence of a PE for maquiladora operations is explicitly contemplated in the Mexico-U.S. tax treaty.

O. PRC to End Capital Gains for Foreign Investors

Although not a U.S. tax law change, it is interesting to note trends in other countries, including some of our major trading partners such as China. To lure more foreign investment into the Peoples' Republic of China, the PRC government announced its plans to exempt foreign investors from PRC capital gains tax related to the yuan-based securities to encourage new investments in PRC domestic bonds and debt.

P. Hong Kong-PRC Double Tax Arrangement

On August 21, 2006, the People's Republic of China and the Hong Kong Special Administrative Region signed a new double tax arrangement (DTA). The new DTA replaces the 1998 DTA and is generally based on the OECD model income tax treaty. Most commentators believe that the new DTA will materially strengthen the competitiveness of Hong Kong as the primary gateway to the P.R.C.

In addition to calling for reduced withholding tax on P.R.C. passive income, the new DTA provides for a capital gains tax exemption under some conditions. Note that the new DTA may be of particular interest to those investors who can structure the P.R.C.-source income in such a manner to attract a zero or reduced withholding tax but also structure the transaction to not be subject to Hong Kong tax.

Q. Offshore Compliance Initiatives

On October 6, 2006, the associate area counsel (international) of the Office of Chief Counsel (SB/SE) provided an update of recent IRS offshore tax compliance initiatives at an American Law Institute-American Bar Association program in Boston on international trusts and estate planning. The following is a summary of the important comments made, all of which directly affect the recent IRS focus on offshore activities of U.S. taxpayers.

The history of the offshore credit card program (OCCP) was reviewed, including the initiatives beginning in 2000 when a U.S. federal judge approved the use of a John Doe summons on American Express and MasterCard to obtain offshore credit card information in countries such as Antigua, the Bahamas, the Cayman Islands, and several other offshore jurisdictions. The IRS believes that using a third-party summons directed to credit card process companies is much more useful because the identity of the user is revealed. A summons issued to the credit card companies provides only the name of the foreign entity in which the foreign credit card account is maintained, but not necessarily the identity of the individuals actually using the offshore credit card.

The IRS has trained about 1,200 revenue agents to participate in the OCCP, and many of the OCCP audit inquiries are becoming routine audit questions for all IRS examinations. About 1,500 investigations that were initiated with the John Doe summons are pending.

The voluntary disclosure procedure, which allows taxpayers to come forward voluntarily and anonymously to describe failure to file or failure to report fact patterns, has been modified. CI does not provide amnesty until the taxpayer is identified, compared with prior procedures in which CI would provide amnesty during the anonymous stage.

Unlike the Offshore Voluntary Compliance Initiative (OVCI)[182] and other settlement initiatives such as the son-of-BOSS U.S. initiative, the Chief Counsel Office cautioned that future settlement initiatives would generally be targeted toward specific participants. The IRS is less likely to issue press releases announcing global settlement programs such as the OVCI.

Other important IRS offshore initiatives include the Joint International Tax Shelter Information Center in which the U.S., U.K., and Canada are jointly coordinating a real-time exchange of information on offshore promotions and schemes. Also, it would be worthwhile to monitor the Leeds Castle group, which involves meetings of the commissioners of the tax authorities of Australia, China, France, Germany, India, Japan, South Korea, the United Kingdom, and the United States.

[182]Initiated in Rev. Proc. 2003-11, 2003-1 C.B. 311 (Jan. 2003).

R. Security Concerns in the Workplace

On June 8, 2006, the IRS announced that it would be reviewing its security measures and would work more quickly to install new fingerprint and encryption devices in the wake of an employee losing an IRS laptop while traveling on a cross-country flight. The IRS employee apparently checked the laptop with his luggage. The laptop contained the fingerprints and personal data of 291 IRS employees and job applicants. The laptop was lost in transit and was never recovered.

S. China-Mauritius Protocol Cuts Back on Capital Gains Exemption

On September 5, 2006, PRC and Mauritius executed a protocol to amend the Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income. Although not directly U.S.-related, this change has significant U.S. international repercussions, as Mauritius has been an excellent inbound investment vehicle in the PRC for U.S. investors.

Under the protocol, and effective January 1, 2007, in the PRC and July 1, 2007, in Mauritius (subject to completion of necessary ratification procedures of both parties by December 31, 2006), this capital gain exemption protection will be terminated. Capital gains derived by Mauritian-resident investors from the disposition of PRC shares, in which the Mauritian-resident investor holds 25 percent or more of the equity interest for the 12 months before the disposition, will be subject to tax in China. The protocol does not include an attribution or aggregation rule, but as mentioned above, would be triggered for any 25 percent or more equity holder. In addition to the capital gains provision, the protocol replaces the exchange of information procedure in article 26 to a much less restrictive version.

From a U.S. perspective, investment in PRC through Mauritius has traditionally been preferable to a direct investment scenario based on the 1984 China-U.S. income tax treaty because of withholding tax rates on dividends. Another historic jurisdiction for inbound Chinese investment has been Barbados because the Barbados-China tax treaty not only exempts withholding tax on capital gains but also exonerates Chinese tax on capital gains associated with immovable property.

Practitioner's Comment: In light of the 2007 effective dates for the protocol, U.S. investors who are structured through a Mauritian holding company should consider several planning alternatives. A U.S. investor with multiple Chinese equity investments should consider structuring each separate Chinese investment under a separate Mauritian holding company so that the disposition of the Mauritian holding company shares could be more easily structured, as opposed to having multiple PRC companies owned by the same holding company. The transfers would need to comport with Chinese regulations, and a good business purpose would need to be shown for the restructuring. Another alternative would be to restructure the holding company to migrate or reorganize the Mauritian holding company into a more favorable tax jurisdiction, such as Barbados, Switzerland, or possibly Hong Kong. Although Barbados and Switzerland offer exemptions from capital gains in their respective treaties, speculation is that those treaties will be modified by a protocol similar to that between Mauritius and the P.R.C. given that the new China-Hong Kong double tax treaty taxes capital gains.

T. U.S. and CNMI Agree to Payment of 'Cover Over' Taxes

The Commonwealth of the Northern Mariana Islands (CNMI) filed a lawsuit against the U.S. Treasury Department claiming that the U.S. government violated article 7 of the Covenant Agreement between the U.S. and the CNMI. The U.S. government refused to remit CNMI estate and gift taxes levied on inhabitants of the CNMI from 1978 to the present (commonly known as "cover over" taxes). According to a press conference held by the CNMI attorney general, the U.S. agreed to pay $6.2 million and to continue to make additional payments on a piecemeal basis.

Practitioner's Comment: Because of the overhaul of the possessions' residency and source rules in the Jobs Act and the litigation from the pre-Jobs Act years, the issue of cover-over tax reimbursements is critical to the relevant U.S. possessions. As of the press date of this article, there was no word on the resolution of this issue for income taxes.

U. Isle of Man-U.S. TIEA

On September 1, 2006, the U.S. Treasury Department announced the tax information exchange agreement between the U.S. and the Isle of Man has been adopted and has entered into force. This is not breaking news, because the agreement was signed on October 3, 2002. However, the agreement cycled through the levels of U.S. and Isle of Man approval before entering into force. ◆