

SUPPLEMENTAL MATERIALS

FOR

**U.S. INTERNATIONAL TAX PLANNING AND POLICY
INCLUDING
CROSS-BORDER MERGERS AND ACQUISITIONS
(Carolina Academic Press 2007)**

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[To Be Updated Periodically]**

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I. CHAPTER 1, SCOPE AND INTRODUCTION

A. Page 53, New Sec. 1.9.B. International No Ruling Areas 2010

Page 53, New Sec. 1.9.B. Replace the current Sec. 1.9.B with the following:
New Sec. 1.9.B. **International No Ruling Areas 2010**

Revenue Procedure 2010-7

International Areas For Which Rulings, Determination Letters Will Not Be Issued I.R.B. 2010-1, 231

[In many instances tax attorneys and accountants will want to ask the IRS for a “private letter ruling” on a particular transaction. The ruling will set out the manner in which the IRS will treat the transaction and is binding on the IRS as long as all of the facts have been correctly disclosed. Each year the IRS issues a Rev. Proc. setting forth areas in which it will not issue private letter rulings. Set out below are excerpts from Rev. Proc. 2010-7, which sets out the “no rulings” areas for 2009 dealing with international issues. In dealing with any issue it is important to ascertain if the issue is set out in the current “no ruling” Rev. Proc.]

.01 This revenue procedure updates Rev. Proc. 2009-7, 2009-1 C.B. 226, by providing a current list of those areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (International) relating to matters on which the Internal Revenue Service will not issue letter rulings or determination letters.

BACKGROUND AND SCOPE OF APPLICATION

Background

In the interest of sound tax administration, the Service answers inquiries from individuals and organizations regarding their status for tax purposes and the tax effects of their acts or transactions before the filing of returns or reports that are required by the Internal Revenue Code. There are, however, areas where the Service will not issue letter rulings or determination letters, either because the issues are inherently factual or for other reasons. These areas are set forth in sections 3 and 4 of this revenue procedure.

Section 3 lists areas in which letter rulings and determination letters will not be issued under any circumstances.

Section 4 lists areas in which they will not ordinarily be issued; in these areas, unique and compelling reasons may justify issuing a letter ruling or determination letter. A taxpayer

who plans to request a letter ruling or determination letter in an area described in Section 4 should contact (by telephone or in writing) the Office of Associate Chief Counsel (International) (hereinafter "the Office") prior to making such request and discuss with the Office the unique and compelling reasons that the taxpayer believes justify issuing such letter ruling or determination letter. While not required, a written submission is encouraged since it will enable Office personnel to arrive more quickly at an understanding of the unique facts of each case. A taxpayer who contacts the Office by telephone may be requested to provide a written submission. The Service may provide a general information letter in response to inquiries in areas on either list. These lists are not all-inclusive. Future revenue procedures may add or delete items. The Service may also decline to rule on an individual case for reasons peculiar to that case, and such decision will not be announced in the Internal Revenue Bulletin.

Scope of Application

This revenue procedure does not preclude the submission of requests for technical advice to the Office from other offices of the Service.

AREAS IN WHICH RULING OR DETERMINATION LETTERS WILL NOT BE ISSUED

Specific Questions and Problems * * *

(3) Section 871 (g).-Special Rules for Original Issue Discount.-Whether a debt instrument having original issue discount within the meaning of § 1273 is not an original issue discount obligation within the meaning of § 871 (g) (1) (B) (i) when the instrument is payable 183 days or less from the date of original issue (without regard to the period held by the taxpayer).

(4) Section 894.-Income Affected by Treaty.-Whether a person that is a resident of a foreign country and derives income from the United States is entitled to benefits under the United States income tax treaty with that foreign country pursuant to the limitation on benefits article. However, the Service may rule regarding the legal interpretation of a particular provision within the relevant limitation on benefits article.

(5) Section 954.-Foreign Base Company Income.-The effective rate of tax that a foreign country will impose on income.

(6) Section 7701 (b).-Definition of Resident Alien and Nonresident Alien.-Whether an alien individual is a nonresident of the United States, including whether the individual has met the requirements of the substantial presence test or exceptions to the substantial presence test. However, the Service may rule regarding the legal interpretation of a particular provision of § 7701 (b) or the regulations thereunder.

General Areas.

- (1) The prospective application of the estate tax to the property or the estate of a living person, except that rulings may be issued on any international issues in a ruling request accepted pursuant to § 5.06 of Rev. Proc. 2010-1.
- (2) Whether reasonable cause exists under Subtitle F (Procedure and Administration) of the Code.
- (3) Whether a proposed transaction would subject a taxpayer to criminal penalties.
- (4) Any area where the ruling request does not comply with the requirements of Rev. Proc. 2010-1.
- (5) Any area where the same issue is the subject of the taxpayer's pending request for competent authority assistance under a United States tax treaty.
- (6) A "comfort" ruling will not be issued with respect to an issue that is clearly and adequately addressed by statute, regulations, decisions of a court, tax treaties, revenue rulings, or revenue procedures absent extraordinary circumstances (e.g., a request for a ruling required by a governmental regulatory authority in order to effectuate the transaction.)
- (7) Any frivolous issue, as that term is defined in § 6.10 of Rev. Proc. 2010-1.

AREAS IN WHICH RULING OR DETERMINATION LETTERS WILL NOT ORDINARILY BE ISSUED

Specific Questions and Problems

- (1) Section 367 (a).-Transfers of Property from the United States.-Whether an oil or gas working interest is transferred from the United States for use in the active conduct of a trade or business for purposes of § 367 (a) (3); and whether any other property is so transferred, where the determination requires extensive factual inquiry.
- (2) Section 367 (b).-Other Transfers.-Whether a foreign corporation is considered a corporation for purposes of any nonrecognition provision listed in § 367 (b), and related issues, unless the ruling request presents a significant legal issue or subchapter C rulings are requested in the context of reorganizations or liquidations involving foreign corporations.
- (3) Section 864.-Definitions and Special Rules.-Whether a taxpayer is engaged in a trade or business within the United States, and whether income is effectively connected with the conduct of a trade or business within the United States; whether an instrument is a security as defined in § 1.864-2 (c) (2); whether a taxpayer effects transactions in the

United States in stocks or securities under § 1.864-2 (c) (2); whether an instrument or item is a commodity as defined in § 1.864-2 (d) (3); and for purposes of § 1.864-2 (d) (1) and (2), whether a commodity is of a kind customarily dealt in on an organized commodity exchange, and whether a transaction is of a kind customarily consummated at such place.

(4) Section 871.-Tax on Nonresident Alien Individuals.-Whether the income earned on contracts that do not qualify as annuities or life insurance contracts because of the limitations imposed by § 72 (s) and § 7702 (a) is portfolio interest as defined in § 871 (h).

(5) Section 881.-Tax on Income of Foreign Corporations Not Connected with United States Business.-Whether the income earned on contracts that do not qualify as annuities or life insurance contracts because of the limitations imposed by § 72 (s) and § 7702 (a) is portfolio interest as defined in § 881 (c).

(6) Section 892.-Income of Foreign Governments and of International Organizations.-Whether income derived by foreign governments and international organizations from sources within the United States is excluded from gross income and exempt from taxation and any underlying issue related to that determination. * * *

(9) Section 894.-Income Affected by Treaty.-Whether a taxpayer has a permanent establishment in the United States for purposes of any United States income tax treaty and whether income is attributable to a permanent establishment in the United States.

(10) Section 894.-Income Affected by Treaty.-Whether certain persons will be considered liable to tax under the laws of a foreign country for purposes of determining if such persons are residents within the meaning of any United States income tax treaty. But see Rev. Rul. 2000-59, 2000-2 C.B. 593. * * *

(15) Section 894.-Income Affected by Treaty.-Whether an entity is treated as fiscally transparent by a foreign jurisdiction for purposes of § 894 (c) and the regulations thereunder.

(16) Section 901.-Taxes of Foreign Countries and of Possessions of United States.-Whether a foreign levy meets the requirements of a creditable tax under §901.

(17) Section 901.-Taxes of Foreign Countries and of Possessions of United States.-Whether a person claiming a credit has established, based on all of the relevant facts and circumstances, the amount (if any) paid by a dual capacity taxpayer under a qualifying levy that is not paid in exchange for a specific economic benefit. See § 1.901-2A (c) (2).

(18) Section 903.-Credit for Taxes in Lieu of Income, Etc., Taxes.-Whether a foreign levy meets the requirements of a creditable tax under § 903 * * *

(22) Section 956.-Investment of Earnings in United States Property.-Whether a pledge of the stock of a controlled foreign corporation is an indirect pledge of the assets of that corporation. See § 1.956-2 (c) (2).

(23) Section 985.-Functional Currency.-Whether a currency is the functional currency of a qualified business unit.

(24) Section 989 (a).-Qualified Business Unit.-Whether a unit of the taxpayer's trade or business is a qualified business unit. * * *

(26) Section 1503 (d).-Dual Consolidated Loss.-Whether the income tax laws of a foreign country would deny any opportunity for the foreign use of a dual consolidated loss in the year in which the dual consolidated loss is incurred under § 1.1503 (d)-3 (e) (1); whether no possibility of foreign use exists under § 1.1503 (d)-6 (c) (1); whether an event presumptively constitutes a triggering event under § 1.1503 (d)-6 (e) (1) (i)-(ix); whether the presumption of a triggering event is rebutted under § 1.1503 (d)-6 (e) (2); and whether a domestic use agreement terminates under § 1.1503 (d)-6 (j) (1). The Service will also not ordinarily rule on the corresponding provisions of prior regulations under section 1503 (d).

(27) Section 2501.-Imposition of Tax.-Whether a partnership interest is intangible property for purposes of § 2501 (a) (2) (dealing with transfers of intangible property by a nonresident not a citizen of the United States).

(28) Section 7701.-Definitions.-Whether an estate or trust is a foreign estate or trust for federal income tax purposes.

(29) Section 7701.-Definitions.-Whether an intermediate entity is a conduit entity under § 1.881-3 (a) (4); whether a transaction is a financing transaction under § 1.881-3 (a) (ii); whether the participation of an intermediate entity in a financing arrangement is pursuant to a tax avoidance plan under § 1.881-3 (b); whether an intermediate entity performs significant financing activities under § 1.881-3 (b) (3) (ii); whether an unrelated intermediate entity would not have participated in a financing arrangement on substantially the same terms under § 1.881-3 (c).

(30) Section 7874.-Expatriated Entities and their Foreign Parents.-Whether, after the acquisition, the expanded affiliated group has substantial business activities in the foreign country in which, or under the law of which, the acquiring foreign entity is created or organized, when compared to the total business activities of the expanded affiliated group.

General Areas

(1) Whether a taxpayer has a business purpose for a transaction or arrangement.

(2) Whether a taxpayer uses a correct North American Industry Classification System (NAICS) code or Standard Industrial Classification (SIC) code.

(3) Any transaction or series of transactions that is designed to achieve a different tax consequence or classification under U.S. tax law (including tax treaties) and the tax law of a foreign country, where the results of that different tax consequence or classification are inconsistent with the purposes of U.S. tax law (including tax treaties).

(4) (a) Situations where a taxpayer or a related party is domiciled or organized in a foreign jurisdiction with which the United States does not have an effective mechanism for obtaining tax information with respect to civil tax examinations and criminal tax investigations, which would preclude the Service from obtaining information located in such jurisdiction that is relevant to the analysis or examination of the tax issues involved in the ruling request.

(b) The provisions of subsection 4.02 (4) (a) above shall not apply if the taxpayer or affected related party (i) consents to the disclosure of all relevant information requested by the Service in processing the ruling request or in the course of an examination to verify the accuracy of the representations made and to otherwise analyze or examine the tax issues involved in the ruling request, and (ii) waives all claims to protection of bank or commercial secrecy laws in the foreign jurisdiction with respect to the information requested by the Service. In the event the taxpayer's or related party's consent to disclose relevant information or to waive protection of bank or commercial secrecy is determined by the Service to be ineffective or of no force and effect, then the Service may retroactively rescind any ruling rendered in reliance on such consent.

(5) The federal tax consequences of proposed federal, state, local, municipal, or foreign legislation.

(6) (a) Situations involving the interpretation of foreign law or foreign documents. The interpretation of a foreign law or foreign document means making a judgment about the import or effect of the foreign law or document that goes beyond its plain meaning.

(b) The Service, at its discretion, may consider rulings that involve the interpretation of foreign laws or foreign documents. In these cases, the Service may request information in addition to that listed in §§ 7.01 (2) (b) and (c) of Revenue Procedure 2009-1, including a discussion of the implications of any authority believed to interpret the foreign law or foreign document, such as pending legislation, treaties, court decisions, notices or administrative decisions. * * *

B. Page 63, New Sec. 1.10.A. South Africa's Secondary Tax on Companies (STC) Abolished

Page 63, New Sec. 1.10.A. Add before Sec. 1.11 the following:

New Sec. 1.10.A. **South Africa's Secondary Tax on Companies (STC)
Abolished**

The STC has been abolished and replaced with a dividend withholding tax of 10%.

***C. Page 64, New Sec. 1.12. President Obama's May 4, 2009
Speech Regarding His Proposed Changes to the
International Tax Rules***

Page 64, New Sec. 1.12. Add at the end of the text the following:

New Sec. 1.12. **President Obama's May 4, 2009 Speech Regarding His
Proposed Changes to the International Tax Rules**

President Obama Speaking at the White House, May 4, 2009

All right. Good morning, everybody. Hope you all had a good weekend.

Let's begin with a simple premise: Nobody likes paying taxes, particularly in times of economic stress. But most Americans meet their responsibilities because they understand that it's an obligation of citizenship, necessary to pay the costs of our common defense and our mutual well-being.

And yet, even as most American citizens and businesses meet these responsibilities, there are others who are shirking theirs. And many are aided and abetted by a broken tax system, written by well-connected lobbyists on behalf of well-heeled interests and individuals. It's a tax code full of corporate loopholes that makes it perfectly legal for companies to avoid paying their fair share. It's a tax code that makes it all too easy for a number — a small number of individuals and companies to abuse overseas tax havens to avoid paying any taxes at all. And it's a tax code that says you should pay lower taxes if you create a job in Bangalore, India, than if you create one in Buffalo, New York.

Now, understand, one of the strengths of our economy is the global reach of our businesses. And I want to see our companies remain the most competitive in the world. But the way to make sure that happens is not to reward our companies for moving jobs off our shores or transferring profits to overseas tax havens. This is something that I talked about again and again during the course of the campaign. The way we make our businesses competitive is not to reward American companies operating overseas with a roughly 2 percent tax rate on foreign profits; a rate that costs — that costs taxpayers tens of billions of dollars a year. The way to make American businesses competitive is not to let some citizens and businesses dodge their responsibilities while ordinary Americans pick up the slack.

Unfortunately, that's exactly what we're doing. These problems have been highlighted by Chairmen Charlie Rangel and Max Baucus, by leaders like Senator Carl Levin and

Congressman Lloyd Doggett. And now is the time to finally do something about them. And that's why today, I'm announcing a set of proposals to crack down on illegal overseas tax evasion, close loopholes, and make it more profitable for companies to create jobs here in the United States.

For years, we've talked about ending tax breaks for companies that ship jobs overseas and giving tax breaks to companies that create jobs here in America. That's what our budget will finally do. We will stop letting American companies that create jobs overseas take deductions on their expenses when they do not pay any American taxes on their profits. And we will use the savings to give tax cuts to companies that are investing in research and development here at home so that we can jumpstart job creation, foster innovation, and enhance America's competitiveness.

For years, we've talked about shutting down overseas tax havens that let companies set up operations to avoid paying taxes in America. That's what our budget will finally do. On the campaign, I used to talk about the outrage of a building in the Cayman Islands that had over 12,000 business — businesses claim this building as their headquarters. And I've said before, either this is the largest building in the world or the largest tax scam in the world.

And I think the American people know which it is. It's the kind of tax scam that we need to end. That's why we are closing one of our biggest tax loopholes. It's a loophole that lets subsidiaries of some of our largest companies tell the IRS that they're paying taxes abroad, tell foreign governments that they're paying taxes elsewhere — and avoid paying taxes anywhere. And closing this single loophole will save taxpayers tens of billions of dollars — money that can be spent on reinvesting in America — and it will restore fairness to our tax code by helping ensure that all our citizens and all our companies are paying what they should.

Now, for years, we've talked about stopping Americans from illegally hiding their money overseas, and getting tough with the financial institutions that let them get away with it. The Treasury Department and the IRS, under Secretary Geithner's leadership and Commissioner Shulman's, are already taking far-reaching steps to catch overseas tax cheats — but they need more support.

And that's why I'm asking Congress to pass some commonsense measures. One of these measures would let the IRS know how much income Americans are generating in overseas accounts by requiring overseas banks to provide 1099s for their American clients, just like Americans have to do for their bank accounts here in this country. If financial institutions won't cooperate with us, we will assume that they are sheltering money in tax havens, and act accordingly. And to ensure that the IRS has the tools it needs to enforce our laws, we're seeking to hire nearly 800 more IRS agents to detect and pursue American tax evaders abroad.

So all in all, these and other reforms will save American taxpayers \$210 billion over the next 10 years — savings we can use to reduce the deficit, cut taxes for American

businesses that are playing by the rules, and provide meaningful relief for hardworking families. That's what we're doing. We're putting a middle class tax cut in the pockets of 95 percent of working families, and we're providing a \$2,500 annual tax credit to put the dream of a college degree or advanced training within the reach for more students. We're providing a tax credit worth up to \$8,000 for first-time home buyers to help more Americans own a piece of the American Dream and to strengthen the housing market.

So the steps I am announcing today will help us deal with some of the most egregious examples of what's wrong with our tax code and will help us strengthen some of these other efforts. It's a down payment on the larger tax reform we need to make our tax system simpler and fairer and more efficient for individuals and corporations.

Now, it will take time to undo the damage of distorted provisions that were slipped into our tax code by lobbyists and special interests, but with the steps I'm announcing today we are beginning to crack down on Americans who are bending or breaking the rules, and we're helping to ensure that all Americans are contributing their fair share.

In other words, we're beginning to restore fairness and balance to our tax code. That's what I promised I would do during the campaign, that's what I'm committed to doing as President, and that is what I will work with members of my administration and members of Congress to accomplish in the months and years to come.

Thanks very much, guys.

***D. Page 64, New Sec. 1.12.A. Treasury Department's
Detailed Discussion of President Obama's Proposed
Changes to the International Tax Rules***

Page 64, New Sec. 1.12.A. Add after New Sec. 1.12 the following:

New Sec. 1.12.A. **Treasury Department's Detailed Discussion of
President Obama's Proposed Changes to the International Tax Rules**

**General Explanations
of the
Administration's Fiscal Year 2011
Revenue Proposals
May 2010**

Reform U.S. International Tax System

**REFORM BUSINESS ENTITY CLASSIFICATION RULES FOR FOREIGN
ENTITIES**

Current Law

Under current Treasury regulations, an eligible business entity can elect its classification

for federal tax purposes. An eligible business entity with a single owner may elect to be treated as a corporation or as an entity disregarded as an entity separate from its owner (a "disregarded entity"). An eligible business entity with at least two owners may elect to be treated as a partnership or as a corporation. Certain foreign entities are always treated as corporations for federal tax purposes (so called "per se corporations").

Reasons for Change

As applied to foreign eligible entities, the entity classification rules may result in the unintended avoidance of current U.S. tax, particularly if a foreign eligible entity elects to be treated as a disregarded entity. In certain cases, locating a foreign disregarded entity under a centralized holding company (or partnership) may permit the migration of earnings to low-taxed jurisdictions without a current income inclusion of the amount of such earnings to a U.S. taxpayer under the subpart F provisions of the Code.

Proposal

Under the proposal, a foreign eligible entity may be treated as a disregarded entity only if the single owner of the foreign eligible entity is created or organized in, or under the law of, the foreign country in, or under the law of, which the foreign eligible entity is created or organized. Therefore, a foreign eligible entity with a single owner that is organized or created in a country other than that of its single owner would be treated as a corporation for federal tax purposes. Except in cases of U.S. tax avoidance, the proposal would generally not apply to a first-tier foreign eligible entity wholly owned by a United States person. The tax treatment of the conversion to a corporation of a foreign eligible entity treated as a disregarded entity would be consistent with current Treasury regulations and relevant tax principles.

The proposal would be effective for taxable years beginning after December 31, 2010.

DEFER DEDUCTION OF EXPENSES, EXCEPT R&E EXPENSES, RELATED TO DEFERRED INCOME

Current law

Taxpayers generally may deduct ordinary and necessary expenses paid or incurred in carrying on any trade or business. The Internal Revenue Code and the regulations thereunder contain detailed rules regarding allocation and apportionment of expenses for computing taxable income from sources within and without the United States.

Reasons for Change

Under current law, a U.S. person that incurs expenses properly allocable and apportioned to foreign-source income may deduct those expenses even if the expenses exceed the taxpayer's gross foreign-source income or if the taxpayer earns no foreign-source income. For example, a U.S. person that incurs debt to acquire stock of a foreign corporation is

generally permitted to deduct currently the interest expense from the acquisition indebtedness even if no income is derived currently from such stock. The U.S. person is also permitted to deduct currently other expenses properly allocated or apportioned to the stock of the foreign corporation. Current law includes provisions that may require a U.S. person to recapture as U.S.-source income the amount by which foreign-source expenses exceed foreign-source income for a taxable year. However, if in a taxable year the U.S. person earns sufficient foreign-source income of the same statutory grouping in which the stock of the foreign corporation is classified, the interest and other expenses properly allocated and apportioned to the stock of the foreign corporation may not be subject to recapture in a subsequent taxable year. This ability to deduct expenses from overseas investments while deferring U.S. tax on the income from the investment may cause U.S. businesses to shift their investments and jobs overseas, harming our domestic economy.

Proposal

The proposal would defer a deduction for expenses (other than research and experimentation expenditures) of a U.S. person that are properly allocated and apportioned to foreign-source income to the extent the foreign-source income associated with the expenses is not currently subject to U.S. tax. The amount of expenses properly allocated and apportioned to foreign-source income generally would be determined under current Treasury regulations. The amount of deferred expenses for a particular year would be carried forward to subsequent years and combined with the foreign-source expenses of the U.S. person for such year before determining the impact of the proposal in such year.

The proposal would be effective for taxable years beginning after December 31, 2010.

REFORM FOREIGN TAX CREDIT: DETERMINE THE FOREIGN TAX CREDIT ON A POOLING BASIS

Current law

Section 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or any possession of the United States. Under section 902, a domestic corporation is deemed to have paid the foreign taxes paid by certain foreign subsidiaries from which it receives a dividend (the deemed paid foreign tax credit). The foreign tax credit is limited to an amount equal to the pre-credit U.S. tax on the taxpayer's foreign-source income. This foreign tax credit limitation is applied separately to foreign-source income in each of the separate categories described in section 904(d), i.e., the passive category and general category.

Reasons for Change

The purpose of the foreign tax credit is to mitigate the potential for double taxation when U.S. taxpayers are subject to foreign taxes on their foreign-source income. The reduction

to two foreign tax credit limitation categories for passive category income and general category income under the American Jobs Creation Act of 2004 enhanced U.S. taxpayers' ability through "cross-crediting" to reduce the residual U.S. tax on foreign-source income.

Proposal

Under the proposal, a U.S. taxpayer would determine its deemed paid foreign tax credit on a consolidated basis by determining the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit (including lower tier subsidiaries described section 902(b)). The deemed paid foreign tax credit for a taxable year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year.

The proposal would be effective for taxable years beginning after December 31, 2010.

REFORM FOREIGN TAX CREDIT: PREVENT SPLITTING OF FOREIGN INCOME AND FOREIGN TAXES

Current law

Section 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or any possession of the United States. Under current law, the person considered to have paid the foreign tax is the person on whom foreign law imposes legal liability for such tax.

Reasons for Change

Current law permits inappropriate separation of creditable foreign taxes from the associated foreign income in certain cases such as those involving hybrid arrangements.

Proposal

The proposal would adopt a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income.

The proposal would be effective for taxable years beginning after December 31, 2010.

LIMIT SHIFTING OF INCOME THROUGH INTANGIBLE PROPERTY TRANSFERS

Current law

Section 482 permits the Commissioner to distribute, apportion, or allocate gross income,

deductions, credits, and other allowances between or among two or more organizations, trades, or businesses under common ownership or control whenever "necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." Section 482 also provides that in the case of any transfer (or license) of intangible property (as defined in section 936(h)(3)(B)), the income with respect to such transfer or license must be commensurate with the income attributable to the intangible property. Further, under section 367(d), if a U.S. person transfers intangible property (as defined in section 936(h)(3)(B)) to a foreign corporation in certain nonrecognition transactions, the U.S. person is treated as selling the intangible property for a series of payments contingent on the productivity, use, or disposition of the property that are commensurate with the transferee's income from the property. The payments generally continue annually over the useful life of the property.

Reasons for Change

Controversy often arises concerning the value of intangible property transferred between related persons. Further, the scope of the intangible property subject to sections 482 and 367(d) is not entirely clear or consistent. This lack of clarity and consistency may result in the inappropriate avoidance of U.S. tax and misuse of the rules applicable to transfers of intangible property to foreign persons.

Proposal

To prevent inappropriate shifting of income outside the United States, the proposal would clarify the definition of intangible property for purposes of sections 367(d) and 482 to include workforce in place, goodwill and going concern value. The proposal would also clarify that in a transfer of multiple intangible properties, the Commissioner may value the intangible properties on an aggregate basis where that achieves a more reliable result. The proposal would also clarify that intangible property must be valued at its highest and best use, as it would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

The proposal would be effective for taxable years beginning after December 31, 2010.

LIMIT EARNINGS STRIPPING BY EXPATRIATED ENTITIES

Current law

Section 163(j) applies to limit the deductibility of certain interest paid by a corporation to related persons. The limitation applies to a corporation that fails a debt-to-equity safe harbor (greater than 1.5 to 1) and that has net interest expense in excess of 50 percent of adjusted taxable income (computed by adding back net interest expense, depreciation, amortization and depletion, and any net operating loss deduction). Disallowed interest expense may be carried forward indefinitely for deduction in a subsequent year. In

addition, the corporation's excess limitation for a tax year (i.e., the amount by which 50 percent of adjusted taxable income exceeds net interest expense) may be carried forward to the three subsequent tax years.

Section 7874 provides special rules for expatriated entities and the acquiring foreign corporations. The rules apply to certain defined transactions in which a U.S. parent company (the expatriated entity) is essentially replaced with a foreign parent (the surrogate foreign corporation). The tax treatment of an expatriated entity and a surrogate foreign corporation varies depending on the extent of continuity of shareholder ownership following the transaction. The surrogate foreign corporation is treated as a domestic corporation for all purposes of the Code if shareholder ownership continuity is at least 80 percent (by vote or value). If shareholder ownership continuity is at least 60 percent, but less than 80 percent, the surrogate foreign corporation is treated as a foreign corporation but any applicable corporate-level income or gain required to be recognized by the expatriated entity generally cannot be offset by tax attributes. Section 7874 generally applies to transactions occurring on or after March 4, 2003.

Reasons for Change

Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. In its recent study of earnings stripping, the Treasury Department found strong evidence of the use of such techniques by expatriated entities. Consequently, amending the rules of section 163(j) for expatriated entities is necessary to prevent these inappropriate income-reduction opportunities. Because the study did not find conclusive evidence of earnings stripping by foreign-controlled domestic corporations that have not expatriated, additional information is needed to determine whether changes to section 163(j) should be made with respect to those companies. The new Form 8926, Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information, should assist in obtaining this information.

Proposal

The proposal would revise section 163(j) to tighten the limitation on the deductibility of interest paid by an expatriated entity to related persons. The current law debt-to-equity safe harbor would be eliminated. The 50 percent adjusted taxable income threshold for the limitation would be reduced to 25 percent of adjusted taxable income with respect to disqualified interest other than interest paid to unrelated parties on debt that is subject to a related-party guarantee ("guaranteed debt"). The 50 percent adjusted taxable income threshold would generally continue to apply to interest on guaranteed debt. The carryforward for disallowed interest would be limited to ten years and the carryforward of excess limitation would be eliminated.

An expatriated entity would be defined by applying the rules of section 7874 and the regulations thereunder as if section 7874 were applicable for taxable years beginning after July 10, 1989. This special rule would not apply, however, if the surrogate foreign

corporation is treated as a domestic corporation under section 7874.

The proposal would be effective for taxable years beginning after December 31, 2010.

PREVENT REPATRIATION OF EARNINGS IN CERTAIN CROSS-BORDER REORGANIZATIONS

Current law

Under section 356(a)(1), if as part of a reorganization transaction an exchanging shareholder receives in exchange for its stock of the target corporation both stock and property that cannot be received without the recognition of gain (so-called "boot"), the exchanging shareholder is required to recognize gain equal to the lesser of the gain realized in the exchange or the amount of boot received (commonly referred to as the "boot within gain" limitation). Further, under section 356(a)(2), if the exchange has the effect of the distribution of a dividend, then all or part of the gain recognized by the exchanging shareholder is treated as a dividend to the extent of the shareholder's ratable share of the corporation's earnings and profits. The remainder of the gain (if any) is treated as gain from the exchange of property.

Reasons for Change

In cross-border reorganizations, the boot-within-gain limitation of current law can permit U.S. shareholders to repatriate previously-untaxed earnings and profits of foreign subsidiaries with minimal U.S. tax consequences. For example, if the exchanging shareholder's stock in the target corporation has little or no built-in gain at the time of the exchange, the shareholder will recognize minimal gain even if the exchange has the effect of the distribution of a dividend and/or a significant amount (or all) of the consideration received in the exchange is boot. This result applies even if the corporation has previously untaxed earnings and profits equal to or greater than the boot. This result is inconsistent with the principle that previously untaxed earnings and profits of a foreign subsidiary should be subject to U.S. tax upon repatriation.

Proposal

The proposal would repeal the boot-within-gain limitation of current law in the case of any reorganization in which the acquiring corporation is foreign and the shareholder's exchange has the effect of the distribution of a dividend, as determined under section 356(a)(2).

The proposal would be effective for taxable years beginning after December 31, 2010.

REPEAL 80/20 COMPANY RULES

Current law

Dividends and interest paid by a domestic corporation are generally U.S.-source income to the recipient and are generally subject to gross basis withholding tax if paid to a foreign person. A limited exception to these general rules applies with respect to a domestic corporation (a so-called "80/20" company) if at least 80 percent of the corporation's gross income during a three-year testing period is foreign-source and attributable to the active conduct of a foreign trade or business. Look-through rules apply to determine the character of certain income of the 80/20 company for this purpose.

Reasons for Change

The 80/20 company provisions can be manipulated and should be repealed.

Proposal

The proposal would repeal the 80/20 company provisions under current law.

The proposal would be effective for taxable years beginning after December 31, 2010.

PREVENT THE AVOIDANCE OF DIVIDEND WITHHOLDING TAXES

Current law

A withholding agent generally must withhold a tax of 30 percent from the gross amount of all U.S.-source fixed or determinable annual or periodical (FDAP) income, profits, or gains of a nonresident alien individual, foreign corporation, or foreign partnership. In general, dividends paid with respect to the stock of a domestic corporation are U.S.-source dividends. Thus, foreign investors holding stock in domestic corporations are generally subject to 30 percent tax on dividends paid with respect to that stock. This rate may be reduced where the dividends are paid to a resident of a jurisdiction with which the United States has entered into a tax treaty.

The source of income from notional principal contracts is generally determined based on the residence of the investor. As a result, substitute dividend payments made to a foreign investor with respect to an equity swap referencing U.S. equities are treated as foreign-source and are therefore not subject to U.S. withholding tax.

Reason for Change

Foreign portfolio investors seeking to benefit from the appreciation in value and dividends paid with respect to the stock of a domestic corporation are not limited to holding stock in the corporation. Instead, such an investor can enter into an equity swap. The U.S. tax consequences of these two alternative investments differ significantly. By entering into equity swaps, foreign portfolio investors receive the economic benefit of dividends paid and appreciation in value with respect to U.S. stock without being subject to gross-basis withholding tax.

Proposal

In order to address the avoidance of U.S. withholding tax through the use of securities lending transactions, the Treasury Department plans to revoke Notice 97-66 and issue guidance that eliminates the benefits of such transactions but minimizes over-withholding.

Further, income earned by foreign persons with respect to equity swaps that reference U.S. equities would be treated as U.S.-source to the extent that the income is attributable to (or calculated by reference to) dividends paid by a domestic corporation. An exception to this source rule would apply to swaps with all of the following characteristics:

- o the terms of the equity swap do not require the foreign person to post more than 20 percent of the value of the underlying stock as collateral;
- o the terms of the equity swap do not include any provision addressing the hedge position of the counterparty to the transaction;
- o the underlying stock is publicly traded and the notional amount of the swap represents less than 5 percent of the total public float of that class of stock and less than 20 percent of the 30-day average daily trading volume;
- o the foreign person does not sell the stock to the counterparty at the inception of the contract, or buy the stock from the counterparty at the termination of the contract;
- o the prices of the equity that are used to measure the parties' entitlements or obligations are based on an objectively observable price; and
- o the swap has a term of at least 90 days.

The Treasury Department would be given regulatory authority to provide additional exceptions to implement the purpose of the rule.

The proposal would be effective for payments made after December 31, 2010.

MODIFY THE TAX RULES FOR DUAL CAPACITY TAXPAYERS

Current law

Section 901 provides that, subject to certain limitations, a taxpayer may choose to claim a credit against its U.S. income tax liability for income, war profits, and excess profits

taxes paid or accrued during the taxable year to any foreign country or any possession of the United States. To be a creditable tax, a foreign levy must be substantially equivalent to an income tax under U.S. tax principles, regardless of the label attached to the levy under foreign law. Under current Treasury regulations, a foreign levy is a tax if it is a compulsory payment under the authority of a foreign government to levy taxes and is not compensation for a specific economic benefit provided by the foreign country. Taxpayers that are subject to a foreign levy and that also receive a specific economic benefit from the levying country (dual-capacity taxpayers) may not credit the portion of the foreign levy paid for the specific economic benefit. The current Treasury regulations provide that, if a foreign country has a generally imposed income tax, the dual-capacity taxpayer may treat as a creditable tax the portion of the levy that application of the generally imposed income tax would yield (provided that the levy otherwise constitutes an income tax or an in lieu of tax). The balance of the levy is treated as compensation for the specific economic benefit. If the foreign country does not generally impose an income tax, the portion of the payment that does not exceed the applicable federal tax rate applied to net income is treated as a creditable tax. A foreign tax is treated as generally imposed even if it applies only to persons who are not residents or nationals of that country.

There is no section 904 foreign tax credit separate category for foreign oil and gas income. However, under section 907, the amount of creditable foreign taxes imposed on foreign oil and gas income is limited in any year to the applicable U.S. tax on that income.

Reasons for Change

The purpose of the foreign tax credit is to mitigate double taxation of income by the United States and a foreign country. When a payment is made to a foreign country in exchange for a specific economic benefit, there is no double taxation. Current law recognizes the distinction between creditable taxes and non-creditable payments for a specific economic benefit but fails to achieve the appropriate split between the two in a case where a foreign country imposes a levy on, for example, oil and gas income only, but has no generally imposed income tax.

Proposal

In the case of a dual-capacity taxpayer, the proposal would treat a foreign levy that would otherwise qualify as an income tax or in lieu of tax as a creditable tax only if the foreign country generally imposes an income tax. An income tax would be considered generally imposed for this purpose only if the income tax applies to trade or business income from sources in that country, and only if the income tax has substantial application to non-dual-capacity taxpayers and to persons who are nationals or residents of that country. The proposal would replace the part of the regulatory safe harbor that applies when a foreign country does not generally impose an income tax. The proposal generally would retain the rule of present law where the foreign country does generally impose an income tax. The proposal also would convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income. The

proposal would yield to U.S. treaty obligations that allow a credit for taxes paid or accrued on certain oil or gas income.

The proposal would be effective for taxable years beginning after December 31, 2010.

Combat Under-Reporting of Income Through Use of Accounts and Entities in Offshore Jurisdictions

The Administration is concerned about the use of offshore accounts and entities by certain U.S. and foreign persons to evade U.S. tax. To reduce such evasion, the Administration is proposing a series of measures to strengthen the information reporting and withholding systems that support U.S. taxation of income earned or held through offshore accounts or entities.

The qualified intermediary (QI) program is intended to bring foreign financial institutions more directly into the U.S. information reporting and withholding tax system, thereby helping to ensure that foreign persons are subject to the proper U.S. withholding tax. Strengthening the withholding and reporting rules under which QIs operate with respect to U.S. and foreign persons while creating incentives for more foreign financial institutions to become QIs will help to ensure that U.S. persons are properly paying tax in connection with foreign income and accounts and that proper withholding tax applies with respect to foreign persons.

REQUIRE GREATER REPORTING BY QUALIFIED INTERMEDIARIES REGARDING U.S. ACCOUNT HOLDERS

Current law

A withholding agent generally must withhold tax at a rate of 30 percent from the gross amount of all U.S.-source fixed or determinable annual or periodical gains, profits, or income (FDAP income) of a nonresident alien individual or foreign entity. A payor is generally required to withhold tax at a rate of 28 percent on a reportable payment made to a U.S. non-exempt recipient if the payee fails to provide a taxpayer identification number or fails to certify, when required, that the payee is not subject to backup withholding, or the payor is notified by the IRS or a broker that the payee is subject to backup withholding.

Treasury regulations address certification, documentation, withholding, and reporting of payments to U.S. and foreign persons through foreign financial institutions. Foreign financial institutions may contract with the IRS to operate according to a set of withholding and reporting rules under the so-called "qualified intermediary" (QI) program. QIs agree to collect identifying documentation from their customers, file withholding tax returns and information returns, and submit to periodic audits performed by external auditors supervised by IRS examiners. QIs may furnish a withholding certificate to a withholding agent in lieu of transmitting to the withholding agent documentation for persons for whom the QI receives the payment and, in the case of U.S.

non-exempt recipients, assumes primary Form 1099 reporting and backup withholding responsibility.

QIs need not assume primary Form 1099 reporting and backup withholding responsibility. If a QI nevertheless assumes primary Form 1099 reporting and backup withholding responsibility with respect to accounts held by U.S. persons, such reporting may be limited to certain income earned through those accounts. Further, a QI that assumes primary Form 1099 reporting and backup withholding responsibility with respect to U.S. persons is not required to assume that responsibility for all accounts. Moreover, in the case of financial institutions that are part of a controlled group, one member of the controlled group may contract to be a QI while other members of the controlled group do not, and thus accounts and clients may be divided between commonly-controlled QI and non-QI institutions.

Reasons for Change

Strengthening the withholding and reporting rules under which QIs operate with respect to U.S. persons while creating incentives for the use of QIs would help to ensure that U.S. persons are properly paying tax on income earned through foreign accounts and that proper withholding tax applies with respect to foreign persons. In order to facilitate operation of this strengthened QI program, a list of QIs must be made publicly available.

Proposal

Under the proposal, no foreign financial institution would qualify as a QI unless it identifies all of its account holders that are U.S. persons. A QI would be required to report all reportable payments (for this purpose, treating the QI as a U.S. payor) received on behalf of all U.S. account holders. Thus, a QI would file Form 1099s with respect to payments to those U.S. account holders as though the QI were a U.S. financial institution. The Treasury Department would be authorized to issue regulations to implement the purposes of this proposal, including authority to require that for any financial institution to be a QI, commonly-controlled foreign financial institutions must meet certain reporting obligations with respect to account holders or that a financial institution may be a QI only if all commonly-controlled financial institutions are also QIs, and including authority to provide that for any financial institution to be a QI it must collect information indicating the beneficial owners of foreign entity account holders and specifically report if a U.S. person is a beneficial owner. The proposal would also clarify that under section 6103 of the Code the IRS may publish the list of QIs.

The proposal would be effective beginning after December 31 of the year of enactment.

REQUIRE WITHHOLDING ON PAYMENTS OF FDAP INCOME MADE THROUGH NONQUALIFIED INTERMEDIARIES

Current law

In general, payments of U.S.-source fixed or determinable annual or periodical gains, profits, or income (FDAP income) to nonresident alien individuals and foreign entities are subject to withholding tax at a rate of 30 percent. This 30-percent withholding tax may be reduced or eliminated pursuant to certain statutory provisions or pursuant to the terms of a tax treaty.

To determine whether the recipient of a payment is exempt from withholding tax or eligible for a reduced rate, withholding agents generally must rely on beneficial ownership documentation provided by the payee certifying that the payee is entitled to an exemption from withholding tax or a reduced rate of withholding tax under a Code provision or relevant tax treaty. In general, withholding agents are entitled to rely on the self-certification they receive absent actual knowledge or reason to know that the information provided is incorrect or unreliable. In the case of payments made through an intermediary, the intermediary generally provides to the withholding agent the appropriate documentation on behalf of the payment's beneficial owners.

Reasons for Change

The Administration is concerned that some persons that are not entitled to an exemption from withholding tax or a reduced rate of withholding tax may attempt to avoid U.S. tax by arranging to receive payments through foreign intermediaries that are not qualified intermediaries (nonqualified intermediaries). The proposal would discourage U.S. and foreign persons from attempting to avoid U.S. tax or to obtain a lower rate of withholding tax by providing incorrect self-certification or otherwise relying on the lack of information reporting associated with using nonqualified intermediaries. The proposal would also encourage use of the strengthened qualified intermediary system, by requiring withholding of tax on payments made through nonqualified intermediaries.

Proposal

Any withholding agent making a payment of FDAP income to a nonqualified intermediary would be required to treat the payment as made to an unknown foreign person (and therefore to withhold tax at a rate of 30 percent). The Treasury Department would receive regulatory authority to provide exceptions, including exceptions for payments collected by nonqualified intermediaries for foreign government, central bank, foreign pension fund, and foreign insurance company payees, and other similar investors, and for payments that the Treasury Department concludes present a low risk of tax evasion. The rules will be designed so as not to disrupt ordinary and customary market transactions. Foreign persons that are subject to over-withholding as a result of this proposal would be permitted to apply for a refund of any excess tax withheld.

The proposal would be effective for payments made after December 31 of the year of enactment.

REQUIRE WITHHOLDING ON GROSS PROCEEDS PAID TO CERTAIN NONQUALIFIED INTERMEDIARIES

Current law

Brokers are generally required to withhold tax at a rate of 28 percent on certain reportable payments made to a U.S. non-exempt recipient if the payee fails to provide a taxpayer identification number or fails to certify that the payee is not subject to backup withholding, or the payor is notified by the IRS or a broker that the payee is subject to backup withholding. Reportable payments include the gross proceeds from certain transactions effected by brokers for their customers. A broker is exempt from reporting a payment (and thus backup withholding) where the broker can, prior to payment, associate the payment with documentation upon which it can rely to either treat the customer as a foreign beneficial owner, or treat the payment as made or presumed to be made to a foreign payee. With respect to payments through foreign intermediaries that are not qualified intermediaries (nonqualified intermediaries), brokers may rely on the beneficial owner's self-certification of non-U.S. status passed on by the nonqualified intermediary to determine whether certain third-party information reporting, and therefore backup withholding, may be required.

A withholding agent generally must withhold tax at a rate of 30 percent from the gross amount of all U.S.-source fixed or determinable annual or periodical gains, profits, or income (FDAP income) of a nonresident alien individual or foreign entity. FDAP income includes interest and dividends, but generally does not include gross proceeds or gains from sales. A foreign payee may claim a refund of any overpayment of tax which is withheld at source.

Reasons for Change

U.S. persons seeking to evade U.S. tax may arrange to receive payments, with respect to which gross proceeds would otherwise be reported, through nonqualified intermediaries and certify that they qualify as foreign persons. A broker making a payment through a nonqualified intermediary is unlikely to be in a position to verify whether self-certification regarding foreign status is accurate. The proposal would discourage U.S. persons from attempting to evade U.S. tax by providing incorrect self-certification or otherwise relying on the lack of information reporting associated with using nonqualified intermediaries. The proposal would also encourage use of the strengthened qualified intermediary system by requiring withholding on gross proceeds on the sale of securities held through nonqualified intermediaries.

Proposal

Under the proposal, a withholding agent would be required to withhold tax at a rate of 20

percent on gross proceeds from the sale of any security of a type that would be reported to a U.S. non-exempt payee, when paid by the withholding agent to a nonqualified intermediary that is located in a jurisdiction with which the United States does not have a comprehensive income tax treaty that includes a satisfactory exchange of information program. The Treasury Department would receive regulatory authority to provide exceptions, including exceptions for payments collected by nonqualified intermediaries for foreign government, central bank, foreign pension fund, and foreign insurance company payees, and other similar investors; payments to nonqualified intermediaries located in jurisdictions with which the United States has a tax information exchange agreement; and payments that the Treasury Department concludes present a low risk of tax evasion. The rules will be designed so as not to disrupt ordinary and customary market transactions. Nonqualified intermediaries would be eligible to claim a refund on behalf of their direct account holders for any taxable year in which they identified all of their direct account holders that are U.S. persons and reported all reportable payments received on behalf of U.S. account holders. Foreign persons that are subject to withholding tax in excess of their income tax liability as a result of this proposal, and on whose behalf a refund claim is not made by a nonqualified intermediary, would be permitted to apply for a refund of any tax withheld.

The proposal would be effective for payments made after December 31 of the year of enactment.

REQUIRE REPORTING OF CERTAIN TRANSFERS OF MONEY OR PROPERTY TO FOREIGN FINANCIAL ACCOUNTS

Current law

United States persons must disclose whether, at any time during the preceding year, they had an interest in, or signature or other authority over, financial accounts in a foreign country, if the aggregate value of these accounts exceeds \$ 10,000. United States persons must also report certain information with respect to certain foreign business entities that they control. Under Treasury regulations, a U.S. person controls a foreign corporation for this purpose if the person owns, actually or constructively, more than 50 percent of the corporation's stock, by vote or by value. Current law does not contain a provision that generally requires reporting of transfers of money or property to, or receipt of money or property from, a foreign bank, brokerage, or other financial account by U.S. individuals.

Reason for Change

The Administration is concerned about the use of foreign accounts by U.S. citizens and residents to evade U.S. tax. To reduce such evasion, the Administration proposes to increase information reporting requirements with respect to transfers to and from certain foreign accounts.

Proposal

A U.S. individual would be required to report, on the individual's income tax return, any transfer of money or property made to, or receipt of money or property from, any foreign bank, brokerage, or other financial account by the individual, or by any entity of which the individual owns, actually or constructively, more than 50 percent of the ownership interest. Transfers to accounts held at qualified intermediaries and receipts from accounts held by U.S. persons at qualified intermediaries would not be required to be reported. In addition, individuals would be exempt from the reporting requirement if the cumulative amount or value of transfers and the cumulative amount or value of receipts that would otherwise be reportable on the individual's income tax return for a given year were each less than \$ 10,000. Failure to report a covered transfer would result in the imposition of a penalty equal to the lesser of \$ 10,000 per reportable transfer or 10 percent of the cumulative amount or value of the unreported covered transfers. No penalty would be imposed for a failure to report due to reasonable cause. The Treasury Department would receive regulatory authority to issue rules to prevent abuse of the reporting exemptions and to provide exceptions to the reporting requirement, such as an exception for arm's-length payments in the ordinary course of business for services or tangible property.

The proposal would be effective for transfers made after December 31 of the year of enactment.

REQUIRE DISCLOSURE OF FBAR ACCOUNTS TO BE FILED WITH TAX
RETURN * * *

REQUIRE THIRD-PARTY INFORMATION REPORTING REGARDING THE
TRANSFER OF ASSETS TO FOREIGN FINANCIAL ACCOUNTS AND THE
ESTABLISHMENT OF FOREIGN FINANCIAL ACCOUNTS * * *

REQUIRE THIRD-PARTY INFORMATION REPORTING REGARDING THE
ESTABLISHMENT OF OFFSHORE ENTITIES * * *

NEGATIVE PRESUMPTION FOR FOREIGN ACCOUNTS WITH RESPECT TO
WHICH AN FBAR HAS NOT BEEN FILED * * *

NEGATIVE PRESUMPTION REGARDING FAILURE TO FILE AN FBAR FOR
ACCOUNTS WITH NONQUALIFIED INTERMEDIARIES * * *

NEGATIVE PRESUMPTION REGARDING WITHHOLDING ON FDAP PAYMENTS
TO CERTAIN FOREIGN ENTITIES * * *

EXTEND STATUTE OF LIMITATIONS FOR CERTAIN REPORTABLE CROSS-
BORDER TRANSACTIONS AND FOREIGN ENTITIES * * *

DOUBLE ACCURACY-RELATED PENALTIES ON UNDERSTATEMENTS

INVOLVING UNDISCLOSED FOREIGN ACCOUNTS * * *
IMPROVE THE FOREIGN TRUST REPORTING PENALTY * * *

E. Page 64, New Sec. 1.12.B. A Critique of President Obama's Proposed Changes to the International Tax Rules

Page 64, New Sec. 1.12.B. Add at after New Sec. 1.12.A the following:
New Sec. 1.12.B. **A Critique of President Obama's Proposed Changes to the International Tax Rules**

Samuel C. Thompson, Jr., Obama's International Tax Proposal is Too Timid
54 Tax Notes Int'l 579 (May 18, 2009)

INTRODUCTION

On May 4 President Obama announced proposals for international tax reform, a topic he addressed during the campaign. The proposals would: (1) reform the deferral rules to "curb a tax advantage for investing and reinvesting overseas"; (2) close loopholes in the foreign tax credit; (3) toughen the rules dealing with overseas tax havens, including elimination of avoidance of the subpart F rules through the use of the check-the-box system for classifying foreign subs; and (4) add new IRS resources to help close the international tax gap.¹ While those proposals would move the law in the right direction, they do not go far enough in addressing the critical issue of deferral.

Understanding Our Deferral System

The best way to grasp the deferral issues is through an example.² Assume that State Oil Corp. is engaged in the oil exploration business and is headquartered in State College, Pennsylvania. It is faced with the following investment decision:

- o invest \$ 50 million in oil exploration and refining in State College, which is expected to produce \$ 10 million in annual taxable income; or
- o set up a subsidiary in China -- China Oil Sub -- and have it invest \$ 50 million in oil exploration and refining in China, which is also expected to produce \$ 10 million in annual taxable income.

The pretax return of both investments is \$ 10 million. However, State Oil Corp. has a 35 percent effective corporate tax rate in the United States, and China Oil Sub would

¹ The White House, Office of the Press Secretary, "White House Outline of Plan to Curb Tax Havens, Remove Tax Incentives for Shifting Jobs Overseas" (May 4, 2009), available at http://news.bna.com/dtln/DTLNWB/split_display.adp?fedfid=12360970&vname=dtrnot&fn=12360970&jd=a0b8q6v7h3&split=0 [hereinafter White House outline].

² The discussion here builds on the discussion in Part VIII of Samuel C. Thompson Jr., "How Should Congress React to Bush's Tax Proposals?" Tax Notes, Mar. 26, 2007, p. 1233, Doc 2007-5025, or [2007 TNT 59-41](#).

have a 15 percent effective corporate tax rate in China.³ Other things being equal, under our deferral system, which investment decision would State Oil Corp. make?

The answer is clear: It would invest in China, because the after-tax return on the China investment is \$ 8.5 million (\$ 10 million minus the \$ 1.5 million China tax), while the after-tax return for the State College investment is only \$ 6.5 million (\$ 10 million minus the \$ 3.5 million U.S. tax). This is the case even though State Oil Corp. would be subject to U.S. tax when China Oil Sub repatriates its after-tax income to State Oil Corp. in the form of dividends. As a result of the FTC provisions, at the time of repatriation, State Oil Corp. would have to pay an additional \$ 2 million in tax, so that the combined China tax (\$ 1.5 million) and U.S. tax (\$ 2 million) on the repatriated income would be 35 percent. Thus, the U.S. tax on the income of China Oil Corp. is "deferred" until the income is repatriated. However, under the U.S. deferral system, there is no requirement that China Oil Sub repatriate its income at any particular time, and with clever tax planning China Oil Sub may be able to defer the repatriation indefinitely. This potential for substantial deferral of the taxation of foreign income has the economic effect of making many foreign investments more attractive from a tax perspective than U.S. investments.

Obama's Proposal to Address Deferral

In discussing deferral and the administration's proposal for addressing it, the White House description of the international tax proposals explains:

Currently, businesses that invest overseas can take immediate deductions on their U.S. tax returns for expenses supporting their overseas investments but nevertheless "defer" paying U.S. taxes on the profits they make from those investments. As a result, U.S. taxpayer dollars are used to provide a significant tax advantage to companies who invest overseas relative to those who invest and create jobs at home. The Obama Administration would reform the rules surrounding deferral so that -- with the exception of research and experimentation expenses -- companies cannot receive deductions on their U.S. tax returns supporting their offshore investments until they pay taxes on their offshore profits. This provision would take effect in 2011, raising \$ 60.1 billion from 2011 to 2019.⁴

The Obama administration is not proposing to eliminate deferral by taxing the income earned by foreign subs like China Oil Sub at the time it is earned. Rather, under the proposal, some deductions that U.S. parent corporations, like State Oil Corp., could otherwise take would be deferred until the deferred foreign income is repatriated.

Obama's Proposal Is Too Timid

³ Assume for purposes of this discussion that the effective corporate tax rates are the same as the maximum statutory rates.

⁴ White House outline, *supra* note 1.

While the administration's expense deferral proposal is sensible in the context of our deferral system for foreign income, it is too timid because it does not adequately deal with the fundamental issue the president addressed in his explanation of the proposals: a "tax code that says you should pay lower taxes if you create a job in Bangalore, India, than if you create one in Buffalo, New York."⁵ Although the expense deferral proposal will reduce some of the benefit of deferral, it will not eliminate the benefit, so there will continue to be a tax incentive for companies to create a job in Bangalore rather than Buffalo.

Instead of proposing deferral of the deduction for expenses attributable to foreign earnings, the Obama administration should have proposed that the deferral system be replaced with a full imputation system. A full imputation system would tax on a current basis all the income of foreign corporations controlled by U.S. taxpayers. This type of change was proposed in 1962 by President Kennedy and more recently by Stephen Shay, Treasury international tax counsel in the administration of President George H.W. Bush.⁶

Under an imputation system, State Oil Corp. would be taxed immediately on the income earned by China Oil Sub; in other words, the income of China Oil Sub would be imputed to State Oil Corp. as it is earned. Also, State Oil Corp. would, within limits, receive an FTC for the China tax paid by China Oil Sub.

If an imputation system applied in the above example, State Oil Corp. would be taxed in the United States on the \$ 10 million of income earned by China Oil Sub, which would produce a tentative U.S. tax of \$ 3.5 million. However, State Oil Corp. would receive a credit of \$ 1.5 million against that tax for the China taxes paid by China Oil Sub, producing a final U.S. tax liability of \$ 2 million. Thus, the total of the U.S. and China taxes would be \$ 3.5 million. Under that system, the after-tax return from investing in the United States and China would be the same, so the playing field would be level.

With an imputation system, there would be no need for the administration's expense deferral proposal because foreign income would be taxed on a current basis, subject to an FTC. Also, an imputation system would significantly reduce transfer pricing disputes between taxpayers and the IRS because there would be no incentive (as there is under the current system) for U.S. parent corporations to aggressively allocate income to foreign subs located in low-tax jurisdictions. As indicated in a recent Government Accountability Office report, the avoidance of tax through questionable transfer pricing is a significant problem,⁷ and there is nothing in the administration's proposals that specifically addresses it. An imputation system would also eliminate abuses through the use of the CTB classification system because the income of all controlled entities would be subject to

⁵ "Obama Targets Corporate Offshore Tax Avoidance," President Obama's remarks at the White House on proposals to change U.S. tax policy on international tax havens (May 4, 2009), available at http://news.bna.com/dtln/DTLNWB/split_display.adp?fedfid=12360970&vname=dtmnot&fn=12360970&jd=a0b8q6v7h3&split=0.

⁶ See, e.g., Robert Peroni, Clifton Fleming, and Stephen Shay, "Getting Serious About Curtailing Deferral of U.S. Tax on Foreign-Source Income," [52 SMU L. Rev. 55 \(1999\)](#). See also Fleming and Peroni, "Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System," *Tax Notes Int'l*, Jan. 16, 2006, p. 217, Doc 2005-24240, or [2006 WTD 11-13](#) (analyzing the territorial proposal of the tax reform panel report and a similar proposal by the Joint Committee on Taxation and concluding that the United States should move to an imputation system).

⁷ See e.g., Robert Goulder, "GAO Report Links Tax Rates With Income Shifting," *Tax Notes Int'l*, Sept. 15, 2008, p. 917, Doc 2008-19135, or [2008 WTD 175-5](#).

immediate taxation. Therefore, there would be no need for the CTB reforms in the administration's proposals. Finally, an imputation system would avoid the likely complexity that would accompany the adoption of the administration's expense deferral rule.

I am not suggesting that we penalize investments by China Oil Sub; I am proposing only that the China profits of China Oil Sub be taxed at the same rate and at the same time as U.S. profits are taxed.

Rationale for a Full Imputation System

In examining the case for eliminating deferral, it is important to consider the opposite policy: the adoption of a territorial system for taxing foreign income. Such a system has been proposed by many business groups and by President George W. Bush's 2005 Advisory Panel on Federal Tax Reform.⁸

Under a territorial system, U.S. corporations would be exempt from paying federal income tax on business income they earn in foreign countries. For example, State Oil Corp. would not be subject to U.S. tax on the income earned by China Oil Sub either when the income was earned or when the income was repatriated to the United States. The principal reason Bush's tax reform panel gave for moving to a territorial system was "competitiveness." A territorial system is designed to make U.S. firms competitive with other firms doing business in China by subjecting the U.S. firm to the tax rate that applies to other companies doing business in China.

Although a territorial regime addresses that aspect of competitiveness, it also creates another competitiveness problem: an unlevel playing field between business conducted in the United States -- in State College, for example -- and business conducted in China. The tax reform panel did not address that.

In purporting to solve a potential competitiveness problem for U.S. companies doing business in foreign countries, a territorial system would exacerbate a competitiveness problem for the people of State College in that it would give U.S. corporations an additional incentive over and above the current incentive in the deferral system to invest capital in foreign markets with lower tax rates, rather than investing that capital here at home.

Revenue Effect of Eliminating Deferral

Without access to all of the data, it is difficult to make an estimate of the revenue effect of eliminating deferral compared with the revenue effect of the administration's expense deferral proposal. The White House outline states that enactment of the expense deferral proposal would raise \$ 60.1 billion from 2011 through 2019.⁹ However, the Joint Committee on Taxation has estimated that the deferral of foreign income of controlled foreign corporations will produce tax expenditures (that is, tax reductions) of \$ 56.4

⁸ The President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System (Nov. 2005), Doc 2005-22112, [2005 WTD 212-8](#).

⁹ White House outline, *supra* note 1.

billion for the five-year period from 2008 through 2012.¹⁰ Thus, the average annual revenue raised by the administration's expense deferral proposal is \$ 6.7 billion, and the average annual revenue lost attributable to the deferral of foreign income is \$ 11.28 billion.

Although the relationship between those two estimates is not clear, for purposes of the discussion here, it is assumed that the revenue pickup from enactment of the expense deferral proposal would reduce the tax expenditure associated with the current deferral of foreign income rule. Under this assumption, the expense deferral proposal eliminates only about half of the tax expenditure associated with the deferral of foreign income. This shows that even with the enactment of the expense deferral proposal, there would still be substantial tax incentives for investing in low-tax jurisdictions.

Under those assumptions, if Congress were to eliminate the benefit from the deferral of foreign income, additional revenues of approximately \$ 60 billion would be realized for the 2011-2019 period. If this amount were dedicated to the reduction in the corporate tax rate, it would make investment in the United States more attractive for both U.S. and foreign companies.

CONCLUSION

The potential for unlimited deferral available with the current deferral of foreign income system in essence makes this system a de facto territorial system. Because it is clear that the Obama administration will not propose the adoption of a territorial system, it would be prudent for the administration to return to the position Kennedy took in 1962 and propose the adoption of a full imputation system. That would both eliminate abuses in our international tax system and ensure that American businesses make cross-border investment decisions on the basis of economic and not tax considerations.

Finally, many opponents of deferral repeal will argue that repeal will force U.S. companies to move abroad. That is a specious argument, because Congress has shown in the enactment of section 7874 -- the anti-inversion provision -- that it knows how to prevent U.S. companies from disguising themselves as foreign corporations.

F. Page 64, New Sec. 1.13. 2010 Codification of the Economic Substance Doctrine

Page 64, New Sec. 1.13. Add at after New Sec. 1.12.B the following:
New Sec. 1.13. **2010 Codification of the Economic Substance Doctrine**

Staff of Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," As Amended, in Combination with the "Patient Protection and Affordable Care Act"

JCX-18-10 March 21, 2010

¹⁰ Staff of the Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012," p. 69 (Oct. 31, 2008).

Codification of Economic Substance Doctrine and Imposition of Penalties (sec. 1409 of the Reconciliation bill and secs. 7701, 6662, 6662A, 6664 and 6676 of the Code)

Present Law

In general

The Code provides detailed rules specifying the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss, and deduction. These rules permit both taxpayers and the government to compute taxable income with reasonable accuracy and predictability. Taxpayers generally may plan their transactions in reliance on these rules to determine the Federal income tax consequences arising from the transactions.

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of a tax-motivated transaction, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. These common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts, the IRS, and litigants. Although these doctrines serve an important role in the administration of the tax system, they can be seen as at odds with an objective, “rule-based” system of taxation.

One common-law doctrine applied over the years is the “economic substance” doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer’s economic position other than a purported reduction in Federal income tax.¹¹

Economic substance doctrine

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of U.S. Federal income tax considerations – notwithstanding that the purported activity actually occurred. The

¹¹ See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff’d* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999); *Klamath Strategic Investment Fund, LLC v. United States*, 472 F. Supp. 2d 885 (E.D. Texas 2007), *aff’d* 568 F.3d 537 (5th Cir. 2009); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *vacating and remanding* 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128); *cert. denied*, 127 S. Ct. 1261 (Mem.) (2007).

Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the “sham transaction doctrine” and the “business purpose doctrine.” See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960) (denying interest deductions on a “sham transaction” that lacked “commercial economic substance”). Certain “substance over form” cases involving tax-indifferent parties, in which courts have found that the substance of the transaction did not comport with the form asserted by the taxpayer, have also involved examination of whether the change in economic position that occurred, if any, was consistent with the form asserted, and whether the claimed business purpose supported the particular tax benefits that were claimed. See, e.g., *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006); *BB&T Corporation v. United States*, 2007-1 USTC ¶ 50,130 (M.D.N.C. 2007), *aff’d* 523 F.3d 461 (4th Cir. 2008). Although the Second Circuit found for the government in *TIFD III-E, Inc.*, on remand to consider issues under section 704(e), the District Court found for the taxpayer. See, *TIFD III-E Inc. v. United States*, No. 3:01-cv-01839, 2009 WL 3208650 (D. Conn. Oct. 23, 2009).

Tax Court has described the doctrine as follows:

The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.¹²

Business purpose doctrine

A common law doctrine that often is considered together with the economic substance doctrine is the business purpose doctrine. The business purpose doctrine involves an inquiry into the subjective motives of the taxpayer – that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which activities with non-tax objectives have been combined with unrelated activities having only tax-avoidance objectives, in order to disallow the tax benefits of the overall transaction.¹³

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine.¹⁴ Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to survive judicial scrutiny.¹⁵ A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction.¹⁶ A third

¹² *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

¹³ See, *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

¹⁴ “The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify.” *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988).

¹⁵ See, e.g., *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) (“The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.”). See also, *Klamath Strategic Investment Fund v. United States*, 568 F. 3d 537, (5th Cir. 2009) (even if taxpayers may have had a profit motive, a transaction was disregarded where it did not in fact have any realistic possibility of profit and funding was never at risk).

¹⁶ See, e.g., *Rice’s Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) (“To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists.”); *IES Industries v. United States*, 253 F.3d 350, 358 (8th Cir. 2001) (“In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose outside of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists (the economic substance test).”). As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a more detailed discussion of the sham transaction doctrine, see, e.g., Joint

approach regards economic substance and business purpose as “simply more precise factors to consider” in determining whether a transaction has any practical economic effects other than the creation of tax benefits.¹⁷

One decision by the Court of Federal Claims questioned the continuing viability of the doctrine. That court also stated that “the use of the ‘economic substance’ doctrine to trump ‘mere compliance with the Code’ would violate the separation of powers” though that court also found that the particular transaction at issue in the case did not lack economic substance. The Court of Appeals for the Federal Circuit (“Federal Circuit Court”) overruled the Court of Federal Claims decision, reiterating the viability of the economic substance doctrine and concluding that the transaction in question violated that doctrine.¹⁸ The Federal Circuit Court stated that “[w]hile the doctrine may well also apply if the taxpayer’s sole subjective motivation is tax avoidance even if the transaction has economic substance, [footnote omitted], a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer’s sole motive is tax avoidance.”¹⁹

Nontax economic benefits

There also is a lack of uniformity regarding the type of non-tax economic benefit a taxpayer must establish in order to demonstrate that a transaction has economic substance. Some courts have denied tax benefits on the grounds that a stated business benefit of a particular structure was not in fact obtained by that structure.²⁰ Several courts have denied tax benefits on the grounds that the subject transactions lacked profit

Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) at 182.

¹⁷ See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d at 247; *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner*, 69 F.3d 982, 985 (9th Cir. 1995) (“Instead, the consideration of business purpose and economic substance are simply more precise factors to consider . . . We have repeatedly and carefully noted that this formulation cannot be used as a ‘rigid two-step analysis’.”)

¹⁸ *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128); *vacated and remanded*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (Mem.) (2007).

¹⁹ The Federal Circuit Court stated that “when the taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance.” The Federal Circuit Court quoted a decision of its predecessor court, stating that “*Gregory v. Helvering* requires that a taxpayer carry an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to the kind of transaction that would never occur absent the motive of tax avoidance.” The Court also stated that “while the taxpayer’s subjective motivation may be pertinent to the existence of a tax avoidance purpose, all courts have looked to the objective reality of a transaction in assessing its economic substance.” *Coltec Industries, Inc. v. United States*, 454 F.3d at 1355, 1356.

²⁰ See, e.g., *Coltec Industries v. United States*, 454 F.3d 1340 (Fed. Cir. 2006). The court analyzed the transfer to a subsidiary of a note purporting to provide high stock basis in exchange for a purported assumption of liabilities, and held these transactions unnecessary to accomplish any business purpose of using a subsidiary to manage asbestos liabilities. The court also held that the purported business purpose of adding a barrier to veil-piercing claims by third parties was not accomplished by the transaction. 454 F.3d at 1358-1360 (Fed. Cir. 2006).

potential.²¹ In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.²² Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.²³ In these cases, in assessing whether a reasonable possibility of profit exists, it may be sufficient if there is a nominal amount of pre-tax profit as measured against expected tax benefits.

Financial accounting benefits

In determining whether a taxpayer had a valid business purpose for entering into a transaction, at least two courts have concluded that financial accounting benefits arising from tax savings do not qualify as a non-tax business purpose.²⁴ However, based on court decisions that recognize the importance of financial accounting treatment, taxpayers have asserted that financial accounting benefits arising from tax savings can satisfy the business purpose test.²⁵

²¹ See, e.g., *Knetsch*, 364 U.S. at 361; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance).

²² See, e.g., *Goldstein v. Commissioner*, 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating that "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

²³ See, e.g., *Rice's Toyota World v. Commissioner*, 752 F. 2d 89, 94 (4th Cir. 1985) (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 781 (5th Cir. 2001) (applied the same test, citing *Rice's Toyota World*); *IES Industries v. United States*, 253 F.3d 350, 354 (8th Cir. 2001); *Wells Fargo & Company v. United States*, No. 06-628T, 2010 WL 94544, at *57-58 (Fed. Cl. Jan. 8, 2010).

²⁴ See *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio 2001), *aff'd*, 326 F.3d 737 (6th Cir. 2003) and *Wells Fargo & Company v. United States*, No. 06-628T, 2010 WL 94544, at *59 (Fed. Cl. Jan. 8, 2010).

²⁵ See, e.g., Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JSC-3-03) February, 2003 ("Enron Report"), Volume III at C-93, 289. Enron Corporation relied on *Frank Lyon Co. v. United States*, 435 U.S. 561, 577-78 (1978), and *Newman v. Commissioner*, 902 F.2d 159, 163 (2d Cir. 1990), to argue that financial accounting benefits arising from tax savings constitute a good business purpose.

Tax-indifferent parties

A number of cases have involved transactions structured to allocate income for Federal tax purposes to a tax-indifferent party, with a corresponding deduction, or favorable basis result, to a taxable person. The income allocated to the tax-indifferent party for tax purposes was structured to exceed any actual economic income to be received by the tax indifferent party from the transaction. Courts have sometimes concluded that this particular type of transaction did not satisfy the economic substance doctrine.²⁶ In other cases, courts have indicated that the substance of a transaction did not support the form of income allocations asserted by the taxpayer and have questioned whether asserted business purpose or other standards were met.²⁷

Penalty regime

General accuracy-related penalty

An accuracy-related penalty under section 6662 applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (or, in the case of corporations, by the lesser of (a) 10 percent of the correct tax (or \$10,000 if greater) or (b) \$10 million), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.²⁸ The section 6662 penalty is increased to 40 percent in the case of gross valuation misstatements as defined in section 6662(h). Except in the case of tax shelters,²⁹ the amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. The Treasury Secretary may prescribe a list of positions which the Secretary believes do not meet the requirements for substantial authority under this provision.

The section 6662 penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was “reasonable cause” for the underpayment and that the taxpayer acted in good faith.³⁰ The relevant regulations for a tax shelter provide that reasonable cause exists where the taxpayer “reasonably relies in

²⁶ See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff’d* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

²⁷ See, e.g., *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006). Although the Second Circuit found for the government in *TIFD III-E, Inc.*, on remand to consider issues under section 704(e), the District Court found for the taxpayer. See, *TIFD III-E Inc. v. United States*, No. 3:01-cv-01839, 2009 WL 3208650 (Oct. 23, 2009).

²⁸ Sec. 6662.

²⁹ A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Sec. 6662(d)(2)(C).

³⁰ Sec. 6664(c).

good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.³¹ For transactions other than tax shelters, the relevant regulations provide a facts and circumstances test, the most important factor generally being the extent of the taxpayer's effort to assess the proper tax liability. If a taxpayer relies on an opinion, reliance is not reasonable if the taxpayer knows or should have known that the advisor lacked knowledge in the relevant aspects of Federal tax law, or if the taxpayer fails to disclose a fact that it knows or should have known is relevant. Certain additional requirements apply with respect to the advice.³²

Listed transactions and reportable avoidance transactions

In general

A separate accuracy-related penalty under section 6662A applies to any "listed transaction" and to any other "reportable transaction" that is not a listed transaction, if a significant purpose of such transaction is the avoidance or evasion of Federal income tax³³ (hereinafter referred to as a "reportable avoidance transaction"). The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Both listed transactions and other reportable transactions are allowed to be described by the Treasury department under section 6011 as transactions that must be reported, and section 6707A(c) imposes a penalty for failure adequately to report such transactions under section 6011. A reportable transaction is defined as one that the Treasury Secretary determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.³⁴ A listed transaction is defined as a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of the reporting disclosure requirements.³⁵

³¹ Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

³² See Treas. Reg. Sec. 1.6664-4(c). In addition to the requirements applicable to taxpayers under the regulations, advisors may be subject to potential penalties under section 6694 (applicable to return preparers), and to monetary penalties and other sanctions under Circular 230 (which provides rules governing persons practicing before the IRS). Under Circular 230, if a transaction is a "covered transaction" (a term that includes listed transactions and certain non-listed reportable transactions) a "more likely than not" confidence level is required for written tax advice that may be relied upon by a taxpayer for the purpose of avoiding penalties, and certain other standards must also be met. Treasury Dept. Circular 230 (Rev. 4-2008) Sec. 10.35. For other tax advice, Circular 230 generally requires a lower "realistic possibility" confidence level or a "non-frivolous" confidence level coupled with advising the client of any opportunity to avoid the accuracy related penalty under section 6662 by adequate disclosure. Treasury Dept. Circular 230 (Rev. 4-2008) Sec. 10.34.

³³ Sec. 6662A(b)(2).

³⁴ Sec. 6707A(c)(1).

³⁵ Sec. 6707A(c)(2).

Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.³⁶ The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the “strengthened reasonable cause exception”), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment were adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment. A “reasonable belief” must be based on the facts and law as they exist at the time that the return in question is filed, and not take into account the possibility that a return would not be audited. Moreover, reliance on professional advice may support a “reasonable belief” only in certain circumstances.³⁷

Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict liability penalty generally applies), and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.³⁸ However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the IRS Commissioner has separately rescinded the separate penalty under section 6707A for failure to disclose a reportable transaction.³⁹ The IRS Commissioner is authorized to do this only if the failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.⁴⁰

A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary specifies. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).⁴¹

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the

³⁶ Sec. 6662A(a).

³⁷ Section 6664(d)(3)(B) does not allow a reasonable belief to be based on a “disqualified opinion” or on an opinion from a “disqualified tax advisor.”

³⁸ Sec. 6662A(c).

³⁹ Sec. 6664(d).

⁴⁰ Sec. 6707A(d).

⁴¹ Sec. 6707A(e).

sum of: (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),⁴² and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

Except as provided in regulations, a taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.⁴³

Strengthened reasonable cause exception

A penalty is not imposed under section 6662A with respect to any portion of an understatement if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires: (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011;⁴⁴ (2) that there is or was substantial authority for such treatment; and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief: (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed; and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.⁴⁵

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a "disqualified tax advisor" or (2) is a "disqualified opinion."

Disqualified tax advisor

A disqualified tax advisor is any advisor who: (1) is a material advisor⁴⁶ and who participates in the organization, management, promotion, or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so

⁴² For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, will be treated as an increase in taxable income. Sec. 6662A(b).

⁴³ Sec. 6662A(e)(3).

⁴⁴ See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

⁴⁵ Sec. 6664(d).

⁴⁶ The term "material advisor" means any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of \$50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons (\$250,000 in any other case). Sec. 6111(b)(1).

participates; (2) is compensated directly or indirectly⁴⁷ by a material advisor with respect to the transaction; (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained; or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

A material advisor is considered as participating in the “organization” of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents: (1) establishing a structure used in connection with the transaction (such as a partnership agreement); (2) describing the transaction (such as an offering memorandum or other statement describing the transaction); or (3) relating to the registration of the transaction with any Federal, state, or local government body.⁴⁸ Participation in the “management” of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the “promotion or sale” of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

An opinion may not be relied upon if the opinion: (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events); (2) unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person; (3) does not identify and consider all relevant facts; or (4) fails to meet any other requirement prescribed by the Secretary.

Coordination with other penalties

Any understatement upon which a penalty is imposed under section 6662A is not subject to the accuracy related penalty for underpayments under section 6662.⁴⁹

⁴⁷ This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

⁴⁸ An advisor should not be treated as participating in the organization of a transaction if the advisor’s only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a “disqualified tax advisor” with respect to the transaction if the advisor participates in the management, promotion, or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction). See Notice 200512, 2005-1 C.B. 494 regarding disqualified compensation arrangements.

⁴⁹ Sec. 6662(b) (flush language). In addition, section 6662(b) provides that section 6662 does not apply to any portion of an underpayment on which a fraud penalty is imposed under section 6663.

However, that understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement under section 6662(d)(1).⁵⁰ Thus, in the case of an understatement (as defined in sec. 6662(d)(2)), the amount of the understatement (determined without regard to section 6662A(e)(1)(A)) is increased by the aggregate amount of reportable transaction understatements for purposes of determining whether the understatement is a substantial understatement. The section 6662(a) penalty applies only to the excess of the amount of the substantial understatement (if any) after section 6662A(e)(1)(A) is applied over the aggregate amount of reportable transaction understatements.⁵¹ Accordingly, every understatement is penalized, but only under one penalty provision.

The penalty imposed under section 6662A does not apply to any portion of an understatement to which a fraud penalty applies under section 6663 or to which the 40-percent penalty for gross valuation misstatements under section 6662(h) applies.⁵²

Erroneous claim for refund or credit

If a claim for refund or credit with respect to income tax (other than a claim relating to the earned income tax credit) is made for an excessive amount, unless it is shown that the claim for such excessive amount has a reasonable basis, the person making such claim is subject to a penalty in an amount equal to 20 percent of the excessive amount.⁵³

The term “excessive amount” means the amount by which the amount of the claim for refund for any taxable year exceeds the amount of such claim allowable for the taxable year.

This penalty does not apply to any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under the accuracy related or fraud penalty provisions (including the general accuracy related penalty, or the penalty with respect to listed and reportable transactions, described above).

Explanation of Provision

The provision clarifies and enhances the application of the economic substance doctrine. Under the provision, new section 7701(o) provides that in the case of any transaction⁵⁴ to which the economic substance doctrine is relevant, such transaction is treated as having economic substance only if (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. The provision provides a uniform definition of economic

⁵⁰ Sec. 6662A(e)(1).

⁵¹ Sec. 6662(d)(2)(A) (flush language)

⁵² Sec. 6662A(e)(2).

⁵³ Sec. 6676.

⁵⁴ The term “transaction” includes a series of transactions.

substance, but does not alter the flexibility of the courts in other respects.

The determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if the provision had never been enacted. Thus, the provision does not change present law standards in determining when to utilize an economic substance analysis.⁵⁵

The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among⁵⁶ these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity;⁵⁷ (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;⁵⁸ (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C;⁵⁹ and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.⁶⁰ Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances.⁶¹ As under present law, whether a particular

⁵⁵ If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. See, e.g., Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which an amount otherwise constituting a deduction, credit, or other allowance is not available are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. Thus, for example, it is not intended that a tax credit (e.g., section 42 (low-income housing credit), section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.

⁵⁶ The examples are illustrative and not exclusive.

⁵⁷ See, e.g., *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946) (respecting debt characterization in one case and not in the other, based on all the facts and circumstances).

⁵⁸ See, e.g., *Sam Siegel v. Commissioner*, 45 T.C. 566 (1966), *acq.* 1966-2 C.B. 3. But see *Commissioner v. Bollinger*, 485 U.S. 340 (1988) (agency principles applied to title-holding corporation under the facts and circumstances).

⁵⁹ See, e.g., *Rev. Proc. 2010-3 2010-1 I.R.B. 110, Secs. 3.01(38), (39), (40), and (42)* (IRS will not rule on certain matters relating to incorporations or reorganizations unless there is a "significant issue"); *compare Gregory v. Helvering*, 293 U.S. 465 (1935).

⁶⁰ See, e.g., *National Carbide v. Commissioner*, 336 U.S. 422 (1949), *Moline Properties v. Commissioner*, 319 U.S. 435 (1943); *compare, e.g. Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925 (1971), *acq.*, 1972-2 C.B. 1; *Commissioner v. Bollinger*, 485 U.S. 340 (1988); see also sec. 7701(l).

⁶¹ See, e.g., *Frank Lyon Co. v. Commissioner*, 435 U.S. 561 (1978); *Hilton v. Commissioner*, 74 T.C. 305, *aff'd*, 671 F.2d 316 (9th Cir. 1982), *cert. denied*, 459 U.S. 907 (1982); *Coltec Industries v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (Mem) (2007); *BB&T Corporation v. United States*, 2007-1 USTC ¶ 50,130 (M.D.N.C. 2007), *aff'd*, 523 F.3d 461 (4th Cir. 2008); *Wells Fargo & Company v. United States*, No. 06-628T, 2010 WL 94544, at *60 (Fed. Cl. Jan. 8, 2010) (distinguishing leasing case *Consolidated Edison Company of New York*, No. 06-305T, 2009 WL 3418533 (Fed. Cl. Oct. 21, 2009) by observing that "considerations of economic substance are factually specific to the transaction involved").

transaction meets the requirements for specific treatment under any of these provisions is a question of facts and circumstances. Also, the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.⁶²

The provision does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.⁶³

Conjunctive analysis

The provision clarifies that the economic substance doctrine involves a conjunctive analysis – there must be an inquiry regarding the objective effects of the transaction on the taxpayer's economic position as well as an inquiry regarding the taxpayer's subjective motives for engaging in the transaction. Under the provision, a transaction must satisfy both tests, i.e., the transaction must change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position and the taxpayer must have a substantial non-Federal-income-tax purpose for entering into such transaction, in order for a transaction to be treated as having economic substance. This clarification eliminates the disparity that exists among the Federal circuit courts regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.⁶⁴

Non-Federal-income-tax business purpose

⁶² As examples of cases in which courts have found that a transaction does not meet the requirements for the treatment claimed by the taxpayer under the Code, or does not have economic substance, see e.g., *BB&T Corporation v. United States*, 2007-1 USTC ¶ 50,130 (M.D.N.C. 2007) *aff'd*, 523 F.3d 461 (4th Cir. 2008); *Tribune Company and Subsidiaries v. Commissioner*, 125 T.C. 110 (2005); *H.J. Heinz Company and Subsidiaries v. United States*, 76 Fed. Cl. 570 (2007); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied* 127 S. Ct. 1261 (Mem.) (2007); *Long Term Capital Holdings LP v. United States*, 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd*, 150 Fed. Appx. 40 (2d Cir. 2005); *Klamath Strategic Investment Fund, LLC v. United States*, 472 F. Supp. 2d 885 (E.D. Texas 2007); *aff'd*, 568 F.3d 537 (5th Cir. 2009); *Santa Monica Pictures LLC v. Commissioner*, 89 T.C.M. 1157 (2005).

⁶³ See, e.g., *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied* 127 S. Ct. 1261 (Mem.) (2007) (“the first asserted business purpose focuses on the wrong transaction—the creation of Garrison as a separate subsidiary to manage asbestos liabilities. . . . [W]e must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale. . . .”) 454 F.3d 1340, 1358 (Fed. Cir. 2006). See also *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48; *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) (“A given result at the end of a straight path is not made a different result because reached by following a devious path.”).

⁶⁴ The provision defines “economic substance doctrine” as the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose. Thus, the definition includes any doctrine that denies tax benefits for lack of economic substance, for lack of business purpose, or for lack of both.

Under the provision, a taxpayer's non-Federal-income-tax purpose⁶⁵ for entering into a transaction (the second prong in the analysis) must be "substantial." For purposes of this analysis, any State or local income tax effect which is related to a Federal income tax effect is treated in the same manner as a Federal income tax effect. Also, a purpose of achieving a favorable accounting treatment for financial reporting purposes is not taken into account as a non-Federal-income-tax purpose if the origin of the financial accounting benefit is a reduction of Federal income tax.⁶⁶

Profit potential

Under the provision, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position or that the taxpayer has a substantial non-Federal-income-tax purpose for entering into such transaction. The provision does not require or establish a minimum return that will satisfy the profit potential test. However, if a taxpayer relies on a profit potential, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.⁶⁷ Fees and other transaction expenses are taken into account as expenses in determining pre-tax profit. In addition, the Secretary is to issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit

⁶⁵ See, e.g., Treas. Reg. sec. 1.269-2(b) (stating that a distortion of tax liability indicating the principal purpose of tax evasion or avoidance might be evidenced by the fact that "the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer"). Similarly, in *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), the court stated:

Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. [citations omitted]

⁶⁶ Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. See, e.g., *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" (citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)); *aff'd*, 326 F.3d 737 (6th Cir. 2003)).

⁶⁷ See, e.g., *Rice's Toyota World v. Commissioner*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner*, 277 F.3d at 781 (applied the same test, citing *Rice's Toyota World*); *IES Industries v. United States*, 253 F.3d at 354 (the application of the objective economic substance test involves determining whether there was a "reasonable possibility of profit . . . apart from tax benefits.").

in appropriate cases.⁶⁸

Personal transactions of individuals

In the case of an individual, the provision applies only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

Other rules

No inference is intended as to the proper application of the economic substance doctrine under present law. The provision is not intended to alter or supplant any other rule of law, including any common-law doctrine or provision of the Code or regulations or other guidance thereunder; and it is intended the provision be construed as being additive to any such other rule of law.

As with other provisions in the Code, the Secretary has general authority to prescribe rules and regulations necessary for the enforcement of the provision.⁶⁹

Penalty for underpayments and understatements attributable to transactions lacking economic substance

The provision imposes a new strict liability penalty under section 6662 for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, as defined in new section 7701(o), or failing to meet the requirements of any similar rule of law.⁷⁰ The penalty rate is 20 percent (increased to 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return). An amended return or supplement to a return is not taken into account if filed after the taxpayer has been contacted for audit or such other date as is specified by the Secretary. No exceptions (including the reasonable cause rules) to the penalty are available. Thus, under the provision, outside opinions or in-house analysis would not protect a taxpayer from imposition of a penalty if it is determined that the transaction lacks economic substance or fails to meet the requirements of any similar rule of law. Similarly, a claim for refund or credit that is excessive under section 6676 due to a claim that is lacking in economic substance or failing to meet the requirements of any similar rule of law is subject to the 20 percent penalty under that section, and the reasonable basis exception is not available.

The penalty does not apply to any portion of an underpayment on which a fraud

⁶⁸ There is no intention to restrict the ability of the courts to consider the appropriate treatment of foreign taxes in particular cases, as under present law.

⁶⁹ Sec. 7805(a).

⁷⁰ It is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine.

penalty is imposed.⁷¹ The new 40-percent penalty for nondisclosed transactions is added to the penalties to which section 6662A will not also apply.⁷²

As described above, under the provision, the reasonable cause and good faith exception of present law section 6664(c)(1) does not apply to any portion of an underpayment which is attributable to a transaction lacking economic substance, as defined in section 7701(o), or failing to meet the requirements of any similar rule of law. Likewise, the reasonable cause and good faith exception of present law section 6664(d)(1) does not apply to any portion of a reportable transaction understatement which is attributable to a transaction lacking economic substance, as defined in section 7701(o), or failing to meet the requirements of any similar rule of law.

Effective Date

The provision applies to transactions entered into after the date of enactment and to underpayments, understatements, and refunds and credits attributable to transactions entered into after the date of enactment.

⁷¹ As under present law, the penalties under section 6662 (including the new penalty) do not apply to any portion of an underpayment on which a fraud penalty is imposed.

⁷² As revised by the provision, new section 6662A(e)(2)(b) provides that section 6662A will not apply to any portion of an understatement due to gross valuation misstatement under section 6662(h) or nondisclosed noneconomic substance transactions under new section 6662(i).

II. CHAPTER 5, ORGANIZATION AND OPERATING A UNITED STATES BUSINESS: FOREIGN CONTROLLED U.S. CORPORATIONS, BRANCHES, AND PARTNERSHIPS

A. Page 196, New Sec. 5.3.D.4.d. U.S.-U.K Treaty Overrides Regs under Sec. 1.882-5—National Westminster

Page 196, New Sec. 5.3.D.4.d. Add before Sec. 5.3.D.5 the following:
New Sec. 5.3.D.4.d. **U.S.-U.K. Treaty Overrides Regs under Sec**
1.882-5—National Westminster

National Westminster Bank PLC v. United States

United States Court of Appeals for the Federal Circuit, 512 F.3d 1347(Fed. Cir. 2008)

Before LOURIE, SCHALL, and GAJARSA, Circuit Judges.

GAJARSA, Circuit Judge.

This is a tax refund action brought by taxpayer National Westminster Bank PLC ("NatWest"), a United Kingdom corporation, for the tax years 1981-1987. The Government appeals from the judgment of the United States Court of Federal Claims ("trial court" or "court") that NatWest is entitled to a refund of \$ 65,723,053 plus interest for the tax years at issue. Central to the trial court's judgment is the issue of whether the application of Treasury Regulation section 1.882-5 is consistent with the United States' obligations under Article 7 of the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, U.S.-U.K., Dec. 31, 1975, 31 U.S.T. 5668 (the "1975 Treaty"). For the reasons stated below, we affirm.

BACKGROUND

The 1975 Treaty, which governs this dispute, was initially negotiated and signed by the United States and the United Kingdom in 1975.⁷³ 31 U.S.T. at 5668. As may be surmised from its title, the 1975 Treaty states that its purpose is "the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains." *Id.* at 5670. Of particular import to this case, Article 7 governs the taxing authority of the signatories with respect to the business profits of an enterprise operating in both countries. *Id.* at 5675-76.

⁷³ The United States and the United Kingdom negotiated a new treaty that entered into force in 2003. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.S.-U.K., July 24, 2001, S. Treaty Doc. No. 107-19 (2002).

NatWest is a United Kingdom corporation engaged in international banking activities. For the tax years 1981-1987, NatWest conducted wholesale banking operations in the United States through six permanently established branch locations (collectively "the U.S. Branch"). On its United States federal income tax returns for the years at issue, NatWest claimed deductions for accrued interest expenses as recorded on the books of the U.S. Branch. On audit, the Internal Revenue Service ("IRS") recomputed the interest expense deduction according to the formula set forth in Treasury Regulation section 1.882-5. The formula excludes consideration of interbranch transactions for the determination of assets, liabilities, and interest expenses. Treas. Reg. section 1.882-5(a)(5) (1981).⁷⁴ The formula also imputes or estimates the amount of capital held by the U.S. Branch based on either a fixed ratio or the ratio of NatWest's average total worldwide liabilities to average total worldwide assets. Id. section 1.882-5(b)(2). Pursuant to the IRS's recalculation of the interest expense deduction, NatWest's taxable income was increased by approximately \$ 155 million for the years at issue.

NatWest concluded that the increased income would result in an additional tax liability of at least \$ 37 million in the United States for which a foreign tax credit would not be available in the United Kingdom. NatWest thus requested, under Article 24 of the 1975 Treaty, that the United Kingdom enter competent authority proceedings with the United States to resolve the double taxation issue. Pursuant to the competent authority proceedings, the United Kingdom presented NatWest with a settlement offer, which NatWest concluded did not sufficiently address its double taxation concerns. NatWest rejected the settlement offer, paid the additional taxes, and filed suit in 1995, claiming that the IRS's application of section 1.882-5 to an international bank such as NatWest violated the terms of the 1975 Treaty.

The 1975 Treaty

After the initial signing of the 1975 Treaty on December 31, 1975, certain provisions not at issue here were amended by three protocols signed between August 1976 and March 1979. 31 U.S.T. at 5668-69. The 1975 Treaty took effect on April 25, 1980. Id. at 5668. Article 7, entitled Business Profits, states as follows:

(1) The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in that other State but only so much of them as is attributable to that permanent establishment.

⁷⁴ Section 1.882-5 remained unchanged for the tax years at issue but was amended in 1996. 61 Fed. Reg. 9329 (Mar. 8, 1996); 61 Fed. Reg. 15891 (Apr. 10, 1996). Section 1.882-5 was amended again in 2006 to comply with the renegotiation of the U.S.-U.K. treaty, as well as a renegotiated U.S.-Japan treaty. 71 Fed. Reg. 7448 (Aug. 17, 2006); 71 Fed. Reg. 56868 (Sept. 28, 2006).

(2) Subject to the provisions of paragraph (3), where an enterprise carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

(3) In the determination of the profits of the permanent establishment, there shall be allowed as deductions those expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere.

Id. at 5675-76 (emphasis added). Relating the terms of the 1975 Treaty to the present appeal, "a Contracting State" is the United Kingdom, "the other Contracting State" is the United States, "an enterprise" is NatWest, and "a permanent establishment" is the U.S. Branch. The emphasized portion of paragraph 2 sets forth the "separate enterprise principle" and frames the dispute in this case.

Treasury Regulation section 1.882-5

Treasury Regulation section 1.882-5 was proposed on February 27, 1980, adopted on December 30, 1980, and took effect on February 6, 1981. 46 Fed. Reg. 1681 (Jan. 7, 1981). As described by the Government, the regulation sets forth a formula for apportioning the interest expense of foreign corporations. The formula applies to all foreign corporations with permanent establishments in the United States and makes no exception for banks or other financial institutions.

At the outset, "[i]nter-branch loans, assets, liabilities, and interest expense amounts resulting from loan or credit transactions of any type between the separate offices or branches of the same foreign corporation are disregarded." section 1.882-5(a)(5). The deductible interest expense is then calculated according to a three-step formula. In step one, the permanent establishment's U.S.-connected assets -- "total value of all assets of the corporation that generate, have generated, or could reasonably have been or be expected to generate income, gain, or loss effectively connected with the conduct of a trade or business in the United States" -- are determined according to the books of the permanent establishment, exclusive of the intracorporate transactions disregarded under section 1.882-5(a)(5). section 1.882-5(b)(1). In step two, the permanent establishment's U.S.-connected liabilities are estimated either by multiplying the U.S.-connected assets

by a capital ratio of 0.95 or by the ratio of the average total amount of corporate worldwide liabilities to the average total value of corporate worldwide assets. section 1.882-5(b)(2). In step three, the interest deduction is computed under either the "branch book/dollar pool method" or the "separate currency pools method." section 1.882-5(b)(3). The IRS used the branch book/dollar pool method to audit the U.S. Branch. Under this method, the permanent establishment is allowed an interest deduction on the larger of the U.S.-connected liabilities or the average total amount of liabilities, again exclusive of transactions disregarded under section 1.882-5(a)(5), shown on the books of the permanent establishment. section 1.882-5(b)(3)(i)(A), (B). The branch book/dollar pool method further specifies which interest rate(s) will be used to determine the total amount of the interest expense deduction. *Id.*

Proceedings in the Court of Federal Claims

The parties agree, both before the trial court and on appeal, that the 1975 Treaty requires that the U.S. Branch be taxed as if it were a separate enterprise from NatWest -- the "separate enterprise principle." The parties differ with respect to the manner in which the separate enterprise principle treats (1) interest expenses on intracorporate loans (i.e., interbranch loans between the U.S. Branch and NatWest's other branches) and (2) the allocation of capital to the U.S. Branch. The trial court decided these issues in three separate summary judgment opinions and orders.

On cross-motions for partial summary judgment, the trial court concluded that the application of section 1.882-5 to a bank such as NatWest violated the terms of the 1975 Treaty. *Nat'l Westminster Bank, PLC v. United States*, 44 Fed. Cl. 120, 131 (1999) (Turner, J.) ("*NatWest I*"). During briefing, the United Kingdom submitted an amicus brief supporting the NatWest position and advocating the result arrived at by the trial court. See *Br. Amicus Curiae of the U.K.* 2-3 (hereinafter "*U.K. Amicus Br.*"). Specifically, the court found that the section 1.882-5's exclusion of all interbranch transactions from the determination of the allowable interest expense violated the separate enterprise principle of the 1975 Treaty. *NatWest I*, 44 Fed. Cl. at 130. The court concluded that the separate enterprise principle required that the determination of the profits of the U.S. Branch be based on the books of account as the U.S. Branch would maintain them if it "were a distinct and separate enterprise dealing wholly independently with the remainder of the foreign corporation," without reference to the worldwide information of NatWest. *Id.* at 128. The books of account, however, "are subject to adjustment as may be necessary for imputation of adequate capital to the branch and to insure use of market rates in computing interest expense." *Id.* Subsequent to the issuance of the *NatWest I* opinion, Judge Turner retired and the case was transferred to Judge Firestone.

The parties then filed cross-motions for partial summary judgment regarding the manner in which the IRS should determine or estimate the amount of "adequate" capital held by the U.S. Branch. *Nat'l Westminster Bank, PLC v. United States*, 58 Fed. Cl. 491, 492 (2003) (Firestone, J.) ("*NatWest II*"). The Government argued that it was permitted to attribute capital to the U.S. Branch based on regulatory and marketplace capital

requirements that applied to U.S. bank corporations -- the "corporate yardstick." Id. at 495-96. NatWest argued that the 1975 Treaty did not permit the imputation of capital to the U.S. Branch based on capital requirements to which it was not subject. Id. at 496. The court ruled in NatWest's favor, concluding that the separate enterprise principle did not require or allow "the government to adjust the books and records of the branch to reflect 'hypothetical' infusions of capital based upon banking and market requirements that do not apply to the branch." Id. at 498. Rather, the court adopted NatWest's position that only capital actually allotted to the U.S. Branch is relevant to a determination of the U.S. Branch's tax liability and that the IRS may only allocate additional capital to the extent that the books of the U.S. Branch do not properly record allotted capital. Id. at 497-98.

After the decision in NatWest II, the U.S. moved to reopen discovery regarding the amount of capital that the books of NatWest's home office show as being allotted to the U.S. branch. The government put forth a new theory that capital held by other branches should be imputed to the U.S. Branch, but the court found that the Government waived this theory by failing to present it during the briefing stage of NatWest II. Nat'l Westminster Bank, PLC v. United States, No. 95-758T (Fed. Cl. Jan. 18, 2005) (hereinafter "Order Denying Reconsideration").

In the third summary judgment opinion, the trial court considered whether uncontroverted facts supported NatWest's assertion that, consistent with the holdings of NatWest I and NatWest II, the U.S. Branch was entitled to a refund of \$ 65,808,076 plus interest. Nat'l Westminster Bank PLC v. United States, 69 Fed. Cl. 128, 131 (2005) ("NatWest III"). The court partially granted NatWest's motion for summary judgment and reached the following conclusions: (1) the books and records of the U.S. Branch were accurately maintained; (2) the six branch locations of the U.S. Branch constituted a single "permanent establishment" under the 1975 Treaty; (3) the U.S. Branch did not claim deductions based on interest expenses paid "on allotted capital or amounts to be treated as allotted capital"; (4) the U.S. Branch paid and received arm's-length interest rates on money market transactions; and (5) issues of material fact required a trial on whether the U.S. Branch paid and received arm's-length interest rates on clearing account transactions. Id. at 139-41, 144, 146-48. The parties then settled the remaining issue of interest rates on the clearing account transactions, and the court entered final judgment in NatWest's favor. The Government timely appealed to this court. We have jurisdiction pursuant to 28 U.S.C. section 1295(a)(3).

DISCUSSION

The Government presents three issues on appeal. First, the Government appeals the ruling of NatWest I and argues that the application of Treasury Regulation section 1.882-5 to NatWest is consistent with the expectations of the United States and the United Kingdom at the time the 1975 Treaty was negotiated, signed, and entered into force. Second, the Government appeals the ruling of NatWest II and submits that as an alternative to section 1.882-5, the proposed corporate yardstick method is a permissible means for imputing capital to the U.S. Branch. Last, the Government appeals the ruling of the Order Denying Reconsideration and requests that it be allowed to take discovery of NatWest's home

office books to determine the capital actually allotted to the U.S. Branch. Should we uphold NatWest I, NatWest II, and the Order Denying Reconsideration, the Government does not appeal the trial court's ruling in NatWest III.

A grant of summary judgment by the Court of Federal Claims is reviewed de novo, drawing justifiable factual inferences in favor of the party opposing the judgment. *SmithKline Beecham Corp. v. Apotex Corp.*, 403 F.3d 1331, 1337 (Fed. Cir. 2005); *Winstar Corp. v. United States*, 64 F.3d 1531, 1539 (Fed. Cir. 1995) (en banc).

When construing a treaty, "[t]he clear import of treaty language controls unless 'application of the words of the treaty according to their obvious meaning effects a result inconsistent with the intent or expectations of its signatories.'" *Sumitomo Shoji America, Inc. v. Avagliano*, 457 U.S. 176, 180 (1982) (quoting *Maximov v. United States*, 373 U.S. 49, 54 (1963)); see also *Xerox Corp. v. United States*, 41 F.3d 647, 652 (Fed. Cir. 1994) (citing *United States v. Stuart*, 489 U.S. 353, 365-66 (1989)). Moreover, effect must be given to the intent of both signatories. *Xerox*, 41 F.3d at 656 (citing *Valentine v. United States*, 299 U.S. 5, 11 (1936)). Thus, when the language of a treaty provision "only imperfectly manifests its purpose," we are required to give effect to its underlying purpose. *Great-West Life Assur. Co. v. United States*, 678 F.2d 180, 183 (Ct. Cl. 1982) (citing *In re Ross*, 140 U.S. 453, 475 (1891)); accord *Xerox*, 41 F.3d at 652 ("[T]he ultimate question remains what was intended when the language actually employed . . . was chosen, imperfect as that language may be." (second alteration in original) (quoting *Great-West Life*, 678 F.2d at 188)). To this end, we must "examine not only the language, but the entire context of agreement." *Great-West Life*, 678 F.2d at 183.

The "entire context" of the 1975 Treaty is informed by, and is based on, the Office of Economic Cooperation and Development's ("OECD") 1963 Draft Double Taxation Convention on Income and Capital ("1963 Draft Convention"). See NatWest I, 44 Fed. Cl. at 125 n.7; S. Exec. Rep. No. 95-18, at 15 (1978), as reprinted in 1980-1 C.B. 411, 427; Technical Explanation of the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains Signed at London, on December 31, 1975, as Amended by the Notes Exchanged at London on April 13, 1976, the Protocol Signed at London on August 26, 1976, and the Second Protocol signed at London on March 31, 1977, submitted to the Senate Foreign Relations Committee at hearings held on July 19-20, 1977, reprinted in 1980-1 C.B. 455, 473-74 (hereinafter "Technical Explanation"). As published, the model Articles of the 1963 Draft Convention issued as Annex I to a report of introductory and explanatory material. 1963 Draft Convention 5. Annex II consists of Commentaries on the Articles of the Draft Convention ("1963 Commentaries") that are "intended to be of great assistance in the application of the conventions and, in particular, in the settlement of eventual disputes." 1963 Draft Convention 18; see also NatWest I, 44 Fed. Cl. at 125. The Senate Report and the Technical Explanation both state specifically that Article 7 of the 1975 Treaty is based on or substantially similar to Article 7 of the 1963 Model Convention. See 1980-1 C.B. at 417, 461.

In NatWest I, the trial court concluded that the application of section 1.882-5 to the U.S. Branch of NatWest violated the separate enterprise principle of the 1975 Treaty. 44 Fed. Cl. at 131. Focusing on paragraphs 2 and 3 of Article 7, the trial court concluded that the plain language of the 1975 Treaty required that for a determination of the taxable income of the U.S. Branch,

the U.S. Branch is to be regarded as an independent, separate entity dealing at arm's length with other units of NatWest as if they were wholly unrelated, except that the U.S. Branch may deduct, in addition to its "own" expenses, a reasonable allocation of home office expense. Words such as "distinct" and "separate" and the phrase "dealing wholly independently" (emphasis added) would appear to permit no other interpretation.

Id. at 124. The trial court also analyzed the 1963 Commentaries, which describe "payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances, etc., (as distinct from capital allotted to them)," as "narrowly related to the ordinary business of such enterprises." NatWest I, 44 Fed. Cl. at 127 (quoting 1963 Draft Convention 83-84, paragraph 15). Thus because section 1.882-5 expressly disregards payments of interest on these types of interbranch transactions, the court concluded that section 1.882-5 was inconsistent with the Treaty as applied to the U.S. Branch of NatWest.⁷⁵ NatWest I, 44 Fed. Cl. at 130. The court further noted that if the U.S. Branch was a subsidiary of NatWest separately incorporated in the United States, the interest expense on transactions between the U.S. Branch and foreign NatWest branches would be subject to adjustment but would not be disregarded. Id. at 130 n.11; see also Treas. Reg. section 1.482-2(a) (1984).

On appeal, the Government criticizes the trial court's conclusion in NatWest I on the following grounds: (1) the court ignored the 1975 Treaty's plain language; (2) the court misapplied the 1963 Commentaries that support the Government's position; (3) the court ignored the parties' shared expectations; and (4) the court did not accord proper deference to the "Treasury's consistent determination that the regulation is consistent with Article 7."

We agree with the trial court's analysis of the plain language of the 1975 Treaty. On a fundamental level, we do not read the separate enterprise language of Article 7, paragraph 2 -- requiring that the U.S. Branch's business profits be determined as "if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment" -- as permitting transactions between the permanent

⁷⁵ The court also concluded that U.S.-connected liabilities under section 1.882-5 were impermissibly computed by reference to the worldwide assets and liabilities of NatWest rather than the operations of the U.S. Branch, NatWest I, 44 Fed. Cl. at 130, but the record demonstrates that the 0.95 capital ratio was used to calculate the U.S.-connected liabilities.

establishment and the enterprise to be disregarded. As did the trial court, we find the comparison to a separately incorporated U.S. subsidiary instructive. In that situation, intracorporate transactions recorded on the subsidiary's books are not disregarded, but are adjusted to reflect arm's length terms. See, e.g., Treas. Reg. section 1.482-2(a)(2) (1984) (defining "arm's length interest rate" as "the rate of interest which was charged, or would have been charged at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances"). The plain language of the 1975 Treaty thus indicates that adjustment of the terms of intracorporate transactions is required and that the disregard of these transactions is prohibited.

To the extent that the Government submits that the "reasonable allocation" language of Article 7, paragraph 3 is relevant to whether section 1.882-5 is permissible under the 1975 Treaty, the Government misreads the treaty. With regard to allowable deductions for a determination of the profits of a permanent establishment, the 1963 Model Convention, which differs slightly from the 1975 Treaty, reads as follows:

In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

1963 Draft Convention 46. The 1975 Treaty modifies this language by including a nonexclusive list of executive and general administrative expenses that are incurred on behalf of the enterprise as a whole (e.g., NatWest's worldwide enterprise including the U.S. Branch) and that may be partially allocated to the permanent establishment (e.g., NatWest's U.S. Branch).

In the determination of the profits of a permanent establishment, there shall be allowed as deductions those expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere.

31 U.S.T. at 5675-76 (emphasis added). Importantly, the "reasonable allocation" language refers to expenses, such as interest, that are "incurred for the purposes of the enterprise as a whole." Furthermore, a comparison of the Treaty to the 1963 Model Convention indicates that no reasonable allocation is necessary for expenses, such as interest, that are directly "incurred for the purposes of the permanent establishment."

As previously noted, the 1963 Draft Convention was published as part of a document that

included the 1963 Commentaries, the purpose of which is "'to illustrate or interpret the provisions'" and to "'be of great assistance . . . in the settlement of eventual disputes.'" NatWest I, 44 Fed. Cl. at 125 (quoting 1963 Draft Convention). Accordingly, the 1963 Draft Convention states that Article 7 "settles the question of the expenses which must be allowed as deductions in computing the profits of the permanent establishment." 1963 Draft Convention 12. Among these expenses that must be allowed are interbranch payments of interest "on advances, etc., (as distinct from capital allotted to [the permanent establishment])." 1963 Draft Convention 83-84, paragraph 15. This commentary indicates that section 1.882-5's disregard of interbranch transactions is inconsistent with the 1963 Draft Convention and the 1975 Treaty as modeled thereon.

On the separate enterprise principle specifically, the 1963 Commentary to Article 7, paragraph 2 states, "[T]he profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market." 1963 Draft Convention 82, paragraph 10. To determine these profits, "it is always necessary to start with the real facts of the situation as they appear from [t]he business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce." *Id.* Exceptions to this rule, however, may exist where no separate accounts exist. *Id.* (allowing for formulaic allocation in the absence of separate accounts). The 1963 Commentary goes on to explain that adjustment to the accounts of the permanent establishment may be necessary in situations such as when the transactions between a permanent establishment and a head office do not reflect market pricing (i.e., market interest rates for financial enterprises). *Id.* at paragraph 11.

Consistent with the 1963 Commentary to Article 7, paragraph 2, the commentary to Article 7, paragraph 3 focuses on whether an expense is incurred by a permanent establishment, rather than whether the expense is paid to a foreign branch of the same worldwide enterprise. "[F]or the sake of removing doubts," the 1963 Commentary states that Article 7, paragraph 3 "specifically recognizes that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment." *Id.* at 83, paragraph 13. The commentary explicitly includes as a deductible expense "payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances, etc., (as distinct from capital allotted to them), in view of the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises." *Id.* at 83-84, paragraph 15.

The Government argues that the use of formulaic allocations for taxing purposes by both parties during the period between the signing of the 1975 Treaty and its entry into force is evidence that the parties did not intend for the Treaty to prohibit the use of allocation formulas. The Government's position is undermined in two important respects. First, in 1978 the United Kingdom abandoned its formula then in use after concluding that the formula was inconsistent with the separate enterprise principle. Second, the interest expense allocation formula used by the United States was significantly different than that

prescribed by section 1.882-5.

The record demonstrates that during the negotiation period of the 1975 Treaty, the United Kingdom did employ a formulaic allocation when determining the interest expense deduction of a U.K. branch of a foreign (e.g., incorporated in the United States) bank. The Government's reliance on this use in furtherance of its appeal is misplaced. Referred to in the record as the "Price Waterhouse formula" ("PW formula"), the United Kingdom used the ratio of the bank's worldwide total free capital to total liabilities and compared the liabilities of the U.K. branch to the bank's total liabilities to allocate free capital to the U.K. branch for taxation purposes. *NatWest II*, 58 Fed. Cl. at 505-06. If the U.K. branch's allocated free capital was less than the net balance owed to the bank's head office, a formula was then used to calculate the interest rate on the remainder of the net balance (less an amount equal to allocated capital) that would be used to determine the amount of the deduction. Unlike section 1.882-5, the PW formula does not disregard transactions simply because they occurred between branches of the same worldwide enterprise. In addition, the United Kingdom abandoned use of the PW formula in 1978 after determining that the formulaic capital allocation violated the separate enterprise principle under the U.S.-U.K. treaty that was in effect before the 1975 Treaty entered into force in 1980. *NatWest II*, 58 Fed. Cl. at 505-06 (citing Counsel's Opinion (Dec. 7, 1978)). The separate enterprise language of that earlier treaty was nearly identical to the language of the 1975 Treaty,⁷⁶ and the United Kingdom continued to maintain that the PW formula was equally violative of the supplanting language in the 1975 Treaty. See *Inland Revenue, Banking Manual* app. 9A, paragraph 3 (1994). This contemporaneous conduct of the United Kingdom supports the position taken in its amicus brief filed with the trial court -- the United Kingdom has never interpreted the provisions of the 1975 Treaty as allowing a taxing authority to disregard interbranch transactions when computing the interest expense properly deductible by a permanent establishment. U.K. Amicus Br. 38-39; Letter from I.N. Hunter, Inland Revenue, to Donald E. Bergherm Jr., Assistant Commissioner (International), Internal Revenue Service (March 13, 1990) (Re: Request for Competent Authority Consideration Dated July 27, 1989).

Nor is the Government's position supported by its own conduct contemporaneous to the negotiations of the 1975 Treaty. The Government points to Revenue Ruling 78-423, 1978-2 C.B. 194 (concluding that the interest expense apportionment formulas of Treasury Regulation section 1.861-8 (1977) were permissible in view of the Business Profits article of the U.S.-Japan treaty, which was also based on 1963 OECD Model Convention), as supporting its argument that Treasury's consistent interpretation of

⁷⁶ The business profits and separate enterprise language of the earlier treaty states, [T]here shall be attributed to such permanent establishment the industrial or commercial profits which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment.

Supplementary Protocol Amending the Convention of April 16, 1945, as modified by the supplementary protocols of June 6, 1946, May 25, 1954, and August 19, 1957, U.S.-U.K., March 17, 1966, 17 U.S.T. 1254.

section 1.882-5 is informative of the United States' intent as a signatory to the 1975 Treaty. This argument, however, overlooks the key difference between the allocation formula of section 1.861-8 and the formula of section 1.882-5 -- namely, that section 1.861-8 does not explicitly disregard interbranch transactions when determining the interest expense deductible by a permanent establishment. Treas. Reg. section 1.861-8(e)(2)(v), (vi) (1977) (apportioning appropriate amount of worldwide interest expense to permanent establishment). In addition, section 1.861-8 expressly stated that if treaty provisions apply to the determination of taxable income, the treaty takes precedence over the regulation.⁷⁷ Treas. Reg. section 1.861-8(f)(1)(iv) (1977).

The Government submits that its unwavering, long-held position is to be accorded significant deference. The Government correctly notes that "[a]lthough not conclusive, the meaning attributed to treaty provisions by the Government agencies charged with their negotiation and enforcement is entitled to great weight." *Sumitomo*, 457 U.S. at 184-85 (according great deference to agency's position where treaty's signatories, neither of which were parties to the lawsuit, agreed as to interpretation). Courts nevertheless "interpret treaties for themselves." *Kolovrat v. Oregon*, 366 U.S. 187, 194 (1961). Moreover, because we are to interpret treaties so as to give effect to the intent of both signatories, *Xerox*, 41 F.3d at 656, an agency's position merits less deference "where an agency and another country disagree on the meaning of a treaty," see *Iceland Steamship Co., Eimskip v. U.S. Dep't of the Army*, 201 F.3d 451, 458 (D.C. Cir. 2000). Finally, this court, when considering different provisions of the 1975 Treaty, has declined to defer to Treasury's contemporaneous interpretation where it conflicted with the contemporaneous intent of the Senate. *Xerox*, 41 F.3d at 653-57 (rejecting agency's interpretation that was published during the ratification process and reasserted at trial).

The Government is correct to assert that it has unwaveringly interpreted section 1.882-5 as being consistent with the 1975 Treaty and other similar treaties based on the 1963 Draft Convention. See, e.g., Rev. Rul. 89-115, 1989-2 C.B. 130-31 (section 1.882-5 consistent with 1975 Treaty); Rev. Rul. 85-7, 1985-1 C.B. 188 (section 1.882-5 consistent with U.S.-Japan treaty). Indeed, in a report issued in 1984, the OECD itself acknowledged that the United States' interpretation of Article 7 of the 1963 Draft Convention⁷⁸ allowed for the application of section 1.882-5 to international financial institutions. Comm. on Fiscal Affairs, OECD, *Transfer Pricing and Multinational Enterprises* 59 (1984) (hereinafter "1984 OECD Report"). The 1984 OECD Report is, however, the earliest indication in the record of the Treasury's belief in the consistency between section 1.882-5 and the 1975 Treaty. Given the nine-year gap between the signing of the 1975 Treaty and the issuance of the 1984 OECD Report (and the four-year

⁷⁷ The Government's reliance on Revenue Ruling 78-423 may also be mistaken in its assumption that the U.S.-Japan treaty considered therein is sufficiently similar to the U.S.-U.K. treaty at issue here. Rather than mandating deductions for "those expenses which are incurred for the purposes of the permanent establishment," 1975 Treaty, art. 7 paragraph 3, the U.S.-Japan treaty requires deduction for "expenses which are reasonably connected with [the] profits" of a permanent establishment, United States-Japan Income Tax Convention, Mar. 8, 1971, art. 8, paragraph 3, reprinted in 1978-1 CB 630, 634.

⁷⁸ The OECD issued a new draft convention in 1977 that did not materially alter Article 7 of the 1963 Draft Convention. See *NatWest II*, 58 Fed. Cl. at 503, 504 n.14.

gap between the implementation of the 1975 Treaty and the issuance of the 1984 Report), the consistent position of the Treasury as of 1984 can hardly be read as dispositive of the issue of the intent of the United States and the United Kingdom in 1975 when the Treaty was signed -- especially when considering that section 1.882-5 was not even proposed until February 27, 1980. Furthermore, to the extent that the 1984 OECD Report establishes that the United States had taken the position that section 1.882-5 is consistent with the 1975 Treaty, the report establishes that of the 24 OECD members (including the United Kingdom), the United States and Japan were the only two that interpreted the 1963 Draft Convention in this fashion. 1984 OECD Report 56-59. Thus, even if the United States' interpretation of the 1963 Draft Convention, and thereby the 1975 Treaty, can be established as of the publication date of the 1984 OECD Report, the United Kingdom's contrary interpretation is established as of the same date.

The record, therefore, contains no evidence prior to the 1984 OECD report that either party understood the separate enterprise principle as allowing a method of determining the interest expense of the U.S. Branch that disregards interbranch transactions. The predecessor to this court, however, did consider post-ratification conduct of the parties, "[i]n an appropriate case," to be relevant to the interpretation of a treaty's terms. *Great-West Life*, 678 F.2d at 189. In *Great-West Life*, the Court of Claims found that the government's proffered interpretation at trial was consistent with the legislative history of the treaty at issue, the "almost contemporaneous" subsequent legislative action, and the negotiation of later signed treaties. *Id.* at 188-89. It was this consistency that lent interpretive weight to the government's post ratification conduct. *Id.* With respect to the 1975 Treaty, the United States' conduct after the adoption of section 1.882-5 is internally consistent as of the publication of the 1984 OECD Report, but the Government fails to adequately support its contention that this conduct is consistent with the expectations of the United States and the United Kingdom when the 1975 Treaty was signed. The record evidence of the United States' post-ratification conduct seems even less relevant in view of the signatories' contemporaneous acknowledgment that the Treaty is based on the 1963 Model Convention, the commentary to which explicitly authorizes deductions for interest expenses incurred on interbranch advances.

In sum, we find that the plain language of the 1975 Treaty -- the separate enterprise principle -- mandates that expenses incurred for the benefit of the U.S. Branch be deductible, including interest expenses paid to foreign branches of NatWest. Our reading of the plain language finds direct support in the 1963 Commentary and the contemporaneous understanding of the United Kingdom. Moreover, there is very little evidence that the contemporaneous understanding of the United States differed in any way from that of the United Kingdom. Lastly, the Government's current interpretation of the 1975 Treaty is entitled to minimal deference where it contravenes the treaty's language and negotiation history, as well as the contemporaneous expectations of the United Kingdom. For these reasons, we conclude that Treasury Regulation section 1.882-5 is inconsistent with the 1975 Treaty as applied to a permanent establishment of an international financial enterprise, e.g., the U.S. Branch of NatWest during the tax years at issue.

After rejecting the application of section 1.882-5 to the U.S. Branch in NatWest I, the court considered in NatWest II the method by which the books of the U.S. Branch should be adjusted for the "imputation of adequate capital to the branch and to insure use of market rates in computing interest expenses." NatWest I, 44 Fed. Cl. at 128; NatWest II, 58 Fed. Cl. at 494. The Government argued that the separate enterprise principle required the U.S. Branch to be taxed as if it were a separately incorporated institution and that the U.S. Branch should be deemed to hold an amount of interest-free capital equal to that required of similarly sized U.S. banks (6.996%, as compared to 5.668% for the largest U.S. banks) -- the corporate yardstick. NatWest II, 58 Fed. Cl. at 495-96. Conversely, NatWest argued that the imputation of capital on any basis other than an as-necessary adjustment of the U.S. Branch's books to reflect actually allotted capital was improper under the 1975 Treaty. Id. at 496.

At issue is whether the separate enterprise principle was intended by the parties to require a permanent establishment to be taxed as a separately incorporated institution or to be taxed according to the reality of its situation and accounts as adjusted to reflect market pricing in its dealings with the home office. Id. at 497. The trial court adopted NatWest's position and concluded that "'separate and distinct' does not mean the branch should be treated as if it were 'separately-incorporated,' but instead 'separate and distinct,' means separate and distinct from the rest of the bank of which it is a part." Id. The court thus held that capital may not be allocated under any formulaic approach, but rather, the capital held by a branch must be determined according to the books of the branch as may be adjusted to accurately characterize transactions and ensure the use of arm's length rates. Id. at 497-98. In support of its conclusion, the trial court noted that the capital determination method proffered by NatWest was consistent with the historic method used by the United Kingdom, as set forth in Inland Revenue, Banking Manual (1994). Id. at 506-07.

On appeal, the Government maintains that the separate enterprise principle allows the IRS to tax the U.S. Branch as if it were subject to the same regulatory and market capital requirements as a separately incorporated U.S. subsidiary. As before, our analysis begins with the language of the 1975 Treaty as informed by the 1963 Draft Convention and the expectations of the parties.

Turning again to the separate enterprise principle set forth in Article 7, paragraph 2,

there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

31 U.S.T. at 5675. Under this language, the Government's position seems to focus on the "dealing wholly independently with" phrase as indicating that for tax purposes, the U.S. Branch should be taxed as if it possesses enough interest free capital to support its own

operations, rather than rely on the capital of the worldwide NatWest enterprise. Conversely, the "same or similar conditions" language seems to support NatWest's position that the U.S. Branch should be taxed in a manner consistent with the actual conditions of its operation -- a branch with operations that are funded with little or no interest free capital.

To the extent the parties' conflicting positions evidence ambiguity in the 1975 Treaty's language, we agree with the trial court that NatWest has espoused the better reading. The "same or similar" language of the separate enterprise principle refers to the activities and conditions in which the U.S. Branch conducted its business. That is, the U.S. Branch should be taxed as if it were a separate enterprise engaged in activities that are the "same or similar" to those activities in which the U.S. Branch engaged and as if it were operating in conditions that are the "same or similar" to the conditions in which the U.S. Branch conducted its activities. By way of contrast, the Government's reading of the separate enterprise principle requires that the "same or similar" language describe the activities of the hypothetical separate enterprise. That is, the U.S. Branch should be taxed as if it were engaged in activities that are the same or similar to those in which a separate enterprise would engage and as if it were operating in conditions that are the same or similar to those in which a separate enterprise would operate.

Under the proper reading of the "same or similar" clauses, it becomes clear that the "dealing wholly independently with" language requires taxing authorities to scrutinize intracorporate transactions involving a permanent establishment to ensure that the transactions are accurately characterized and reflect arm's length terms and pricing. Conversely, the Government's reliance on "dealing wholly independently with" is at odds with a proper reading of the "same or similar" clauses. To conclude that "wholly independently" requires that the U.S. Branch be taxed as if it were subject to regulatory and market capital requirements is to ignore the fact that the U.S. Branch does not operate under conditions in which it is subject to these requirements. In essence, the Government would read the "same or similar conditions" language out of the 1975 Treaty.

Our analysis of the 1975 Treaty's plain language is supported by the 1963 Draft Convention. The 1963 Commentary to Article 7, paragraph 2 states that the analysis of taxable business profits is to begin with the "trading accounts of the permanent establishment," but allows for a formulaic allocation of profits in circumstances where the permanent establishment does not maintain separate accounts from the home office. 1963 Draft Convention 82, paragraph 10. The commentary goes on to state:

It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce.

Id. (emphasis added). In the instant case, the real facts of the situation are that the U.S. Branch is not required to maintain any minimal amount of capital. Therefore, because the corporate yardstick would essentially recharacterize loans that bear an interest expense as equity capital infusions based on regulatory and domestic market requirements that do not apply to the U.S. Branch, the corporate yardstick ignores the real facts of the U.S. Branch's situation and violates the 1975 Treaty as informed by the 1963 Draft Convention. As stated by the trial court in NatWest II, "The Commentary confirms that the purpose of any adjustment should be to reflect the real facts of the branch's transactions with the entity of which it is a part." 58 Fed. Cl. at 498.

The Government argues that because both parties used capital allocation formulae during the period of the 1975 Treaty's negotiation, the parties expected that the use of similar formulas, e.g., the corporate yardstick, would be permissible under the treaty. Specifically, the Government identifies the adoption of Treasury Regulation section 1.861-8 in 1977, see 49 Fed. Reg. 1195 (Jan. 6, 1977), and the United Kingdom's use of the PW Formula in support of its position. The record reveals, however, that the implementation or abandonment of these formulae provide little, if any, support for the Government's use of the corporate yardstick.

As discussed previously, section 1.861-8 used worldwide information of an international financial enterprise to allocate an interest expense to a permanent establishment doing business in the United States. Section 1.861-8, however, contained language expressly stating that applicable treaty provisions would take precedence over the regulation. Treas. Reg. section 1.861-8(f)(1)(iv) (1977). Thus, to the extent that section 1.861-8 conflicts with our reading of the 1975 Treaty and analysis of the signatories' expectations, the treaty governs.

More importantly, the analysis of the Queen's Counsel opinion when the United Kingdom abandoned the PW Formula in 1978 is particularly instructive. The opinion explicitly considered the appropriateness of treating a permanent establishment as "a company with independent shareholders," Counsel's Opinion 2 (Dec. 7, 1978), and speaks directly to the issue before us on appeal.

[I]n our view the Convention gives no authority to write into the branch accounts a level of capital which the branch does not have. To do this is to go against the scheme of Article III and the requirement of the paragraph (2) hypothesis that the United Kingdom branch is trading under "... the same or similar conditions ...". This directs that the actual conditions under which the United Kingdom branch trades are taken into account. It is those conditions which dictate the expenses in question.

Accordingly the "notional interest formula", under which interest is disallowed to the extent that the (actual) capital

account of the branch falls short of an amount (estimated by the Revenue) which would be required as "free working capital" by an independent banking enterprise is in our opinion unwarranted. The notional interest formula may very well result in the disallowance of actual expenditure which is attributable to the branch and that is something which Article III plainly does not authorise. Like the global apportionment referred to in paragraph 5 above the formula may offer a convenient method of avoiding the difficulties involved in the allocation of actual receipts and expenses, but in our opinion it is not sound in law.

Id. at 3 (alterations in original). This analysis of the separate enterprise principle (as similarly set forth in Article III of the previous U.S.-U.K. double taxation treaty, see *supra* note 4) led the United Kingdom to abandon the PW formula. U.K. Amicus Br. at 24-25. We are persuaded by the clarity of the Queen's Counsel's analysis that when the 1975 Treaty was negotiated, the parties did not understand the separate enterprise principle to allow for imputation of capital to the U.S. Branch according to estimates generated by the IRS's use of the corporate yardstick.

Having concluded that the corporate yardstick violates the 1975 Treaty as applied to the U.S. Branch, we uphold the trial court's decision in *NatWest II*. "[B]ranch profits must be based on the properly maintained books of the branch," subject to examination and adjustment where: "(1) an interest expense was deducted for advances to the branch that were not used in the ordinary course of its banking business; (2) an interest expense was deducted on amounts designated as capital on its books or on amounts that were in fact allotted to it for capital purposes, such as funding capital infrastructure; and (3) interest paid on inter-branch borrowing [that] was not at arms' length." *NatWest II*, 58 Fed. Cl. at 505.

Having upheld the trial court's decision in *NatWest I* and *NatWest II*, we turn now to the Government's appeal from the Order Denying Reconsideration. Following its ruling in *NatWest II*, the trial court issued a Scheduling Order that limited the scope of discovery regarding the "capital issue." Order Denying Recons. 1. In the Scheduling Order, the court stated that "the 'capital issue' does not include attributing capital to the U.S. branches from other National Westminster branches or its home office." *Id.* Thereafter, the Government filed Defendant's Motion for Reconsideration of Court's July 16, 2004, Order, Limiting Scope of Capital Issue (hereinafter "Motion for Reconsideration"). The Government argued that United Kingdom banking regulations required *NatWest* to hold sufficient capital to support the operations of the U.S. Branch and that this capital should be attributed to the U.S. Branch for tax purposes. Mot. for Recons. 2. As evidence supporting its motion, the Government offered the expert report of Mr. Farrant and the decision of a Dutch court applying this capital allocation approach under a treaty similar to the 1975 Treaty. *Id.* at 1. The court denied the motion, concluding that the Government was seeking to introduce yet another capital allocation theory and thus waived this issue by failing to introduce it during briefing that gave rise *NatWest II*. Order Denying

Recons. 3. Central to this conclusion was the court's finding that the Government did not dispute that it had for nine years been aware of NatWest's compliance with the United Kingdom banking regulations, yet had never sought to attribute capital held by foreign offices and branches to the U.S. Branch for tax purposes. *Id.* at 3.

We review the denial of a motion for reconsideration by the Court of Federal Claims for an abuse of discretion. *Mass. Bay Transp. Auth. v. United States*, 254 F.3d 1367, 1378 (Fed. Cir. 2001). Likewise, the issue of waiver is also "within the discretion of the trial court, consistent with its broad duties in managing the conduct of cases pending before it." *United States v. Zielger Bolt & Parts Co.*, 111 F.3d 878, 882 (Fed. Cir. 1997). An abuse of discretion occurs when a court misunderstands or misapplies the relevant law or makes a clearly erroneous finding of fact. *PPG Indus., Inc. v. Celanese Polymer Specialties Co.*, 840 F.2d 1565, 1572 (Fed. Cir. 1988).

The trial court's denial of the Motion for Reconsideration was not an abuse of discretion. The Government identifies no allegedly clearly erroneous finding of fact. In addition, having concluded that NatWest II was correctly decided, we find no misapplication of the relevant law. Discovery of NatWest's home office books was not necessary because the interest expense deduction for the U.S. Branch is to be determined according to the properly maintained books of the branch. We further find that the trial court did not abuse its discretion by finding that the Government had waived its argument that capital held by the NatWest home office should be imputed to the U.S. Branch for tax purposes.

CONCLUSION

We are persuaded that the signatories to the 1975 Treaty expected that the interest expenses incurred by a permanent establishment of an international financial enterprise, e.g., the U.S. Branch of NatWest, would be deductible to the extent the expenses were related to the permanent establishment's ordinary course of business. Accordingly, we conclude that Treasury Regulation section 1.882-5 and the corporate yardstick as applied to the U.S. Branch violate the 1975 Treaty. We further conclude that the Court of Federal Claims did not abuse its discretion by denying the Government's Motion for Reconsideration. The judgment of the Court of Federal Claims is therefore affirmed.

AFFIRMED

COSTS

No costs.

III. CHAPTER 6, ORGANIZATION AND OPERATION OF FOREIGN BRANCHES BY U.S. PERSONS: IMPACT OF FOREIGN TAX CREDIT, SOURCING RULES, AND FOREIGN CURRENCY RULES

A. Page 252, New Sec. 6.5.E Final Regulations on Foreign Tax Credit Generators

Page 252, New Sec. 6.5.E. Add before Sec. 6.6 the following:
New Sec. 6.5.E. **Final Regulations on Foreign Tax Credit Generators**

Treasury Decision 9416, Determining Amount off Taxes to Be Paid for Foreign Tax Credit Purposes
July 16, 2008

ACTION: Final and temporary regulations

SUMMARY: This document contains final and temporary regulations under section 901 of the Internal Revenue Code providing guidance relating to the determination of the amount of taxes paid for purposes of the foreign tax credit. The regulations affect taxpayers that claim direct and indirect foreign tax credits. The text of these temporary regulations also serves as the text of the proposed regulations (REG-156779-06) published in the Proposed Rules section in this issue of the **Federal Register**. * * *

BACKGROUND

On March 30, 2007, the **Federal Register** published proposed amendments (72 FR 15081) to the Income Tax Regulations (26 CFR part I) under section 901 of the Internal Revenue Code (Code) relating to the amount of taxes paid for purposes of the foreign tax credit (the “2007 proposed regulations”). The 2007 proposed regulations would revise §1.901-2(e)(5) in two ways. First, for purposes of §1.901-2(e)(5), the 2007 proposed regulations would treat as a single taxpayer all foreign entities in which the same U.S. person has a direct or indirect interest of 80 percent or more (a “U.S.-owned foreign group”). Second, the 2007 proposed regulations would treat amounts paid to a foreign taxing authority as noncompulsory payments if those amounts are attributable to certain structured passive investment arrangements. The 2007 proposed regulations provide that the regulations will be effective for foreign taxes paid or accrued during taxable years of the taxpayer ending on or after the date on which the regulations are finalized.

The IRS and Treasury Department received written comments on the 2007 proposed regulations, which are discussed in this preamble. A public hearing was held on July 30, 2007. In response to written comments, the IRS and Treasury Department determined that the proposed change to §1.901-2(e)(5) relating to U.S.-owned foreign groups may lead to inappropriate results in certain cases. Accordingly, on November 19, 2007, the IRS and Treasury Department issued Notice 2007-95, 2007-49 IRB 1 (see

§601.601(d)(2)(ii)(b)). Notice 2007-95 provided that the proposed rule for U.S.-owned foreign groups would be severed from the portion of the 2007 proposed regulations addressing the treatment of foreign payments attributable to certain structured passive investment arrangements. Notice 2007-95 further provided that the proposed rules for U.S.-owned groups would be effective for taxable years beginning after final regulations are published in the **Federal Register**.

In light of comments, the IRS and the Treasury Department believe that it is appropriate to issue new proposed and temporary regulations addressing the treatment of foreign payments attributable to structured passive investment arrangements. These new regulations make several changes to the 2007 proposed regulations to take into account comments received, while adopting without amendment substantial portions of the 2007 proposed regulations. The new temporary and proposed regulations will permit the IRS to enforce the rules relating to structured passive investment arrangements, while also allowing taxpayers a further opportunity for comment. The significant comments and revisions are described in this preamble.

Explanation of Provisions

The temporary regulations address the application of §1.901-2(e)(5) in cases in which a person claiming foreign tax credits is a party to a structured passive investment arrangement. These complex arrangements are intentionally structured to create a foreign tax liability when, removed from the elaborately engineered structure, the basic underlying business transaction generally would result in significantly less, or even no, foreign taxes. The parties use these arrangements to exploit differences between U.S. and foreign law in order to permit a person to claim a foreign tax credit for the purported foreign tax payments while also allowing the counterparty to claim a duplicative foreign tax benefit. The person claiming foreign tax credits and the counterparty share the cost of the purported foreign tax payments through the pricing of the arrangement.

The temporary regulations treat foreign payments attributable to such arrangements as noncompulsory payments under §1.901-2(e)(5) and, thus, disallow foreign tax credits for such amounts. For periods prior to the effective date of the temporary regulations, the IRS will continue to utilize all available tools under current law to challenge the U.S. tax results claimed in connection with these and other similar abusive arrangements, including the substance over form doctrine, the economic substance doctrine, debt-equity principles, tax ownership principles, other provisions of §1.901-2, section 269, and the partnership anti-abuse rules of §1.701-2.

The temporary regulations retain the general rule in the existing regulations that a taxpayer need not alter its form of doing business or the form of any transaction in order to reduce its foreign tax liability. However, §1.901-2T(e)(5)(iv)(A) provides that, notwithstanding the general rule, an amount paid to a foreign country (a “foreign payment”) is not a compulsory payment, and thus is not an amount of tax paid, if the foreign payment is attributable to a structured passive investment arrangement. For this purpose, §1.901-2T(e)(5)(iv)(B) defines a structured passive investment arrangement as an arrangement that satisfies six conditions. The six conditions consist of features that are common to arrangements that are intentionally structured to generate the foreign payment.

Section 1.901-2T(e)(5)(iv)(B)(1): Special Purpose Vehicle

The first condition provided in the 2007 proposed regulations is that the arrangement utilizes an entity that meets two requirements (an “SPV”). The first requirement is that substantially all of the gross income (for United States tax purposes) of the entity, if any, is attributable to passive investment income and substantially all of the assets of the entity are assets held to produce such passive investment income. The second requirement is that there is a purported foreign tax payment attributable to income of the entity. The purported foreign tax may be paid by the entity itself, by the owner(s) of the entity (if the entity is treated as a pass-through entity under foreign law) or by a lower-tier entity (if the lower-tier entity is treated as a pass-through entity under U.S. law).

For purposes of the first requirement, §1.901-2(e)(5)(iv)(C)(4) of the 2007 proposed regulations defines passive investment income as income described in section 954(c), with two modifications. The first modification excludes income of a holding company attributable to qualifying equity interests in lower-tier entities that are predominantly engaged in the active conduct of a trade or business (or that are themselves holding companies). The second modification is that passive investment income is determined by disregarding sections 954(c)(3) and 954(c)(6) and by treating income attributable to transactions with a counterparty as ineligible for the exclusions under sections 954(h) and 954(i).

One commentator recommended, in lieu of the holding company rules in the 2007 proposed regulations, applying look-through rules to income and assets of lower-tier entities similar to the rules of section 1297(c), under which a foreign corporation, if it owns at least 25 percent of the stock of another corporation, is treated as owning its proportionate share of the assets of the other corporation and receiving its proportionate share of the income of the other corporation. Alternatively, the commentator recommended that the holding company rules in the 2007 proposed regulations be modified to eliminate the requirement that substantially all of the assets of the tested entity must consist of qualified equity interests; to permit income other than dividends (for example, interest and royalties) received from a lower-tier entity that is predominantly engaged in an active business to qualify as active income; and to treat a lower-tier entity as an operating company if more than 50 percent of either its assets or its income meet the active business test. In addition, commentators suggested eliminating the requirement that the U.S. party and the counterparty must share the opportunity of gain or loss with respect to the lower-tier entity, or replacing it with a rule disqualifying the equity interest if contractual restrictions limit the counterparty's recourse against the lower-tier entity's income or assets. Finally, commentators suggested that preferred stock should be treated as a qualifying equity interest.

These comments were not adopted. The holding company exception is intended only to clarify that a joint venture arrangement is not treated as a structured passive investment arrangement solely because it is conducted through a holding company structure, not to liberalize the definition of structured passive investment arrangements. The requirement that the parties share the opportunity for gain and risk of loss with respect to the holding

company's assets is intended to ensure that the arrangement between the parties is a bona fide joint venture. In this regard, a commentator recommended that the regulations be clarified to provide that the holding company exception is not satisfied if either the U.S. party or the counterparty is solely a creditor with respect to the entity because it either owns a hybrid instrument that is debt for U.S. tax purposes or purchases stock subject to an obligation to sell the stock back. This modification is reflected in §1.901-2T(e)(5)(iv)(C)(5)(ii) of the temporary regulations. In addition, *Example 2* of §1.901-2T(e)(5)(iv)(D) is modified to clarify that the holding company exception is not met if the counterparty's interest is acquired in a sale-repurchase transaction.

The IRS and Treasury Department recognize that under the regulations an entity conducting business through an active foreign subsidiary may fail to meet the holding company exception, even though the entity would not be treated as an SPV under the “substantially all” test if it operated the subsidiary's business directly through a branch operation. The IRS and Treasury Department believe this result is appropriate because the segregation of active business income and assets in a lower-tier entity may facilitate the use of an upper-tier entity to conduct a structured passive investment arrangement. The IRS and Treasury Department remain concerned that taxpayers may continue to enter into structured passive investment arrangements designed to generate foreign tax credits through entities that meet the technical requirements of the holding company exception. The IRS and Treasury Department intend to monitor the use of holding companies to facilitate abusive foreign tax credit arrangements, utilize all available tools under current law to challenge the U.S. tax results claimed in connection with such arrangements (including the substance over form doctrine, the economic substance doctrine, debt-equity principles, tax ownership principles, other provisions of §1.901-2, section 269, and the partnership anti-abuse rules of §1.701-2) in appropriate cases, and to issue additional regulations modifying or eliminating the holding company exception if necessary to prevent abuse.

The second modification in the 2007 proposed regulations is that passive investment income is determined by disregarding sections 954(c)(3) and 954(c)(6) and by treating income attributable to transactions with a counterparty as ineligible for the exclusions under sections 954(h) and 954(i). The IRS and Treasury Department received a number of comments suggesting that the definition of passive investment income should be narrowed by excluding income that would be treated as non-subpart F income under section 954(c)(3) or 954(c)(6), excluding income from unrelated persons other than the counterparty, or eliminating the requirement in section 954(h) that the tested entity's activity be conducted in the entity's “home country.” Other commentators suggested substituting other tests for the active financing exception in section 954(h), such as exempting financial services income as defined in section 904(d), with or without modification. For example, commentators suggested various modifications, such as excluding income derived from unrelated persons or from direct activities of employees of the tested entity; exempting any income derived from or related to transactions with customers; exempting income that would be considered attributable to an active foreign trade or business under the principles of section 864 and §1.367(a)-2T(b); or exempting income other than income from “tainted” assets such as cash or cash equivalents, stock or

notes of persons related to the U.S. party or counterparty, or assets giving rise to U.S. source income. One commentator suggested that payments described in section 954(c)(3) should not be treated as passive investment income to the extent the payment was deductible under foreign law and the corresponding income inclusion by the tested entity did not result in a net increase in foreign taxes paid. This commentator suggested that the result in the U.S. borrower transaction described in *Example 2* of the 2007 proposed regulations was inappropriate since the foreign tax paid by the SPV was offset by a reduction in tax paid by the CFC borrower.

The IRS and Treasury Department carefully considered these suggestions but ultimately determined that none of the suggested approaches has significant advantages over relying on section 954(h) to determine whether income from financing activities is sufficiently active that it should be excluded from passive investment income for purposes of these regulations. Section 954(h) includes detailed requirements that ensure that the entity is predominantly engaged in the active conduct of a banking, financing or similar business and conducts substantial activity with respect to such business. In addition, the IRS and Treasury Department continue to believe it is not appropriate to exclude income described in sections 954(c)(3) and 954(c)(6) from passive investment income, because financing arrangements between related parties that are engaged in the active conduct of a trade or business are commonly used in the structured transactions that are the target of these regulations. The IRS and Treasury Department also do not believe that U.S. borrower transactions should not be considered to result in a net increase in foreign tax, since in the absence of the structured passive investment arrangement the CFC borrower would still reduce its foreign tax by reason of the interest expense deduction but the U.S. party would not claim foreign tax credits for foreign payments attributable to income in the SPV that is in substance the foreign lender's interest income. Accordingly, §1.901-2T(e)(5)(iv)(C)(5)(i) generally retains the definition of passive investment income in the 2007 proposed regulations.

However, the temporary regulations include two modifications in response to comments. First, the IRS and Treasury Department agree it is appropriate to require the entity's activities to be conducted directly by its own employees rather than by employees of affiliates, because the purpose of the SPV condition is to distinguish between active entities and those with largely passive income, and it is reasonable to require an entity engaged in an active business to conduct that business through its own employees. Accordingly, §1.901-2T(e)(5)(iv)(C)(5)(i) provides that section 954(h)(3)(E) shall not apply, and that the entity must conduct substantial activity through its own employees. Second, the IRS and Treasury Department agree that the requirement that activities be conducted in the entity's "home country" reflects a subpart F policy that is more restrictive than necessary for purposes of these regulations. Accordingly, §1.901-2T(e)(5)(iv)(C)(5)(i) provides that for purposes of these regulations the term *home country* means any foreign country.

Concerning the requirement in §1.901-2(e)(5)(iv)(B)(1)(i) of the 2007 proposed regulations that substantially all of the gross income of the entity be passive investment income and substantially all of the entity's assets are assets held to produce such passive

investment income, one commentator recommended that the regulations provide examples illustrating situations in which such requirement is met. The IRS and Treasury Department did not adopt this comment because the “substantially all” test requires evaluation of all the facts and circumstances and cannot be satisfied by reference to a specific percentage benchmark.

Several commentators requested that the regulations clarify the time at which the six conditions must be met to result in a structured passive investment arrangement. Section 1.901-2T(e)(5)(iv)(B)(1)(ii) of the temporary regulations is revised to clarify that the foreign payment must be made with respect to a U.S. tax year in which substantially all of the gross income (for U.S. tax purposes) of the entity, if any, is attributable to passive investment income and substantially all of the assets of the entity are assets held to produce such passive investment income. This clarification is intended to ensure that foreign tax credits are disallowed for foreign payments that relate primarily to passive investment income, but not for taxes that relate to active business income earned in an earlier or later year when the entity is not treated as an SPV. The regulations do not, however, require all six conditions to be met in the same tax year. For example, the regulations disallow credits for foreign payments with respect to income of an SPV even if the U.S. party acquires its interest, or a hybrid instrument is issued to the counterparty, after the foreign payments are made.

Other commentators recommended that the regulations eliminate the SPV condition and treat as noncompulsory payments only those foreign payments that directly relate to passive investment income, or with respect to which duplicative tax benefits are claimed. The IRS and Treasury Department did not adopt such an approach in the temporary regulations because of the administrative difficulty of tracing specific foreign payments to specific income or to the duplicative tax benefits. Accordingly, the temporary regulations retain the SPV condition and the approach of treating all foreign payments attributable to a structured passive investment arrangement as noncompulsory. However, the IRS and Treasury Department recognize that an element of the arrangements intended to be covered by the regulations is that they are designed to generate duplicative tax benefits, and that some connection between the counterparty's foreign tax benefit and the U.S. party's share of the foreign payments should be a pre-condition to the finding of a structured passive investment arrangement. Accordingly, as described in section D of this preamble, the foreign tax benefit condition is revised to provide that the counterparty's foreign tax benefit must correspond to 10 percent or more of the U.S. party's share of the foreign payments or the U.S. party's share (under U.S. tax principles) of the foreign tax base used to compute such payments.

Section 1.901-2T(e)(5)(iv)(B)(2): U.S. Party

Section 1.901-2T(e)(5)(iv)(B)(2) of the temporary regulations adopts without change the second overall condition of the 2007 proposed regulations that a person (a “U.S. party”) would be eligible to claim a credit under section 901(a) (including a credit for foreign taxes deemed paid under section 902 or 960) for all or a portion of the foreign payment if such payment were an amount of tax paid.

One commentator requested that the regulations be amended to clarify that the “U.S. party” condition must be met at the same time as the other five conditions. The temporary regulations do not include this condition because the IRS and Treasury Department believe it is inappropriate to exempt arrangements that are structured so that the U.S. party claims a credit in a taxable year or period that is not the same taxable year or period in which the counterparty is entitled to a foreign tax benefit. In addition, the IRS and Treasury Department are concerned that this modification would allow a person to acquire an interest in an SPV and claim credits with respect to purported foreign taxes paid in an earlier period by the SPV in connection with an arrangement that met the other five conditions of the regulations.

Section 1.901-2T(e)(5)(iv)(B)(3): Direct Investment

The third overall condition provided in the 2007 proposed regulations is that the foreign payment or payments are (or are expected to be) substantially greater than the amount of credits, if any, that the U.S. party would reasonably expect to be eligible to claim under section 901(a) if such U.S. party directly owned its proportionate share of the assets owned by the SPV, other than through a branch, a permanent establishment or any other arrangement (such as an agency arrangement) that would subject the income generated by its share of the assets to a net basis foreign tax. Commentators recommended several changes to the direct investment condition, several of which are adopted in the temporary regulations. First, in order to reach appropriate results in cases where more than one person owns an equity interest in the SPV for U.S. tax purposes, the temporary regulations amend the direct investment test to compare the U.S. party's proportionate share of the foreign payment made by the SPV to the amount of foreign tax the U.S. party would be eligible to credit if the U.S. party directly owned its proportionate share of the assets. Second, the temporary regulations clarify that a dual resident corporation that is an SPV meets the direct investment condition since its ownership of the passive assets is treated the same as ownership through a branch operation. Third, a commentator suggested that the direct investment test of the 2007 proposed regulations could be avoided by entering into a sale-repurchase transaction using an SPV that acquires passive assets subject to foreign withholding tax. This commentator recommended that the direct investment condition be revised to reduce the value of the U.S. party's interest by any amount advanced by the foreign counterparty that is treated as debt for U.S. tax purposes but as equity for foreign tax purposes. The IRS and Treasury Department agree that situations where the SPV's income is subject to gross basis foreign taxes raise the same foreign tax credit policy concerns as situations where the SPV's income is subject to net basis foreign taxes. The IRS and Treasury Department, however, believe the commentator's recommended solution is incomplete, since the other conditions of the regulations can be met by structures employing techniques other than sale-repurchase agreements. Accordingly, the temporary regulations provide that the U.S. party's proportionate share of the SPV's assets does not include any assets that produce income subject to gross basis withholding tax.

Several commentators recommended that the regulations include an exception for certain transactions in which the amount of the foreign payments attributable to income of an SPV does not substantially exceed the amount of foreign taxes that would have been paid by a controlled foreign corporation that owns the SPV in the absence of the arrangement. The commentators suggested that such foreign payments should not be treated as noncompulsory payments because they effectively substitute for taxes that would have been imposed on the controlled foreign corporation in the absence of the arrangement. These comments raise the fundamental question as to the appropriate baseline to which such transactions should be compared to determine if there has been a significant increase in the total amount of foreign taxes paid. Although the IRS and Treasury Department carefully considered an exception from the definition of structured passive investment arrangements for such transactions, the IRS and Treasury Department have been unable to develop an exception that can be administered by the IRS and that does not exclude abusive cases. Accordingly, the temporary regulations do not include this exception.

Section 1.901-2T(e)(5)(iv)(B)(4): Foreign Tax Benefit

The fourth condition provided in the 2007 proposed regulations is that the arrangement is structured in such a manner that it results in a foreign tax benefit (such as a credit, deduction, loss, exemption or a similar tax benefit) for a counterparty or for a person that is related to the counterparty, but not related to the U.S. party. In response to comments, to relieve administrative burdens these regulations clarify that while the benefit must be reasonably expected, there is no requirement to show that the benefit be intended or actually realized. The temporary regulations also provide that the ability to surrender the use of a tax loss to another person is a foreign tax benefit because a foreign tax benefit need only be made available to a counterparty. See *Example 9* of §1.901-2T(e)(5)(iv)(D). Several commentators recommended that the regulations be revised to require a causal relationship between one or more of the six conditions. For example, one commentator recommended adding a requirement that the foreign tax benefit either relate to the foreign tax paid by the SPV or result from the counterparty being treated for foreign but not U.S. tax purposes as owning an equity interest in the SPV or a portion of the SPV's assets. Another commentator suggested requiring that the inconsistent aspect of the arrangement be created or used to achieve the foreign tax benefit. Another commentator recommended requiring that the foreign tax benefit would not have been allowed or allowable “but for” the existence of one or more of the other conditions.

In response to the comments, the temporary regulations revise the “foreign tax benefit” condition to provide that the credit, deduction, loss, exemption, exclusion or other tax benefit must correspond to 10 percent or more of the U.S. party's share (for U.S. tax purposes) of the foreign payment or 10 percent or more of the foreign tax base with respect to which the U.S. party's share of the foreign payment is imposed. The revisions are intended to clarify that a joint venture that does not involve any duplication of tax benefits is not covered by the temporary regulations. At the same time, the temporary regulations provide that the duplication need not be direct. For example, while the U.S. party generally seeks to claim foreign tax credits in the United States for foreign payments attributable to income of the SPV, the counterparty's foreign tax benefit may

consist of tax-exempt income corresponding to the SPV's income with respect to which foreign payments claimed as credits by the U.S. party were made and deductions or losses attributable to payments of corresponding amounts to the SPV or U.S. party. See *Example 3* of §1.901-2T(e)(5)(iv)(D).

Section 1.901-2T(e)(5)(iv)(B)(5): Counterparty

The 2007 proposed regulations define a counterparty as a person (other than the SPV) that is unrelated to the U.S. party and that (i) directly or indirectly owns 10 percent or more of the equity of the SPV under the tax laws of a foreign country in which such person is subject to tax on the basis of place of management, place of incorporation or similar criterion or otherwise subject to a net basis foreign tax or (ii) acquires 20 percent or more of the assets of the SPV under the tax laws of a foreign country in which such person is subject to tax on the basis of place of management, place of incorporation or similar criterion or otherwise subject to a net basis foreign tax.

Commentators proposed that the counterparty factor be amended to include certain related parties. Commentators noted that structured transactions engaged in by related persons under common foreign ownership present the same tax policy concerns as transactions between unrelated persons. However, these same commentators noted that structured transactions engaged in by related parties that are under common U.S. ownership do not pose the same tax policy concerns because the reduction in foreign tax liability obtained by the U.S.-controlled foreign counterparty will result in a corresponding increase in U.S. taxes when the foreign counterparty repatriates its earnings to the United States. The IRS and Treasury Department agree with these comments. Consequently, the temporary regulations amend the definition of a counterparty to include related persons, but excluding cases where the U.S. party is a U.S. corporation or individual that owns (directly or indirectly) at least 80 percent of the value of the potential counterparty and cases where at least 80 percent of the value of the U.S. party and the potential counterparty are owned (directly or indirectly) by the same U.S. corporation or individual.

Several commentators also suggested that the requirement that the counterparty own at least 10 percent (directly or indirectly) of the equity of the SPV or acquire at least 20 percent of the assets of the SPV should be revised. Some commentators proposed these thresholds be increased to 50 percent. Other commentators proposed that the ownership of all foreign parties deriving a foreign tax benefit should be aggregated to determine whether the thresholds are met. The IRS and Treasury Department agree that the regulatory conditions should be revised to better reflect that the counterparty is entitled to more than a nominal foreign tax benefit. Accordingly, the temporary regulations eliminate the percentage ownership thresholds from the counterparty definition, and modify the definition of a foreign tax benefit in §1.901-2T(e)(5)(iv)(B)(4), as described in section D of this preamble.

Section 1.901-2T(e)(5)(iv)(B)(6): Inconsistent Treatment

The sixth condition in the 2007 proposed regulations is that the U.S. and an applicable foreign country treat the arrangement differently under their respective tax systems. For this purpose, an applicable foreign country is any foreign country in which either the counterparty, a person related to the counterparty or the SPV is subject to net basis tax. To provide clarity and limit the scope of this factor, the 2007 proposed regulations provide that the arrangement must be subject to one of four specified types of inconsistent treatment. Specifically, the U.S. and the foreign country (or countries) must treat one or more of the following aspects of the arrangement differently, and the U.S. treatment of the inconsistent aspect must materially affect the amount of foreign tax credits claimed, or the amount of income recognized, by the U.S. party to the arrangement: (i) the classification of an entity as a corporation or other entity subject to an entity-level tax, a partnership or other flow-through entity or an entity that is disregarded for tax purposes; (ii) the characterization as debt, equity or an instrument that is disregarded for tax purposes of an instrument issued in the transaction; (iii) the proportion of the equity of the SPV (or an entity that directly or indirectly owns the SPV) that is considered to be owned directly or indirectly by the U.S. party and the counterparty; or (iv) the amount of taxable income of the SPV for one or more tax years during which the arrangement is in effect.

Commentators recommended that this condition be clarified so that the U.S. treatment of the inconsistent aspect must materially increase the amount of the U.S. party's foreign tax credits or materially decrease the U.S. party's income for U.S. tax purposes. The temporary regulations reflect this clarification. In addition, commentators requested that this factor be limited to instances when the inconsistent treatment is reasonably expected to result in a permanent difference in the U.S. party's income or foreign tax credits. The IRS and Treasury Department believe that the revisions to the foreign tax benefit condition described in Section D of this preamble are sufficient to establish the appropriate linkage between the inconsistent U.S. and foreign law treatment and the duplicative tax benefits. Accordingly, the temporary regulations retain the inconsistent treatment factor without further changes.

One commentator also recommended that the inconsistent treatment condition be narrowed to instances where the inconsistent treatment under U.S. and foreign law related to definitions of ownership and the amount of the SPV's taxable income. The IRS and Treasury Department have not adopted this recommendation because it would cause certain types of abusive arrangements to fall outside the scope of the regulations and because differences in entity classification are features common to structured passive investment arrangements.

Other Comments

Commentators also made suggestions that did not relate to any single factor. For example, commentators also requested clarification that the foreign payments treated as noncompulsory amounts under the regulation may be deductible payments under sections

162 and 212 and reduce a foreign corporation's earnings and profits for purposes of subpart F. The IRS and Treasury Department believe that providing guidance regarding sections 162, 212, and 964 is beyond the scope of this regulation project. The usual rules for determining the deductibility of a payment and determining the earnings and profits of a foreign corporation for subpart F purposes apply.

In addition, commentators requested that foreign payments attributable to a structured passive investment arrangement be excluded from the scope of the regulations if the arrangement has a valid business purpose. Other commentators suggested that the regulations adopt a broad anti-abuse rule that would deny a foreign tax credit in any case where allowance of the credit would be inconsistent with the purpose of the foreign tax credit regime. The IRS and Treasury Department are concerned that these approaches would create uncertainty for both taxpayers and the IRS. The IRS and Treasury Department have concluded that, at this time, a targeted rule denying foreign tax credits in arrangements described in the temporary regulations is more appropriate.

Other Examples

In response to comments, the temporary regulations include more examples illustrating additional variations of the structured passive investment arrangements that are covered by the regulations. For example, new *Example 3* illustrates a U.S. borrower transaction in which a foreign lender acquires assets instead of an equity interest in the SPV and new *Example 10* illustrates a joint venture in which the counterparty's foreign tax benefits do not correspond to the U.S. party's share of the base with respect to which the foreign payment is imposed. Modifications to examples in the 2007 proposed regulations were also necessary to reflect comments received and other changes to the regulations.

Effective/Applicability Dates

The 2007 proposed regulations were proposed to be effective for foreign taxes paid or accrued during taxable years of the taxpayer ending on or after the date on which the final regulations are published in the **Federal Register**. A commentator observed that the final regulations would potentially be retroactively effective because the regulations would apply, for example, to calendar year taxpayers as of January 1 of the year in which the final regulations are published in the **Federal Register** and to taxpayers that participated in structured passive investment arrangements involving entities with taxable years that differ from the U.S. taxpayers' taxable years. Commentators also requested clarification of whether the relevant taxable year for purposes of the effective date is the taxable year of the SPV in which it pays or accrues the purported foreign taxes, or the taxable year of the U.S. taxpayer in which it claims a credit. For example, commentators observed that if the taxable year of the U.S. taxpayer in which it claims a credit is the relevant taxable year, the final regulations would apply to U.S. shareholders of controlled foreign corporations where the shareholder claims a deemed paid credit under section 902 with respect to foreign taxes paid by the foreign corporation in years prior to the effective date of the regulations. These commentators recommended that the regulations provide that the relevant taxable year is the SPV's taxable year. Commentators also recommended that

the final regulations apply only to foreign taxes paid or accrued in taxable years beginning after the date the final regulations are published, or only to foreign taxes paid or accrued with respect to income accrued after the date the final regulations are published.

The IRS and Treasury Department have not adopted the recommendation to delay the effective date of these regulations to apply only in tax years beginning after the regulations are published. The IRS and Treasury Department generally believe the regulations should apply to disallow credits for foreign payments that would otherwise be eligible to be claimed as credits in taxable years ending after the regulations are published. The IRS and Treasury Department agree, however, that the regulations should not apply to foreign taxes paid or accrued by a foreign corporation in a U.S. taxable year of the foreign corporation ending prior to the effective date of the regulations, provided that such year ends prior to the first taxable year of the domestic corporate shareholder for which these regulations are first applicable.

Accordingly, the effective date for these regulations is July 16, 2008. The regulations generally apply to foreign payments that, if they were an amount of tax paid, would be considered paid or accrued by a U.S. or foreign entity in taxable years ending on or after July 16, 2008. In the case of foreign payments by a foreign corporation that has a domestic corporate shareholder, the regulations also apply to such payments that would be considered paid or accrued in the foreign corporation's U.S. taxable years ending with or within taxable years of its domestic corporate shareholder ending on or after July 16, 2008. Finally, in the case of foreign payments by a partnership, trust or estate for which any partner or beneficiary would otherwise be eligible to claim a foreign tax credit, the regulations also apply to payments that would be considered paid or accrued in taxable years ending with or within taxable years of such partners or beneficiaries ending on or after July 16, 2008.

No inference is intended regarding the U.S. tax consequences of structured passive investment arrangements prior to the effective date of the regulations. For periods after the effective date of the temporary regulations, the IRS and Treasury Department will continue to scrutinize other arrangements that are not covered by the regulations but are inconsistent with the purpose of the foreign tax credit. Such arrangements may include arrangements that are similar to arrangements described in the temporary regulations, but that do not meet all of the conditions included in the temporary regulations. The IRS will continue to challenge the claimed U.S. tax results in appropriate cases. In addition, the IRS and Treasury Department may issue additional regulations in the future in order to address such other arrangements.

Miscellaneous Amendments

The temporary regulations also amend §1.901-1(a) and (b) to reflect statutory changes made by the Foreign Investors Tax Act of 1966 (Public Law 89-809 (80 Stat. 1539), section 106(b)), the Tax Reform Act of 1976 (Public Law 94-455 (90 Stat. 1520), section

1901(a)(114)), and the American Jobs Creation Act of 2004 (Public Law 108-357 (118 Stat. 1418-20), section 405(b)). * * *

B. Page 304, New Sec. 6.17.A Final Regulations on Dual Consolidated Losses

Page 304, New Sec. 6.17.A. Add at the bottom of the page the following:

New Sec. 6.17.A. **Final Regulations on Dual Consolidated Losses**

Treasury Decision 9315

March 19, 2007

SUMMARY: This document contains final regulations under section 1503(d) of the Internal Revenue Code (Code) regarding dual consolidated losses. Section 1503(d) generally provides that a dual consolidated loss of a dual resident corporation cannot reduce the taxable income of any other member of the affiliated group unless, to the extent provided in regulations, the loss does not offset the income of any foreign corporation. Similar rules apply to losses of separate units of domestic corporations. These final regulations address various dual consolidated loss issues, including exceptions to the general prohibition against using a dual consolidated loss to reduce the taxable income of any other member of the affiliated group. * * *

BACKGROUND

Congress enacted section 1503(d), as part of the Tax Reform Act of 1986, to prevent a dual resident corporation from using a single economic loss once to offset income that was subject to U.S. tax, but not foreign tax, and a second time to offset income subject to foreign tax, but not U.S. tax (double dip). In 1988, Congress extended the application of section 1503(d), by adding section 1503(d)(3) and (4), to apply the provisions to separate units of domestic corporations and to grant the Secretary authority to promulgate regulations to prevent the avoidance of section 1503(d) through the contribution of assets to a corporation with a dual consolidated loss after the loss was sustained. The IRS and Treasury Department issued temporary regulations under section 1503(d) in 1989 (TD 8261, 1989-2 CB 220) and final regulations in 1992 (TD 8434, 1992-2 CB 240), see section 601.601(d)(2)(ii)(b). These final regulations were updated and amended over the next 11 years (current regulations).

On May 24, 2005, the IRS and Treasury Department published in the Federal Register a notice of proposed rulemaking (REG-102144-04; 70 FR 29868). The proposed regulations addressed the following fundamental concerns arising under the current regulations: (1) the potential over- and under-application of the current regulations; (2) various issues arising in the application of the current regulations, particularly in light of the adoption of the entity classification regulations under sections 301.7701-1 through 301.7701-3 (check-the-box regulations); and (3) the administrative burden of the current regulations. The public hearing with respect to the 2005 proposed regulations was

cancelled because no request to speak was received. However, the IRS and Treasury Department received a number of written comments which are discussed in this preamble.

Summary of Comments and Explanation of Provisions

Application of Section 1503(d) to Regulated Investment Companies and Real Estate Investment Trusts

Under the current regulations, a dual resident corporation is a domestic corporation that is subject to an income tax of a foreign country on its worldwide income or on a residence basis. As a result, unless specifically exempted, certain entities that are domestic corporations, but not generally taxed at the entity level, may be subject to the current regulations. The current regulations provide that an S corporation, which is a domestic corporation, is not treated as a dual resident corporation. The proposed regulations, and these final regulations, provide that an S corporation is not treated as a domestic corporation and thus cannot be a dual resident corporation or own a separate unit.

Under the current regulations, as a domestic corporation, a regulated investment company (as defined in section 851) or a real estate investment trust (as defined in section 856) could be a dual resident corporation or own a separate unit. In the preamble to the proposed regulations, however, the IRS and Treasury Department requested comments as to whether regulated investment companies or real estate investment trusts should, like S corporations, be excluded from the application of the dual consolidated loss rules. One commentator suggested that regulated investment companies and real estate investment trusts should be subject to the dual consolidated loss rules, but would limit recapture pursuant to a domestic use agreement to situations where there was a foreign use and a section 381 transaction occurred.

The IRS and Treasury Department believe that subjecting regulated investment companies and real estate investment trusts to the dual consolidated loss rules is inappropriate. Section 1503(d) was intended to apply to domestic corporations that are subject to entity-level tax. Although regulated investment companies and real estate investment trusts are domestic corporations under the Code, unlike most domestic corporations these entities often do not pay tax at the entity level because they may deduct the amount of dividends paid to their shareholders from their own taxable income. Thus, under the final regulations regulated investment companies and real estate investment trusts are excluded from the definition of a domestic corporation and, as a result, are not subject to the dual consolidated loss rules.

Separate Units

Separate unit combination rule

Section 1.1503-2(c)(3)(ii) of the current regulations provides that if two or more foreign branches located in the same foreign country are owned by a single domestic corporation

and the losses of each branch are available to offset the income of the other branches under the tax laws of the foreign country, then the branches are treated as a single separate unit.

In response to comments that the current combination rule was unnecessarily limited and did not appropriately address the check-the-box regulations, the proposed regulations adopt a broader combination rule that, subject to certain requirements, combines all separate units of a single domestic corporation. One requirement for combining separate units, both under the current regulations and the proposed regulations, is that the losses of each separate unit are made available to offset the income of the other separate units under the tax laws of a single foreign country.

The combination rule in the proposed regulations does not combine dual resident corporations that are members of the same consolidated group, or separate units of multiple domestic corporations that are members of the same consolidated group. However, in the preamble to the proposed regulations, the IRS and Treasury Department requested comments as to whether combination was appropriate in these cases.

Numerous comments were received on the scope and application of the combination rule. Commentators uniformly recommended that the combination rule be expanded to include separate units that are located in or subject to tax in the same foreign country (same-country separate units) and that are owned by multiple domestic corporations that are members of the same consolidated group. The IRS and Treasury Department believe that combining same-country separate units of domestic corporations that are members of the same consolidated group is consistent with the policies underlying section 1503(d) because, in general, all of the items of income, gain, deduction, and loss of such combined separate units are taken into account in both the United States and the foreign country. Therefore, these final regulations expand the combination rule to apply to same-country separate units of multiple domestic corporations that are members of the same consolidated group.

Two commentators recommended that the combination rule be expanded to combine dual resident corporations that are members of the same consolidated group. The IRS and Treasury Department do not believe that Congress intended that multiple dual resident corporations be treated as a single domestic corporation for purposes of section 1503(d). Combining dual resident corporations and separate units would also add complexity because certain rules apply differently to dual resident corporations and separate units. As a result, the combination rule in these final regulations does not apply to dual resident corporations.

Nevertheless, it is important to note that a dual resident corporation will often carry on its activities through a foreign branch (as defined in section 1.367(a)-6T(g)(1)) and, as a result, will be a domestic owner of a foreign branch separate unit. In these cases, the foreign branch separate unit through which it carries on its activities in the foreign country will be eligible for combination. In addition, in many cases, a significant number of the items of income, gain, deduction, and loss of a dual resident corporation that owns

a foreign branch separate unit will be attributable to the foreign branch separate unit (and therefore will not be items of the dual resident corporation itself). As a result, not extending the combination rule to dual resident corporations should, as a practical matter, have limited effect.

One commentator recommended eliminating the proposed regulations' requirement that losses of each separate unit must be available to offset the income of other separate units under the tax laws of a single foreign country in order for them to combine. The IRS and Treasury Department believe that it is appropriate to remove this requirement, provided that the individual separate units are located, or subject to income tax on a worldwide or residence basis, in the same foreign country. This is the case because it is likely that all of the items of the combined separate unit will be recognized in both the United States and the foreign jurisdiction, without regard to whether such items are available for offset under the income tax laws of the foreign country. In addition, the IRS and Treasury Department believe that eliminating this requirement will reduce complexity, and will further refine the application of the rules. As a result, these final regulations eliminate this requirement from the combination rule.

Commentators also recommended making combination elective in certain situations. The IRS and Treasury Department believe that elective combination would add complexity and create administrative burdens. Therefore, this comment is not adopted.

The IRS and Treasury Department recognize that the expanded combination rule may necessitate that the basis of the stock of multiple domestic corporations, which are members of the same consolidated group, be adjusted to reflect the items of income, gain, deduction, and loss entering into the computation of the dual consolidated loss of a combined separate unit. These regulations provide guidance on the manner of such basis adjustments.

These final regulations also clarify that the separate unit combination rule generally applies for all purposes of section 1503(d). As a result, except as specifically provided in these regulations, any individual separate unit composing a combined separate unit loses its character as an individual separate unit. For example, in determining whether there is a triggering event as a result of the transfer of the assets of a combined separate unit, all of the assets of the combined separate unit are taken into account (rather than only the assets of any individual separate unit within the combined separate unit).

Definition of a foreign branch by reference to section 1.367(a)-6T(g)

One commentator stated that the reference in the current and proposed regulations to section 1.367(a)-6T(g) for the definition of a foreign branch, which implicitly includes references to section 1.367(a)-6T(g)(1) through (3), creates needless complexity. The IRS and Treasury Department generally agree with this comment. Accordingly, these final regulations clarify that a foreign branch is defined, in part, by reference to section 1.367(a)-6T(g)(1), rather than by reference to section 1.367(a)-6T(g).

Treaty exception to the definition of a foreign branch separate unit

One commentator suggested that the definition of a foreign branch separate unit should not include a branch that would not be subject to income tax in a foreign jurisdiction either as a result of an income tax convention or because of the passive nature of the activities. This commentator explained that such an exclusion is appropriate because in these cases there would be no potential use of a branch loss for foreign tax purposes.

The IRS and Treasury Department agree that it is appropriate to exclude from the definition of a foreign branch separate unit certain business operations that, under an applicable income tax convention, would not be considered a permanent establishment. As a result, these final regulations include an exception to the definition of a foreign branch separate unit. The IRS and Treasury Department do not, however, believe an exception is appropriate where the business operations are not subject to tax in the foreign jurisdiction because of the passive nature of the activities. Such an exception would require the analysis of foreign law which, to the extent possible, should not be required under these rules.

Activities owned by a dual resident corporation or a hybrid entity

One commentator requested clarification that home-country activities of a dual resident corporation or hybrid entity separate unit can qualify as a foreign branch separate unit. The IRS and Treasury Department agree that this clarification is warranted and these final regulations are modified accordingly.

Elimination of the Consistency Rule

As a result of the expansion of the separate unit combination rule in these final regulations, the IRS and Treasury Department believe that the consistency rule would have only limited application. Therefore, the consistency rule has been eliminated from these final regulations. The IRS and Treasury Department believe that eliminating the consistency rule will simplify the application of the dual consolidated rules and will eliminate various issues that arise under the rule.

Domestic Reverse Hybrid Entities

One commentator noted that the application of the current and proposed regulations to certain structures involving domestic reverse hybrid entities appears inconsistent with the underlying policies of section 1503(d). In a typical structure, a foreign corporation owns the majority of the interests in a partnership or limited liability company that elects to be treated as a corporation for U.S. tax purposes and, therefore, is subject to tax on its worldwide income in the United States, but is treated as a pass-through entity under foreign law (domestic reverse hybrid). The domestic reverse hybrid is the parent of a consolidated group, is the obligor on group indebtedness, and holds stock of other group members. This structure allows the interest expense of the domestic reverse hybrid to offset income of the foreign corporation, which is not subject to U.S. tax, and to offset

income of the other members of the consolidated group, which is not subject to foreign tax.

The commentator noted that because the domestic reverse hybrid is neither a dual resident corporation (because it is not subject to tax on a residence basis or on its worldwide income in the foreign country, but is instead treated as a pass-through entity) nor a separate unit of a domestic corporation, the current and proposed regulations do not apply to the losses of the domestic reverse hybrid. The commentator asserted that this result is inconsistent with the policies underlying section 1503(d), which was adopted, in part, to ensure that domestic corporations were not put at a competitive disadvantage as compared to foreign corporations through the use of certain inbound acquisition structures. See S. Rep. No. 99-313, 1986-3 CB Vol. 3 at 420, see section 601.601(d)(2)(ii)(b). The commentator suggested that the scope of the final regulations be broadened to treat such entities as separate units, the losses of which are subject to the restrictions of section 1503(d). This change would, in effect, apply the provisions of section 1503(d) to a separate unit of a foreign corporation.

The IRS and Treasury Department recognize that this type of structure results in a double dip similar to that which Congress intended to prevent through the adoption of section 1503(d). However, the IRS and Treasury Department believe that a domestic reverse hybrid is neither a dual resident corporation nor a separate unit and, therefore, is not subject to section 1503(d). As a result, this comment is not adopted. However, the IRS and Treasury Department continue to study these and similar structures.

Transparent Entities

Section 1.1503-2(c)(3) and 1.1503-2(c)(4) of the current regulations define a separate unit of a domestic corporation as a foreign branch (within the meaning of section 1.367(a)-6T(g)), and an interest in a partnership, trust, or hybrid entity. As a result, the current regulations potentially apply not only to entities that are subject to tax in a foreign country (for example, hybrid entities), but also to entities that are not subject to tax in a foreign country, and otherwise have no connection to a foreign jurisdiction (for example, a domestic partnership engaged in a U.S. trade or business).

The proposed regulations modify the definition of a separate unit to exclude interests in non-hybrid entity partnerships and non-hybrid entity grantor trusts. These interests were excluded because the IRS and Treasury Department believe that it is unlikely that losses and deductions attributable to these interests could be put to a foreign use (as that term is defined in the proposed regulations). However, the proposed regulations retain the rule that a domestic corporation can own a separate unit through a non-hybrid entity partnership or non-hybrid entity grantor trust.

Commentators noted that, as a result of this change, the proposed regulations may not sufficiently and consistently address the treatment of certain entities. Such an entity is a pass-through entity for U.S. tax purposes (for example, a disregarded entity, a partnership or a grantor trust), but is not a hybrid entity because it is not subject to tax on its

worldwide income or on a residence basis in a foreign country. In addition, the entity would not be treated as a pass-through entity under the laws of the applicable foreign country. One example of such an entity (transparent entity) is a limited liability company organized in the United States that for U.S. tax purposes is a partnership or disregarded entity, but, for purposes of the applicable foreign country, is not viewed as a pass-through entity. Another example is a foreign entity that is a pass-through entity for U.S. tax purposes, is not subject to income tax in a foreign country as a corporation (or otherwise at the entity level) either on its worldwide income or on a residence basis (because, for example, it is organized in a foreign country that does not impose an income tax), and is not treated as a pass-through entity under the laws of the applicable foreign country.

The commentators noted that under the proposed regulations items of income, gain, deduction, and loss of a transparent entity that is a partnership for U.S. tax purposes would be taken into account in computing the dual consolidated loss of a dual resident corporation or hybrid entity separate unit that owns an interest in such entity, even though it is unlikely that the items are taken into account by the jurisdiction in which the dual resident corporation or hybrid entity is subject to tax. As a result, items of deduction or loss which are unlikely to be available for a double dip (because they are not taken into account by the foreign country in which the dual resident corporation or hybrid entity is subject to tax) could inappropriately result in a dual consolidated loss. The commentators further noted that items of income or gain which are unlikely to be taken into account by the foreign country could inappropriately reduce (or eliminate) a dual consolidated loss of the dual resident corporation or hybrid entity separate unit that owns an interest in such entity.

The IRS and Treasury Department believe that losses attributable to interests in transparent entities should not be subject to section 1503(d), but also believe that items attributable to these interests should not influence the calculation or use of a dual consolidated loss of a dual resident corporation or separate unit in a manner that is inconsistent with the purposes of section 1503(d). Accordingly, these final regulations provide four new rules that address transparent entities (and interests therein).

First, these final regulations provide a definition of a transparent entity that is consistent with the description and examples in the preceding discussion.

Second, rules are provided for attributing items of income, gain, deduction, and loss to interests in transparent entities. The rules applicable for attributing items to these interests are consistent with the rules for attributing items to hybrid entity separate units.

Third, these final regulations provide that items of income, gain, deduction, and loss attributable to interests in transparent entities are not considered when calculating whether a dual resident corporation that holds an interest in such entity has income or a dual consolidated loss. This modification ensures that in cases where the foreign country in which the dual resident corporation is subject to tax is unlikely to take into account items of the transparent entity, such items do not inappropriately affect the computation of income or a dual consolidated loss of the dual resident corporation. Similar rules apply

for purposes of calculating the income or dual consolidated loss of a separate unit through which an interest in a transparent entity is owned (directly or indirectly).

Finally, an interest in a transparent entity will be treated as a domestic affiliate for purposes of determining whether there is a domestic use of a dual consolidated loss. This change prevents a dual consolidated loss from being used to offset the income of a transparent entity such that there is no inappropriate domestic use of the loss.

These final regulations do not treat transparent entities, or interests therein, as dual resident corporations or separate units and, as a result, do not cause such entities (or interests therein) to be subject to the limitations of section 1503(d). Instead, the rules aim to appropriately take into account such entities when applying the dual consolidated loss rules to dual resident corporations and separate units.

Reasonable Cause Exception

The current regulations require various filings to be included on a timely filed income tax return. In addition, taxpayers that fail to include these filings must request an extension of time to file under sections 301.9100-1 through 301.9100-3. The proposed regulations eliminate the requirement that a taxpayer obtain an extension of time under sections 301.9100-1 through 301.9100-3 and instead adopt a reasonable cause standard.

On January 31, 2006, the IRS and Treasury Department published Notice 2006-13 (2006-8 IRB 496), see section 601.601(d)(2)(ii)(b), announcing that taxpayers that must file agreements, statements, and other information under section 1503(d) may cure any late filings by applying a reasonable cause exception similar to the standard contained in the proposed regulations, until such time as the proposed regulations become final. In addition to allowing the use of the reasonable cause exception prior to the proposed regulations being published as final regulations in the Federal Register, the notice modifies the procedures for obtaining reasonable cause relief to ensure that requests for reasonable cause relief are handled in a timely and efficient manner.

These final regulations adopt the reasonable cause standard contained in the proposed regulations and Notice 2006-13, with certain modifications. See paragraph S(3) of this preamble for the application of the reasonable cause exception to losses that are subject to the current regulations.

Foreign Use

In general

Section 1.1503-2(g)(2)(i) of the current regulations provides that, in order to elect relief from the general limitation on the use of a dual consolidated loss to offset income of a domestic affiliate ((g)(2)(i) election), the taxpayer must, among other things, certify that no portion of the losses, expenses, or deductions taken into account in computing the dual consolidated loss has been, or will be, used to offset the income of any other person under

the income tax laws of a foreign country. If, contrary to this certification, there is such a use, the dual consolidated loss subject to the (g)(2)(i) election generally must be recaptured and reported as gross income.

The proposed regulations modify the definition of "use" and provide a rule based on "foreign use" in order to minimize the potential over- and under-application of the current regulations. The proposed regulations provide that a foreign use is deemed to occur only if two conditions are satisfied. The first condition is satisfied if any portion of a deduction or loss taken into account in computing the dual consolidated loss is made available under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws (including items of income or gain generated by the dual resident corporation or separate unit itself), regardless of whether income or gain is actually offset, and regardless of whether these items are recognized under U.S. tax principles. The second condition is satisfied if items that are (or could be) offset pursuant to the first condition are considered, under U.S. tax principles, to be items of: (1) a foreign corporation; or (2) a direct or indirect (for example, through a partnership) owner of an interest in a hybrid entity, provided such interest is not a separate unit.

Indirect foreign use

As noted, the proposed regulations provide that a foreign use of a dual consolidated loss will occur when any item of deduction or loss, entering into the computation of the dual consolidated loss, is made available, directly or indirectly, to offset under foreign law, income of a foreign corporation or an owner of an interest in a hybrid entity that is not a separate unit. The proposed regulations do not provide comprehensive examples illustrating when an indirect use of a dual consolidated loss occurs. However, the provision was included in the proposed regulations to address transactions that are structured to avoid the application of section 1503(d) through, for example, the use of a back-to-back lending or conduit financing-type arrangements, or through the use of one or more hybrid instruments.

Commentators requested additional guidance regarding an indirect foreign use. In response to these comments, these final regulations clarify when an indirect foreign use is deemed to occur, include an exception to the general indirect foreign use rule for certain ordinary course transactions, and provide related examples.

The indirect foreign use rules are designed to limit an indirect use to situations in which taxpayers have engaged in transactions which have the effect of transferring an item of deduction or loss composing a dual consolidated loss to another entity for foreign tax purposes, so that it is made available to offset the income of a foreign corporation or the owner of an interest in an entity which is not a separate unit. In general, these rules are intended to target structured transactions that are designed to achieve a double dip that is contrary to the policies of section 1503(d), and are not intended to apply to ordinary business transactions.

Exceptions to foreign use

The proposed regulations contain three exceptions to the definition of a foreign use, including an exception where there is no dilution of an interest in a separate unit. In the preamble to the proposed regulations, the IRS and Treasury Department request comments as to whether a de minimis exception should be provided to the dilution limitation. The preamble also states that a revenue procedure would be issued, in conjunction with the proposed regulations being published as final regulations in the Federal Register, that would provide additional exceptions (safe harbors) under which a triggering event would be deemed rebutted if various conditions were satisfied, including, in certain cases, a demonstration that there can be no foreign use of a significant portion of the dual consolidated loss.

The IRS and Treasury Department received a number of comments on transactions and situations that could be included in the list of safe harbors. One commentator suggested an exception whereby recapture would not be required following transactions outside the taxpayer's control. For example, this commentator suggested that a recapture of a dual consolidated loss should not occur following the conveyance or relinquishment of assets of a separate unit, or interests in a separate unit, to a foreign government.

Commentators also suggested that relief should be provided following certain transactions, similar to those mentioned in the preamble to the proposed regulations, where there is a de minimis potential for foreign use, a de minimis carryover of asset basis, and for which rebuttal would otherwise be difficult or impossible. According to these commentators, this safe harbor would apply to many common business transactions in which the policies underlying section 1503(d) would not be violated because of only a de minimis potential for foreign use.

Another commentator stated that an exception to foreign use would be appropriate where the taxpayer enters into a binding and irrevocable agreement with the tax authorities of a foreign country which ensures that no portion of the dual consolidated loss can be put to a foreign use in the foreign country. The commentator explained that, pursuant to such an arrangement, the taxpayer and the foreign tax authorities would agree that the foreign tax attributes of a dual resident corporation or separate unit (for example, loss carryforwards and asset basis) would be eliminated such that there would be no opportunity for a foreign use.

After considering these comments, the IRS and Treasury Department believe that it is appropriate to include certain safe harbors where a foreign use will be deemed not to occur. As a result, these final regulations (rather than a revenue procedure) set forth additional exceptions to the definition of a foreign use. These exceptions generally apply in cases where the potential for foreign use is de minimis, or where the transaction giving rise to a foreign use occurs as a result of events largely outside of the taxpayer's control.

These new exceptions to foreign use include a de minimis rule and rules that apply to certain transactions involving the carry over of asset basis and the assumption of

liabilities. Another new exception applies to a transaction that qualifies for the multiple-party event exception to a triggering event (referred to as successor elector events under the proposed regulations) where the acquiring unaffiliated domestic owner or consolidated group owns, immediately after the transaction, less than 100 percent of the acquired assets or interests. Without this exception to foreign use, many transactions that would qualify for the multiple-party event exception would immediately result in a foreign use triggering event when the unaffiliated domestic corporation or consolidated group acquires between 90 and 100 percent of the assets or interests. Finally, these regulations modify the "no dilution" exception contained in the proposed regulations to, among other things, incorporate a de minimis exception.

These final regulations provide that the exceptions may be supplemented through subsequent guidance published in the Internal Revenue Bulletin, as appropriate. As a result, the IRS and Treasury Department request comments on additional transactions or situations that should be added as safe harbors. For example, additional comments are requested on arrangements with foreign tax authorities whereby foreign tax attributes could be eliminated to ensure that no portion of the dual consolidated loss can be put to a foreign use.

Ordering rules for determining a foreign use

The current and proposed regulations provide rules for determining the order in which dual consolidated losses are used in cases where the laws of a foreign country provide for the foreign use of such loss, but do not provide applicable rules for determining the order in which these losses are used in a taxable year.

A commentator noted that in certain cases involving dual consolidated losses incurred in different taxable years, the ordering rules may result in losses being deemed to be made available for a foreign use resulting in recapture, even though there are other losses which, if deemed to be used, would not result in recapture. This commentator recommended that in these situations the losses be deemed to first be used in a manner that will not result in the recapture of a dual consolidated loss. The commentator also noted that this approach is consistent with the exception to foreign use contained in section 1.1503(d)-1(b)(14)(iii)(B) of the proposed regulations where there is no foreign country rule for determining use. Finally, the commentator stated that losses that do give rise to a foreign use should be deemed to be used on a "last-in/first-out" basis. The IRS and Treasury Department believe these rules are appropriate and, as a result, these comments are adopted.

Mirror legislation

The current regulations contain a mirror legislation rule that denies a taxpayer the ability to make an election to use a dual consolidated loss to offset the income of a domestic affiliate where the foreign country has enacted legislation that operates in a manner similar to section 1503(d), and, as a result, prohibits the taxpayer from claiming the dual consolidated loss in the foreign country. The mirror legislation rule was designed to

prevent the revenue gain resulting from the disallowance of a double dip from inuring solely to the foreign country. Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 1065-66 (J. Comm. Print 1987), see section 601.601(d)(2)(ii)(b); see also *British Car Auctions, Inc. v. United States*, 35 Fed. Cl. 123 (1996), *aff'd without op.*, 116 F.3d 1497 (Fed. Cir. 1997) (upholding the validity of the mirror legislation rule). The effect of the mirror legislation rule is that a dual consolidated loss may be disallowed in the United States and in the foreign country. In such cases, Congress intended for the Treasury Department to pursue a bilateral agreement with the foreign jurisdiction so that the loss could offset income of an affiliate in only one country.

The proposed regulations retain the mirror legislation rule and modify it to better take into account the policies underlying its adoption.

A number of comments were received on the scope and utility of the mirror legislation rule. Several commentators encouraged the IRS and the Treasury Department to pursue bilateral agreements where the dual consolidated loss is disallowed in both the United States and the foreign country.

The IRS and Treasury Department agree that such agreements are necessary and recently concluded a competent authority agreement on such matters with the United Kingdom on October 6, 2006 (the Agreement). For the text of the Agreement, see Announcement 2006-86, 2006-45 IRB 842; see section 601.601(d)(2)(ii)(b). The Agreement applies to dual consolidated losses attributable to certain UK permanent establishments that are otherwise subject to both section 1503(d) and mirror legislation enacted by the United Kingdom. In general, the Agreement provides that taxpayers can elect to use or relieve the loss in either the United Kingdom or the United States, but not both.

The IRS and Treasury Department believe that these final regulations and the Agreement appropriately refine and limit the scope of the mirror rule. In addition, the IRS and Treasury Department believe that the provisions of the Agreement can serve as a model for future competent authority agreements, if necessary, between the United States and its treaty partners which would further the Congressional intent with respect to the application of the mirror legislation rule. Accordingly, comments are requested on the provisions of the Agreement and on specific jurisdictions and considerations that should be taken into account in future agreements.

Commentators also suggested that a "stand-alone" exception to the mirror legislation rule be adopted. This exception would apply where filing a domestic use election with respect to a dual consolidated loss otherwise subject to the mirror legislation rule would not violate the policies of section 1503(d). According to the commentators, this is the case because the mirror legislation in the foreign country would not have the effect of forcing taxpayers to use the losses in the United States. The commentators suggested that the mirror legislation rule would not apply provided there is not a foreign affiliate to which the separate unit or dual resident corporation could put the dual consolidated loss to a foreign use. The commentators noted that in these situations, the mirror legislation does

not result in the revenue loss inuring solely to the United States, because it is factually impossible for the loss to offset taxable income in the foreign country that is not also taken into account in the United States.

The IRS and Treasury Department generally agree with this comment. As a result, these final regulations contain a stand-alone exception to the mirror legislation rule.

Elimination of a Dual Consolidated Loss After Certain Transactions

Both the current and proposed regulations contain rules that eliminate a dual consolidated loss that is subject to the general restrictions under section 1503(d)(1) following certain transactions. In the case of a dual resident corporation, the dual consolidated loss is generally eliminated in transactions described in section 381(a) because the dual resident corporation ceases to exist. In the case of a separate unit, the dual consolidated loss is generally eliminated in transactions where the separate unit ceases to be a separate unit of its domestic owner (either through a transaction described in section 381(a) or otherwise). In these cases, and subject to the exceptions discussed in this preamble, after the transaction it is no longer possible for the dual resident corporation or separate unit to generate income that can be offset by the dual consolidated loss. As a result, any unused dual consolidated loss is eliminated.

Both the current and the proposed regulations provide exceptions to the general elimination rule in the case of certain transactions to which section 381(a) applies. These exceptions generally apply in cases where it is possible that income that is generated by the transferee corporation after the transaction is subject to tax in both the United States and the foreign country such that it is appropriate for the income to be offset by the dual consolidated loss that carries over to the transferee.

These final regulations make certain modifications to the elimination rules. For example, the rules are modified to reflect the expansion of the separate unit combination rule. Thus, these final regulations take into account transactions involving combined separate units that have more than one domestic owner. For example, a dual consolidated loss of a domestic owner that is attributable to a separate unit will not be eliminated under these final regulations if the separate unit continues to be a separate unit of any member of its domestic owner's consolidated group.

Application of SRLY Limitation to a Former Dual Resident Corporation

Section 1.1503(d)-3(c)(3) of the proposed regulations provides that a dual consolidated loss is treated as a loss incurred by a dual resident corporation or separate unit in a separate return limitation year (SRLY) and is generally subject to all the limitations of section 1.1502-21(c). The proposed regulations provide that when determining the general SRLY limitation with respect to a dual resident corporation, the calculation of aggregate consolidated taxable income only includes income, gain, deduction, and loss generated in years in which the dual resident corporation is a resident (or is taxed on its worldwide income) in the same foreign country in which it was a resident (or was taxed

on its worldwide income) during the year in which the dual consolidated loss was generated. See proposed section 1.1503(d)-3(c)(3)(iii).

One commentator noted that this rule prevents the dual consolidated loss of a dual resident corporation from being taken into account by its consolidated group after the dual resident corporation ceases to be subject to tax on a residence basis (or on its worldwide income), regardless of whether the former dual resident corporation contributes taxable income to the consolidated taxable income of the group. The commentator stated that this result is inappropriate because it does not merely limit the use of a dual consolidated loss from offsetting the income of a domestic affiliate, but has the effect of limiting the use of a dual consolidated loss from offsetting the domestic corporation's own taxable income.

The IRS and Treasury Department agree with this comment. Section 1503(d)(1) provides that a dual consolidated loss of a corporation shall not reduce the taxable income of any other member of the affiliated group for the taxable year or for any other taxable year. However, the limitations of section 1503(d)(1) do not prevent the use of a dual consolidated loss to offset the income of the dual resident corporation that incurred the loss, even where the dual resident corporation ceases to be subject to tax in the foreign country. As a result, this rule is not contained in these final regulations. But see section 1503(d)(4) (relating to tainted assets contributed to a dual resident corporation).

Effect of Section 1503(d) on Foreign Tax Credits

Section 1503(d)(2) generally defines a dual consolidated loss to mean any net operating loss of a dual resident corporation or a separate unit. Section 172(c) generally defines a net operating loss as the excess of deductions over gross income. Section 164(a)(3) generally provides that foreign taxes are allowed as a deduction for the taxable year in which paid or accrued. However, section 275(a)(4) provides that no deduction is allowed for any such taxes, to the extent the taxpayer chooses to take to any extent the benefits of section 901 (which permits taxpayers to claim a credit for certain taxes paid or accrued during the taxable year to any foreign country or any possession of the United States).

Commentators asked whether a creditable foreign tax expenditure incurred by a dual resident corporation or separate unit, for which an election is made to claim a credit pursuant to section 901, may be subject to the limitations of section 1503(d)(1).

The IRS and Treasury Department recognize that policy concerns arise in certain transactions in which two or more parties claim a credit for the same foreign taxes. Although these policy concerns are similar to those arising under section 1503(d), the IRS and Treasury Department do not believe that Congress intended the limitations of section 1503(d) to apply to foreign taxes, so long as the foreign taxes do not enter into the computation of a net operating loss (that is, so long as an election is made to claim a credit for such taxes, in lieu of deducting them). As a result, under the terms of the statute, the limitations of section 1503(d) do not apply to creditable foreign tax expenditures incurred by a dual resident corporation or a separate unit, provided an

election is made to claim a credit with respect to such expenditures in accordance with section 901 and the related regulations.

Even though section 1503(d) does not apply to foreign tax credits that are claimed by more than one person, the IRS and Treasury Department continue to study these transactions and, as appropriate, intend to address them in future published guidance under other provisions.

Tainted Income Rule

Section 1503(d)(4) grants the Secretary authority to prescribe such regulations as may be necessary or appropriate to prevent the avoidance of the purposes of section 1503(d) by contributing assets to the corporation with the dual consolidated loss after such loss is incurred. Section 1.1503-2(e) of the current regulations prevents the dual consolidated loss of a dual resident corporation that ceases being a dual resident corporation from offsetting the income from assets that are acquired by the dual resident corporation in a nonrecognition transaction, or as a contribution to capital, at any time during the three taxable years immediately preceding the taxable year in which the corporation ceases to be a dual resident corporation, or any time thereafter. The proposed regulations retained the tainted income rule, with certain modifications.

One commentator noted that the tainted income rule of the current and proposed regulations applies with respect to assets acquired by a dual resident corporation, regardless of whether such tainted assets were received from a member of the dual resident corporation's affiliated group. According to this commentator, because section 1503(d) was intended to prevent the use of a dual consolidated loss from offsetting the taxable income of any other member of the affiliated group, applying the tainted income rule where the tainted assets were not received from a member of the dual resident corporation's affiliated group is inconsistent with the policies underlying section 1503(d).

Section 1503(d)(4) grants the Secretary broad regulatory authority to implement the tainted income rule. In addition, the IRS and Treasury Department believe that adopting the rule suggested by the commentator would require the IRS to trace the source of tainted assets received (for example, to ensure that the rule cannot be avoided through the imposition of an intermediary entity, such as a partnership, or through indirect transfers of assets). Moreover, such a rule would be difficult for both taxpayers and the IRS to apply, and would increase complexity. Accordingly, the IRS and Treasury Department believe that the tainted income rule should continue to apply without regard to the source of the tainted assets. As a result, this comment is not adopted.

Items Taken into Account in Computing Income or a Dual Consolidated Loss

In general

Section 1503(d)(2)(A) generally defines a dual consolidated loss to mean any net operating loss of a domestic corporation which is subject to an income tax of a foreign

country on its income without regard to whether such income is from sources inside or outside such foreign country, or is subject to such a tax on a residence basis. Section 1503(d)(3) grants the Secretary broad authority to subject any loss of a separate unit of a domestic corporation to the limitations of section 1503(d). Because separate units are not themselves taxpayers, it is necessary to determine which items of income, gain, deduction, and loss of the domestic owner of the separate unit should be taken into account for purposes of calculating a dual consolidated loss.

Section 1.1503-2(d)(1)(ii) of the current regulations provides a limited rule for attributing items of a domestic owner to a separate unit. Under this rule, a separate unit must compute its income as if it were a separate domestic corporation that is a dual resident corporation, using only those items of income, expense, deduction, and loss that are otherwise attributable to such separate unit. For this purpose, only items of the domestic owner that are recognized for U.S. tax purposes are taken into account.

In response to requests for additional guidance in this area, the proposed regulations provide more detailed rules for determining the amount of income or dual consolidated loss of a separate unit. This determination depends on various factors, including the type of separate unit, the ownership structure, and the nature of the item. The determination generally turns on whether it is likely that the relevant foreign country would take into account the item (assuming the item is recognized) for tax purposes. This determination is solely for purposes of section 1503(d) and does not apply for any other purpose, such as attributing items under an applicable income tax treaty or under other Code sections such as section 884 or 987.

These final regulations adopt the attribution rules contained in the proposed regulations, with modifications.

Books and records

The proposed regulations provide that, in general, the items of income, gain, deduction, and loss that are attributable to a hybrid entity (and, therefore, attributable to interests in the hybrid entity) are those that are properly reflected on its books and records, as adjusted to conform to U.S. tax principles. The proposed regulations further provide that the principles of section 1.988-4(b)(2) apply for purposes of making this determination.

One commentator asked whether section 1.988-4(b)(2) is a strict booking rule, or whether it would instead permit taxpayers to take positions contrary to how items are reflected on the books and records if, under the facts and circumstances, the items were not appropriately reflected on the books and records. Another commentator stated that the clause "to the extent consistent with U.S. tax principles" in the proposed regulations created uncertainty.

In response to these comments, the final regulations clarify that only the Commissioner, and not the taxpayer, may make adjustments to the books and records where the booking practices are employed with a principle purpose of avoiding the principles of section

1503(d), including inconsistently treating the same or similar items of income, gain, deduction, and loss. In addition, these final regulations clarify that, in general, a domestic owner's items of income, gain, deduction, and loss are attributable to the domestic owner's hybrid entity separate unit, or interest in a transparent entity, to the extent such items are reflected on the hybrid entity or transparent entity's books and records (as defined in section 1.989(a)-1(d)), as adjusted to conform to U.S. tax principles.

The books and records standard set forth in these final regulations is intended to be consistent with the more detailed approach for attributing items that was adopted in proposed section 1.987-2(b) that was published on September 7, 2006 (REG-208270-86, 71 FR 52875). It is anticipated that when those regulations are published as final regulations in the Federal Register, that approach will, as appropriate, be incorporated into these regulations. The IRS and Treasury Department believe that applying consistent standards under these two provisions, where appropriate, would make the rules more administrable. Comments are requested as to whether the standard contained in the section 987 proposed regulations is appropriate for purposes of section 1503(d).

Attributing interest expense under the principles of section 1.882-5

The proposed regulations provide that the principles of section 1.882-5, as modified, apply for purposes of determining the interest expense that is attributable to a foreign branch separate unit. In making this determination, and solely for this purpose, the domestic owner is treated as a foreign corporation, the foreign branch separate unit is treated as a trade or business within the United States, and assets other than those of the foreign branch separate unit are treated as assets that are not U.S. assets.

Two comments were received on the application of this rule. First, commentators stated that adopting the principles of section 1.882-5 results in unnecessary complexity. These commentators suggested that, in lieu of using the principles of section 1.882-5, the interest expense of a foreign branch separate unit be determined by reference to its books and records. Another commentator noted the rationale of using the principles of section 1.882-5 as a general matter, but suggested that where the foreign country looks to the books and records of the foreign branch separate unit for purposes of computing the interest expense of the separate unit, it would be appropriate to use the books and records for purposes of section 1503(d).

The IRS and Treasury Department continue to believe that the principles of section 1.882-5, as modified, serve as a reasonable proxy for determining the items of interest expense recognized for U.S. tax purposes that, if recognized by the foreign country, would be taken into account by the foreign country. Therefore, the principles of section 1.882-5, as modified, are retained as the general rule for purposes of determining the interest expense that is attributable to a foreign branch separate unit.

However, to minimize complexity, the IRS and Treasury Department believe it is appropriate to use a books and records approach, where possible. Therefore, these final regulations provide an exception to the general rule such that interest expense is

attributable to a foreign branch separate unit to the extent it is reflected on its books and records. This exception only applies if the foreign country in which the foreign branch is located determines, for purposes of computing the taxable income (or loss) under the laws of the foreign country, the interest expense of the foreign branch separate unit by taking into account only the items of interest expense reflected on the foreign branch separate unit's books and records. This rule will not apply, however, in cases where the foreign country does not use a strict booking approach for interest expense.

Finally, it is important to note that in all cases only items of interest expense, as determined for U.S. tax purposes, are taken into account. The treatment of interest expense in the foreign country is only relevant for purposes of determining the method under which items of interest expense (determined for U.S. tax purposes) is attributed to the foreign branch separate unit.

Treaty-based methods

The proposed regulations provide that for purposes of determining the items of income, gain, deduction (other than interest), and loss that are taken into account in determining the taxable income or loss of a foreign branch separate unit, the principles of sections 864(c)(2) and (c)(4) as set forth in sections 1.864-4(c) and 1.864-6 shall apply.

One commentator stated that domestic corporations operating foreign branch separate units should be allowed to attribute items to the foreign branch separate unit based on the method provided under an income tax treaty between the United States and the foreign country (or between two foreign countries if foreign branch operations are conducted by a hybrid entity outside its home country). The IRS and Treasury Department believe that this approach is inappropriate for two reasons. First, it would have the effect of attributing items recognized by the foreign jurisdiction, which may not be recognized as items for U.S. tax purposes. This would be inconsistent with section 1503(d), which defines a dual consolidated loss solely based on U.S. tax rules. Second, this approach would require the interpretation of foreign law, which the IRS and Treasury Department believe should be avoided, to the extent possible. Accordingly, this comment is not adopted.

Gain or loss recognized under section 987

The proposed regulations do not provide whether gain or loss of a domestic owner recognized under section 987 as a result of a remittance or transfer is attributable to a separate unit for purposes of calculating income or dual consolidated loss, but instead request comments.

Commentators stated that gain or loss recognized under section 987 should not be attributable to a separate unit because in most cases the foreign country would not recognize such items since the income of the separate unit will be computed in the local currency. The IRS and Treasury Department agree with this comment. As a result, these final regulations provide that gain or loss recognized under section 987, as a result of a

remittance or transfer, will not be taken into account for purposes of computing the income or dual consolidated loss of a separate unit.

Attributable to or taken into account

The proposed regulations generally provide that items are attributable to a hybrid entity separate unit, but are taken into account by a foreign branch separate unit. The IRS and Treasury Department believe that the use of these different terms is unnecessary and may lead to confusion. As a result, these final regulations provide that items are attributable to a separate unit, regardless of whether the separate unit is a foreign branch separate unit or a hybrid entity separate unit.

Basis Adjustments

Section 1.1503-2(d)(3) of the current regulations contains special basis adjustment rules that override the normal investment adjustment rules under section 1.1502-32 for stock of affiliated dual resident corporations and affiliated domestic owners owned by other members of the consolidated group. Similar rules apply to separate units arising from the ownership of an interest in a partnership. These special basis adjustment rules were included in the current regulations to prevent the indirect deduction of a dual consolidated loss. Although the proposed regulations retain these rules, the IRS and Treasury Department requested comments on whether the special basis adjustment rules should be retained.

A number of commentators recommended that the special basis adjustment rules be removed for several reasons. For example, the commentators noted that an indirect use, which the special basis rules were intended to prevent, may not occur for many years after the dual consolidated loss was incurred. In response to these comments, the special basis rules are not contained in these final regulations. Thus, the basis adjustment rules under section 1.1502-32 shall apply without modification for purposes of determining the adjusted basis in the stock of a dual resident corporation or the stock of an affiliated domestic owner owned by other members of the consolidated group. These final regulations also contain rules to ensure consistent treatment for a partner's basis in a partnership interest that is a separate unit, or through which a separate unit is owned indirectly.

Losses of a Foreign Insurance Company Treated as a Domestic Corporation

In general

Section 953(d) generally provides that a foreign corporation that would qualify to be taxed as an insurance company if it were a domestic corporation may, under certain circumstances, elect to be treated as a domestic corporation (section 953(d) company). Section 953(d)(3) provides that if a section 953(d) company is treated as a member of an affiliated group, any loss of such corporation is treated as a dual consolidated loss for purposes of section 1503(d), without regard to section 1503(d)(2)(B) (grant of regulatory

authority to exclude losses which do not offset the income of foreign corporations from the definition of a dual consolidated loss).

The current regulations do not address the application of section 953(d)(3). In the proposed regulations, however, the definition of a dual resident corporation includes a section 953(d) company that is a member of an affiliated group. In addition, the proposed regulations clarify that a section 953(d) company may not make a domestic use election. These rules are consistent with section 953(d)(3).

In response to comments, these final regulations provide additional guidance on the application of the dual consolidated loss rules to section 953(d)(3) companies, including the treatment of separate units owned by such companies.

Transactions intended to avoid the limitations of sections 953(d)(3) and 1503(d)

The IRS and Treasury Department understand that taxpayers may be implementing structures that result in the same overall tax consequences as structures that Congress intended to be subject to the loss limitation rules provided under sections 953(d)(3) and 1503(d). However, taxpayers may be taking the position that the structures are not subject to these loss limitation rules. For example, a foreign insurance company may, in lieu of making an election under section 953(d) and thus being subject to the limitations of sections 953(d)(3) and 1503(d), file a certificate of domestication in a state as a limited liability company. As a business entity with multiple charters, this entity would be treated as a domestic corporation for U.S. tax purposes under section 301.7701-2(b)(9). Taxpayers may take the position that this entity would be entitled to the same benefits of a company that makes an election under section 953(d), without being subject to the limitations on the use of its losses that are imposed under sections 953(d)(3) and 1503(d).

The IRS and Treasury Department disagree with the taxpayer's characterization of these structures under current law. In addition, the IRS and Treasury Department believe the taxpayers' characterization of the structures is contrary to the policies underlying section 953(d). Accordingly, the IRS and Treasury Department are considering issuing regulations, which may be retroactive, that would clarify the application of section 953(d)(3) to these structures. These regulations would provide that if a foreign insurance company is eligible to make an election to be treated as a domestic corporation pursuant to section 953(d), but in lieu of making such election becomes a domestic corporation through other means (for example, by filing a certificate of domestication in a state as a limited liability company), then such company shall be subject to the limitations under sections 953(d)(3) and 1503(d) (without regard to paragraph (2)(B) thereof). The IRS and Treasury Department request comments regarding appropriate rules to address these structures and other structures that are intended to avoid the purposes of section 953(d)(3).

All or Nothing Rule

Under the current regulations a triggering event (other than a foreign use) generally can

be rebutted only if no portion of the dual consolidated loss can be used by (or carries over to) another person under foreign law. See section 1.1503-2(g)(2)(iii)(A)(2) through (7). Thus, even a de minimis foreign use will cause the entire amount of the dual consolidated loss to be recaptured and reported as income.

The proposed regulations retain this so-called all or nothing principle because the IRS and Treasury Department recognize that departing from it would lead to significant administrative burdens for the Commissioner and taxpayers. Although the all or nothing principle was retained, the IRS and Treasury Department requested comments regarding administrable alternatives that would not involve substantial analysis of foreign law.

Several comments were received with respect to this issue. A number of commentators stated that the final regulations should remove the all or nothing principle and allow for a pro-rata recapture such that, for example, the disposition of an individual separate unit, which is part of a combined separate unit, would not result in the entire recapture of the combined separate unit's dual consolidated loss, but only the portion of the loss attributable to the individual separate unit. Another commentator suggested removing the all or nothing rule and allowing a taxpayer to establish that the losses otherwise subject to recapture were not, in fact, used under foreign law. The commentator suggested that any concerns regarding an analysis of foreign law could be mitigated by requiring the taxpayer to provide certified copies of foreign tax returns and, in addition, where the foreign tax base differs substantially from the U.S. tax base, by adopting an apportionment methodology.

The IRS and Treasury Department continue to believe that, even under the approaches suggested by these commentators, departing from the all or nothing principle would lead to substantial administrative complexity. As a result, these comments are not adopted.

Another commentator suggested that the final regulations include a general de minimis rule for purposes of applying the triggering and recapture provisions. Under this approach, if a taxpayer could establish that less than a specific percentage of the dual consolidated loss is available for a foreign use, the taxpayer could avoid recapture altogether. However, in situations where the potential loss available for a foreign use exceeds the de minimis amount, the dual consolidated loss would be recaptured to the extent it was actually put to a foreign use.

The IRS and Treasury Department do not believe that a de minimis rule as described would be meaningful given that the Commissioner and taxpayers would be required to determine the actual amount of the dual consolidated loss available for foreign use, which poses the same administrative concerns as generally departing from the all or nothing principle (that is, a complex analysis of foreign law or complicated ordering, stacking, or tracing rules). As a result, this suggestion is not adopted.

Finally, commentators suggested that following certain events otherwise requiring recapture, a taxpayer should be allowed to reduce the amount of recapture by establishing that a portion of the dual consolidated loss is attributable to items of deduction or loss

that, due to permanent differences between the U.S. and foreign tax law, do not give rise to a corresponding item of deduction or loss in the foreign country. The commentators cited items of deduction or loss composing the dual consolidated loss attributable to a basis step-up following a section 338 election, or attributable to a deduction arising from the amortization of goodwill or certain intangibles under section 197, as examples of such items.

The IRS and Treasury Department recognize that items of deduction or loss that are never taken into account in the foreign country cannot be put to a foreign use. However, the IRS and Treasury Department believe that the suggested approach would, in most situations, involve many items of deduction and loss and, as a result, would present the same concerns as are present in the other approaches discussed above. For example, if the deductions giving rise to a dual consolidated loss were the result of a step-up in basis following a section 338 election, but the various assets to which such basis attached had, prior to the election, a basis for foreign tax purposes, complex ordering and stacking rules would be required to determine that, in fact, no portion of the dual consolidated loss is attributable to the pre-existing foreign tax basis. In addition, this approach would require rules to distinguish a permanent (or base) difference from a timing difference, in order to ensure that the portion of the dual consolidated loss that is not being recaptured would not be available for a foreign use at some point in the future. As a result, such rules would add complexity and would be administratively burdensome. Accordingly, this comment is not adopted.

Although these comments are not adopted in the final regulations, the IRS and Treasury Department believe that the application of the all or nothing rule will be significantly reduced under these regulations as a result of the new exceptions to foreign use and the further reduction of the term of the certification period.

Triggering Events and Related Rules

Modification of exceptions to triggering events

The proposed regulations contain exceptions to triggering events that generally apply where assets or interests sold or disposed of are acquired, directly or through certain wholly-owned pass-through entities, by members of the consolidated group that includes the dual resident corporation or separate unit, or by the unaffiliated domestic owner.

The final regulations generally retain these exceptions, but modify them to take into account the new exceptions to foreign use. For example, the exceptions are modified to include certain acquisitions by pass-through entities that are more than 90-percent owned (rather than wholly owned) by the consolidated group or unaffiliated domestic owner. These rules also address certain deemed transactions (for example, pursuant to Rev. Rul. 99-5 (1999-1 CB 434)) to minimize the likelihood that they result in triggering events, where appropriate, see section 601.601(d)(2)(ii)(b).

Finally, in response to comments discussed in section G(3) of this preamble, these

regulations contain a new exception to triggering events that occur as a result of certain compulsory transfers.

Rebuttal

Under the current regulations, taxpayers may rebut all but two of the triggering events such that there is no recapture of a certified dual consolidated loss (or related interest charge) as a result of a putative triggering event. In general, under the current regulations, a triggering event is rebutted if the taxpayer demonstrates to the satisfaction of the Commissioner that, depending on the triggering event, either: (1) the losses, expenses, or deductions of the dual resident corporation (or separate unit) cannot be used to offset income of another person under the laws of a foreign country; or (2) the transfer of assets did not result in a carryover under foreign law of the losses, expenses, or deductions of the dual resident corporation (or separate unit). See section 1.1503-2(g)(2)(iii)(A)(2) through 1.1503-2(g)(2)(iii)(A)(7). The dual consolidated loss rules do not require recapture or an interest charge in such cases because there is no opportunity for any portion of the dual consolidated loss to be used to offset income of any other person under the income tax laws of a foreign country.

The proposed regulations generally retain the rebuttal standard contained in the current regulations, with modifications. Taxpayers may rebut a triggering event under the proposed regulations if it can be demonstrated, to the satisfaction of the Commissioner, that there can be no foreign use of the dual consolidated loss. However, unlike the current regulations that have different standards for different triggering events, the proposed regulations apply the same standard to all triggering events (other than a foreign use triggering event, which cannot be rebutted).

One commentator noted that the rebuttal standard of the proposed regulations is unnecessarily broad with respect to certain asset transfers. For example, according to this commentator, a triggering event cannot be rebutted under this standard where a separate unit transfers over 50 percent of its assets in a transaction that does not result in a loss carryover to the transferee under foreign law. This is the case because the separate unit would not be able to establish that the dual consolidated loss, which did not carry over to the transferee, could never be put to a foreign use. Accordingly, this commentator requested that the rebuttal standard for asset transfers contained in the current regulations be adopted in the final regulations.

The IRS and Treasury Department agree with this comment and these final regulations are modified accordingly.

Another commentator noted that neither the proposed nor current regulations specify how taxpayers must demonstrate that there can be no foreign use during the remaining certification period by any means. The commentator stated that this lack of specificity creates uncertainty and, as a result, requested additional guidance as to how the determination is to be made.

The IRS and Treasury Department believe that this demonstration can be made in a number of ways, including based on the taxpayer's interpretation of foreign law, on an opinion from local advisors, or on assurance from the local country tax authorities. In all cases, however, the determination must be made to the satisfaction of the Commissioner. These final regulations are modified accordingly.

Reduction of recapture amount

The proposed regulations permit the elector to reduce the amount of the dual consolidated loss that must be recaptured upon a triggering event. The recapture amount can be reduced to the extent the elector demonstrates that the dual consolidated loss would have offset other income of the dual resident corporation or separate unit reported on a timely filed U.S. income tax return for any taxable year up to and including the taxable year of the triggering event if such loss had been subject to the limitation under section 1.1503(d)- 2(b) of the proposed regulations.

Commentators questioned the requirements for the reduction of the recapture amount. One commentator suggested that recapture should be reduced by the amount of subsequent income attributable to the dual resident corporation or separate unit, irrespective of the income or loss of other group members.

The IRS and Treasury Department recognize that the policies underlying the SRLY rules differ from those underlying section 1503(d). Although the SRLY rules do not provide for a reduction in recapture in all cases consistent with the views of this commentator, the IRS and Treasury Department continue to believe that the SRLY rules are a reasonable and appropriate mechanism for implementing the restrictions of section 1503(d)(1) in the vast majority of cases. Further, the IRS and Treasury Department believe that deviating from the SRLY mechanism would add considerable complexity to the rules and could lead to unintended consequences. As a result, this comment is not adopted. The IRS and Treasury Department will consider addressing the interaction of the SRLY rules with the recapture provisions in future guidance. Comments are requested as to alternative mechanisms that are more consistent with dual consolidated loss policy and that are not unduly complicated.

Interest due on recapture

Under both the current regulations and these final regulations, taxpayers must pay an interest charge in connection with recapture that is computed under the rules of section 6601. In response to comments, these final regulations clarify that this interest charge is deductible to the same extent as interest under section 6601.

Treatment of recapture income under section 384

One commentator requested clarification regarding a subsequent elector's agreement to treat potential recapture amounts as unrealized built-in gain for purposes of section 384(a). The commentator stated that it may be unclear as to whether section 384 must

otherwise apply to the transaction, whether the thresholds of section 384 apply, and whether potential recapture income treated as unrealized built-in gain is subject to reduction for income earned by a separate unit or dual resident corporation.

The IRS and Treasury Department believe that potential recapture amounts should be treated as unrealized built-in gains for purposes of determining whether section 384 applies, but that the requirements and exceptions of section 384 otherwise apply. In addition, the potential recapture amount treated as unrealized built-in gain may be reduced by potential offset, as permitted under the regulations. These final regulations have been modified accordingly.

Reconstituted dual consolidated loss

Both the current and proposed regulations contain a reconstituted loss provision. This rule generally provides that if a dual consolidated loss is recaptured as a result of a triggering event, the dual resident corporation or separate unit that incurred the loss is treated as having a net operating loss in an amount equal to the amount recaptured. The loss is reconstituted in the taxable year immediately following the year of the recapture and is subject to the general restrictions of section 1503(d). This rule is intended to put the taxpayer in the same approximate position it would have been in had it never made an election to use the dual consolidated loss.

These final regulations modify the proposed regulations' reconstituted loss rule to reflect the expansion of the separate unit combination rule and the rules that eliminate dual consolidated losses following certain transactions. In addition, the rule was modified to better take into account the interaction of the dual consolidated loss rules with the general loss carryover rules. For example, these final regulations provide that, other than with respect to the multiple-party event exception, a transfer of an interest in a separate unit by its domestic owner to another corporation cannot cause all or a portion of the dual consolidated loss of such separate unit to carry over to the acquiring corporation, absent the application of section 381.

Certification Period

Section 1.1503-2(g)(2)(vi)(B) of the current regulations provides that if a (g)(2)(i) election is made with respect to a dual consolidated loss of a dual resident corporation or a hybrid entity separate unit, the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner, as the case may be, must file with its tax return an annual certification during the 15 year certification period. This filing permits the dual consolidated loss to be used in the United States to offset the income of a domestic affiliate but certifies that the losses or deductions that make up the dual consolidated loss have not been used to offset the income of another person under the tax laws of a foreign country. The current regulations do not require annual certifications for (g)(2)(i) agreements entered into with respect to dual consolidated losses of foreign branch separate units. The current regulations also provide that if there is a triggering event during the 15 year period following the year in which the dual consolidated loss

was incurred (certification period), the taxpayer must recapture and report as income the amount of the dual consolidated loss, and pay an interest charge. section 1.1503-2(g)(2)(iii)(A).

The proposed regulations reduce the certification period from 15 years to seven years, and expand the annual certification requirement to include dual consolidated losses of foreign branch separate units.

Commentators recommended that the certification period in the proposed regulations be further reduced to five years, because such five-year period would be sufficient to deter the types of double dips with which section 1503(d) is concerned, and would be consistent with time periods used under similar provisions (for example, the term of gain recognition agreements entered into under section 367(a)). The IRS and Treasury Department agree with this comment, and, as a result, the certification period in these final regulations is five years.

Another commentator asserted that extending the annual certification requirement to foreign branch separate units is both unnecessary and administratively burdensome and, as a result, such certification should not be included in these final regulations.

The IRS and Treasury Department continue to believe that the annual certification requirement improves taxpayer compliance and is beneficial in monitoring and deterring inappropriate double dips. In addition, the IRS and Treasury Department believe that, where appropriate, treating foreign branch separate units, hybrid entity separate units, and dual resident corporations consistently for purposes of section 1503(d) will reduce the administrative complexity of these regulations. As a result, this comment is not adopted.

Other Comments and Modifications

Information provided with domestic use election

One commentator recommended that certain information provided with the domestic use election should not bind a taxpayer if the information is provided in good faith, but subsequently is determined to be erroneous. The IRS and Treasury Department believe that adopting this recommendation would be administratively burdensome. Accordingly, this comment is not adopted.

No possibility of foreign use

One commentator noted that taxpayers may be eligible to demonstrate no possibility of foreign use, but still choose to enter into a domestic use agreement. The commentator explained that taxpayers may do so to avoid the cost and effort required to satisfy the no possibility of foreign use standard, recognizing that this demonstration would only be beneficial if there is a triggering event during the certification period. The commentator further stated that the taxpayer should nonetheless retain the ability to argue at a later time, when a foreign use may occur after a change in foreign law, that no dual

consolidated loss existed in the year in which the loss was actually incurred. Thus, if there was a change in foreign law, taxpayers would not be penalized for being unable to rebut the triggering event in the current year (due to a change in foreign law) but could instead rely on the foreign law in effect for the year in which the loss was incurred.

The IRS and Treasury Department recognize that taxpayers may simply choose to file a domestic use election, rather than engage in additional efforts to demonstrate no possibility of foreign use. The IRS and Treasury Department believe that these final regulations provide ample opportunities for taxpayers willing to demonstrate no possibility of foreign use. Taxpayers have three opportunities to demonstrate no possibility of foreign use under the final regulations: first under section 1.1503(d)-6(c) to be excepted from the domestic use limitation, second under section 1.1503(d)-6(e)(2) to rebut a triggering event, and third under section 1.1503(d)-6(j)(2) to terminate a domestic use agreement. Because of these opportunities and the administrative burdens that would ensue from taking into account changes in foreign law, this comment is not adopted.

Effective Dates

General rule

Except as provided in this preamble, these final regulations apply to dual consolidated losses incurred in taxable years beginning on or after April 18, 2007. However, a taxpayer may apply these regulations, in their entirety, to dual consolidated losses incurred in taxable years beginning on or after January 1, 2007.

Certification period

A number of commentators requested that the reduced certification period of these final regulations apply with respect to dual consolidated losses that are subject to the current regulations. The commentators asserted that the policies underlying the reduced certification period should apply equally to dual consolidated losses that are subject to the current regulations. Commentators also recommended that the reduced certification period contained in these final regulations apply to closing agreements entered into between taxpayers and the IRS pursuant to section 1.1503-2(g)(2)(iv)(B)(3)(i) and Rev. Proc. 2000-42 (2000-2 CB 394), see section 601.601(d)(2)(ii)(b).

The IRS and Treasury Department generally agree with these comments and these final regulations are modified accordingly.

Reasonable cause exception

These final regulations adopt the reasonable cause procedure for purposes of curing all late filings as introduced in the proposed regulations, and subsequently modified by Notice 2006-13 (2006-8 IRB 496) see section 601.601(d)(2)(ii)(b). Moreover, these final regulations provide that the reasonable cause procedures supplant the current procedures for all untimely filings with respect to dual consolidated losses incurred under the current

regulations as well, except with respect to requests for closing agreements. Taxpayers requiring relief to cure a late request for a closing agreement must continue to seek extensions of time under sections 301.9100-1 through 301.9100-3 and Rev. Proc. 2000-42 (2000-2 CB 394), see section 601.601(d)(2)(ii)(b). Taxpayers seeking relief for other late filings required in connection with such closing agreements must, however, use the reasonable cause procedure of these final regulations. Therefore, as a result of these changes, untimely filings under section 1503(d) and these regulations will no longer be eligible for the relief provided by sections 301.9100-1 through 301.9100-3, regardless of whether such filings were required under the current regulations (except for certain closing agreements) or these final regulations.

Multiple-party event exception to triggering events

These final regulations provide an exception to certain triggering events involving multiple parties. In general, the exceptions provided under these final regulations with respect to multiple-party events are similar to those provided under section 1.1503-2(g)(2)(iv)(B)(1). The procedures required to satisfy these multiple-party event exceptions are also similar to those found in section 1.1503-2(g)(2)(iv)(B)(3). One important difference is that these final regulations do not require (or permit) taxpayers to obtain closing agreements. These final regulations also provide a special effective date provision with respect to events described in section 1.1503-2(g)(2)(iv)(B)(1) that occur after April 18, 2007, that are with respect to dual consolidated losses subject to the current regulations. Such events are not eligible for the exception described in section 1.1503-2(g)(2)(iv)(B)(1) and thus are not eligible for a closing agreement as described in section 1.1503-2(g)(2)(iv)(B)(3)(i). Instead, such events are eligible for the multiple-party event exception described in these final regulations and as modified by the special effective date provision of section 1.1503(d)-8(b)(4). Taxpayers may, however, choose to apply the multiple-party exception to events described in section 1.1503-2(g)(2)(iv)(B)(1)(i) through (iii) that occur after March 19, 2007 and on or before April 18, 2007.

Basis adjustments

One commentator requested that the elimination of the special basis adjustments described in paragraph M of this preamble be applied retroactively. The commentator further requested that such retroactive application apply to adjustments that occurred in closed taxable years if the basis of the stock is relevant in an open taxable year.

The IRS and Treasury Department agree with this comment. As a result, these regulations provide that taxpayers may apply the basis adjustment rules of these final regulations for all taxable years if such adjustments affected tax basis that is relevant in an open taxable year.

Other provisions

A number of commentators requested that the IRS and Treasury Department provide that

taxpayers be allowed to electively apply other provisions of these regulations to dual consolidated losses that are subject to the current regulations.

The IRS and Treasury Department do not believe that it would be appropriate to allow taxpayers to selectively apply provisions of these regulations (other than those that the IRS and Treasury Department view as clarifications) retroactively, because it would lead to administrative complexity for the IRS and could lead to unintended results.

Effect on Other Documents

These final regulations obsolete Notice 2006-13 (2006-8 IRB 496), see section 601.601(d)(2)(ii)(b). These final regulations also obsolete Rev. Proc. 2000-42 (2000-2 CB 394), see section 601.601(d)(2)(ii)(b), with respect to triggering events occurring after April 18, 2007.

IV. CHAPTER 9, SECTION 482: TRANSACTIONS BETWEEN COMMONLY CONTROLLED CORPORATIONS

A. Page 378, New Sec. 9.6.A. Illustration of Treatment under Section 482 of Cost Sharing Payments--Xilinx

Page 378, New Sec. 9.6.A. Add before Sec. 9.7 the following:
New Sec. 9.6.A. **Illustration of Treatment under Section 482 of Cost
Sharing Payments—Xilinx 2010**

Xilinx, Inc. v. Commissioner
United States Court Of Appeals For The Ninth Circuit, 2010
598 F.3d 1191

NOONAN, Circuit Judge:

On this appeal from the tax court, we must decide whether, under the tax regulations in effect during tax years 1997, 1998 and 1999, related companies engaged in a joint venture to develop intangible property must include the value of certain stock option compensation one participant gives to its employees in the pool of costs to be shared under a cost sharing agreement, even when companies operating at arm's length would not do so. The tax court found related companies are not required to share such costs and ruled that the Commissioner of Internal Revenue's attempt to allocate such costs was arbitrary and capricious. We affirm.

BACKGROUND

Xilinx, Inc. ("Xilinx") researches, develops, manufactures, and markets integrated circuit

devices and related development software systems. Xilinx wanted to expand its position in the European market and established Xilinx Ireland ("XI") in 1994 as an unlimited liability company under the laws of Ireland. XI sold programmable logic devices and conducted research and development ("R&D"). Two wholly owned Irish subsidiaries of Xilinx owned XI during the tax years of 1997, 1998 and 1999, the only years at issue in this appeal.

In 1995, Xilinx and XI entered into a Cost and Risk Sharing Agreement ("the Agreement"), which provided that all right, title and interest in new technology developed by either Xilinx or XI would be jointly owned. Under the Agreement, each party was required to pay a percentage of the total R&D costs in proportion to the anticipated benefits to each from the new technology that was expected to be created. Specifically, the Agreement required the parties to share: (1) direct costs, defined as costs directly related to the R&D of new technology, including, but not limited to, salaries, bonuses and other payroll costs and benefits; (2) indirect costs, defined as costs incurred by departments not involved in R&D that generally benefit R&D, including, but not limited to, administrative, legal, accounting and insurance costs; and (3) costs incurred to acquire products or intellectual property rights necessary to conduct R&D. The Agreement did not specifically address whether employee stock options (ESOs) were a cost to be shared.

Xilinx offered ESOs to its employees under two plans. Under one plan, employees were granted options as part of the employee hiring and retention program. The options were of two varieties: incentive stock options (ISOs) and nonstatutory stock options (NSOs). Employees could exercise these options two ways: (1) by purchasing the stock at the market price on the day the option was issued ("exercise price") regardless of its then-current market price or (2) by simultaneously exercising the option at the exercise price and selling it at its then-current price, pocketing the difference. Under the other plan, employees could acquire employee stock purchase plan shares (ESPPs) by contributing to an account through payroll deductions and purchasing stock at 85 percent of either its exercise price or its market price on the purchase date. Employees must always pay taxes on NSOs, *see* 26 U.S.C. § 83, but have to pay taxes on ISOs and ESPPs only if they sell acquired stock shares before a specified waiting period has expired ("a disqualifying disposition"), *see* 26 U.S.C. § 421(b). In determining the R&D costs to be shared under the Agreement for tax years 1997, 1998 and 1999, Xilinx did not include any amount related to ESOs.

In tax years 1997, 1998 and 1999, Xilinx deducted as business expenses under 26 U.S.C. §§ 83 and 162 approximately \$ 41,000,000, \$ 40,000,000 and \$ 96,000,000, respectively, based on its employees' exercises of NSOs or disqualifying dispositions of ISOs and ESPPs.⁷⁹ It also claimed an R&D credit under 26 U.S.C. § 41 for wages related to R&D

⁷⁹ Under 26 U.S.C. § 162(a)(1), employers may deduct from their taxable income "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered."^{HN2} Under 26 U.S.C. § 83(h), employers may deduct under § 162 the value of any property transferred to an employee in connection with the performance of employment.

activity, of which approximately \$ 34,000,000, \$ 23,000,000 and \$ 27,000,000 in the respective tax years were attributable to exercised NSOs or disqualifying dispositions of ISOs and ESPPs.⁸⁰ Furthermore, in 1996 Xilinx and XI entered into two agreements that allowed XI employees to acquire options for Xilinx stock. Both agreements provided XI would pay Xilinx for the "cost" of the XI employees' exercise of the stock options, which was to equal the stock's market price on the exercise date minus the exercise price. In the 1997, 1998 and 1999 tax years, XI paid Xilinx \$ 402,978, \$ 243,094 and \$ 808,059, respectively, under these agreements.

The Commissioner of Internal Revenue ("Commissioner") issued notices of deficiency against Xilinx for tax years 1997, 1998 and 1999, contending ESOs issued to its employees involved in or supporting R&D activities were costs that should have been shared between Xilinx and XI under the Agreement. Specifically, the Commissioner concluded the amount Xilinx deducted under 26 U.S.C. § 83(h) for its employees' exercises of NSOs or disqualifying dispositions of ISOs and ESPPs should have been shared. By sharing those costs with XI, Xilinx's deduction would be reduced, thereby increasing its taxable income. The Commissioner's determination resulted in substantial tax deficiencies and accuracy-related penalties under 26 U.S.C. § 6662(a).

Xilinx timely filed suit in the tax court. The tax court denied cross motions for summary judgment. After a bench trial, the tax court found that two unrelated parties in a cost sharing agreement would not share any costs related to ESOs. After assuming ESOs were costs for purposes of 26 C.F.R. § 1.482-7(d)(1), the tax court then found 26 C.F.R. § 1.482-1(b)(1) -- which requires cost sharing agreements between related parties to reflect how two unrelated parties operating at arm's length would behave -- dispositive and concluded the Commissioner's allocation was arbitrary and capricious because it included the ESOs in the pool of costs to be shared under the Agreement, even though two unrelated companies dealing with each other at arm's length would not share those costs.

The Commissioner timely appealed. On appeal, the parties focused primarily on whether the requirement in 26 C.F.R. § 1.482-7(d)(1) that "all costs" be shared between related parties in a cost sharing agreement or whether the controlling requirement was 26 C.F.R. § 1.482-1(b)(1) that all transactions between related parties reflect what two parties operating at arm's length would do. After oral argument, we requested supplemental briefing on whether ESOs were "costs" and whether they were "related to" the intangible product development for purposes of 26 C.F.R. § 1.482-7(d)(1), and whether a literal application of 26 C.F.R. § 1.482-7(d)(1) would conflict with a tax treaty between the United States and Ireland that was in effect during the 1998 and 1999 tax years.

STANDARD OF REVIEW

"Decisions of the tax court are reviewed on the same basis as decisions from civil bench trials in the district court." *DHL Corp. v. Comm'r*, 285 F.3d 1210, 1216 (9th Cir. 2002).

⁸⁰ 26 U.S.C. § 41(b)(2)(A), companies can claim a tax credit for "wages paid or incurred to an employee for qualified [research] services performed by such employee."

"Thus, we review the tax court's conclusions of law de novo and its factual findings for clear error." *Id.*

DISCUSSION

The Commissioner does not dispute the tax court's factual finding that unrelated parties would not share ESOs as a cost. Instead, the Commissioner maintains ESOs are a cost that must be shared under § 1.482-7(d)(1), even if unrelated parties would not share them.

Ambiguity. Congress has authorized the Secretary of the Treasury to allocate income and deductions among related business entities to prevent tax avoidance.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

26 U.S.C. § 482. The Secretary in turn promulgated regulations authorizing the Commissioner to allocate income and deductions among related entities. The introduction to these regulations explains:

The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. This section sets forth general principles and guidelines to be followed under section 482.

26 C.F.R. § 1.482-1(a)(1)⁸¹. The next subsection states that the standard to be employed "in every case" to ensure taxpayers accurately reflect income from controlled transactions and do not avoid taxes through such transactions is an arm's length standard:

In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.

26 C.F.R. § 1.482-1(b)(1).

⁸¹ Controlled taxpayer is defined as "any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers." 26 C.F.R. § 1.482-1(i)(5).

Another section, however, specifically governing cost sharing agreements between controlled parties to develop intangible property, authorizes the Internal Revenue Service "to make each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development" 26 C.F.R. § 1.482-7(a)(2). Controlled participants, under paragraph (d) of § 1.482-7, must include "all" costs in the pool of costs to be shared proportionally (the "all costs requirement"):

For purposes of this section, a controlled participant's costs of developing intangibles for a taxable year mean all of the costs incurred by that participant related to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants, minus all of the cost sharing payments it receives from other controlled and uncontrolled participants. Costs incurred related to the intangible development area consist of: operating expenses, as defined in § 1.482-5(d)(3), other than depreciation or amortization expense, plus (to the extent not included in such operating expenses, as defined in § 1.482-5(d)(3)) the charge for the use of any tangible property made available to the qualified cost sharing arrangement.

26 C.F.R. § 1.482-7(d)(1). "Operating expenses" are defined as "includ[ing] all expenses not included in cost of goods sold except for interest expense, foreign income taxes, domestic income taxes, and any other expenses not related to the operation of the relevant business activity." 26 C.F.R. § 1.482-5(d)(3). How these various provisions interact is the crux of the parties' dispute.

Section 1.482-1(b)(1) specifies that the true taxable income of controlled parties is calculated based on how parties operating at arm's length would behave. The language is unequivocal: this arm's length standard is to be applied "in every case." In the context of cost sharing agreements, this rule would require controlled parties to share only those costs uncontrolled parties would share. By implication, costs that uncontrolled parties would not share need not be shared. In contrast, § 1.482-7(d)(1) specifies that controlled parties in a cost sharing agreement must share *all* "costs . . . related to the intangible development area," and that phrase is explicitly defined to include virtually all expenses not included in the cost of goods. The plain language does not permit any exceptions, even for costs that unrelated parties would not share. Each provision's plain language mandates a different result. Accordingly, we conclude that ^{HN11}when related to each other, the two provisions establish an ambiguous standard for determining which costs must be shared between controlled parties in cost sharing agreements specifically related to intangible product development.

Given the resultant ambiguity, our choice is to:

1. Apply a rule of thumb: the specific controls the general.
2. Resolve the ambiguity based on the dominant purpose of the regulations.

The first alternative is a simple solution. It is plausible. But it is wrong. It converts a canon of construction into something like a statute.

Often the specific controls the general. This rule has been used by the Supreme Court. *E.g.*, *Long Island Care At Home, Ltd. v. Coke*, 551 U.S. 158, 127 S. Ct. 2339, 2348, 168 L. Ed. 2d 54 (2007). Apply this simple rule here, and section 1.482-7(d)(1) controls. The conflict dissolves. The Commissioner is vindicated.

This simple solution is all too pat. It gives controlling importance to a single canon of construction. But, as every judge knows, ^{HNI2} the canons of construction are many and their interaction complex. The canons "are not mandatory rules." *Chickasaw Nation v. United States*, 534 U.S. 84, 94, 122 S. Ct. 528, 151 L. Ed. 2d 474 (2001). They are guides "designed to help judges determine the Legislature's intent." *Id.* They can be "overcome" by "other circumstances" manifesting that intent. *Id.* The canons are "tools designed to help courts better determine what Congress intended, not to lead courts to interpret the law contrary to that intent." *Scheidler v. National Org. of Women, Inc.*, 547 U.S. 9, 23, 126 S. Ct. 1264, 164 L. Ed. 2d 10 (2006). In the light of these principles, two considerations show the Commissioner's position to be untenable.

Purpose. Purpose is paramount. The purpose of the regulations is parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions. The regulations are not to be construed to stultify that purpose. If the standard of arm's length is trumped by 7(d)(1), the purpose of the statute is frustrated. If Xilinx cannot deduct all its stock option costs, Xilinx does not have tax parity with an independent taxpayer.

Treaties. The "arm's length" standard used in the United States Ireland Tax Treaty RIA Int. Tax Treaty 3057, aids in understanding the mind and practice of the Treasury. A tax treaty is negotiated by the United States with the active participation of the Treasury. The Treasury's reading of the treaty is "entitled to great weight." *United States v. Stuart*, 489 U.S. 353, 369, 109 S. Ct. 1183, 103 L. Ed. 2d 388 (1989) (quoting *Sumitomo Shoji America, Inc. v. Avagliano*, 457 U.S. 176, 184-185, 102 S. Ct. 2374, 72 L. Ed. 2d 765 (1982)). Simultaneous with the signing of the treaty into law, the Treasury issued its "Technical Explanation." As to Article 9, the Explanation reads:

This article incorporates in the Convention the arm's length principle reflected in the U.S. domestic transfer pricing provision, particularly Code section 482.

Department of the Treasury Technical Explanation of the 1997 United States-Ireland Tax Treaty, RIA Int. Tax Treaty 3095. *See also, e.g.*, United States-France, Article 9 (RIA Int. Tax Treaty 2225); United States-Germany, Article 9 (RIA Int. Tax Treaty 1542); and United States-United Kingdom, Article 9 (RIA Int. Tax Treaty 2546).

We do not, however, need to decide in this case whether the treaty obligations "constitute binding federal law enforceable in United States courts." *Medellin v. Texas*, 552 U.S. 491, 128 S. Ct. 1346, 1356, 170 L. Ed. 2d 190 (2008). It is enough that our foreign treaty partners and responsible negotiators in the Treasury thought that arm's length should function as the readily understandable international measure.

The judgment of the tax court is AFFIRMED.

CONCUR BY: Raymond C. Fisher

FISHER, Circuit Judge, concurring:

I concur, but write to explain my particular reasons for rejecting the Commissioner's position in this case.

The parties provide dueling interpretations of the "arm's length standard" as applied to the ESO costs that Xilinx and XI did not share. Xilinx contends that the undisputed fact that there are no comparable transactions in which unrelated parties share ESO costs is dispositive because, under the arm's length standard, controlled parties need share only those costs uncontrolled parties share. By implication, Xilinx argues, costs that uncontrolled parties would not share need not be shared.

On the other hand, the Commissioner argues that the comparable transactions analysis is not always dispositive. The Commissioner reads the arm's length standard as focused on what unrelated parties would do *under the same circumstances*, and contends that analyzing comparable transactions is unhelpful in situations where related and unrelated parties always occupy materially different circumstances. As applied to sharing ESO costs, the Commissioner argues (consistent with the tax court's findings) that the *reason* unrelated parties do not, and would not, share ESO costs is that they are unwilling to expose themselves to an obligation that will vary with an unrelated company's stock price. Related companies are less prone to this concern precisely because they are related -- i.e., *because* XI is wholly owned by Xilinx, it is already exposed to variations in Xilinx's overall stock price, at least in some respects. In situations like these, the Commissioner reasons, the arm's length result must be determined by some method other than analyzing what unrelated companies do in their joint development transactions.

Under Xilinx's interpretation, § 1.482-1(b)(1) and § 1.482-7(d)(1) are irreconcilable. The latter specifies that controlled parties in a cost sharing agreement must share *all* "costs . . . related to the intangible development area," and that phrase is explicitly defined to include virtually all expenses not included in the cost of goods. The plain language does not permit any exceptions, even for costs that unrelated parties would not share, so each provision mandates a different result.

Under the Commissioner's interpretation, § 1.482-7(d)(1)'s "all costs" is consistent with § 1.482-1(b)(1)'s arm's length standard and controls. In particular, the Commissioner argues that, because there are material differences in the economic circumstances of related and unrelated companies in relation to cost-sharing agreements like the one in this case, it was proper for the IRS to require that in this narrow context the arm's length result should be defined by the "all costs" requirement.

Having thoroughly considered not only the plain language of the regulations but also the various interpretive tools the parties and amici have brought before us, including the legislative history of § 482, the drafting history of the regulations, persuasive authority

from international tax treaties⁸² and what appears to have been the understanding of corporate taxpayers in similar circumstances and of others,⁸³ I conclude that Xilinx's understanding of the regulations is the more reasonable even if the Commissioner's current interpretation may be theoretically plausible. Traditional tools of statutory construction do not resolve the apparent conflict in these regulations as applied to Xilinx, and the Commissioner's attempts to square the "all costs" regulation with the arm's length standard have only succeeded in demonstrating that the regulations are at best ambiguous.⁸⁴

Although I would not go so far as Xilinx in characterizing the Commissioner's interpretation as merely a "convenient litigating position," *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 213, 109 S. Ct. 468, 102 L. Ed. 2d 493 (1988), we need not defer to it because he has not clearly articulated his rationale until now. *See United States v. Thompson/Ctr. Arms Co.*, 504 U.S. 505, 518-19 & n.9, 112 S. Ct. 2102, 119 L. Ed. 2d 308 (1992) (declining to defer to an agency interpretation of a tax statute where no prior guidance went directly "to the narrow question presented"). Indeed, I am troubled by the complex, theoretical nature of many of the Commissioner's arguments trying to reconcile the two regulations. Not only does this make it difficult for the court to navigate the regulatory framework, it shows that taxpayers have not been given clear, fair notice of how the regulations will affect them.⁸⁵

Accordingly, I join Judge Noonan in affirming the tax court. These regulations are hopelessly ambiguous and the ambiguity should be resolved in favor of what appears to have been the commonly held understanding of the meaning and purpose of the arm's length standard prior to this litigation.

DISSENT BY: Stephen Reinhardt

REINHARDT, Circuit Judge, dissenting:

⁸² I agree that the 1997 United States-Ireland Tax Treaty, along with Treasury's Technical Explanation, although not addressing the specific regulatory conflict at issue here, is evidence that Xilinx's understanding of the arm's length standard was and is quite reasonable. The treaty, and others like it, reinforce the arm's length standard as Congress' intended touchstone for § 482.

⁸³ Apparently Xilinx's understanding was widely shared in the business community and tax profession. See Brief of PricewaterhouseCoopers LLP, Deloitte Tax LLP and KMPG LLM as Amici Curiae on the Petition for Rehearing at 5-6 (describing a "global consensus"); Brief of Cisco Systems, Inc. and Thirty-Two Other Affected Companies as Amici Curiae on the Petition for Rehearing at 3 (describing "settled business expectations"); cf. Brief of Former U.S. Treasury and Internal Revenue Service Officials at 3-5.

⁸⁴ The dissent invokes the prior, withdrawn majority opinion. Dissent at 4613-14; see *Xilinx, Inc. v. CIR*, 567 F.3d 482 (9th Cir. 2009), withdrawn January 13, 2010. In writing that opinion, I was persuaded that the arm's length standard and the all costs regulation were in conflict, and that the more specific of the two should control. See 567 F.3d at 486. I no longer share Judge Reinhardt's confidence in that resolution because the Commissioner's response to Xilinx's petition for rehearing declined to fully endorse its reasoning. Instead, the thrust of the Commissioner's response was that our result was correct, even though our reasoning was not.

⁸⁵ It is an open question whether these flaws have been addressed in the new regulations Treasury issued after the tax years at issue in this case. See 26 C.F.R. § 1.482-7T(a) & (d)(1)(iii) (2009) (stating explicitly that ESOs are costs that must be shared and that the all costs requirement is an arm's length result).

I have considerable doubt as to whether Xilinx, Inc. ("Xilinx") and Xilinx Ireland allocated the costs associated with employee stock options in a manner that can be characterized as an arm's length result. I will assume, however, that the tax court correctly resolved that issue. If so, there is clearly a conflict between the arm's length regulation codified at 26 C.F.R. § 1.482-1(b)(1), which applies to all transactions between controlled parties, and the "all costs" regulation codified at § 1.482-7(d)(1), which applies only to cost-sharing arrangements between controlled parties.⁸⁶ I continue to believe that, as a matter of law, the "all costs" regulation, as the specific of the two provisions, the one designed to deal specifically with the type of question before us, controls. I would therefore reverse the tax court's ruling that the Commissioner's proposed allocation was arbitrary and capricious for the reasons explained in our opinion, *Xilinx Inc. v. CIR*, 567 F.3d 482 (9th Cir. 2009), *withdrawn* on January 13, 2010 in anticipation of the issuance of Judge Noonan's and Judge Fisher's new opinions, *supra*.

I agree with the majority that the canons of construction "are not mandatory rules," and that their interpretive force can be overcome by other circumstances evidencing legislative intent. Maj. op. at 4608-09 (quoting *Chickasaw Nation v. United States*, 534 U.S. 84, 94, 122 S. Ct. 528, 151 L. Ed. 2d 474 (2001)). Such circumstances, however, are not present here. Contrary to the majority's assertions, the conflict between the arm's length provision and the "all costs" requirement cannot be resolved by looking to the purpose of the regulations or to Treasury's Technical Explanation of the 1997 United States-Ireland Tax Treaty. Judge Fisher also looks to the understanding of the multinational corporations and their business and tax advisors, a dubious practice for which he cites no legal authority.

The stated purpose of the regulatory scheme is "to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions." 26 C.F.R. § 1.482-1(a)(1). In the context of this case, neither regulation more clearly implements that purpose than the other. Controlled and uncontrolled parties always operate under materially different circumstances with regard to employee stock option costs. Accordingly, the "all costs" regulation may simply reflect the conclusion that, whatever uncontrolled parties might do, requiring controlled parties to share such costs "ensure[s] that taxpayers clearly reflect [the] income attributable to [the] controlled transaction[]" as a whole. Nor is it clear that excluding those costs would better achieve tax parity. It is not the identity of treatment with respect to a single item that controls with respect to this general goal, but the overall manner in which the transaction is treated. The Commissioner has determined that including "all costs" is the best manner of achieving this general objective, and his decision does not appear to be unreasonable.

Similarly, Treasury's Technical Explanation of the 1997 United States-Ireland Tax Treaty does not justify disregarding the "all costs" requirement when determining deductible costs. A Technical Explanation is not subject to the APA's notice and comment

⁸⁶ To be clear, I refer here only to the regulations in effect during tax years 1997, 1998, and 1999. I express no view as to whether subsequent regulations resolved this conflict.

requirement and does not carry the force of law. *See* 5 U.S.C. § 553(a)(1) (exempting "foreign affairs function[s] of the United States" from the APA); *see, e.g.*, Explanation of Convention with Ireland (1997) ("The Technical Explanation is an official *guide* to the Convention and Protocol." (emphasis added)). Certainly, it cannot trump the plain language of the duly enacted "all costs" regulation, which does have the force of law and is entitled to this court's deference. *United States v. Mead Corp.*, 533 U.S. 218, 226-27, 121 S. Ct. 2164, 150 L. Ed. 2d 292 (2001); *cf. Cent. Laborers' Pension Fund v. Heinz*, 541 U.S. 739, 748, 124 S. Ct. 2230, 159 L. Ed. 2d 46 (2004) ("[N]either an unreasoned statement in the manual nor allegedly longstanding agency practice can trump a formal regulation with . . . the force of law.").

I recognize that Xilinx and amici have raised serious doubts as to whether the result that I believe to be legally required is, from both a practical and an equitable standpoint, the proper one. I am particularly troubled by the international tax consequences that such a result would apparently create. Tax law, however, involves the resolution by Congress of complex political and economic issues that sometimes may affect business or individual interests in unforeseen ways, and sometimes in ways that benefit one political or economic interest at the expense of another. These resolutions are not always arrived at in an open, objective, or non-political manner. To put it plainly, fairness is not always Congress's ultimate objective in enacting tax legislation. Accordingly, some provisions of tax law may appear to some businesses, individuals, or even judges to be in conflict with reasonable or sensible tax or national policy. Yet they may reflect the intent of Congress when it enacted the statute. Tax regulations are frequently even more complex than the legislation they implement, and it is often difficult for judges to clearly resolve their meaning. Still, it is the job of the courts to make the necessary determinations and in doing so to apply established legal rules and principles. By contrast, it is the business of Congress and the Treasury, not the courts, to correct any errors in those statutes or regulations, especially as they can be readily corrected once they are called to their attention.

For the reasons I have explained, it is particularly inappropriate for courts to resolve tax cases on a practical or equitable basis or to interpret tax statutes and regulations other than strictly in accordance with settled legal principles. The canon of construction under which the specific controls the general is one such settled legal principle, and one that is especially pertinent here. Indeed, it is controlling. I adhere to the previous majority opinion of this court.⁸⁷

⁸⁷ I, like Judge Fisher, am less than enthusiastic about the Commissioner's explanation of how he believes we should resolve this case. His preference is that we find somehow that the arm's length standard is met by way of the all costs requirement. I must confess that I have difficulty following his reasoning and, like Judge Fisher, am not persuaded by that argument. However, the Commissioner then says that if we still believe that the two provisions are in conflict, we must apply the rule on which Judge Fisher originally relied and on which I continue to rely. I guess I am just not as sensitive as Judge Fisher. Simply because the Commissioner advanced an argument that we reject, but then argued that if we reject it, we should apply the rule that we held applicable in our opinion is hardly a reason for abandoning the rule that we believed to be correct. We can't expect anyone, let alone the Commissioner of Internal Revenue, to agree completely with everything we say. Rejecting the Commissioner's first argument leaves us exactly where we were

For these reasons, I respectfully dissent.

V. CHAPTER 10, CONTROLLED FOREIGN CORPORATIONS

A. Page 423, New Sec. 10.8.C. Service's Position on Use of Partnerships to Avoid Section 956

Page 423, New Sec. 10.8.C. Add at the end of the text the following:

New Sec. 10.8.C. **Service's Position on Use of Partnerships to Avoid Section 956**

IRS Notice 2009-7 Designating as Transaction of Interest, Outlining Disclosure Requirements for Situations Where Domestic Partnership Is Used to Shield Subpart F Income
Jan. 20, 2009.

The Internal Revenue Service (IRS) and the Treasury Department are aware of a type of transaction, described more fully below, in which a U.S. taxpayer that owns controlled foreign corporations (CFCs) that hold stock of a lower-tier CFC through a domestic partnership takes the position that subpart F income of the lower-tier CFC or an amount determined under section 956(a) of the Internal Revenue Code (Code) related to holdings of United States property by the lower-tier CFC does not result in income inclusions under section 951(a) for the U.S. taxpayer. The IRS and Treasury Department believe this transaction (which includes taking the position that the U.S. taxpayer has no income inclusion under section 951(a)) has the potential for tax avoidance or evasion, but lack enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction. This notice identifies this transaction and substantially similar transactions as transactions of interest for purposes of §1.6011-4(b)(6) of the Income Tax Regulations and sections 6111 and 6112 of the Code. This notice also alerts persons involved in these transactions to certain responsibilities that may arise from their involvement with these transactions.

FACTS

In a typical transaction, a U.S. taxpayer (Taxpayer) wholly owns two CFCs, (CFC1 and CFC2). CFC1 and CFC2 are partners in a domestic partnership (USPartnership). USPartnership owns 100 percent of the stock of another CFC (CFC3). Some or all of the income of CFC3 is subpart F income (as defined in section 952). As part of the

before he advanced it: The two regulations are in conflict, and (as Judge Fisher and I once agreed) that conflict must be resolved by applying the specific regulation rather than the general one.

transaction, Taxpayer takes the position that the subpart F income of CFC3 is currently included in the income of USPartnership (which is not subject to U.S. tax) and is not included in the income of Taxpayer. The result of the claimed tax treatment is that income that would otherwise be taxable currently to Taxpayer under subpart F of the Code is not taxable to Taxpayer because of the interposition of a domestic partnership in the CFC structure. Without the interposition of USPartnership, the section 951(a) inclusion resulting from the subpart F income of CFC3 would be taxable currently to Taxpayer. In some variations of the transaction, there may be more than one person that owns the stock of CFC1 and/or CFC2, USPartnership may own less than all of the stock of CFC3, a domestic trust may be used instead of a domestic partnership, or the section 951(a) inclusion amount may result from an amount determined under section 956. The IRS and Treasury Department are concerned that taxpayers are taking the position that structures described in this notice result in no income inclusion to Taxpayer under section 951. Therefore the IRS and Treasury Department are identifying as transactions of interest such structures with respect to which the Taxpayer takes the position that there is no income inclusion to Taxpayer under section 951, as well as substantially similar transactions. The IRS and Treasury Department believe that the position there is no income inclusion to Taxpayer under section 951 is contrary to the purpose and intent of the provisions of subpart F of the Code.

TRANSACTION OF INTEREST

Effective Date

Transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as transactions of interest for purposes of § 1.6011-4(b)(6) and sections 6111 and 6112 effective December 29, 2008, the date this notice was released to the public. Persons entering into these transactions on or after November 2, 2006, must disclose the transaction as described in 1.6011-4. Material advisors who make a tax statement on or after November 2, 2006, with respect to transactions entered into on or after November 2, 2006, have disclosure and list maintenance obligations under sections 6111 and 6112. See §1.6011-4(h) and §§301.6111-3(i) and 301.6112-1(g) of the Procedure and Administration Regulations.

Independent of their classification as transactions of interest, transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the requirements of sections 6011, 6111, or 6112, or the regulations thereunder. When the IRS and Treasury Department have gathered enough information to make an informed decision as to whether these transactions are a tax avoidance type of transaction, the IRS and Treasury Department may take one or more administrative actions, including removing the transactions from the transactions of interest category in published guidance, designating the transactions as a listed transaction, or providing a new category of reportable transactions. In the interim, in appropriate situations, the IRS may challenge the taxpayer's position taken as part of these transactions under subpart F, subchapter K, or other provisions of the Code or under judicial doctrines such as sham transaction, substance over form, and economic substance.

Participation

Under §1.6011-4(c)(3)(i)(E), Taxpayer and USPartnership are participants in this transaction for each year in which their respective returns reflect tax consequences or a tax strategy described in this notice.

Time for Disclosure

See §1.6011-4(e) and §301.6111-3(e).

Material Advisor Threshold Amount

The threshold amounts are the same as those for listed transactions. See § 301.6111-3(b)(3)(i)(B).

Penalties

Persons required to disclose these transactions under §1.6011-4 who fail to do so may be subject to the penalty under section 6707A. Persons required to disclose these transactions under section 6111 who fail to do so may be subject to the penalty under section 6707(a). Persons required to maintain lists of advisees under section 6112 who fail to do so (or who fail to provide such lists when requested by the Service) may be subject to the penalty under section 6708(a). In addition, the Service may impose other penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under section 6662 or section 6662A. * * *

VI. CHAPTER 13, TAXABLE SALE AND ACQUISITION OF FOREIGN CORPORATIONS: IMPACT OF SECTIONS 1248 AND 338

A. Page 503, New Sec. 13.8. Service's View on the Check and Sell Issue

Page 504, New Sec. 13.8. Add at the bottom of the page the following:
New Sec. 13.8. **Service's View on the Check and Sell Issue**

Notice 2003-46
2003-2 C.B. 53

On November 29, 1999, the IRS and Treasury issued proposed regulations (REG-110385-99, 1999-2 C.B. 670 [64 FR 66591]) addressing certain transactions that occur within a specified period of time before or after a change in entity classification. The proposed regulations generally would provide that if an "extraordinary transaction," as defined in the proposed regulations, occurred either one day before or within 12 months

after the date a foreign entity changed its classification to disregarded-entity status, then the entity would not be treated as a disregarded entity but instead would be classified as an association taxable as a corporation for all purposes. In addition to this extraordinary transaction rule, the proposed regulations also address "grandfathered" pass-through entities and the determination of relevance of the classification of a foreign entity for U.S. federal income tax purposes.

A public hearing on the proposed regulations was held on January 31, 2000. In addition, written comments were received. Most commentators criticized the approach adopted in the proposed regulations as overly broad and expressed concern that it would mitigate the increased certainty promoted by the entity classification regulations issued in 1996.

After considering the comments received, the IRS and Treasury have decided to withdraw the extraordinary transaction rule of the proposed regulations. Therefore, the IRS and Treasury will withdraw proposed section 301.7701-3(h). The IRS and Treasury received minimal comments on the portions of the proposed regulations addressing grandfathered entities and the relevancy of classification status and intend to finalize those portions of the proposed regulations.

The IRS and Treasury remain concerned about cases in which a taxpayer, seeking to dispose of an entity, makes an election to disregard it merely to alter the tax consequences of the disposition. The IRS will continue to pursue the application of other principles of existing law (such as the substance over form doctrine) to determine the proper tax consequences in such cases. As the Supreme Court has noted: "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334, 89 L. Ed. 981, 65 S. Ct. 707, 1945 C.B. 58 (1945).

In addition, the IRS and Treasury are continuing to examine the potential use of the entity classification regulations to achieve results inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties. In contrast to the approach of the extraordinary transaction rule, which would operate to change the classification of an entity if certain conditions are met, this examination will focus on ensuring that the substantive rules of particular Code provisions and U.S. tax treaties reach appropriate results notwithstanding changes in entity classification.

One category of transactions that the IRS and Treasury are considering is the acquisition of the assets of one controlled foreign corporation (the acquired CFC) by a second controlled foreign corporation (the acquiring CFC) that involves the acquisition of the stock in the acquired CFC followed by its liquidation into the acquiring CFC (through an actual liquidation or by electing to treat the acquired CFC as a disregarded entity). Such a transaction typically would be treated as an asset reorganization under section 368(a)(1)(C) or (D), provided that the transaction meets the other requirements generally applicable to reorganizations, including the requirements that the transaction have a valid business purpose and continuity of business enterprise. See §1.368-1. Although the

regulations under section 367(a) would require certain U.S. shareholders of the acquired corporation to enter into a gain recognition agreement if the acquiring CFC had acquired the stock of the acquired CFC, the regulations do not require a gain recognition agreement in an asset reorganization. §1.367(a)-3(a) and (b)(1)(ii). A gain recognition agreement generally requires former U.S. shareholders of the acquired corporation to recognize gain on their original transfers if the acquiring corporation disposes of the stock or substantially all of the assets of the acquired corporation (including a disposition of substantially all of the assets following a liquidation of the acquired corporation) during the five-year period following the initial transaction. The IRS and Treasury are considering whether to extend the gain recognition agreement requirement for nonrecognition treatment under the section 367 regulations to asset reorganizations.

Another category of transactions that the IRS and Treasury are considering is the disposition of a controlled foreign corporation by liquidating the corporation (through an actual liquidation or by electing to treat the corporation as a disregarded entity) and selling its assets rather than by selling the stock of the controlled foreign corporation. For purposes of subpart F, section 954(c)(1) generally characterizes gain on the sale of assets based on the type of income produced by such assets. Thus, section 954(c)(1) distinguishes between gain from the sale of stock, which generally is characterized as subpart F income because stock gives rise to dividend income, and gain from the sale of the underlying assets of the corporation, which is characterized as subpart F income or other income based on the types of income produced by such assets. The IRS and Treasury are continuing to consider the proper treatment of these transactions under the substantive rules of subpart F.

Written comments concerning this notice may be submitted to: CC:PA:RU (Notice 2003-46), room 5226, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 am and 4 pm to: CC:PA:RU (Notice 2003-46), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044.

Alternatively, taxpayers may submit comments electronically to:
notice.comments@irs.counsel.treas.gov.

B. Page 507, New Sec. 13.2.Ca. Final Regulations on Attribution of E&P

Page 507, New Sec. 13.2.Ca. Add before Sec. 14.2.D the following:
New Sec. 13.2.Ca. **Final Regulations on Attribution of E&P**

Treasury Decision 9345), Section 1248 Attribution Principles
July 30, 2007

SUMMARY: This document contains final regulations under section 1248 of the Internal Revenue Code (Code) that provide guidance for determining the earnings and profits attributable to stock of controlled foreign corporations (or former controlled foreign corporations) that are (were) involved in certain nonrecognition transactions. The final regulations are necessary in order to supplement and clarify existing guidance in the regulations under section 1248. The final regulations affect persons subject to the regulations under section 1248, as well as persons to which regulations under other Code provisions, such as section 367(b), apply to the extent that those regulations incorporate the principles of the section 1248 regulations. In addition, the final regulations provide that with respect to the sale by a foreign partnership of the stock of a corporation, the partners in such foreign partnership shall be treated as selling or exchanging their proportionate share of the stock of such corporation for purposes of section 1248.

DATES: Effective Date: These regulations are effective on July 30, 2007.

Applicability Dates: For dates of applicability, see sections 1.1248-1(g) and 1.1248-8(d).

FOR FURTHER INFORMATION CONTACT: Michael Gilman at (202) 622-3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION

BACKGROUND

On June 2, 2006, proposed revisions to the regulations under section 1248(a) of the Code (REG-135866-02) were published in the Federal Register (71 FR 31985-01). On August 14, 2006, two corrections to those proposed regulations were published in the Federal Register (71 FR 46415 and 71 FR 46416). Two written comments were received. A public hearing was not requested and none was held. After consideration of the written comments and other comments, the June 2, 2006, proposed regulations are adopted as amended by this Treasury decision.

SUMMARY OF COMMENTS AND EXPLANATION OF REVISIONS

With respect to attribution of earnings and profits to stock of an acquiring corporation held by a non-exchanging shareholder, section 1.1248-8(b)(4) of the proposed regulations provides a rule by cross-reference to section 1.1248-2 or section 1.1248-3 (whichever is applicable) and section 1.1248-8(b)(6) (as applicable). A commentator asserted that the proposed regulations did not adequately explain which earnings and profits were attributed to the stock of the non-exchanging shareholder. This commentator thought that the rule was better explained in the preamble to the proposed regulations, which states that generally the earnings and profits attributable to stock of an acquiring corporation held by a non-exchanging shareholder immediately prior to a restructuring transaction continue to be attributed to such stock, and the earnings and profits of the acquired corporation accumulated prior to the restructuring transaction attributable to the stock of

an acquired corporation are not attributed to the non-exchanging shareholder's stock in the acquiring corporation. In order to clarify the regulations, this language from the preamble to the proposed regulations is included in section 1.1248-8(b)(4) of the final regulations.

Under section 1.1248-1(a)(4) of the proposed regulations, the partners in a foreign partnership shall be treated as selling or exchanging their proportionate share of stock of a corporation sold or exchanged by the foreign partnership. The proposed regulations also apply section 1248(a) in cases where the stock in a corporation that is sold or exchanged is held through tiers of foreign partnerships. This treatment is necessary to reflect properly each partner's share of the corporation's earnings and profits as a dividend.

A commentator noted that section 1.1248-1(a)(4) of the proposed regulations could be read to apply to the sale by a partner of its interest in a partnership holding the stock of a corporation. The Treasury Department and the IRS did not intend that interpretation because it would be contrary to section 1248(g)(2)(B). An amount that is received by a partner in exchange for all or part of its partnership interest is treated as ordinary income under section 751(a) and (c) to the extent attributable to stock in a foreign corporation as described in section 1248. Section 1248(g)(2)(B) provides that section 1248 will not apply if any other provision of the Code treats an amount as ordinary income. Accordingly, section 1.1248-1(a)(4) in the final regulations is revised to clarify that a foreign partnership is treated as an aggregate for this purpose only when a foreign partnership sells or exchanges stock of a corporation. Finally, a commentator requested that the final regulations allow a taxpayer to elect to apply the rule in section 1.1248-1(a)(4) to taxable years ending before the effective date of the final regulations. The Treasury Department and the IRS regard this rule as a clarification of existing law, but recognize that some practitioners have expressed the view that prior law was not entirely clear. Accordingly, the final regulations allow taxpayers to apply the rule in section 1.1248-1(a)(4) to open years provided that the taxpayer consistently applies the rule in all such years. A partner makes this election by treating its distributive share of gain attributable to a sale of shares in a controlled foreign corporation as gain recognized on a sale or exchange of stock in a foreign corporation within the meaning of section 1248(a).

In order to clarify the application of section 1.1248-8, the definition of controlled foreign corporation at section 1.1248-8(b)(1)(iii) has been revised to provide that a controlled foreign corporation includes corporations described in either section 953(c)(1)(B) or section 957.

A commentator requested the addition of an example to section 1.367(b)-4(d) to clarify that earnings and profits attributable to certain lower-tier subsidiaries are not taken into account in determining the all earnings and profits amount attributable to transactions described in section 1.367(b)-3. In response to this comment, such an example is included in section 1.367(b)-4(d) of the final regulations.

VII. CHAPTER 15, CROSS BORDER ACQUISITIVE REORGANIZATIONS AND SPIN-OFFS

A. Page 543, New Sec. 15.4.G.1. 2009 Regulations Addressing the Interface between Sections 367, 351, and 304

Page 544, New Sec. 15.4.G.1. Add at the bottom of the page the following:
New Sec. 15.4.G.1. **2009 Regulations Addressing the Interface
between Sections 367, 351, and 304**

**Treasury Decision 9444, Application of Section 367 to a Section 351 Exchange
Resulting from a Transaction Described in Section 304 (a) (1); Treatment of Gain
Recognized under Section 301 (c) (3) for Purposes of Section 1248
February 10, 2009**

SUMMARY:

This document contains final and temporary regulations under sections 367 (a), 367 (b) and 1248 (a) of the Internal Revenue Code (Code). The final regulations under section 367 revise existing final regulations and add cross-references. The final regulations under section 1248 update an effective/applicability date. The temporary regulations under section 367 (a) and (b) revise existing final regulations concerning transfers of stock to a foreign corporation that are described in section 351 by reason of section 304 (a) (1). The temporary regulations under section 1248 (a) provide that, for purposes of section 1248 (a), gain recognized by a shareholder under section 301 (c) (3) in connection with the receipt of a distribution of property from a foreign corporation with respect to its stock shall be treated as gain from the sale or exchange of the stock of such foreign corporation. The temporary regulations affect certain persons that transfer stock to a foreign corporation in a transaction described in section 304 (a) (1), or certain persons that recognize gain under section 301 (c) (3) in connection with the receipt of a distribution of property from a foreign corporation with respect to its stock. The text of the temporary regulations serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject published in the Proposed Rules section in this issue of the **Federal Register**. * * *

BACKGROUND

Section 367 (a) (1) generally provides that if a United States person transfers property to a foreign corporation in an exchange described in section 332, 351, 354, 356, or 361, the foreign corporation shall not be considered a corporation for purposes of determining the extent to which the United States person recognizes gain on such transfer. Exceptions to

the general rule are provided by section 367 (a) (2) and (3), and the Secretary has broad authority under section 367 (a) (6) to promulgate regulations providing exceptions for other transactions.

Section 367 (b) (1) provides that in the case of an exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367 (a) (1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes. Section 367 (b) (2) provides that the regulations prescribed pursuant to section 367 (b) (1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing the circumstances under which gain is recognized, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to the basis of stock or securities.

Regulations under section 367 (b) generally provide that if the potential application of section 1248 cannot be preserved immediately following the acquisition of the stock or assets of a foreign corporation (foreign acquired corporation) by another foreign corporation in an exchange subject to section 367 (b), then certain exchanging shareholders of the foreign acquired corporation must include in income as a dividend the section 1248 amount (as defined in §1.367 (b)-2 (c)) attributable to the stock of the foreign acquired corporation. See §1.367 (b)-4 (b).

Section 304 (a) (1) generally provides that, for purposes of sections 302 and 303, if one or more persons are in control of each of two corporations and in return for property one of the corporations (the acquiring corporation) acquires stock in the other corporation (the issuing corporation) from the person (or persons) so in control, then such property shall be treated as a distribution in redemption of the stock of the acquiring corporation. To the extent section 301 applies to the distribution, the transferor and the acquiring corporation are treated as if (1) the transferor transferred the stock of the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351 (a) applies, and (2) the acquiring corporation then redeemed the stock it is deemed to have issued. Under section 304 (b) (2), the determination of the amount of the property distribution that is a dividend (and the source thereof) is made as if the property is distributed by the acquiring corporation to the extent of its earnings and profits, and then by the issuing corporation to the extent of its earnings and profits.

On February 21, 2006, the IRS and Treasury Department issued final regulations (TD 9250) providing that section 367 (a) and (b) shall not apply to certain transfers of stock of a foreign or domestic corporation to a foreign acquiring corporation to which section 351 applies (deemed section 351 exchange) by reason of section 304 (a) (1) (final 2006 regulations). Specifically, §1.367 (a)-3 (a) provides that if, pursuant to section 304 (a) (1), a United States person is treated as transferring stock of a domestic or foreign corporation to a foreign corporation in exchange for stock of such foreign corporation in a deemed section 351 exchange, the deemed section 351 exchange is not a transfer to a foreign

corporation subject to section 367 (a). Similarly, §1.367 (b)-4 (a) provides that if, pursuant to section 304 (a) (1), a foreign corporation is treated as acquiring the stock of another foreign corporation in a deemed section 351 exchange, the deemed section 351 exchange is not an acquisition subject to section 367 (b).

The preamble to the final 2006 regulations explained that the IRS and Treasury Department determined that the policies underlying section 367 (a) and (b) are preserved even if a deemed section 351 exchange is not subject to section 367 (a) and (b) because generally the income recognized by the transferor in the transaction (dividend income, capital gain, or both) should equal or exceed the built-in gain in the transferred stock. Comments were received, however, stating that the transferor may not recognize income equal to or greater than the built-in gain in the transferred stock if, under section 301 (c) (2), the transferor were permitted to recover the basis of shares of the foreign acquiring corporation held before (and after) the transaction. For example, assume a domestic corporation, P, wholly owns F1 and F2, both foreign corporations. The F1 stock has a \$0x basis and \$100x fair market value. The F2 stock has a \$100x basis and \$100x fair market value. Neither F1 nor F2 has current or accumulated earnings and profits. In a transaction subject to section 304 (a) (1), P sells the F1 stock to F2 for \$100x cash. Under section 304 (a) (1), P and F2 are treated as if P transferred the F1 stock to F2 in exchange for F2 stock in a transaction to which section 351 applies, and then F2 redeemed its stock deemed issued to P. Because the redemption of the F2 stock would be described in section 302 (d) and therefore subject to section 301, the commentators posited that P may not recognize gain under section 301 (c) (3) on the receipt of the \$100x cash in redemption of the F2 stock if the basis of both the F2 stock that is received by P in the deemed section 351 exchange (\$0x), and of the F2 stock held by P prior to (and after) the transaction (\$100x), is available for reduction under section 301 (c) (2). If that were the case, P would recognize no gain in the transaction.

The preamble to the final 2006 regulations stated, however, that the IRS and Treasury Department believe current law does not provide for the recovery of basis of any shares of the acquiring corporation other than the shares deemed issued to the transferor and redeemed by the acquiring corporation as provided under section 304 (a) (1). Thus, in the example above, P would recognize \$100x gain under section 301 (c) (3) (the built-in gain on the F1 stock), and the basis of the F2 stock held by P after the transaction would continue to be \$100x. The IRS and Treasury Department continue to study the basis recovery issue as part of a larger project and have determined that it is necessary to revise the final 2006 regulations prior to the completion of that project.

EXPLANATION OF PROVISIONS

Modified Application of Section 367 (a) to Deemed Section 351 Exchanges

Consistent with the final 2006 regulations, the temporary regulations under section 367 (a) generally provide that if, pursuant to section 304 (a) (1), a United States person is treated as transferring stock of a domestic or foreign corporation to a foreign corporation in exchange for stock of such foreign corporation in a deemed section 351 exchange, the

deemed section 351 exchange is not a transfer to a foreign corporation subject to section 367 (a). However, if the distribution received by the United States person in redemption of the foreign acquiring corporation stock received in the deemed section 351 exchange is subject to section 301 (by reason of section 302 (d)), the temporary regulations provide an exception to the general rule if the distribution is applied against and reduces (in whole or in part), pursuant to section 301 (c) (2), the basis of stock of the foreign acquiring corporation held by the United States person other than the stock deemed issued to the United States person in the deemed section 351 exchange. In such a case, the United States person shall recognize gain under section 367 (a) (1) equal to the amount by which the gain realized by the United States person with respect to the transferred stock in the deemed section 351 exchange exceeds the amount of the distribution received by the United States person in redemption of the foreign acquiring corporation stock that is treated as a dividend under section 301 (c) (1) and included in gross income by the United States person. Thus, in the hypothetical transaction described above, if any amount of the distribution received by P in redemption of the F2 stock was applied against the basis of the F2 stock held by P before (and after) the transaction, then under the temporary regulations P would recognize \$100x gain under section 367 (a) (1) in connection with its transfer of the F1 stock to F2 in the deemed section 351 exchange.

The exceptions to the application of section 367 (a) (1) for transfers of stock provided in §1.367 (a)-3 are not available to transfers covered by the temporary regulations. For example, a United States person cannot avoid gain recognition under the temporary regulations by entering into a gain recognition agreement under §§1.367 (a)-3 (b) (1) (ii) and 1.367 (a)-8 with respect to the deemed section 351 exchange.

The temporary regulations provide rules to coordinate the recognition of gain under the temporary regulations and the corresponding increase to the basis of the stock of the foreign acquiring corporation received by the United States person in the transaction. Under such rules the increase to the basis of the stock of the foreign acquiring corporation by reason of gain recognized by the United States person under the temporary regulations would be taken into account before determining the consequences of the redemption of the shares of the foreign acquiring corporation. For example, in the hypothetical transaction described above, the basis of the F2 stock deemed received by P in exchange for the F1 stock would be increased to \$100x under section 358 before determining the consequences of the redemption of such stock under section 301. The gain recognized by P will be treated as recognized with respect to the F1 stock transferred in the deemed section 351 exchange in proportion to the gain realized with respect to the F1 stock.

Modified Application of Section 367 (b) to Deemed Section 351 Exchanges

The temporary regulations make similar revisions to the final 2006 regulations under section 367 (b). Specifically, the temporary regulations provide that §1.367 (b)-4 (b) shall apply to a deemed section 351 exchange to the extent the distribution received by the exchanging shareholder in redemption of the stock deemed issued by the foreign acquiring corporation is applied against and reduces, pursuant to section 301 (c) (2), the

adjusted basis of stock of the foreign acquiring corporation held by the exchanging shareholder before the transaction.

The temporary regulations provide rules to determine the amount of an income inclusion that is attributable to the shares of stock of the foreign acquired corporation transferred in the deemed section 351 exchange when the income inclusion required under the regulations is less than the aggregate section 1248 amount attributable to all of the shares of stock transferred in the deemed section 351 exchange.

Treatment of Gain Recognized under Section 301 (c) (3) for Purposes of Section 1248 (a)

The temporary regulations under section 1248 (a) provide that gain recognized under section 301 (c) (3) on the receipt of a distribution of property from a foreign corporation shall be treated, for purposes of section 1248 (a), as gain from the sale or exchange of the stock of such corporation. The temporary regulations preserve the policies underlying section 367 (b), are consistent with the premise of the final 2006 regulations, and ensure that the earnings and profits of lower-tier foreign subsidiaries described in section 1248 (c) (2) are taken into account.

Effective Dates

The temporary regulations apply to transfers or distributions occurring on or after February 11, 2009.

B. Page 575, New Sec. 15.7.B.1. 2009 Regulations under Section 7874

Page 575, New Sec. 15.7.B.1. Add before Sec. 15.7.C the following:

New Sec. 15.7.B.1. **2009 Regulations under Section 7874**

Treasury Decision 9453, Guidance under Section 7874 Regarding Surrogate Foreign Corporations

June 9, 2009

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations under (Code) concerning the determination of whether a foreign corporation shall be treated as a surrogate foreign corporation. The temporary regulations primarily affect domestic corporations or partnerships (and certain parties related thereto), and certain foreign corporations that acquire substantially all of the properties of such domestic corporations or partnerships. The text of these temporary regulations serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject also published in this issue of the Federal Register. * * *

BACKGROUND

A foreign corporation is generally treated as a surrogate foreign corporation under section 7874(a)(2)(B) if pursuant to a plan (or a series of related transactions) three conditions are satisfied. First, the foreign corporation completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation. Second, after the acquisition at least 60 percent of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation. Third, after the acquisition the expanded affiliated group (defined in section 7874(c)(1)) that includes the foreign corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized, when compared to the total business activities of the expanded affiliated group. Similar provisions apply to transactions involving the acquisition by a foreign corporation of substantially all of the properties constituting a trade or business of a domestic partnership. The level of ownership in the surrogate foreign corporation by former shareholders of the domestic corporation (or former partners in the domestic partnership) determines the treatment of the transaction.

COMPARE SECTIONS 7874(A)(1) AND 7874(B).

Temporary regulations ([TD 9265](#)) were published in the Federal Register (71 FR 32437) on June 6, 2006, concerning the treatment of a foreign corporation as a surrogate foreign corporation (2006 temporary regulations). A notice of proposed rulemaking () cross-referencing the temporary regulations was published in the same issue of the Federal Register (71 FR 32495). On July 28, 2006, Notice 2006-70 (2006-2 CB 252), (see §601.601(d)(2)(ii)(b)) was published, announcing that the effective date in §1.7874-2T(j) would be amended for certain acquisitions initiated prior to December 28, 2005. No public hearing was requested or held; however, comments were received. After consideration of the comments, the 2006 temporary regulations and the related notice of proposed rulemaking are withdrawn and replaced with new temporary regulations and a new notice of proposed rulemaking. These new temporary regulations are discussed in this preamble.

SUMMARY OF TEMPORARY REGULATIONS

Stock Held by a Partnership Section 1.7874-1T(b), as contained in revised as of April 1, 2008, provided that, for purposes of section 7874(c)(2)(A), stock held by a partnership shall be considered as held proportionately by the partners of the partnership.

Final regulations published in the Federal Register (73 FR 29054-29058) on May 20, 2008 (2008 final regulations) modified this provision to apply for all purposes of section 7874. See §1.7874-1(e). By its terms, §1.7874-1(e) applies only to stock held by a partnership, not to all properties held by the partnership.

Commentators have questioned the scope of §1.7874-1(e). In response to these comments, the temporary regulations modify the rule to apply only for purposes of determining whether the ownership condition of section 7874(a)(2)(B)(ii) is satisfied. The temporary regulations provide other partnership look-through rules, as appropriate. See, for example, the discussion in section F.4. of this preamble concerning the partnership items that are taken into account for purposes of section 7874(a)(2)(B)(iii).

Indirect Acquisition of Properties

Clarification of Temporary Regulations

The 2006 temporary regulations identify certain acquisitions that constitute indirect acquisitions of properties held by a domestic corporation. See §1.7874-2T(b). The temporary regulations retain these rules and clarify that the identified transactions do not represent an exclusive list of transactions that constitute indirect acquisitions. The temporary regulations also clarify that the acquisition of an interest in a partnership is an indirect acquisition of a proportionate amount of the properties of the partnership for purposes of section 7874(a)(2)(B)(i).

2. Certain Acquisitions by Members of the Expanded Affiliated Group The 2006 temporary regulations provide that if a corporation (acquiring corporation) acquires stock or assets of a domestic corporation in exchange for stock of a foreign corporation (foreign issuing corporation) that directly or indirectly owns more than 50 percent of the stock (by vote or value) of the acquiring corporation after the acquisition, the foreign issuing corporation shall be treated as acquiring a proportionate amount of the stock or assets of the domestic corporation. §1.7874-2T(b)(4).

The temporary regulations retain this rule, with modifications. First, the rule is modified to apply if the acquiring corporation and the foreign issuing corporation are members of the same expanded affiliated group after the acquisition. Second, the rule is modified to apply to an acquisition of properties of a partnership. Finally, the rule is modified to apply if a partnership acquires properties of a domestic corporation (or partnership) in exchange for stock of a foreign issuing corporation, but only if the foreign issuing corporation and the partnership would be members of the same expanded affiliated group after the acquisition if the partnership were a corporation.

Acquisitions by Multiple Foreign Corporations

The IRS and the Treasury Department have become aware of transactions intended to avoid section 7874 that involve two or more foreign corporations completing, in the aggregate, an acquisition described in section 7874(a)(2)(B)(i). For example, pursuant to a plan (or a series of related transactions), two foreign corporations would collectively acquire substantially all of the properties held by a domestic corporation. Taxpayers may take the position that neither foreign corporation is a surrogate foreign corporation because no foreign corporation separately acquires substantially all of the properties held

by the domestic corporation. Taxpayers may also take the position that section 7874(c)(4) does not apply to these transactions.

Even if substantially all of the properties held by a domestic corporation (or constituting a trade or business of a domestic partnership) are not acquired by a single foreign corporation, this type of transaction presents the policy concerns that prompted the enactment of section 7874. Accordingly, the temporary regulations provide that, if pursuant to a plan (or a series of related transactions) two or more foreign corporations complete, in the aggregate, an acquisition described in section 7874(a)(2)(B)(i), then each foreign corporation shall be treated as completing the acquisition for purposes of determining whether such foreign corporation shall be treated as a surrogate foreign corporation. See also section 7874(c)(4).

Acquisition of Multiple Domestic Corporations (or Partnerships)

The preamble to the 2008 final regulations identifies another transaction intended to avoid section 7874 that involves a single foreign corporation completing more than one acquisition described in section 7874(a)(2)(B)(i) as part of the same plan (or a series of related transactions). The preamble to the 2008 final regulations explains that the IRS and the Treasury Department disagree with the characterization of this type of transaction for purposes of section 7874 under current law and are considering issuing regulations clarifying the application of section 7874 to such transactions. In particular, the IRS and the Treasury Department disagree with the position that in determining whether the foreign corporation is a surrogate foreign corporation the ownership percentage under section 7874(a)(2)(B)(ii) is determined separately with respect to each domestic corporation (or partnership).

The preamble to the 2008 final regulations explains that any regulations issued would clarify that references in section 7874(a)(2)(B) to “a domestic corporation” shall, as appropriate, mean “one or more domestic corporations” where the properties of more than one domestic corporation are, directly or indirectly, acquired by a foreign corporation pursuant to the same plan. See §1.368-2(h). The preamble indicates that similar clarifications would be made for transactions involving domestic partnerships.

The temporary regulations clarify that if a foreign corporation completes more than one acquisition described in section 7874(a)(2)(B)(i) pursuant to a plan (or a series of related transactions), then, for purposes of section 7874(a)(2)(B)(ii), the acquisitions shall be treated as a single acquisition and the domestic corporations (and/or domestic partnerships) shall be treated as a single entity. This rule shall apply equally to transactions involving multiple corporations, multiple partnerships, or multiple corporations and partnerships.

The IRS and the Treasury Department determined that providing a specific operative rule was preferable to simply stating that, for purposes of section 7874(a)(2)(B), any reference to a single domestic corporation (or partnership) includes one or more domestic corporations (or partnerships). However, the operative rule of the temporary regulations is not a change from current law.

“By Reason of” Standard of Section 7874(a)(2)(B)(ii)

Distributions and Other Transactions

The 2006 temporary regulations provide that stock of a foreign corporation received by a former shareholder of a domestic corporation in exchange for stock of the domestic corporation is held by reason of holding stock in the domestic corporation. §1.7874-2T(c)(1). Commentators have questioned whether an exchange is the exclusive means by which stock of a foreign corporation can be held by reason of holding stock in the domestic corporation. For example, one commentator questioned whether stock of a foreign corporation received by a former shareholder as a distribution with respect to the stock of the domestic corporation is held by reason of holding stock in the domestic corporation.

Section 7874(a)(2)(B)(ii) does not require stock of the foreign corporation to be received in exchange for stock of the domestic corporation (or an interest in the domestic partnership). Therefore, the temporary regulations clarify that the “by reason of” condition of section 7874(a)(2)(B)(ii) is satisfied if stock of a foreign corporation is received in exchange for, or with respect to, stock in a domestic corporation (or an interest in a domestic partnership). This includes a taxable or nontaxable distribution. The temporary regulations also clarify that the “by reason of” condition may be satisfied other than through exchanges or distributions.

Acquisitions Involving Other Property One commentator questioned whether all the stock of a foreign corporation received by a former shareholder in exchange for stock of a domestic corporation and other property could be treated as held by reason of holding stock of the domestic corporation, if the other property bears some relationship to the stock of the domestic corporation.

In response to this comment, the temporary regulations clarify that, subject to section 7874(c)(4) and general tax principles, the “by reason of” standard applies based on the amount of stock of the foreign corporation received in exchange for, or with respect to, the stock of the domestic corporation (or interest in the domestic partnership). This determination is based on the relative values of the stock of the domestic corporation (or interest in a domestic partnership) and any other property exchanged for the stock of the foreign corporation. Thus, subject to section 7874(c)(4) and general tax principles, the “by reason of” standard is not affected by a relationship between stock of the domestic corporation (or interest in the domestic partnership) and such other property.

Substantial Business Activities Condition of Section 7874(a)(2)(B)(iii)

Removal of Safe Harbor and Examples

The third condition for the treatment of a foreign corporation as a surrogate foreign corporation is that, after the acquisition, the expanded affiliated group (defined in section 7874(c)(1)) that includes the foreign corporation does not have substantial business

activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized, when compared to the total business activities of the expanded affiliated group (the substantial business activities condition). Section 7874(a)(2)(B)(iii). For purposes of determining whether the substantial business activities condition is satisfied, the 2006 temporary regulations provide a general rule that, with certain exceptions, is based on all the facts and circumstances, and a safe harbor. §1.7874-2T(d)(1) through (3). The 2006 temporary regulations also provide examples illustrating the application of the general rule. §1.7874-2T(d)(4).

The IRS and the Treasury Department have concluded that the safe harbor provided by the 2006 temporary regulations may apply to certain transactions that are inconsistent with the purposes of section 7874, which is meant to prevent certain transactions that seek to avoid U.S. tax by merely shifting the place of organization of a domestic corporation (or partnership). The temporary regulations, therefore, do not retain the safe harbor provided by the 2006 temporary regulations. The temporary regulations also do not retain the examples illustrating the general rule contained in the 2006 temporary regulations. Thus, taxpayers can no longer rely on the safe harbor or the examples illustrating the general rule provided by the 2006 temporary regulations. Instead, taxpayers must apply the general rule to determine whether the substantial business activities condition is satisfied. In addition, the question of whether the substantial business activities condition is satisfied will continue to be on the list of provisions with respect to which the IRS will not ordinarily issue rulings or determination letters. See [Rev. Proc. 2009-7 \(2009-1 IRB 226\)](#), Section 4.01(30). Comments are requested with respect to these changes.

Sales and Services Between Expanded Affiliated Group Members

The 2006 temporary regulations identify sales made by the expanded affiliated group to customers located in the foreign country as an item to consider in determining whether the substantial business activities condition is satisfied. §1.7874-2T(d)(1)(ii)(3).

Commentators have asked whether sales (or the performance of services) between expanded affiliated group members may be taken into account for this purpose.

The IRS and the Treasury Department are concerned that sales (and the performance of services) between expanded affiliated group members can be structured in a manner that does not represent actual business activities.

However, subject to section 7874(c)(4) and general tax principles, the IRS and the Treasury Department believe that in appropriate circumstances sales (or the performance of services) between members of the expanded affiliated group may be taken into account under the general rule.

Items Not to Be Considered

The 2006 temporary regulations identify certain assets, activities, or income not to be taken into account in determining whether the substantial business activities condition is satisfied. See §1.7874-2T(d)(1)(iii). See also section 7874(c)(4). The temporary regulations add to these items any assets, business activities, or employees located in the foreign country in which, or under the law of which, the foreign acquiring corporation is

created or organized if such assets, business activities or employees are transferred to another country pursuant to a plan in existence at the time of the acquisition.

Partnership Items

The 2006 temporary regulations provide that if one or more members of the expanded affiliated group own capital or profits interests in a partnership, the proportionate amount of certain items of the partnership are considered to be items of the member (or members) of the expanded affiliated group. §1.7874-2T(d)(3)(iv).

The temporary regulations retain and modify this provision to provide that, for purposes of the substantial business activities condition, a member of the expanded affiliated group that holds at least a 10 percent capital and profits interest in a partnership shall take into account its proportionate share of the items of the partnership, including business activities, employees, assets, income, and sales.

Publicly Traded Foreign Partnerships

Scope

For purposes of section 7874, the 2006 temporary regulations treat as a foreign corporation any foreign partnership that would, but for section 7704(c), be treated as a corporation under section 7704 at any time during the two-year period following the completion by the foreign partnership of an acquisition described in section 7874(a)(2)(B)(i). The IRS and the Treasury Department are concerned that taxpayers may be taking the position that the rule does not apply to a foreign partnership whose interests become publicly traded outside this two-year period, even if the public trading occurs pursuant to a plan that existed at the time of the acquisition.

To address these transactions, the temporary regulations modify the rule to apply to any foreign partnership that would, but for section 7704(c), be treated as a corporation under section 7704(a) at the time of the acquisition described in section 7874(a)(2)(B)(i), or at any time after the acquisition pursuant to a plan that existed at the time of the acquisition. For this purpose, a plan shall be deemed to exist at the time of the acquisition if the foreign partnership would, but for section 7704(c), be treated as a corporation under section 7704(a) at any time during the two-year period following the acquisition. The temporary regulations also clarify that a publicly traded foreign partnership treated as foreign corporation under the rule is treated as a foreign corporation for all purposes of section 7874.

Implication Regarding Scope of Public Offering Rule

Section 1.7874-2T(e)(5), Example 3, involves a publicly traded foreign partnership that is treated as a surrogate foreign corporation under section 7874(a)(2)(B), but not as a domestic corporation under section 7874(b). In the example, the publicly traded foreign partnership acquires the stock of a domestic corporation in exchange for 75 percent of its outstanding interests. At the same time as the acquisition, an unrelated

person acquires the remaining 25 percent interest in exchange for stock of a foreign corporation. The example concludes that the former shareholders of the domestic corporation hold 75 percent of the interests in the publicly traded foreign partnership by reason of holding stock of the domestic corporation. Implicit in this conclusion is that the 25 percent interest received by the unrelated person in exchange for the stock of the foreign corporation is not subject to the public offering rule of section 7874(c)(2)(B). The IRS and the Treasury Department did not intend for this example to address the scope or application of the public offering rule of section 7874(c)(2)(B). The temporary regulations modify the example to eliminate the implication. The IRS and the Treasury Department are considering issuing guidance concerning the public offering rule of section 7874(c)(2)(B). Comments are requested in this regard.

Options and Similar Interests

The 2006 temporary regulations provide that, for purposes of section 7874(a)(2)(B)(ii), options and interests that are similar to options held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership) shall be treated as exercised. Not addressed by the 2006 temporary regulations, however, is the treatment of options (or similar interests) or stock in a foreign corporation held by reason of holding options (or similar interests) in a domestic corporation (or a partnership, domestic or foreign). This issue may arise, for example, if the holder of a warrant to acquire stock of the domestic corporation exchanges the warrant for a warrant to acquire stock of the foreign acquiring corporation. The 2006 regulations also do not address the treatment of options (or similar interests) in a foreign corporation not held by reason of holding stock in a domestic corporation (or an interest in a domestic partnership).

Further, the IRS and the Treasury Department believe that treating options (or similar interests) as exercised may, in certain cases, lead to inappropriate results. For example, treating options (or similar interests) as exercised may distort the ownership of the foreign corporation for purposes of section 7874(a)(2)(B)(ii). For these reasons, the temporary regulations make the following changes to the rule provided by the 2006 temporary regulations.

Domestic Corporations (or Partnerships)

An option (or similar interest) represents a claim on equity to the extent the value of the stock (or partnership interest) that may be acquired pursuant to the option (or similar interest) exceeds the exercise price under the terms of the option (or similar interest). As a result, the temporary regulations provide that, for purposes of section 7874, an option (or similar interest) in a domestic corporation (or a partnership, domestic or foreign) shall be treated as stock of the domestic corporation (or an interest in the partnership) with a value equal to the holder's claim on the equity of the domestic corporation (or partnership) immediately before the acquisition described in section 7874(a)(2)(B)(i). For this purpose, the equity of the domestic corporation (or partnership) shall not include the value of any property the holder of the option (or similar interest) would be required to provide to the domestic corporation (or partnership) pursuant to the terms of the option (or similar interest) if such option (or similar interest) were exercised.

Pursuant to these rules, for example, if the holder of an option in a domestic corporation receives stock of a foreign corporation by reason of holding the option, the holder shall be treated as holding the stock of the foreign corporation by reason of holding stock in the domestic corporation.

Foreign Corporations

The temporary regulations further provide that an option (or similar interest) in a foreign corporation shall generally be treated as stock of the foreign corporation with a value equal to the holder's claim on the equity of the foreign corporation immediately after the acquisition described in section 7874(a)(2)(B)(i). As is the case for options (and similar interests) with respect to domestic corporations (or partnerships), for this purpose the equity of the foreign corporation shall not include the value of any property the holder of the option (or similar interest) would be required to provide to the foreign corporation pursuant to the terms of the option (or similar interest) if such option (or similar interest) were exercised. This rule shall not apply, however, if a principal purpose of the issuance or acquisition of an option (or similar interest) is to avoid the foreign corporation being treated as a surrogate foreign corporation.

Multiple Claims on Equity

The rules of the temporary regulations concerning options (or similar interests) shall not apply to the extent treating an option (or similar interest) as stock of a corporation (or an interest in a partnership) would duplicate, in whole or in part, a shareholder's (or partner's) claim on the equity of the corporation (or partnership). However, except to the extent otherwise provided in section 7874, stock of a corporation held by a shareholder, or an interest in a partnership held by a partner, shall in all cases be taken into account for purposes of section 7874.

Comments

The IRS and the Treasury Department request comments on the rules provided by the temporary regulations concerning options (or similar interests).

For example, comments are requested as to whether the rules should not apply to certain options, such as publicly traded options or compensatory options.

Comments are also requested on the general approach of the rules, which treats the option (or similar interest) as stock or a partnership interest to the extent of the holder's claim on equity, as compared to an approach that would deem the options (or similar interests) as exercised. Any comments should consider the potential impact of treating options (or similar interests) as exercised on the determination of ownership in the foreign corporation under section 7874(a)(2)(B)(ii).

ECONOMICALLY EQUIVALENT INTERESTS

The IRS and the Treasury Department have become aware of transactions intended to avoid section 7874 by using interests (such as stock or partnership interests) that,

although not in form exchangeable or convertible into stock of a foreign corporation, are structured to be substantially equivalent to an equity interest in the foreign corporation. In one such transaction, for example, a privately held domestic corporation (UST) intends to make an initial public offering of its stock for cash. The UST shareholders, however, would prefer a foreign corporation to be the publicly-traded corporation.

To accomplish these objectives the following transactions are completed.

A newly formed foreign corporation (FC) issues shares to the public in exchange for cash and then contributes all or part of the cash to a newly-formed domestic corporation (S) in exchange for all the stock of S. S then merges with and into UST. Pursuant to the merger agreement, the UST shareholders exchange their UST stock for a new class of UST stock (class B stock) and cash. FC exchanges its S stock for all of the remaining class of stock of UST (class A stock). FC holds few assets other than the class A stock.

The class B stock entitles the UST shareholders to dividend distributions approximately equal to any dividend distributions made by FC with respect to its publicly traded stock.

The class B stock also permits the UST shareholders, in certain cases, to require UST to redeem the class B stock at fair market value.

The class B stock does not provide the holder voting rights with respect to FC.

Because FC holds few assets other than the class A stock of UST, the value of the class B stock held by the former UST shareholders is approximately equal the value of a corresponding amount of FC stock. Further, the distribution and liquidity rights provided by the class B stock are intended to place the former UST shareholders in the same approximate economic position as if they had received publicly traded FC stock instead of the class B stock in the merger.

Nonetheless, the former UST shareholders may take the position that they hold UST stock (and not FC stock) by reason of holding, in form, stock in UST and that the 2006 temporary regulations do not treat the class B stock as FC stock.

For example, the former UST shareholders may take the position that the class B stock is not, in substance, an instrument other than debt that is convertible into stock of FC. See §1.7874-2T(f)(2). The former UST shareholders may further take the position that section 7874(c)(4) does not apply to the transaction. If these positions are correct, FC would not be treated as a surrogate foreign corporation. The IRS and the Treasury Department understand that similar transactions may be structured using a partnership.

The IRS and the Treasury Department believe these transactions are contrary to the policies underlying section 7874. Therefore, the temporary regulations provide that, for purposes of section 7874, any interest (including stock or a partnership interest) that is not otherwise treated as stock of a foreign corporation (including under the rules concerning options (or similar interests)) shall be treated as stock of the foreign corporation if the following two conditions are satisfied: (1) the interest entitles the holder to distribution rights that are substantially similar in all material respects to the distribution rights entitled to a shareholder of the foreign corporation by reason of holding stock in the foreign corporation; and (2) treating the interest as stock of the

foreign corporation has the effect of treating the foreign corporation as a surrogate foreign corporation.

For purposes of the first condition, distribution rights include rights to dividend distributions (or partnership distributions), distributions in redemption of the interest (in whole or in part), distributions in liquidation, or other similar distributions that represent a return on, or of, the holder's investment in the interest.

Insolvent Entities

The preamble to the 2008 final regulations describes a transaction involving an insolvent domestic corporation in which the creditors of the corporation claim not to be shareholders of the corporation for purposes of determining whether a foreign corporation that acquires substantially all of the properties held by the domestic corporation is treated as a surrogate foreign corporation. As further stated in the preamble, the IRS and the Treasury Department disagree with this interpretation under current law. See, for example, *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), and §1.368-1(e)(6).

The temporary regulations clarify that, for purposes of section 7874, if immediately prior to the first date properties are acquired as part of an acquisition described in section 7874(a)(2)(B)(i), a domestic corporation is in a title 11 or similar case (as defined in section 368(a)(3)), or the liabilities of the domestic corporation exceed the value of its assets, then any claim by a creditor against the domestic corporation shall be treated as stock of the domestic corporation.

Therefore, any stock of a foreign corporation held by a creditor of the domestic corporation by reason of its claim against the domestic corporation would be considered held by a former shareholder of the domestic corporation by reason of holding stock in the domestic corporation.

A similar rule applies with respect to a domestic or foreign partnership. Foreign partnerships are included in this rule because, for purposes of section 7874(a)(2)(B)(ii), the acquisition of an interest in a foreign partnership that owns stock of a domestic corporation is considered an acquisition of a proportionate amount of the stock of domestic corporation. Therefore, if a foreign corporation acquired a sufficient interest in that foreign partnership, the foreign corporation could be treated as a surrogate foreign corporation.

One commentator requested the regulations clarifying the treatment of creditors for purposes of section 7874 make clear that a creditor that is treated as a shareholder of a domestic corporation is treated as a shareholder for all purposes of section 7874. In particular, the commentator requested the regulations make clear that the provisions of the 2008 final regulations concerning the determination of the stock of a foreign corporation held by reason of holding stock of the domestic corporation apply equally to such a creditor. The IRS and the Treasury Department agree with this comment.

Accordingly, the temporary regulations clarify that a creditor that is treated as a shareholder of a domestic corporation (or as a partner in a partnership) is treated as a shareholder (or partner) for all purposes of section 7874. Thus, for example, subject to section 7874(c)(4) and general tax principles, stock of the foreign corporation received by a creditor in exchange for other property would not be taken into account in determining former shareholder (or former partner) ownership under section 7874(a)(2)(B)(ii).

Modification to Internal Restructuring Exception of 2008 Final Regulations

The IRS and the Treasury Department have become aware of divisive transactions involving an acquisition described in section 7874(a)(2)(B)(i) in which the ownership condition of section 7874(a)(2)(B)(ii) may not be satisfied by reason of the internal group restructuring exception provided by §1.7874-1(c)(2).

For example, assume that a publicly-traded domestic corporation (USP) wholly owns a domestic subsidiary (S1) that in turn wholly owns another domestic subsidiary (S2). The S2 stock does not represent substantially all of the properties of S1. Pursuant to a plan, S2 transfers substantially all of its properties to a newly formed foreign corporation (F1) in exchange for F1 stock and then distributes the F1 stock to S1. Pursuant to the same plan, S1 distributes the F1 stock to USP, and USP then distributes the F1 stock to its shareholders.

The acquisition by F1 of substantially all of the properties held by S2 is described in section 7874(a)(2)(B)(i). In addition, S1, the former shareholder of S2, holds all the F1 stock by reason of holding S2 stock. However, taxpayer may take the position that the condition of section 7874(a)(2)(B)(ii) is not satisfied by reason of the internal group restructuring exception under §1.7874-1(c)(2). In relevant part, the internal group restructuring exception provides that, for purposes of section 7874(a)(2)(B)(ii), stock of the foreign corporation held by a member of the expanded affiliated group shall be included in the denominator, but not in the numerator, of the ownership fraction, if: (i) before the acquisition, at least 80 percent of the stock (by vote and value) of the domestic corporation was held directly or indirectly by the corporation that is the common parent of the expanded affiliated group after the acquisition; and (ii) after the acquisition, at least 80 percent of the stock (by vote and value) of the acquiring foreign corporation is held directly or indirectly by such common parent. Taxpayer may take the position that the internal restructuring exception applies because before the acquisition USP indirectly owned 100 percent of the stock of S2 and after the acquisition USP indirectly owned 100 percent of the stock of F1. Therefore, the F1 stock held by S1 would be included in the denominator but not the numerator of the ownership fraction, yielding zero percent former shareholder ownership and resulting in F1 not being treated as a surrogate foreign corporation.

The IRS and the Treasury Department believe it is inappropriate for the internal restructuring exception to apply to divisive transactions such as the one described above. Accordingly, the IRS and the Treasury Department will issue regulations that determine former shareholder ownership under section 7874(a)(2)(B)(ii) when pursuant to the same plan (or a series of related transactions) that includes the acquisition described in section

7874(a)(2)(B)(i), all or part of the stock of the foreign corporation is transferred outside the expanded affiliated group that includes the foreign corporation after the acquisition. The regulations will provide that the internal group restructuring exception of §1.7874-1(c)(2) does not apply to such transactions and will also modify the application of the general rule of §1.7874-1(b) to such transactions. The regulations may apply to acquisitions completed on or after June 9, 2009.

Effective/Applicability Dates

The temporary regulations included in this document generally apply to acquisitions completed on or after June 9, 2009. However, taxpayers may apply the temporary regulations to acquisitions completed prior to June 9, 2009, if the temporary regulations are applied consistently to all acquisitions completed prior to such date.

The temporary regulations include the modifications announced by Notice 2006-70 (2006-2 CB 252) to the effective date paragraph of §1.7874-2T, as contained in revised as of April 1, 2009, for certain acquisitions initiated prior to December 28, 2005.

No inference is intended as to the applicability of other Code or regulatory provisions, or judicial doctrines, to any transactions described in this preamble.

These regulations will expire on or before June 8, 2012.

Effect on Other Documents

Notice 2006-70 (2006-2 CB 252) is obsolete as of June 9, 2009.

C. Page 575, New Sec. 15.7.B.2. 2009 Notice under Section 7874

Page 575, New Sec. 15.7.B.2. Add after New Sec. 15.7.B.1 the following:

New Sec. 15.7.B.2. **2009 Notice under Section 7874: Treatment of Certain Stock of the Foreign Acquiring Corporation**

2009 Notice under Section 7874: Treatment of Certain Stock of the Foreign Acquiring Corporation

Notice 2009-78; 2009 IRB LEXIS 470

OVERVIEW

The Internal Revenue Service (IRS) and the Treasury Department (Treasury) intend to issue regulations under section 7874 of the Internal Revenue Code (Code) incorporating the rules described in this notice that will identify certain stock of a foreign corporation that is disregarded for determining ownership of the foreign corporation for purposes of section 7874 (a) (2) (B) (ii). In general, and as described below, the regulations to be issued pursuant to this notice shall apply to acquisitions completed on or after September 17, 2009.

BACKGROUND

Section 7874 provides rules for expatriated entities and their surrogate foreign corporations. An expatriated entity is a domestic corporation (or domestic partnership) with respect to which a foreign corporation (which includes certain publicly traded foreign partnerships) is a surrogate foreign corporation, and any United States person related to such domestic corporation (or domestic partnership) (within the meaning of sections 267 (b) or 707 (b) (1)). Section 7874 (a) (2) (A).

A foreign corporation constitutes a surrogate foreign corporation if three conditions are satisfied. First, the foreign corporation completes, after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation. Section 7874 (a) (2) (B) (i). Second, after the acquisition at least 60 percent of the stock of the foreign corporation (by vote or value) is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation (the Ownership Condition). Section 7874 (a) (2) (B) (ii). Third, after the acquisition the expanded affiliated group (defined in section 7874 (c) (1)) that includes the foreign corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized, when compared to the total business activities of the expanded affiliated group. Section 7874 (a) (2) (B) (iii). Similar provisions apply if a foreign corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.

Under section 7874 (c) (2), certain stock of the foreign corporation is not taken into account in determining whether the Ownership Condition is satisfied: (1) stock of the foreign corporation held by members of the expanded affiliated group that includes the foreign corporation, and (2) stock of the foreign corporation sold in a public offering related to the acquisition described in section 7874 (a) (2) (B) (i).

Regulations addressing the Ownership Condition were published in the Federal Register on May 20, 2008, and June 12, 2009 (TD 9399, 73 FR 29054; TD 9453, 74 FR 27920).

Under section 7874 (c) (4) a transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfer is part of a plan a principal purpose of which is to avoid the purposes of section 7874.

Section 7874 (g) grants the Secretary broad authority to provide regulations necessary to carry out section 7874, including regulations adjusting the application of section 7874 as necessary to prevent the avoidance of the purposes of section 7874. More specifically, section 7874 (c) (6) grants the Secretary authority to prescribe regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations to treat stock as not stock.

In TD 9453, the IRS and Treasury modified §1.7874-2T (e) (5), Example 3, to eliminate an unintended implication as to the scope or application of the public offering rule of section 7874 (c) (2) (B). The TD 9453 preamble states that the IRS and Treasury are

considering issuing guidance concerning the scope and application of the public offering rule and request comments in this regard.

TRANSACTIONS AT ISSUE

The IRS and Treasury have become aware of transactions intended to avoid the application of section 7874 that involve a transfer of cash (or certain other assets) to the foreign corporation in a transaction related to the acquisition described in section 7874 (a) (2) (B) (i), thereby minimizing the former shareholders' ownership in the foreign corporation for purposes of the Ownership Condition. In one such transaction, for example, the shareholders of a domestic corporation (DC) transfer all their DC stock to a newly-formed foreign corporation (New FCo) in exchange for 79 percent of the stock of New FCo and, in a related transaction, an investor transfers cash to New FCo in exchange for the remaining 21 percent of the New FCo stock. The parties to the transaction take the position that the New FCo stock issued to the investor is not "sold in a public offering" and thus not subject to section 7874 (c) (2) (B). The parties also assert that the transfer of cash from the investor to New FCo was not part of a plan a principal purpose of which is to avoid the purposes of section 7874 such that section 7874 (c) (4) does not apply to disregard the investor's transfer of cash to New FCo in exchange for New FCo stock.

Under these positions, the parties assert that the investor's New FCo stock would be taken into account for purposes of the Ownership Condition. Thus, the former shareholders of DC would hold only 79 percent of the stock of New FCo by reason of holding stock of DC, in which case section 7874 (a) (1) would apply to DC (and any other expatriated entity) but section 7874 (b) would not apply to treat New FCo as a domestic corporation for purposes of the Code. The IRS and Treasury understand that similar transactions may be structured with respect to the acquisition of a domestic corporation in a title 11 or similar case (as defined in section 368 (a) (3)) or a domestic partnership. These transactions are inconsistent with the purposes of section 7874.

The IRS and Treasury also understand that taxpayers are concerned the public offering rule of section 7874 (c) (2) (B) applies to all public issuances of stock by a foreign corporation, regardless of the property exchanged for the stock. For example, assume that, pursuant to a business combination, the shareholders of a publicly-traded foreign corporation (FT) and a publicly-traded domestic corporation (DT) intend to transfer their FT and DT stock, respectively, to a newly-formed foreign corporation (FA) that will be publicly-traded. To effectuate the transaction, as part of a plan FA acquires all of the FT and the DT stock, respectively, from the FT and DT shareholders in exchange solely for newly-issued FA stock. If the FA stock issued to the FT shareholders is considered "sold in a public offering" and thus subject to section 7874 (c) (2) (B), the former shareholders of DT would be treated as owning 100 percent of the stock of FA for purposes of the Ownership Condition, and FA would therefore be treated as a domestic corporation for purposes of the Code under section 7874 (b). A similar result would occur if instead FT merged with and into FA and the FT shareholders exchanged their FT stock for FA pursuant to the merger. The IRS and Treasury believe that such a result could be inappropriate in certain cases.

REGULATIONS TO BE ISSUED

To address certain transactions, including those described in Section 3 of this notice, the IRS and Treasury intend to issue regulations identifying stock of the foreign corporation that is not taken into account for purposes of the Ownership Condition. The regulations will identify stock of the foreign corporation that shall not be taken into account for purposes of the Ownership Condition, even if such stock may not otherwise be described in section 7874 (c) (2) (B). The regulations will also clarify that certain stock, which may be described in section 7874 (c) (2) (B), shall nonetheless be taken into account for purposes of the Ownership Condition.

The regulations issued pursuant to this notice shall provide that stock of the foreign corporation issued in exchange for "nonqualified property" in a transaction related to the acquisition described in section 7874 (a) (2) (B) (i) is not taken into account for purposes of the Ownership Condition, without regard to whether such stock is publicly traded on the date of issuance or otherwise. Subject to certain exceptions, the term "nonqualified property" shall generally mean: (1) cash or cash equivalents; (2) marketable securities as defined in section 453 (f) (2); and (3) any other property acquired in a transaction with a principal purpose of avoiding the purposes of section 7874.

For this purpose, however, marketable securities generally shall not include stock (or a partnership interest) issued by a member of the expanded affiliated group (as defined in section 7874 (c) (1)) that after the acquisition includes the foreign corporation, unless a principal purpose of the issuance of the stock of the foreign corporation in exchange for such property was the avoidance of the purposes of section 7874. For this purpose, a partnership shall be treated as a member of an expanded affiliated group if the partnership would be a member of the expanded affiliated group if it were a corporation.

The regulations shall provide similar rules to address acquisitions of property by one or more members of the expanded affiliated group (that includes the foreign corporation after the acquisition) in exchange for stock of the foreign corporation, including, for example, pursuant to a triangular reorganization. For this purpose, a partnership shall be treated as a member of an expanded affiliated group if the partnership would be a member of the expanded affiliated group if it were a corporation.

The rules described in this notice are not intended to affect the application of section 7874 (c) (2) (A), §1.7874-1, or section 7874 (c) (4).

The following examples illustrate the rules concerning the Ownership Condition that are intended to be included in the regulations described in this notice. For purposes of the examples, unless otherwise indicated, FA, FMS and FT are foreign corporations, DMS and DT are domestic corporations, PRS is a partnership, all entities are unrelated, and section 7874 (c) (4) may apply to disregard certain transfers.

Example 1. Stock issued in exchange for marketable securities. (i) Facts. Individual A

wholly owns DT. FA, a newly formed corporation, acquires all the DT stock from individual A in exchange solely for FA stock. In a transaction related to FA's acquisition of the DT stock, PRS transfers marketable securities (within the meaning of section 453 (f) (2)) to FA solely in exchange for FA stock.

(ii) Analysis. The FA stock issued to PRS in exchange for the marketable securities is not taken into account for purposes of the Ownership Condition.

Example 2. Stock issued with a principal purpose of avoiding section 7874. (i) Facts. FA acquires all the DT stock in exchange solely for FA stock. In a transaction related to FA's acquisition of the DT stock, PRS transfers marketable securities (within the meaning of section 453 (f) (2)) to FT, a newly formed corporation, solely in exchange for FT stock and then transfers the FT stock to FA in exchange solely for FA stock. The shares of FT stock do not constitute marketable securities within the meaning of section 453 (f) (2).

(ii) Analysis. The FA stock issued to PRS in exchange for the FT stock is not taken into account for purposes of the Ownership Condition because a principal purpose of such issuance is the avoidance of the purposes of section 7874.

Example 3. Stock issued or exchanged for stock of a foreign corporation. (i) Facts. The stock of DT and FT is publicly traded. The following transactions are completed pursuant to a plan: FT forms FA, and FA forms DMS and FMS. FMS merges with and into FT, with FT surviving the merger. Pursuant to the FMS-FT merger, the FT shareholders exchange their FT stock solely for FA stock. Following the FMS-FT merger, DMS merges with and into DT, with DT surviving the merger. Pursuant to the DMS-DT merger, the DT shareholders exchange their DT stock solely for FA stock. After completion of the plan, FA wholly owns FT and DT.

(ii) Analysis. After the FMS-FT merger, FT is a member of the expanded affiliated group that includes FA. Therefore, the shares of FT stock are not treated as marketable securities and therefore do not constitute nonqualified property. Thus, the FA stock issued or exchanged for the FT stock is taken into account for purposes of the Ownership Condition.

(iii) Alternative facts. Assume the same facts as in paragraph (i) of this example except that, instead, FT merges with and into FA with FA surviving the merger. At the time of the merger, FT does not hold nonqualified property. Pursuant to the FT-FA merger, the FT shareholders exchange their FT stock solely for FA stock. Because the properties transferred by FT to FA pursuant to the FT-FA merger do not constitute nonqualified property, the FA stock issued in exchange for such properties pursuant to the merger will be taken into account for purposes of the Ownership Condition.

EFFECTIVE DATE

The regulations described in this notice shall apply to acquisitions completed on or after September 17, 2009. * * *

D. Page 624, New Sec. 15.19.F.2. 2008 Final Regulations on Killer Bs

Page 624, New Sec. 15.19.F.2.	Replace the current 15.19.F.2 with the following:
New Sec. 15.19.F.2.	2008 Final Regulations on Killer Bs

Treasury Decision 9400

May 27, 2008

SUMMARY: This document contains final and temporary regulations under section 367(b) of the Internal Revenue Code (Code). The final regulations revise an existing final regulation and add a cross-reference. The temporary regulations implement the rules described in Notice 2006-85 and Notice 2007-48. The regulations affect corporations engaged in certain triangular reorganizations involving one or more foreign corporations. The text of the temporary regulations serves as the text of the proposed regulations (REG-136020-07) set forth in the notice of proposed rulemaking on this subject published in the Proposed Rules section in this issue of the Federal Register. * * *

BACKGROUND

On September 22, 2006, the IRS and Treasury Department issued Notice 2006-85 (2006-41 IRB 677), which announced that regulations would be issued under section 367(b) to address certain triangular reorganizations under section 368(a) involving one or more foreign corporations. On May 31, 2007, the IRS and Treasury Department issued Notice 2007-48 (2007-25 IRB 1428), which amplified Notice 2006-85 and announced that additional regulations would be issued under section 367(b). Each notice describes transactions the IRS and Treasury Department believe raise significant policy concerns.

Notice 2006-85 describes triangular reorganizations in which a subsidiary (S) purchases stock of its parent corporation (P) from P in exchange for property, and then exchanges the P stock for the stock or assets of a target corporation (T), but only if P or S (or both) is foreign. Notice 2006-85 announced that regulations to be issued under section 367(b) would make adjustments that would have the effect of a distribution of property from S to P under section 301 (deemed distribution). Notice 2006-85 further announced that regulations would address similar transactions where S acquires the P stock from a related party that purchased the P stock in a related transaction.

Notice 2007-48 describes transactions in which S purchases all or a portion of the P stock exchanged in the reorganization from a person other than P (such as from public shareholders on the open market). Notice 2007-48 announced that regulations to be issued under section 367(b) would also make adjustments that would have the effect of a distribution of property from S to P (under section 301) followed by a deemed contribution of such property by P to S. Notice 2007-48 further announced that the regulations would take into account the earnings and profits of other corporations, as appropriate, if a principal purpose of creating, organizing, or funding S is to avoid the adjustments to be made by the regulations.

These temporary regulations set forth the regulations described in Notices 2006-85 and 2007-48. The existing final regulations under section 1.367(b)-13 are revised to conform the definitions of the terms P, S, and T in those regulations to the definitions of such terms in these temporary regulations. The existing final regulations under section 1.367(b)-2 are revised to clarify that the definition of earnings and profits in section 1.367(b)-2(l)(8) applies only for purposes of sections 1.367(b)-7 and 1.367(b)-9.

EXPLANATION OF PROVISIONS

Section 367 -- In General

Section 367(a)(1) provides that if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. However, exceptions are provided under section 367(a)(2) and (3), and the Secretary has broad authority under section 367(a)(6) to provide that section 367(a)(1) will not apply to certain transfers otherwise described therein.

Section 367(b)(1) provides that in the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes.

Section 367(b)(2) provides that the regulations prescribed pursuant to section 367(b)(1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing the circumstances under which gain is recognized, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to basis of stock or securities.

Policies of Section 367(b)

Section 367(b) was enacted to ensure that international tax considerations are adequately addressed when the nonrecognition provisions of subchapter C of the Code apply to certain exchanges involving foreign corporations. Congress further noted that "it is essential to protect against tax avoidance in transfers to foreign corporations and upon the repatriation of previously untaxed foreign earnings. . . ." H.R. Rep. No. 658, 94th Cong., 1st Sess. 241 (1975). Accordingly, Congress granted the Secretary authority to provide regulations "necessary or appropriate to prevent the avoidance of Federal income taxes" and identified "transfers constituting a repatriation of foreign earnings" as a type of transfer to be covered in regulations to be promulgated by the Secretary. *Id.* The Secretary has exercised this grant of authority to address a wide range of international policy concerns. For further discussion, see Notices 2006-85 and 2007-48.

Adjustments Made Under Section 367(b)

These temporary regulations apply to triangular reorganizations where P or S (or both) is foreign and, in connection with the reorganization, S acquires, in exchange for property, all or a portion of the P stock that is used to acquire the stock or assets of T. The "in connection with" standard is a broad standard that includes any transaction related to the reorganization even if the transaction is not part of the plan of reorganization. For example, the temporary regulations apply to a triangular reorganization regardless of whether P controls S (within the meaning of section 368(c)) when S acquires the P stock that is used in the reorganization.

In a triangular reorganization subject to the temporary regulations, adjustments shall be made that have the effect of a distribution of property from S to P under section 301. The amount of the deemed distribution shall equal the amount of money plus the fair market value of other property that S used to acquire P stock. For this purpose, the term property has the meaning set forth in section 317(a), but includes any liability assumed by S in exchange for the P stock (notwithstanding the application of section 357(a)) and any S stock used by S to acquire the P stock from a person other than P. Consistent with the rule announced in Notice 2007-48, these temporary regulations provide that to the extent S buys P stock from a person other than P, immediately after taking into account the deemed distribution to P, P is deemed to contribute to S the property deemed distributed to P.

These temporary regulations provide that the deemed distribution shall be treated as a distribution for all purposes of the Code. For example, provisions such as sections 312, 881, 897, 902, 959, 1442, and 1445 apply, as appropriate, to the deemed distribution. Similarly, the deemed contribution of property shall be treated as a contribution of property for all purposes of the Code. For example, appropriate adjustments to P's basis in the S stock and other affected items shall be made according to applicable Code provisions.

Ordering rules are provided that generally require the deemed distribution and, in cases where S buys P stock from a person other than P, the deemed contribution to be taken into account before the transfers undertaken pursuant to the triangular reorganization. If P does not control S (within the meaning of section 368(c)) at the time that S purchases the P stock, the deemed distribution and deemed contribution shall be treated as separate transactions occurring immediately after P acquires control of S. Thus, in a transaction where S purchases the P stock from a person other than P, after taking into account the adjustments made under these temporary regulations, S's purchase and transfer of P stock pursuant to the triangular reorganization are taken into account under generally applicable Code provisions, such as sections 304, 354, 356, 358, and 368.

These temporary regulations also provide that appropriate adjustments will be made if in connection with a triangular reorganization described in the regulations, a transaction is engaged in with a view to avoid the purpose of the regulations. For example, if S is a

newly formed corporation and, in connection with the reorganization, P contributes to S another corporation with positive earnings and profits (S2) to facilitate S's purchase of the P stock or to facilitate the repayment of an obligation incurred by S to purchase the P stock, then, under the temporary regulations, the earnings and profits of S may be deemed to include the earnings and profits of S2.

Finally, these temporary regulations contain a coordination rule that applies to transactions described in section 367(a) and section 1.367(b)-14T. The IRS and Treasury Department continue to study transactions that implicate the policies of section 367(a) and (b), but that are not subject to both provisions as a result of the application of the coordination rule. Comments are requested on such transactions.

Availability of IRS Documents

IRS notices cited in this preamble are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Effective/Applicability Dates

With respect to those rules addressing transactions described in Notice 2006-85, these temporary regulations are generally applicable to transactions occurring on or after September 22, 2006, with limited transition relief. With respect to those rules addressing transactions described in Notice 2007-48, these temporary regulations are generally applicable to transactions occurring on or after May 31, 2007, with limited transition relief. Other rules included in these temporary regulations are generally applicable to transactions occurring on or after May 23, 2008, with limited transition relief. See section 1.367(b)-14T(e).

No inference is intended as to the potential applicability of other Code or regulatory provisions or judicial doctrines (including substance over form) to transactions described in these temporary regulations.

Effect on Other Documents

The following publications are obsolete as of May 27, 2008:

Notice 2006-85 (2006-41 IRB 677).

Notice 2007-48 (2007-25 IRB 1428).

E. Page 635, New Sec. 15.22a. 2008 Proposed Regulations under Sections 367(a), 367(a)(5), 367(b), 1248(a), 1248(e), 1248(f), and 6038B

Page 635, New Sec. 15.22a. Add before Sec. 15.23 the following:

New Sec. 15.22a. **2008 Proposed Regulations under Sections 367(a), 367(a)(5), 367(b), 1248(a), 1248(e), 1248(f), and 6038B**

Proposed Regulations, REG-209006-89

August 20, 2008

SUMMARY: This document contains proposed regulations under sections 367(a), 367(a)(5), 367(b), 1248(a), 1248(e), 1248(f), and 6038B of the Internal Revenue Code (Code). The proposed regulations under sections 367(a)(5) and 367(b) apply when a domestic corporation transfers certain property to a foreign corporation in an exchange described in section 361(a) or (b). The proposed regulations under section 1248(e) suspend the application of section 1248(e) when capital gains are taxed at a rate equal to or greater than the rate at which ordinary income is taxed. The proposed regulations under section 1248(f) apply when a domestic corporation distributes stock of certain foreign corporations in a distribution to which section 337, 355, or 361 applies. The proposed regulations under section 1248(f) include regulations described in Notice 87-64 (1987-2 CB 375). The proposed regulations under section 6038B establish reporting requirements for certain transfers of property by a domestic corporation to a foreign corporation in certain exchanges described in section 361(a) or (b). Finally, the proposed regulations under section 367(a) include the regulations described in Notice 2008-10 (2008-3 IRB 277).

The proposed regulations included in this document affect domestic corporations that transfer property to foreign corporations in certain transactions, or that distribute the stock of certain foreign corporations, and certain shareholders of such domestic corporations. The proposed regulations are necessary, in part, to provide guidance on changes to the law made by the Technical and Miscellaneous Revenue Act of 1988 (Public Law 100-647, 102 Stat. 3342). * * *

BACKGROUND

This document contains proposed amendments to 26 CFR part 1 under sections 367(a), 367(a)(5), 367(b), 1248(a), 1248(e), 1248(f), and 6038B of the Code.

Section 367(a)(1) generally provides that if a United States person transfers property to foreign corporation in connection with an exchange described in section 332, 351, 354, 356, or 361, then the foreign corporation shall not be considered a corporation for purposes of determining the extent to which the United States person recognizes gain on the transfer. Sections 367(a)(2) and 367(a)(3), respectively, provide exceptions to the general rule of section 367(a)(1) for transfers of stock or securities of a foreign corporation that is a party to the exchange or a party to the reorganization, and for certain property used in an active foreign trade or business. However, section 367(a)(5) provides that, except to the extent provided in regulations, the exceptions to the general rule of section 367(a)(1) provided by section 367(a)(2) and (a)(3) do not apply to a transfer of property by a domestic corporation to a foreign corporation in an exchange described in section 361(a) or (b).

Section 367(b)(1) provides that in the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes. A fundamental policy of section 367(b) is to preserve the potential application of section 1248 following the acquisition of the stock or assets of a foreign corporation by another foreign corporation. H.R. Rep. No. 94-658, at 242 (1975).

Section 367(c)(1) provides that for purposes of section 367, any distribution described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is an exchange.

Section 1248(a) provides that a United States person shall include in gross income as a dividend any gain recognized on the sale or exchange of stock of a foreign corporation that was a controlled foreign corporation (CFC) (as defined in section 957(a)) at any time during the five-year period ending on the date of the sale or exchange but only if the United States person owned (or is considered to have owned, within the meaning of section 958) 10 percent or more of the total combined voting power of the foreign corporation at any time during that five-year period (a section 1248 shareholder). The amount of the gain recognized by the United States person on the sale or exchange that is recharacterized as a dividend is limited to the earnings and profits of the foreign corporation, and of certain foreign subsidiaries of such corporation, attributable to the stock sold or exchanged that were accumulated in taxable years of the foreign corporation beginning after December 31, 1962, and during the period or periods the stock was held by the United States person while the foreign corporation was a CFC.

Section 1248(e) provides that, except as provided in regulations, if a United States person sells or exchanges stock of a domestic corporation that was formed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations, such sale or exchange shall be treated for purposes of section 1248 as a sale or exchange of the stock of the foreign corporations held by the domestic corporation.

Section 1248(f)(1) provides that, except as provided in regulations, a domestic corporation that distributes stock of a foreign corporation in a distribution to which section 311(a), 337, 355(c)(1), or 361(c)(1) applies, shall include in gross income as a dividend an amount equal to the excess of the fair market value of such stock over its adjusted basis, but only to the extent of the earnings and profits of the foreign corporation attributable (under regulations prescribed by the Secretary) to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock was held by the domestic corporation while the foreign corporation was a CFC.

EXPLANATION OF PROVISIONS

Section 367(a)(5)

Overview

As noted in the Background part of this preamble, section 367(a)(2) and (3) provide exceptions to the general rule of section 367(a)(1). Section 367(a)(2) provides that, except to the extent provided in regulations, section 367(a)(1) shall not apply to the transfer of stock or securities of a foreign corporation that is a party to the exchange or a party to the reorganization. Section 367(a)(3) provides that, except to the extent provided in regulations, section 367(a)(1) shall not apply to the transfer of property used in an active foreign trade or business. Sections 1.367(a)-2T and section 1.367(a)-3, along with other related provisions, implement the exceptions in section 367(a)(2) and (a)(3). In addition, section 367(a)(6) grants the Secretary authority to promulgate regulations providing additional exceptions to the general rule of section 367(a)(1).

Section 367(a)(5) provides that the exceptions to the general rule of section 367(a)(1) provided under section 367(a)(2) and (3) shall not apply in the case of a transfer of property by a domestic corporation (U.S. transferor) to a foreign corporation (foreign acquiring corporation) in an exchange described in section 361(a) or (b) (section 361 exchange). The general rule under section 367(a)(5), therefore, is that a transfer of property by a U.S. transferor to a foreign acquiring corporation in a section 361 exchange is subject to the general rule of section 367(a)(1). In that case, the U.S. transferor recognizes gain with respect to the transfer of appreciated property in the section 361 exchange. See section 367(a)(1) and the regulations under that section.

Section 367(a)(5), however, further provides that subject to such basis adjustments and such other conditions as shall be provided in regulations the general rule of section 367(a)(5) shall not apply (and therefore the exceptions to the general rule of section 367(a)(1) may be available) if the U.S. transferor is controlled (within the meaning of section 368(c)), by five or fewer domestic corporations. For purposes of the control requirement, members of the same affiliated group (within the meaning of section 1504) are treated as a single corporation. The legislative history to section 367(a)(5) explains that regulations are expected to provide relief from the general rule only if the "U.S. corporate shareholders in the transferor agree to take a basis in the stock they receive in a foreign corporation that is a party to the reorganization equal to the lesser of (a) the U.S. corporate shareholders' basis in such stock received pursuant to section 358, or (b) their proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation." S. Rep. No. 100-445, at 62 (1988).

The legislative history explains that "the requirement that five or fewer domestic corporations own at least 80 percent of the U.S. transferor's stock assures that the bulk of the built-in gain [in the transferred property] remains subject to U.S. taxing jurisdiction." The legislative history further states that "it is expected that regulations [issued under

section 367(a)(5)] will require the U.S. corporate transferor to recognize immediately any built-in gain that does not remain subject to U.S. taxing jurisdiction by virtue of a substituted stock basis." For example, the U.S. transferor would recognize gain "where 20 percent or less of the U.S. corporate transferor is owned by foreign shareholders who receive substituted basis stock in the transferee corporation, which stock would not be subject to U.S. taxing jurisdiction on disposition." The U.S. transferor would also recognize gain to the extent each controlling domestic corporate shareholder does not receive an amount of stock of the issuing corporation in the reorganization sufficient to preserve its share of the built-in gain in the property transferred by the U.S. transferor in the section 361 exchange.

Explanation of proposed regulations

The proposed regulations confirm the general rule of section 367(a)(5), but provide an elective exception to the general rule pursuant to which the exceptions provided by section 367(a) and the regulations under that section may be available.

General rule of section 367(a)(5)

Consistent with section 367(a)(5), the proposed regulations confirm that the exceptions to the general rule of section 367(a)(1) provided in section 367(a) generally are not available to a transfer of property by a U.S. transferor to a foreign acquiring corporation in a section 361 exchange. As noted, under the general rule of section 367(a)(5), section 367(a)(1) would require the U.S. transferor to recognize gain on the transfer of appreciated property to the foreign acquiring corporation in the section 361 exchange. This general rule applies even if the conditions and requirements for the application of such exceptions would otherwise be met. The proposed regulations clarify that the general rule of section 367(a)(5) applies to a transfer of property pursuant to an exchange described in section 351 (section 351 exchange) that qualifies as both a section 351 exchange and a section 361 exchange. See Notice 2008-10, 2008-3 IRB 277.

Elective exception to the general rule

The proposed regulations provide an elective exception to the general rule of section 367(a)(5) if certain conditions and requirements are satisfied (discussed in parts A.2.b.i through v of this preamble). If the exception applies, then the exceptions to the general rule of section 367(a)(1) provided in section 367(a) and the regulations under that section are available to the transfer of property by the U.S. transferor to the foreign acquiring corporation in the section 361 exchange, subject to any conditions and requirements for the application of such exceptions. In addition, even if the exception provided by the proposed regulations applies, the U.S. transferor may still recognize gain on the section 361 exchange in certain circumstances (discussed in part A.2.b.ii of this preamble), including any gain otherwise required to be recognized under section 367(a). See, for example, section 367(a)(3)(B) and (C).

The conditions and requirements of the elective exception carry out the policy of section

367(a)(5) by ensuring that the exceptions to the general rule of section 367(a)(1) are available only to the extent the net built-in gain in certain property transferred by the U.S. transferor in the section 361 exchange remains subject to corporate-level taxation in the hands of the controlling domestic corporate shareholders of the U.S. transferor through their ownership of stock received in the transaction. References to "stock received" in this preamble include stock deemed received in the transaction.

The proposed regulations apply to all property transferred by the U.S. transferor in the section 361 exchange, other than property to which section 367(d) applies (section 367(d) property). But see part D.2 of this preamble regarding proposed regulations under section 367(a) that require section 367(d) property to be treated as property to which section 367(a) applies (section 367(a) property) in transactions that may be eligible for the exception to the coordination rule of section 1.367(a)-3(d)(2)(vi)(A) provided by section 1.367(a)-3(d)(2)(vi)(B)(1). For purposes of these proposed regulations, section 367(a) property includes any property transferred by the U.S. transferor in the section 361 exchange (other than section 367(d) property), whether the property is appreciated (built-in gain property) or depreciated (built-in loss property) at the time of the section 361 exchange. The proposed regulations preserve (or require the recognition of) the net built-in gain in the section 367(a) property transferred in the section 361 exchange (generally defined as "inside gain" by the proposed regulations). In this regard, a transfer of section 367(a) property pursuant to a section 361 exchange to which the elective exception applies is treated differently than a transfer of built-in gain property and built-in loss property by a U.S. person to a foreign corporation in a section 351 exchange that is not also a section 361 exchange. In the latter transaction, only the built-in gain property would be subject to section 367(a)(1), and the U.S. transferor would be required to recognize gain with respect to such property without offsetting the gain with losses related to the built-in loss property.

The proposed regulations contain an anti-stuffing rule pursuant to which any property that would otherwise constitute section 367(a) property shall not be considered section 367(a) property for purposes of any determination under the proposed regulations for which the amount of section 367(a) property is relevant, if the U.S. transferor acquires such property in connection with the section 361 exchange with a principle purpose of affecting any such determination (for example, inside gain and inside basis). This rule may apply, for example, if the U.S. transferor acquires built-in loss property or cash proceeds from indebtedness incurred in connection with the transaction.

The conditions and requirements for the application of the exception provided by the proposed regulations ensure that, in the aggregate, the inside gain is recognized currently by the U.S. transferor or preserved for future taxation in the stock received in the transaction by the controlling domestic corporate shareholders of the U.S. transferor. If the entire inside gain is preserved in the stock received by the controlling domestic corporate shareholders, the basis adjustment required by the exception (discussed in part A.2.b.iii of this preamble) effectively results in the section 361 exchange being treated similarly to a transfer of the section 367(a) property in a section 351 exchange insofar as, in the aggregate, the controlling domestic corporate shareholders' adjusted basis in the

stock received in the transaction generally would reflect the aggregate bases of the section 367(a) property and the net built-in gain in such property on the date of the section 361 exchange.

The inside gain equals the amount by which the aggregate gross fair market value of the section 367(a) property transferred by the U.S. transferor in the section 361 exchange exceeds the sum of the aggregate bases of such property and a proportionate amount of any liabilities of the U.S. transferor assumed in the section 361 exchange or satisfied in the reorganization pursuant to section 361(c)(3), but only to the extent the payment of any such liability would give rise to a deduction (deductible liabilities). For this purpose, gross fair market value means fair market value determined without regard to mortgages, liens, pledges, or other liabilities. However, the fair market value of any property subject to nonrecourse indebtedness shall not be less than the amount of such indebtedness. In addition, the aggregate bases of the section 367(a) property is determined after taking into account any gain otherwise required to be recognized by the U.S. transferor under section 367(a). See, for example, section 367(a)(3)(B) and (C). The proposed regulations provide rules for determining the proportionate amount of any deductible liabilities taken into account in determining the inside gain. The IRS and Treasury Department believe that taking deductible liabilities into account in determining inside gain comports with the policy of section 367(a)(5) to protect the corporate tax base following the repeal of the "General Utilities" doctrine, insofar as the U.S. transferor would have received the benefit of any deductible liabilities if it had disposed of its assets in a taxable transaction in which the deductible liabilities were assumed by the acquirer.

In determining the inside gain, the IRS and Treasury Department declined to consider attributes (for example, net operating losses and foreign tax credits) of the U.S. transferor other than the tax bases of the section 367(a) property and deductible liabilities allocable to section 367(a) property. These attributes are not considered for this purpose because of concerns regarding the complexity for determining how any limitations on the use of such attributes should be taken into account and the potential for duplicating the benefit of such attributes. Comments are requested regarding whether and how other attributes of the U.S. transferor should be taken into account for determining inside gain.

If the section 361 exchange is part of a divisive reorganization described in section 368(a)(1)(D) in which the U.S. transferor distributes the stock of the foreign acquiring corporation in a distribution to which section 355 applies (section 355 distribution) and, as part of a plan or series of related transactions, such stock is subsequently distributed in one or more section 355 distributions, in addition to the conditions discussed in parts A.2.b.i through v of this preamble, two additional conditions must be satisfied. First, each section 355 distribution must be to a member of the affiliated group (within the meaning of section 1504) that includes the U.S. transferor at the time of the 361 exchange. Second, each affiliated group member that receives stock of the foreign acquiring corporation in the final section 355 distribution must adjust the basis of the stock received (as determined under section 358 and the regulations under that section) as required by the proposed regulations (discussed in part A.2.b.iii of this preamble). These two additional conditions ensure that the amount of inside gain attributable to the U.S. transferor's

controlling domestic corporate shareholders remains subject to corporate-level taxation following the final section 355 distribution and permit section 355 distributions of the stock of the foreign acquiring corporation within an affiliated group.

Control requirement

At the time of the section 361 exchange, the U.S. transferor must be controlled (within the meaning of section 368(c)) by five or fewer, but at least one, domestic corporations (the control group). For this purpose, members of the same affiliated group (within the meaning of section 1504) are treated as one corporation. If the U.S. transferor is controlled (within the meaning of section 368(c)) by more than five domestic corporations, but some combination of five or fewer domestic corporations control the U.S. transferor within the meaning of section 368(c), the U.S. transferor must designate the five or fewer domestic corporations that comprise the control group on Form 926, "Return by a U.S. Transferor of Property to a Foreign Corporation."

Although a regulated investment company (as defined in section 851(a)) (RIC), a real estate investment trust (as defined in section 856(a)) (REIT), and a subchapter S corporation (as defined in section 1361(a)) is each generally treated as a domestic corporation for purposes of the Code, such entities are not generally subject to corporate-level taxation. Therefore, the proposed regulations provide that these entities cannot be members of the control group.

The proposed regulations confirm that because the stock ownership threshold for the control requirement is determined by reference to section 368(c), only direct ownership of the stock of the U.S. transferor is taken into account. The IRS and Treasury Department declined to exercise the authority under section 367(a)(6) to permit indirect ownership (through a partnership or other entity) to be taken into account for this purpose, in part, because of the complexity and administrative difficulties that would arise from the basis adjustments (discussed in part A.2.b.iii of this preamble) that would be needed to account for the intervening partnership or other entity. For example, in the case of indirect ownership through a partnership, basis adjustments would need to account for differences between a partner's basis in its partnership interest and the partnership's basis in the stock of the U.S. transferor. Comments are requested regarding the manner in which indirect ownership could be taken into account for this purpose without undue complexity.

Gain recognition by U.S. transferor

Even if the exception provided by the proposed regulations applies, in two instances the U.S. transferor must recognize gain on the transfer of section 367(a) property in the section 361 exchange. This is the case even if an exception to the general rule of section 367(a)(1) would otherwise apply to such transfer.

First, the U.S. transferor must recognize gain equal to the aggregate amount of inside gain allocable to non-control group members. The inside gain is allocated among control

group members and non-control group members based on each shareholder's ownership interest (by value) in the U.S. transferor at the time of the section 361 exchange. The U.S. transferor must recognize gain with respect to non-control group members even if the entire inside gain could be preserved in the stock received by the control group members as a group.

Second, the U.S. transferor must recognize gain to the extent any control group member cannot preserve its share of inside gain in the stock received that is allocable to the section 367(a) property transferred in the section 361 exchange. The amount of a control group member's share of inside gain that cannot be preserved in the stock received is the amount by which the control group member's share of inside gain exceeds the fair market value of the stock received by the control group member that is allocable to section 367(a) property. Gain is required to be recognized in such a case because the fair market value of the stock equals the maximum amount of the control group member's share of inside gain that can be preserved in such stock (if the basis of such stock were zero). Under this rule, stock received that is allocable to property other than section 367(a) property is not available to preserve any portion of the control group member's share of inside gain. The U.S. transferor may be required to recognize gain under this rule when, for example, non-qualifying property (property other than stock or securities permitted to be received under section 361(a)) is received or when the foreign acquiring corporation assumes certain liabilities of the U.S. transferor in the section 361 exchange.

The proposed regulations provide rules for determining the portion of the stock received by a control group member that is attributable to section 367(a) property that are consistent with general tax principles, including Rev. Rul. 68-55, 1968-1 CB 140, and the authorities cited therein. Under these rules, stock received by a control group member is allocated between the aggregate section 367(a) property and all other property transferred in the section 361 exchange based on relative gross fair market value.

The U.S. transferor must recognize gain with respect to any control group member that cannot preserve its entire share of inside gain in the stock received in the transaction even if the control group members' aggregate share of inside gain can be preserved in the stock received by the control group members as a group. For example, assume that the U.S. transferor is wholly owned by two domestic corporations (US1 and US2) and that each control group member's share of inside gain is \$ 40x. If in the transaction US1 received stock with a value of \$ 30x and \$ 20x of non-qualifying property, the U.S. transferor would recognize \$ 10x gain with respect to US1, even if US2 received sufficient stock to preserve \$ 50x gain (the sum of US2's \$ 40x share of inside gain and the portion of US1's share of inside gain (\$ 10x) that cannot be preserved in the stock received by US1).

Adjustments to basis of stock received by control group members

Under the proposed regulations, each control group member's basis in the stock received in the transaction as determined under section 358 and the regulations under that section (section 358 basis) that is allocable to the section 367(a) property transferred by the U.S. transferor in the section 361 exchange is reduced to the extent necessary to preserve the

control group member's share of inside gain. As a general matter, if the U.S. transferor must recognize gain with respect to a control group member because the control group member's entire share of inside gain cannot be preserved in the stock received by the control group member in the transaction (see part A.2.b.ii of this preamble), the control group member's section 358 basis in the stock received that is attributable to section 367(a) property is reduced to zero.

Only the basis of stock received by the control group member that is attributable to section 367(a) property transferred in the section 361 exchange is reduced (for example, the basis of stock attributable to section 367(d) property is not reduced). The reduction to a control group member's section 358 basis in the stock received that is attributable to section 367(a) property equals the amount, if any, by which the control group member's share of inside gain (reduced by the amount of any gain recognized by the U.S. transferor with respect to the control group member (discussed in part A.2.b.ii of this preamble)) exceeds the built-in gain in such stock (outside gain). The outside gain is the amount by which the fair market value of such stock exceeds the section 358 basis of the stock (as determined before any required adjustment to such basis under the proposed regulations). The proposed regulations provide special rules that apply if the control group member holds more than one block of stock received in the transaction.

If the section 361 exchange is part of a divisive reorganization described in section 368(a)(1)(D) that is eligible for the exception (see part A.2.b of this preamble for additional conditions that must be satisfied in such a case), each affiliated group member that receives stock of the foreign acquiring corporation in the final section 355 distribution must reduce the section 358 basis of such stock to the same extent that the control group member that initially received the stock from the U.S. transferor would have reduced its section 358 basis in such stock. In such a case, the control group member that received the stock of the foreign acquiring corporation from the U.S. transferor is not required to reduce the section 358 basis of such stock.

A section 361 exchange that is subject to section 367(a)(5) may be part of a triangular reorganization in which the control group members receive stock of the corporation that controls the foreign acquiring corporation (the controlling corporation). In such a case, the proposed regulations require the control group members to adjust (if necessary) the section 358 basis of the stock of the controlling corporation (whether foreign or domestic) received in the transaction. The IRS and Treasury Department believe adjusting the basis of such stock to be appropriate even if the controlling corporation is domestic because the control group members' aggregate share of inside gain may not be preserved in the stock of the foreign acquiring corporation held by the controlling corporation in all cases. For example, liabilities assumed or incurred by the foreign acquiring corporation in connection with the transaction could reduce the amount of inside gain preserved in such stock. Moreover, even if the control group members' aggregate share of inside gain could be preserved in such stock, such an approach would shift the inside gain to the domestic controlling corporation, rather than to the control group members as intended by section 367(a)(5).

Agreement to recognize gain and file amended tax return

The proposed regulations require the U.S. transferor to include a statement with its U.S. income tax return for the year of the section 361 exchange certifying that if the foreign acquiring corporation disposes of a significant amount of the section 367(a) property transferred in the section 361 exchange in one or more related transactions entered into with a principal purpose of avoiding the U.S. tax that would have been imposed on a sale of such property by the U.S. transferor at the time of the section 361 exchange, then the U.S. transferor (or the foreign acquiring corporation on behalf of the U.S. transferor) shall file a U.S. income tax return (or amended U.S. income tax return, as the case may be) for the year of the section 361 exchange reporting the gain realized but not recognized on the section 361 exchange. This requirement is intended to prevent the potential use of reorganizations subject to section 367(a)(5) to avoid the repeal of the "General Utilities" doctrine. Interest must be paid (determined under section 6621) on the amount of any additional tax due on such return. For this purpose, a disposition of a significant amount of the section 367(a) property occurs if the foreign acquiring corporation disposes of an amount of the section 367(a) property transferred in the section 361 exchange that is greater than forty percent of the fair market value of the section 367(a) property at the time of the section 361 exchange. Comments are requested regarding whether an exception from this rule should be provided for dispositions of section 367(a) property occurring in the ordinary course of business.

Election and reporting requirements

To elect to apply the exception, the proposed regulations require the U.S. transferor and the control group members to enter into a written agreement to make such election on or before the due date for the U.S. transferor's timely-filed return for the taxable year in which the section 361 exchange occurs. Each party to the written agreement must also include a statement with its timely-filed return for the year of the section 361 exchange reporting the election and other specified information. If the section 361 exchange is part of a divisive reorganization described in section 368(a)(1)(D) that is eligible for the exception (see part A.2.b of this preamble for additional conditions that must be satisfied in such a case), each affiliated group member that receives stock of the foreign acquiring corporation in the final section 355 distribution must enter into the written agreement and include the reporting statement with its timely-filed return (instead of the control group member that initially received the stock of the foreign acquiring corporation from the U.S. transferor.) Relief for reasonable cause may be available for the failure to comply with the election and reporting requirements.

Special entities

The proposed regulations apply to property transfers by U.S. transferors, including RICs, REITs, and subchapter S corporations. Comments are requested regarding whether and the extent to which the IRS and Treasury Department should exercise the authority under section 367(a)(6) to provide an exception from the general rule of section 367(a)(5) for a transfer of property by a RIC, a REIT, or a subchapter S corporation to a foreign

corporation pursuant to a section 361 exchange.

Section 367(b)

Overview

Section 367(b)(1) provides that in the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes.

A fundamental policy of section 367(b) is to preserve the potential application of section 1248 following certain section 367(b) exchanges. H.R. Rep. No. 94-658, at 242 (1975). Thus, if the potential application of section 1248 cannot be preserved immediately following the acquisition of the stock or assets of a foreign acquired corporation by a foreign acquiring corporation in a section 367(b) exchange, the final regulations (TD 8862) under section 367(b) issued on January 24, 2000 (2000 final regulations) require certain shareholders of the foreign acquired corporation to include in income as a dividend the section 1248 amount attributable to the stock of the foreign acquired corporation. See section 1.367(b)-4(b). For example, the inclusion in income of the section 1248 amount is required if the section 367(b) exchange results in the loss of section 1248 shareholder status or if the foreign acquired corporation or foreign acquiring corporation is not a CFC immediately after the section 367(b) exchange. See section 1.367(b)-4(b)(1)(i).

Outbound asset reorganizations -- in general

The 2000 final regulations require a U.S. transferor that is a section 1248 shareholder of a foreign acquired corporation and that transfers the stock of such corporation to a foreign acquiring corporation in a section 361 exchange to include in income the section 1248 amount attributable to the stock of the foreign acquired corporation. The U.S. transferor must include the section 1248 amount in income even if the foreign acquiring corporation and the foreign acquired corporation are CFCs with respect to which the U.S. transferor is a section 1248 shareholder immediately after the section 361 exchange. See section 1.367(b)-4(b)(1)(iii), Example 4. Moreover, under section 1248(f)(1) the U.S. transferor generally would be required to include in income the section 1248 amount attributable to the stock of the foreign acquiring corporation distributed under section 361(c)(1). The section 1248 amount attributable to the stock of the foreign acquiring corporation would generally include the section 1248 amount attributable to the stock of the foreign acquired corporation. See generally section 1.1248-8.

The final regulations (TD 9243) under section 367(b) issued on January 26, 2006 (2006 final regulations) provided an exception to the general rule of section 1.367(b)-4(b)(1)(i) that applies in certain triangular reorganizations where the exchanging shareholder receives stock of a domestic corporation that controls the foreign acquiring corporation.

This exception only applies, however, to a shareholder that exchanges stock of the foreign acquired corporation for stock of the domestic corporation in an exchange described under section 354 or 356. Thus, the exception provided by the 2006 final regulations does not apply where the U.S. transferor receives stock of a domestic controlling corporation for stock of a foreign acquired corporation in a section 361 exchange.

After studying the issue further and in response to comments received, the IRS and Treasury Department have determined that requiring the U.S. transferor to include the section 1248 amount in income may not be necessary in cases where the section 1248 amount attributable to the stock of the foreign acquired corporation can be preserved. Accordingly, the proposed regulations under section 367(b) included in this document provide an additional exception to the general rule of the 2000 final regulations that applies to certain transfers of stock of a foreign acquired corporation by a U.S. transferor to a foreign acquiring corporation in a section 361 exchange.

In such a case, the proposed regulations provide that the U.S. transferor must include in income the section 1248 amount attributable to the stock of the foreign acquired corporation only if immediately after the section 361 exchange the foreign acquiring corporation or the foreign acquired corporation is not a CFC with respect to which the U.S. transferor is a section 1248 shareholder. Example 4 in section 1.367(b)-4(b)(1)(iii) is modified accordingly. The proposed regulations under section 1248(f) included in this document supplement this exception to ensure that the section 1248 amount can be preserved in the hands of a corporate section 1248 shareholder following the distribution of the stock of the foreign acquiring corporation by the U.S. transferor. See part C of this preamble for discussion of the proposed regulations under section 1248(f).

Special rules for outbound triangular asset reorganizations

As noted, the 2000 final regulations also require the U.S. transferor to include in income the section 1248 amount attributable to stock of a foreign acquired corporation transferred to a foreign acquiring corporation in a section 361 exchange that is part of triangular asset reorganization, even if the corporation that controls the foreign acquiring corporation is domestic. The provisions of section 1.367(b)-13 (TD 9243) do not apply to preserve the section 1248 amount attributable to the stock of the foreign acquired corporation in such a case. The proposed regulations under section 367(b) included in this document, however, would provide an exception to the general rule of the final 2000 regulations in such triangular asset reorganizations.

If the controlling corporation is foreign, the exception applies if, immediately after the section 361 exchange, the foreign controlling corporation, the foreign acquiring corporation, and the foreign acquired corporation are CFCs with respect to which the U.S. transferor is a section 1248 shareholder. If the controlling corporation is domestic, the exception applies if, immediately after the section 361 exchange, the foreign acquired corporation is a CFC with respect to which the domestic controlling corporation is a section 1248 shareholder. In addition, in either case, the controlling corporation (foreign

or domestic) must apply the principles of section 1.367(b)-13 to determine the adjustment to the basis of the stock of the foreign acquiring corporation (instead of the over-the-top basis adjustment rules of section 1.358-6) to ensure that the section 1248 amount attributable to the stock of the foreign acquired corporation at the time of the section 361 exchange is preserved in the stock of the foreign acquiring corporation immediately after the section 361 exchange. Under these principles, each share of stock of the foreign acquiring corporation would generally be divided into the portions necessary to preserve the pre-exchange section 1248 amounts attributable to the stock of the foreign acquired corporation and the foreign acquiring corporation, respectively. If the controlling corporation is foreign, the proposed regulations under section 1248(f) included in this document supplement this exception to ensure that the section 1248 amount can be preserved following the distribution of the stock of the foreign controlling corporation by the U.S. transferor to its shareholders.

Section 1248(f)

Overview

Section 1248(f)(1) provides that, except as provided in regulations, if a domestic corporation (domestic distributing corporation) that is a section 1248 shareholder with respect to a foreign corporation distributes the stock of such foreign corporation in a distribution described in section 311(a), 337, 355(c)(1), or 361(c)(1), then notwithstanding any other provisions of the Code, the domestic distributing corporation must include in income as a dividend the section 1248 amount attributable to such stock. Section 1248(f)(1) requires the inclusion of the section 1248 amount because the section 1248 amount attributable to the stock distributed may not be preserved in the hands of the distributee shareholders following the distribution. Section 1248(f)(1) does not apply to the extent the domestic distributing corporation otherwise recognizes gain on the distribution, in which case the gain recognized would be recharacterized as a dividend under section 1248(a), as appropriate.

Section 1248(f)(2), however, provides that section 1248(f)(1) shall not apply to a domestic distributing corporation's distribution of stock of a foreign corporation to a domestic corporation that is treated as holding the stock for the period during which the stock was held by the domestic distributing corporation and that, immediately after the distribution, is a section 1248 shareholder with respect to the foreign corporation. The legislative history explains that where "the corporate distribute[e] does not receive a stepped up basis as a result of the distribution and...the potential for the future application of section 1248 still exists, it is not necessary to [apply section 1248(f)(1) to] override the nonrecognition provisions which otherwise apply to a corporate distribution." S. Rep. No. 94-938, at 270 (1976).

The legislative history provides that the Treasury Department may exercise the regulatory authority granted under section 1248(f)(1) to provide that, where section 1248(f)(2) does not otherwise apply, "the recipient corporation may be required to take a carryover basis in the stock received (rather than a substituted basis under section 358, for example, in

the case of a section 355 or 361 distribution) and section 1248(f)(1) will not apply to such distribution." S. Rep. No. 100-445, at 64 (1988).

In Notice 87-64 (1987-2 CB 375), the IRS and Treasury Department announced that, in the case of section 355 distributions of CFC stock, regulations under section 1248(f) may limit the application of section 1248(f)(1) to distributions in which the CFC is no longer a CFC after the distribution or in which one or more of the distributees are not United States shareholders (within the meaning of section 951(b)) of the CFC after the distribution. The notice further states that the regulations would ensure that, subsequent to a section 355 distribution of CFC stock that would not be subject to section 1248(f)(1) under the regulations, the amount of gain recognized from a disposition of the CFC stock that would be recharacterized as a dividend under section 1248(a) would include the earnings and profits attributable to the CFC stock under section 1248 as of the date of the section 355 distribution. To achieve this result, the notice provides that the regulations may require appropriate adjustments to the basis and holding period of the CFC stock received by one or more of the distributees.

General rules

The proposed regulations under section 1248(f) included in this document provide that a domestic distributing corporation that is a section 1248 shareholder of a foreign corporation and that distributes stock of such foreign corporation in a distribution to which section 337 applies (section 337 distribution), shall generally include in income as a dividend the section 1248 amount attributable to the stock distributed.

The proposed regulations further provide that a domestic distributing corporation that is a section 1248 shareholder of a foreign corporation and that distributes stock of such foreign corporation in a section 355 distribution, other than stock received by the domestic distributing corporation in a section 361 exchange, shall generally include in income as a dividend the section 1248 amount attributable to the stock distributed. This rule applies, however, only to the extent the domestic distributing corporation does not otherwise recognize gain on the section 355 distribution, in which case the gain recognized would be recharacterized as a dividend under section 1248(a), as appropriate.

Finally, the proposed regulations provide that a domestic distributing corporation that is a section 1248 shareholder of a foreign distributed corporation and that distributes stock of such corporation received in a section 361 exchange, in a section 355 distribution or a distribution to which section 361 applies (section 361 distribution), shall, notwithstanding any other provision of the Code, include in income as a dividend the " section 1248(f) amount" attributable to the stock distributed. The section 1248(f) amount equals the aggregate amount that would be included in income as a dividend by the foreign distributed corporation under section 964(e) if, immediately after the section 361 exchange that preceded the section 355 distribution or section 361 distribution, the foreign distributed corporation sold the stock of each foreign corporation received in the section 361 exchange. This rule supplements the proposed regulations under section 367(b) which provide an exception to the general rule of section 1.367(b)-4(b)(1)(i) in

certain cases where stock of a foreign acquired corporation is transferred by a U.S. transferor in a section 361 exchange.

Exceptions to the general rules

The proposed regulations incorporate the statutory exception provided by section 1248(f)(2) for distributions that meet certain conditions. The proposed regulations also provide elective exceptions for section 355 distributions and section 361 distributions. The exceptions for such distributions are elective because applying the exceptions may reduce a corporate distributee's section 358 basis in the stock received in the distribution. The conditions of the exceptions carry out the policy of section 1248(f) by limiting the exceptions to distributions where the potential application of section 1248 and the relevant section 1248 amounts can be preserved following the distribution.

Section 337 distributions

The general rule will not apply to a section 337 distribution of the stock of a foreign corporation if immediately after the distribution the 80-percent distributee (described in section 337(c)) is a section 1248 shareholder with respect to the foreign corporation, the 80-percent distributee's holding period in the stock received in the distribution is the same as the domestic distributing corporation's holding period in such stock at the time of the distribution, and the 80-percent distributee's basis in the stock received in the distribution is not greater than the domestic distributing corporation's basis in such stock at the time of the distribution.

The IRS and Treasury Department believe the conditions should be satisfied in most section 337 distributions because of the application of sections 334 and 1223. However, comments are requested regarding any cases where these conditions may not be met and whether the 80-percent distributee should be permitted to adjust the basis or holding period of the stock received so that the conditions can be met.

Certain section 355 distributions

The proposed regulations provide an elective exception to the general rule for a section 355 distribution of stock of a foreign corporation not received by the domestic distributing corporation in a section 361 exchange to a domestic corporation that is a section 1248 shareholder with respect to the foreign corporation immediately after the distribution. The election to apply the exception is irrevocable and must be made by the domestic distributing corporation and all such section 1248 shareholders. If the election is made, adjustments may be made to each section 1248 shareholder's section 358 basis and holding period in the stock received to preserve the section 1248 amount attributable to such stock at the time of the distribution.

To apply the exception, the proposed regulations require the domestic distributing corporation and the section 1248 shareholders to enter into a written agreement on or before the due date (including extensions) of the domestic distributing corporation's tax

return for the taxable year during which the section 355 distribution occurs. The proposed regulations also require the domestic distributing corporation and each section 1248 shareholder to include a statement with its tax return for the taxable year during which the distribution occurs reporting that the election to apply the exception has been made and any required adjustments to stock basis or holding period. Each party to the agreement must retain the original or a copy of the agreement as part of its records. The proposed regulations provide relief for reasonable cause for the failure to comply with the election and reporting requirement.

If the exception applies, two adjustments may be required with respect to each section 1248 shareholder. First, solely for purposes of section 1248, immediately following the distribution the section 1248 shareholder's holding period in the stock received in the distribution shall equal the domestic distributing corporation's holding period in such stock at the time of the distribution. Second, if the section 1248 amount attributable to the stock of the foreign corporation at the time of the distribution exceeds the section 1248 shareholder's postdistribution amount attributable to such stock (excess amount), the section 1248 shareholder's section 358 basis in such stock is reduced by the excess amount. The postdistribution amount is the section 1248 shareholder's section 1248 amount attributable to the stock received in the distribution, computed immediately after the distribution and taking into account the adjustment to the shareholder's holding period in such stock.

Distributions pursuant to a plan of reorganization

The proposed regulations provide an elective exception to the general rule for a section 355 distribution or section 361 distribution of stock of a foreign corporation received by the domestic distributing corporation in the section 361 exchange that precedes such distribution to a domestic corporation that is a section 1248 shareholder with respect to the foreign corporation immediately after the distribution. The election to apply the exception is irrevocable and must be made by the domestic distributing corporation and all such section 1248 shareholders. If the exception applies, adjustments may be made to each section 1248 shareholder's section 358 basis (as adjusted under the proposed regulations under section 367(a)(5)) and the amount of earnings and profits attributable to the stock received for purposes of section 1248 to preserve the section 1248(f) amount attributable to such stock at the time of the distribution.

To apply the exception, the proposed regulations require the domestic distributing corporation and the section 1248 shareholders to enter into a written agreement on or before the due date (including extensions) of the domestic distributing corporation's tax return for the taxable year during which the distribution occurs. The proposed regulations also require the domestic distributing corporation and each section 1248 shareholder to include a statement with its tax return for the taxable year during which the distribution occurs reporting that the election to apply the exception has been made and any required adjustments to stock basis or the amount of earnings and profits attributable to the stock received for purposes of section 1248. Each party to the agreement must include the original or a copy of the agreement as part of its records. The proposed regulations

provide relief for reasonable cause for the failure to comply with the election and reporting requirements.

If the exception applies, two adjustments may be required with respect to each section 1248 shareholder. First, each share of stock of the foreign corporation received by the section 1248 shareholder is divided into portions attributable to each block of stock of a foreign acquired corporation transferred by the domestic distributing corporation in the section 361 exchange with respect to which the domestic distributing corporation was a section 1248 shareholder at the time of the section 361 exchange, and to all other property transferred by the domestic distributing corporation in the section 361 exchange. For example, if in the section 361 exchange the domestic distributing corporation transfers a block of stock in each of three foreign corporations with respect to which it is a section 1248 shareholder, then each share of stock of the foreign distributed corporation received by the section 1248 shareholder must be divided into three portions.

Alternatively, if multiple blocks of stock in each of the three foreign corporations were transferred in the section 361 exchange, then each share of the stock of the foreign distributed corporation would be divided into additional portions to account for the additional blocks of stock transferred. The proposed regulations further provide that, for purposes of section 1248, the earnings and profits attributable to each block of stock of a foreign acquired corporation transferred in the section 361 exchange that results in a divided portion of a share of stock of the foreign acquiring corporation (or whole share, if no division is required) are attributable to such portion (or whole share, if no division is required) based on the section 1248 shareholder's ownership interest (by value) in the domestic distributing corporation at the time of the section 361 exchange.

Second, if the section 1248(f) amount attributable to a portion of a share (or whole share, if no division is required) of stock of the foreign distributed corporation received in the distribution exceeds the section 1248 shareholder's postdistribution amount attributable to such portion (or whole share) (excess amount), then the section 1248 shareholder's section 358 basis in such portion (or whole share, if no division is required), as adjusted under the proposed regulations under section 367(a)(5) (discussed in part A.2.b.iii of this preamble), is reduced by such excess amount. This adjustment ensures that the section 1248 shareholder's share of the section 1248 amount attributable to the stock of each foreign acquired corporation transferred in the section 361 exchange is preserved in the stock of the foreign distributed corporation received by such shareholder in the distribution.

The IRS and Treasury Department declined to adopt rules that would not require the division of shares to preserve section 1248 amounts because such rules could inappropriately increase or decrease the section 1248 amount attributable to the stock of the foreign distributed corporation received by a section 1248 shareholder in the distribution. For example, if in the section 361 exchange the domestic distributing corporation transferred appreciated tangible property and stock of a CFC with earnings and profits for purposes of section 1248(a) in excess of the built-in gain in such stock, then the appreciation in the tangible property could inappropriately increase the section 1248 amount attributable to the stock of the foreign distributed corporation received by a

section 1248 shareholder in the distribution (to the extent the CFC's earnings and profits exceed the section 1248 amount attributable to the CFC stock at the time of the section 361 exchange). A similar inappropriate increase would result if the domestic distributing corporation transferred appreciated stock of two CFCs in the section 361 exchange, one CFC without a section 1248 amount and the other CFC with a section 1248 amount but with earnings and profits for purposes of section 1248 in excess of such section 1248 amount.

The IRS and Treasury Department also declined to adopt rules that would preserve any reduction to a section 1248 shareholder's section 358 basis in a portion of a share (or whole share, if no division is required) of stock of the foreign distributed corporation received in the distribution by increasing the basis of other portions of the share (or other whole shares, if no division is required) of stock or by establishing a suspended basis account equal to the basis reduction. Those rules were not adopted because a capital loss would be created that could economically offset the section 1248 amount, which would not be consistent with the policy underlying section 1248(f) and the regulations described in Notice 87-64. S. Rep. No. 94-938, at 270 (1976).

Comments are requested on how the rules of the proposed regulations can be simplified and how the rules should apply to different classes of stock.

Section 964(e) and inclusions under section 367(b)

Comments are requested regarding whether the IRS and Treasury Department should exercise the authority under section 367(b) to apply the principles of section 1248(f)(1) to section 355 distributions or section 361 distributions of stock of a foreign corporation by a CFC, to the extent the transaction does not otherwise result in an income inclusion to the exchanging shareholders of the CFC under section 367(b) and the regulations under that section. Comments should consider the appropriate balance between the policy of sections 1248(a) and 964(e) and the associated complexity and compliance burdens.

Changes to Exception to Coordination Rule of section 1.367(a)-3(d)(2)(vi)(A)

Overview

Section 1.367(a)-3(d)(2)(vi)(A) (the coordination rule) provides that if, in connection with an indirect stock transfer, a U.S. person transfers assets to a foreign corporation (direct asset transfer) in an exchange described in section 351 or section 361, the rules of section 367 and the regulations under that section shall first apply to the direct asset transfer and then to the indirect stock transfer. However, an exception to the coordination rule (coordination rule exception) provides that section 367(a) and (d) shall not apply to a direct asset transfer otherwise subject to the coordination rule to the extent that assets transferred by a domestic acquired corporation to a foreign acquiring corporation in an asset reorganization are re-transferred to a domestic corporation controlled by the foreign acquiring corporation (domestic controlled corporation), but only if the domestic controlled corporation's basis in the retransferred assets is not greater than the domestic

acquired corporation's basis in such assets and other conditions are satisfied. See section 1.367(a)-3(d)(2)(vi)(B)(1).

The 2006 final regulations established the conditions for the application of the coordination rule exception. The preamble to the notice of proposed rulemaking that preceded the 2006 final regulations explained that the conditions were adopted to limit the use of asset reorganizations subject to the coordination rule that might facilitate inversion transactions and certain divisive transactions. See REG-125628-01 (issued January 5, 2005).

Clarification of conditions for application of the coordination rule exception

In response to transactions intended to use the coordination rule exception inappropriately to repatriate earnings and profits of foreign corporations without the recognition of gain or a dividend inclusion, the IRS and Treasury Department issued Notice 2008-10 (2008-3 IRB 277). The notice announced that the conditions for the application of the coordination rule exception would be revised to clarify that any adjustment to basis required under section 367(a)(5) must be made to the basis of stock of the foreign acquiring corporation received by the control group members in the asset reorganization such that the appropriate amount of built-in gain in the property transferred by the domestic acquired corporation to the foreign acquiring corporation is reflected in such stock. The notice clarifies that the control group members cannot satisfy the basis adjustment requirement by adjusting the basis of stock of the foreign acquiring corporation held before the reorganization. The notice further states that the revised regulations would confirm that to the extent the appropriate amount of built-in gain in the property transferred by the domestic acquired corporation cannot be preserved in the stock received by the control group members in the reorganization, then the domestic acquired corporation's transfer of property to the foreign acquiring corporation shall be subject to section 367(a) and (d).

The proposed regulations included in this document incorporate, with modifications, the clarifications to the conditions for the application of the coordination rule exception announced in the notice. The proposed regulations also provide that to the extent any of the re-transferred assets constitutes section 367(d) property, the coordination rule exception shall apply only if the section 367(d) property is treated as section 367(a) property for purposes of satisfying the conditions and requirements of section 367(a)(5) and the regulations under that section. Thus, for example, any gain that the U.S. transferor must recognize on the direct asset transfer or any adjustment required to a control group member's section 358 basis in stock received in the transaction must take into account any inside gain attributable to section 367(d) property (treated as section 367(a) property for purposes of determining such inside gain) that is part of the re-transferred assets.

The IRS and Treasury Department continue to study transactions that have the effect of repatriating earnings and profits of foreign corporations without the recognition of gain or a dividend inclusion. Temporary regulations were recently issued (TD 9400 and TD

9402) under sections 367(b) and 956(e) to address the inappropriate use of certain cross-border triangular reorganizations and other nonrecognition transactions to repatriate earnings and profits of a foreign corporation without the recognition of gain or a dividend inclusion. The IRS and Treasury Department are evaluating other transactions that have a similar effect to determine whether guidance is appropriate. In particular, the IRS and Treasury Department are analyzing whether it is appropriate for the gain limitation rule of section 356(a)(1) to apply in an acquisitive asset reorganization involving a foreign acquiring corporation, considering that a policy of section 367(b) is "to protect against tax avoidance in transfers to foreign corporations and upon the repatriation of previously untaxed foreign earnings." H.R. Rep. No. 94-658 (1975). Comments are requested in this regard, including whether the application of any such guidance should be limited to cases where section 356(a)(2) would otherwise apply to the shareholder's receipt of non-qualifying property.

The IRS and Treasury Department also continue to study whether appropriate modifications should be made to the "all earnings and profits" inclusion requirement of section 1.367(b)-3(b) when a domestic corporation acquires the assets of a foreign corporation pursuant to an acquisitive asset reorganization under section 368(a)(1) and then transfers all or part of the acquired assets to another foreign corporation in a transaction described in section 1.368-2(k). Comments are requested in this regard, including regarding the appropriate adjustment to the domestic corporation's basis in the stock of the foreign corporation to which the acquired assets are transferred to ensure that the basis of such stock reflects an after-tax amount.

Other Proposed Regulations Under Section 367(a)

The proposed regulations under section 367(a) would revise current section 1.367(a)-1T(b)(4)(i)(B) to provide that an increase to basis for the amount of gain recognized by a U.S. person under section 367(a) in connection with a transfer of property to a foreign corporation is allocated among the transferred property with respect to which gain is recognized in proportion to the gain realized by the U.S. person on the transfer of such property. The IRS and Treasury Department believe the current temporary regulation may produce inappropriate results because it allocates the basis increase among the transferred property with respect to which gain is recognized in proportion to the amount realized by the U.S. person on the transfer of such property.

The proposed regulations also clarify that a transfer of property by a U.S. person to a foreign corporation that is subject to section 367(a) is not recharacterized for U.S. Federal tax purposes merely because the U.S. person is required to recognize gain in connection with such transfer under section 367(a). For example, if a U.S. person transfers appreciated stock of a CFC to another CFC in a section 351 exchange, the section 351 exchange is not recharacterized as other than a section 351 exchange for U.S. Federal tax purposes merely because the U.S. person recognizes gain in connection with the exchange under section 367(a).

Other Proposed Regulations Under Section 1248

The proposed regulations under section 1248(a) remove as deadwood an exception from the application of section 1248(a) for gain recognized under section 356. In addition, consistent with Notice 87-64, the proposed regulations under section 1248(e) suspend the application of section 1248(e) for periods when capital gains are taxed at a rate that equals or exceeds the rate of tax on ordinary income.

Effective/Applicability Dates

Sections 367(a)(5) and 6038B

Section 1.367(a)-7 and the revisions to section 1.6038B-1 apply to transfers occurring on or after the date that is 30 days after the date these regulations are published as final regulations in the Federal Register.

Section 1248(e)

In accordance with Notice 87-64 (1987-2 CB 375), section 1.1248-6(d) (suspending application of section 1248(e)) applies to sales, exchanges, or other dispositions of stock of a domestic corporation occurring on or after September 21, 1987.

Changes to coordination rule exception

The revisions to section 1.367(a)-3(d)(2)(vi)(B)(1) and (2) described in Notice 2008-10 (2008-3 IRB 277) generally apply to transactions occurring on or after December 28, 2007. The requirement to treat section 367(d) property as section 367(a) property for purposes of the coordination rule exception (as discussed in part D.2 of this preamble) applies to transactions occurring on or after August 19, 2008.

Sections 1248(f) and 367(b)

Section 1.1248-8(b)(2)(iv), sections 1.1248(f)-1 through 1.1248(f)-3, and the modifications to section 1.367(b)-4 apply to transfers or distributions occurring on or after the date that is 30 days after the date these regulations are published as final regulations in the Federal Register.

Adjustments under Section 367(a)(5) Before Final Regulations are Published

The general rule of section 367(a)(5) is that the exceptions to section 367(a)(1) provided by section 367(a)(2) and (a)(3) are not available for a transfer of property by a domestic corporation to a foreign corporation in a section 361 exchange, including a section 351 exchange that also qualifies as a section 361 exchange. However, until the date that is 30 days after the date these regulations are published as final regulations, taxpayers may make reasonable adjustments, as described in the legislative history to section 367(a)(5), that are consistent with the policy of section 367(a)(5) so that the exceptions provided by section 367(a)(2) and (a)(3) may apply to the transfer of property by a U.S. transferor to a

foreign corporation in a section 361 exchange.

Reasonable adjustments must include adjusting the basis of the stock received by the control group members in the transaction that is attributable to section 367(a) property so that each control group member's basis of such stock equals the lesser of (1) the control group member's section 358 basis in the stock or (2) the control group member's proportionate share of the basis of the section 367(a) property transferred by the U.S. transferor in the section 361 exchange. Adjusting the basis of stock of the foreign acquiring corporation held by a control group member before the section 361 exchange shall not be a reasonable adjustment.

In addition, the U.S. transferor must recognize gain to the extent it has shareholders that are not control group members and to the extent any built-in gain in the section 367(a) property transferred in the section 361 exchange cannot be preserved in the hands of the control group members through their ownership of stock received in the transaction in exchange for the stock or securities of the U.S. transferor. For example, the U.S. transferor may recognize gain if the control group members receive non-qualifying property in the transaction, if the foreign acquiring corporation assumes liabilities of the U.S. transferor in the section 361 exchange, or if the U.S. transferor distributes the stock received in the section 361 exchange disproportionately to its shareholders. For this purpose, the stock or other property received by the U.S. transferor in the section 361 exchange must be allocated between the section 367(a) property and all other property transferred in the section 361 exchange consistent with general tax principles, including the principles of Rev. Rul. 68-55, 1968-1 CB 140, and the authorities cited therein.

Adjustments made in accordance with the proposed regulations under section 367(a)(5) included in this document shall be considered reasonable and in accordance with the policy of section 367(a)(5).

Availability of IRS Documents

IRS notices cited in this preamble are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Effect on Other Documents

The following publications are proposed to be obsolete as of the date 30 days after the date these regulations are published as final regulations in the Federal Register:

Notice 87-64 (1987-2 CB 375).

Notice 2008-10 (2008-3 IRB 277).

F. Page 635, New Sec. 15.22b. Service's Position on Use of Outbound Section 367 Regulations for Tax Avoidance

Page 635, New Sec. 15.22b. Add after New Sec. 15.22a the following:

New Sec. 15.22b. **Service's Position on Use of Outbound Section 367 Regulations for Tax Avoidance**

Notice 2008-10

Regulations under Section 367 (a) Applicable to Certain Outbound Reorganizations and Section 351 Exchanges

2008-3 I.R.B. 277, December 28, 2007

OVERVIEW

The Internal Revenue Service (IRS) and the Treasury Department (Treasury) will issue regulations under section 367 (a) of the Internal Revenue Code (Code) to clarify how the two exceptions to the rule in §1.367 (a) -3 (d) (2) (vi) of the Income Tax Regulations (coordination rule) provided by §1.367 (a)-3 (d) (2) (vi) (B) apply to certain outbound reorganizations described in section 368 (a) and certain successive transfers to which section 351 applies. This notice is issued in response to certain transactions designed to avoid U.S. income tax. The regulations issued pursuant to this notice will apply to transactions occurring on or after December 28, 2007.

TRANSACTIONS AT ISSUE

The IRS and Treasury are aware that certain taxpayers are engaging in transactions intended to repatriate cash or other property from foreign subsidiaries without the recognition of gain or a dividend inclusion. In one such transaction, for example, USP, a domestic corporation, owns 100 percent of the stock of FA, a foreign corporation, and USP's basis in its FA stock is \$100x. USP also owns 100 percent of the stock of UST, a domestic corporation, and USP's basis in its UST stock equals its fair market value of \$100x. UST's property consists of property with zero tax basis, such as self-created intangibles or fully depreciated tangible property. UST sells its property to FA in exchange for \$100x cash and, in connection with the transaction, UST liquidates and FA transfers all of the property acquired from UST to U.S. Newco, a newly formed domestic corporation, in exchange for 100 percent of the U.S. Newco stock (the Transaction). Other variations of the Transaction may be available. For example, FA may purchase the stock of UST from USP for \$100x and, in connection with the acquisition, UST merges into a domestic limited liability company (LLC) wholly owned by FA that is disregarded as separate from FA for U.S. tax purposes. FA then contributes all of its LLC interests to U.S. Newco, a newly formed domestic corporation, in exchange for 100 percent of the U.S. Newco stock.

Taxpayers take the position that, pursuant to §1.367 (a)-3 (d) (2) (vi) (B)(1)(i), UST's transfer of property to FA is not subject to section 367 (a) or (d) because the basis adjustment requirement of section 367 (a) (5) is satisfied if USP reduces by \$100x its basis in the FA stock that it held prior to the Transaction.

BACKGROUND

Section 367 (a) (1) provides that if, in connection with an exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. Section 367 (a) (2) provides that, except to the extent provided in regulations, section 367 (a) (1) shall not apply to the transfer of stock or securities of a foreign corporation that is a party to a reorganization. Section 367 (a) (3) provides that, except to the extent provided in regulations, section 367 (a) (1) shall not apply to the transfer of property used in an active foreign trade or business. Section 367 (a) (6) grants regulatory authority to provide additional exceptions to the general rule of section 367 (a) (1).

Section 367 (a) (5) provides that in the case of an exchange described in section 361 (a) or (b) (section 361 exchange), the exceptions to section 367 (a) (1) provided under sections 367 (a) (2) and (a) (3) shall not apply. Therefore, the general rule under section 367 (a) (5) is that a transfer of property by a domestic corporation (U.S. transferor) to a foreign corporation in a section 361 exchange is subject to section 367 (a) (1). Section 367 (a) (5) also provides, however, that subject to basis adjustments and other conditions to be provided in regulations, the general rule will not apply (and the transfer may therefore be eligible for the exceptions under sections 367 (a) (2) and (a) (3)) if the U.S. transferor is controlled (within the meaning of section 368 (c)) by five or fewer domestic corporations.

Regulations have not been issued under section 367 (a) (5). However, the legislative history of section 367 (a) (5) explains how the required basis adjustments would have to be made:

It is expected that regulations will provide this relief only if the U.S. corporate shareholders in the transferor agree to take a basis in the stock they receive in a foreign corporation that is a party to the reorganization equal to the lesser of (a) the U.S. corporate shareholders' basis in such stock received pursuant to section 358, or (b) their proportionate share of the basis in the property of the transferor corporation transferred to the foreign corporation.

S. Rep. No. 100-445, 100th Cong., 2d Sess. at 62 (Aug. 3, 1988). Thus, the gain realized, but not recognized, by the U.S. transferor in connection with the section 361 exchange must be preserved in the stock received by certain corporate shareholders of the U.S. transferor in the reorganization.

The rules regarding the treatment of transfers of stock or securities to foreign corporations are contained in §1.367 (a)-3. Certain outbound reorganizations followed by transfers to controlled corporations and certain successive transfers of property to which

section 351 applies constitute "indirect stock transfers" and are subject to §1.367 (a)-3. See §1.367 (a)-3 (d) (1). Such indirect stock transfers are subject to gain recognition under section 367 (a) (1), unless they qualify for the exceptions contained in §1.367 (a)-3 (b) (for transfers of foreign stock) or -3 (c) (for transfers of domestic stock). See §1.367 (a)-3 (d) (1).

The general coordination rule of §1.367 (a)-3 (d) (2) (vi) (A) provides, in general, that if, pursuant to an indirect stock transfer, a U.S. person transfers (or is deemed to transfer) property to a foreign corporation in an exchange described in sections 351 or 361, such transfer is subject to sections 367 (a) and (d), prior to the application of the indirect stock transfer rules of §1.367 (a)-3 (d). Section 1.367 (a)-3 (d) (2) (vi) (A). This general coordination rule, however, is subject to two exceptions (Exception One and Exception Two).

Exception One is available for certain section 361 transfers of property made pursuant to a reorganization to the extent the foreign acquiring corporation transfers the acquired property (re-transferred property) to a domestic corporation controlled within the meaning of section 368 (c) (domestic controlled corporation) as part of the same transaction. However, Exception One applies only if the domestic controlled corporation's basis in the re-transferred property is no greater than the basis the U.S. transferor had in such property and either (i) the domestic acquired corporation is controlled (within the meaning of section 368 (c)) by five or fewer domestic corporate shareholders, appropriate basis adjustments as provided in section 367 (a) (5) are made to the stock of the foreign acquiring corporation, and any other conditions provided in regulations under section 367 (a) (5) are satisfied; or (ii) the indirect transfer of stock of the domestic acquired corporation satisfies the requirements of §1.367 (a)-3 (c) (1) (i), (ii), and (iv), and (c) (6), and the domestic acquired corporation attaches a statement to its tax return for the taxable year of the transfer. Section 1.367 (a)-3 (d) (2) (vi) (B) (1) (i) and (ii).

Exception Two is available for transfers described in §1.367 (a)-3 (d) (1) (vi) where a U.S. person transfers property to a foreign corporation in a section 351 exchange, to the extent that such property is transferred by such foreign corporation to a domestic corporation in another section 351 exchange, but only if the domestic transferee's basis in the property is no greater than the basis that the U.S. transferor had in such property. See §1.367 (a)-3 (d) (2) (vi) (B) (2).

REGULATIONS TO BE ISSUED UNDER SECTION 367 (a)

The IRS and Treasury will issue regulations under section 367 (a) to clarify how the two exceptions to the general coordination rule of §1.367 (a)-3 (d) (2) (vi) (A) are to be applied.

The rule of Exception One contained in §1.367 (a)-3 (d) (2) (vi) (B)(1)(i) will be modified to clarify that the basis adjustment required as provided in section 367 (a) (5) must be made to the stock of the foreign acquiring corporation received by domestic

corporate shareholders of the U.S. transferor in the reorganization such that the appropriate amount of unrecognized gain in the U.S. transferor's property is reflected in such stock. Thus, the basis adjustment requirement cannot be satisfied by adjusting the basis in stock of the foreign acquiring corporation held by such shareholders prior to the reorganization. The regulations will clarify that to the extent the appropriate amount of unrecognized gain in the U.S. transferor's property cannot be preserved in the stock of the foreign acquiring corporation received in the reorganization, then the U.S. transferor's transfer of property to the foreign acquiring corporation shall be subject to sections 367 (a) and (d).

Section 1.367 (a)-3 (d) (2) (vi) (B) (2) will be modified to clarify that Exception Two shall not apply to a section 351 transfer that is also a section 361 exchange. Thus, a section 351 transfer that is also a section 361 exchange may only qualify, if at all, for Exception One.

EFFECTIVE DATE

The regulations described in this notice will apply to transactions occurring on or after December 28, 2007. No inference is intended as to the treatment of transactions described herein under current law, and the IRS may, where appropriate, challenge such transactions under applicable provisions or judicial doctrines.

COMMENTS

The IRS and Treasury are studying other transactions and structures that have the effect of repatriating earnings of foreign corporations without the recognition of gain or a dividend inclusion. Comments are requested in this regard. Comments are also requested regarding more fundamental changes that can be made in this area, including possible changes to the coordination rule. * * *