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RECENT DEVELOPMENTS IN U.S. TAX LAW AFFECTING INTERNATIONAL TRANSACTIONS

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1. Corporate Transactions

a. ETI Repeal Saga

One of the major battles currently raging in Congress is the method by which the tax increase that will be generated by the repeal of the Foreign Sales Corporation/ Extraterritorial Income Exclusion provisions of U.S. tax law. Two competing approaches have been put forward. One is a general reduction of tax on international operations; the other is a reduction of tax on the profits of manufacturers and other persons who benefitted from the FSC/ETI tax regime. The latter provision would not be limited to exporters, and consequently is viewed to be immune from attack by the WTO/GATT.

Supporters of the first approach tend to consist of multinational companies having operations around the world. These companies would benefit from the repeal of the foreign base company rules of Subpart F, simplification of the foreign basket rule under the foreign tax credit, rationalization of the interest expense allocation rules that force interest expense to be apportioned to foreign source income even when foreign affiliates conduct their own borrowing. Supporters of the second group tend to consist of labor unions, farmers, construction and engineering companies, and the entertainment industry. Historically, these are enterprises that have operations based in the U.S. and have comprised the largest group of exporters.

No one knows what the final legislation will look like. Tax policy in the House has developed into a partisan affair and the Chairmen of the Senate and House tax writing committees appear to be rivals. Nonetheless, the matter must be resolved before the end of 2003 (perhaps with a brief extension to the first quarter of 2004) in order to avoid the imposition of sanctions by the E.U. In principle, $4 billion of retaliatory tariffs were authorized when the FSC/WTO regime was found to violate international trading rules.

b. Earning Stripping Legislative Proposals

Legislation which would tighten the earnings stripping rules of Code §163(j) has been a topic of interest for foreign based multinational groups having a U.S. presence. The effect of the proposals is a sub rosa tax increase on these groups.

Under current law, the earnings stripping legislation places limits on the benefit of the interest expense deduction when interest is paid to a foreign related person and withholding tax is eliminated or reduced or interest is paid to an unrelated person on a loan that is guaranteed or otherwise supported by a foreign related person. The interest is nondeductible to the extent that adjusted taxable income (which is essentially income computed on a cash method of accounting) is reduced by more than 50% as a result of net interest expense. The effect of the limitation is softened by (i) a safe harbor provision applicable to corporations that have a debt-equity ratio of not more than 1.5 to 1, (ii) a 3-year carryover of excess limitation, and (iii) an unlimited carryover of disallowed interest expense.

With the deluge of corporate inversions, the Treasury Department became concerned that inverted companies began to over-finance U.S. operations through the mechanism of intercompany loans and several legislative proposals contained provisions that would tighten the earnings stripping rules for inverted companies. At some point, the Treasury Department determined that virtually all U.S. members of foreign based groups were overcapitalized. Consequently, the Treasury Department has indicated that it would support a general tightening of the limitations of Code §163(j).

Over the course of the year, several proposals were put forward. Some would have reduced the safe harbor debt-equity ratio to 1.25-1 or 1.35-1 or would have eliminated it entirely. Others would have added an additional limitation based on the worldwide debt-equity of the foreign based group. Interest on loans exceeding the worldwide ratio would not be deductible and no carryforward of disallowed interest would be permitted. The Administration proposed a series of safe harbors based on typical funding patterns for certain assets. The ratio would exceed the current ratio of 1.5 -1 for liquid assets and inventory. Still, others propose to have a double ratio.

Currently, the principal proponent for revisions to the earnings stripping rules is Chairman Thomas of the House Ways & Means Committee. He has put forward a plan that calls for the following:

i. The existing 1.5 -1 debt-equity safe harbor would be repealed.

ii. The existing limitation based on 50% of adjusted taxable income would remain for interest paid to third parties on non-guaranteed debt. However, a second limitation based on 25% of adjusted taxable income would be applied to interest paid on related party debt and to debt guaranteed by a related party. The new limitation would be applied first to disallow related-party interest in excess of 25% of adjusted taxable income. Then, the 50%limitation of present law would apply. Some believe that this proposal mathematically produces a $2 reduction for every $1 of excess interest expense because related party interest expense is subject to both limitations.

iii. No carryforward of excess imitation would be allowed.

iv. Unused interest expense could be carried forward for 10 years, rather than indefinitely. No grandfather provision would exist for disallowed interest

> expense under existing law. Consequently, the 10-year carryover period would apply to existing disallowed interest.

Throughout the year, companies, coalitions, and accounting and law firms have submitted comments against all versions of the legislative proposals. Some of the comments contend that the proposal will hurt American competitiveness because it will drive foreign based groups to manufacture abroad and to sell only finished products in the U.S. These commentators must have in mind the reaction to Code §956A, which remained in the law for two years, although it was repealed retroactively. Enacted as a measure to get tough with U.S. based multinationals who were reportedly keeping large amounts of liquid assets outside the U.S., the provision had the unintended effect of encouraging U.S. based multinationals to invest in plant and equipment outside the U.S. Others comment that the earnings stripping rules violate the spirit of the bargain that is inherent in the interest article of a tax treaty. These people point out that the exemption from withholding tax on interest expense which is a key provision in an income tax treaty is surreptitiously devalued when it is accompanied by a loss of deduction for the company paying the interest. Others comment that, with the exception of inverted companies, there is no evidence that foreign based multinational groups thinly capitalize their U.S. affiliates. Finally, others have commented that the proposal is overly complex and does not work.

In the circumstances, many advisers believe that some form of legislation will be enacted. However, the scope of that legislation remains open to question. In light of the current uncertainties, few know how to make business decisions that employ capital.

c. Code §367(e)(2) Outbound Liquidations – Anti-abuse Rule

The I.R.S. adopted regulations that narrow the scope of the anti-abuse rule in Regs. §1.367(e)-2(d), to complete liquidations of domestic corporations into their foreign parent corporations so that the liquidation of a foreign corporation with a U.S. branch will not be covered. The anti-abuse rule applies where a principal purpose of the liquidation is the avoidance of U.S. tax.

Generally, a liquidating corporation does not recognize gain or loss when it distributes property to an 80%-corporate parent company. Except to the extent provided in regulations, this favorable treatment, however, does not apply when the liquidation distribution is made to a foreign parent corporation. See Code §367(e)(2). Prior regulations contained an anti-abuse rule under which the I.R.S. could require a foreign or domestic liquidating corporation to recognize gain on a liquidating distribution if a principal purpose of the liquidation was the avoidance of U.S. tax. An example of an abusive situation is a liquidation of a domestic liquidating corporation which facilitates the distribution of the domestic corporation's earnings and profits without a U.S. withholding tax. Another example is a liquidation that facilitates the inappropriate use of corporate attributes such as net operating losses.

Because the anti-abuse rule of prior regulations was not limited by its express terms to outbound liquidations, it was viewed to be overly broad in light of its intended purpose. It prevented tax-free

liquidations of foreign corporations from being undertaken even though the liquidation could have no impact on the distribution of earnings from a domestic corporation. Consequently, the regulations have been revised to provide that the anti-abuse rule applies only in the context of a domestic corporation being liquidated into a foreign parent.

d. Proposed Regulations 1.302-5 – Basis Shifting in Redemptions

In October 2002, the I.R.S. proposed regulations addressing the computation of basis in the context of redemptions treated as dividends under Code §302. That section attempts to distinguish between distributions that have capital gain characteristics because they are not made pro rata among the various shareholders and distributions characterized as dividends because no meaningful change in ownership has occurred from the transaction.

Under Code §302, a corporation's redemption of its stock is treated as a distribution in part or full payment in exchange for the stock only if the redemption satisfies one of the following criteria: (1) the redemption is not essentially equivalent to a dividend; (2) the redemption is substantially disproportionate (; (3) the redemption completely terminates the redeemed shareholder's interest; or (4) the redemption is in connection with a qualifying partial liquidation. Rules of attribution apply in determining whether any of the foregoing tests have been met. If none of the tests are met, the redemption is treated as a dividend distribution, assuming sufficient earnings and profits exist.

The foregoing rules for the treatment of redemptions apply in simple cases, where an issuing corporation acquires its own stock, and in more complicated cases where stock is acquired by corporations related to the issuer of the acquired stock. Under Code §304(a)(1), an acquisition of stock by a corporation from one or more persons that are in control of both the acquiring and issuing corporations is treated as if the property received in respect of the acquired stock were part of a distribution in redemption of the stock of the acquiring corporation. To the extent that this deemed distribution is treated as a dividend distribution, the shareholder and the acquiring corporation are treated as if the shareholder had transferred the stock of the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which Code §351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in that transaction. Under Code §304(a)(2), an acquisition of stock by a corporation controlled by the issuer of the acquired stock is treated as if the property received in respect of the acquired stock was a distribution in redemption of the stock of the issuing corporation.

Neither Code §301 nor §302 prescribe the proper tax treatment of the unutilized basis of the redeemed stock or the stock treated as redeemed, although existing regulations under Code §302 provide that proper adjustment of the basis of the remaining stock is to be made with respect to the stock redeemed. Examples in the regulations indicate that the basis of the shares of the redeeming corporation that the shareholder owns after the redemption is increased by the basis of the redeemed shares. If, after the redemption, the shareholder no longer owns any shares of stock in the corporation other than by attribution, the examples in the existing regulations indicate that the increased basis shifts to the related parties that are the actual shareholders.

The I.R.S. previously announced its concern regarding taxpayers that have entered into redemption transactions that shift basis from a person not subject to U.S. tax to a person that is subject to U.S. tax or to stock other than stock of the redeeming corporation. See Notice 2001-45 which identified these transactions as "listed transactions" for which penalties will be imposed on taxpayers and documentation obligations are imposed on promoters and advisers.

The proposed regulations provide a replacement for the proper adjustment approach of the current regulations. Instead of an adjustment to basis in other shares, the unutilized basis of the redeemed stock will not disappear. Rather, it will be taken into account for Federal income tax purposes at a future time. In addition, any tax benefit associated with the unutilized basis of redeemed stock will remain with the taxpayer that made, or succeeded to, the investment that gave rise to the unutilized basis and will not shift to the related party that is the actual shareholder. Accordingly, these regulations propose that, in any case where a redemption of stock is treated as a distribution of a dividend, an amount equal to the adjusted basis of the redeemed stock is treated as a loss recognized on the disposition of the redeemed stock on the date of the redemption.

The regulations also control the time at which the loss is taken into account. Once the facts and circumstances that cause the redemption distribution to be treated as a dividend distribution no longer exist (*viz*., the redeemed shareholder has sufficiently reduced its actual and constructive ownership interest in the redeeming corporation), the loss attributable to the unutilized basis of redeemed stock is taken into account. The proposed regulations refer to that date as the "final inclusion date."

A date may also be considered to be the final inclusion date if there is no later date on which the redeemed shareholder could take the loss into account. Under this standard, the following dates are all final inclusion dates:

i. If the redeemed shareholder is an individual, his or her date of death.

ii. If the redeemed shareholder is a corporation, the date such corporation transfers its assets in a liquidation described in Code §331.

iii. If the redeemed shareholder is a foreign corporation, the date such corporation transfers its assets to a domestic corporation in either a liquidation described in Code §332 or a reorganization to which Code §381 applies.

iv. If the redeemed shareholder is a foreign corporation that is not a controlled foreign corporation within the meaning of Code §957(a)the date such corporation transfers its assets to a controlled foreign corporation in a liquidation described in Code §332 or a reorganization to which Code §381 applies.

These proposed regulations also provide that the redeemed shareholder is permitted to take into account the loss attributable to the unutilized basis of the redeemed stock when the redeemed

shareholder recognizes a gain on stock of the redeeming corporation. The loss will be allowed to the extent of the gain recognized. Any date on which the redeemed shareholder must take into account gain recognized pursuant to Code §301(c)(3) or gain recognized on a disposition of stock of the redeeming corporation is referred to as an "accelerated loss inclusion date." Although there can be only one final inclusion date, there can be several accelerated loss inclusion dates.

Because the loss attributable to the basis of the redeemed stock is treated as recognized on a disposition of the redeemed stock on the redemption date, the tax attributes such as character (ordinary or long term capital or short term capital) and source (foreign or domestic) of the loss are fixed on the redemption date, even if the loss is not taken into account until after the redemption date. Thus, for example, if a corporation redeems its stock from a shareholder within one year after the shareholder's acquisition of such stock and the proceeds of the redemption are treated as a dividend distribution, the character of any amount of the loss that is taken into account is treated as short-term capital loss even if the loss is taken into account more than one year after the redeemed stock was purchased. Although the character is frozen on the redemption date, the loss is treated as a loss for the taxable year in which it is taken into account rather than for the taxable year of the stock redemption that gave rise to such loss.

Additional rules are provided for members of an affiliated group that join in the filing of a consolidated tax return if the loss would result in the creation or increase in an excess loss account and for transaction realized through passthrough entities. Also, for purposes of apportioning interest expense on the basis of the tax book value of assets, the adjusted basis in any remaining shares of the redeeming corporation that are owned by the redeemed shareholder or certain affiliated corporations will be increased by the amount of the unutilized basis of redeemed stock.

The proposed regulations are effective for transactions after the date of adoption of final regulations. Until then, taxpayers must take account of Notice 2001-45, mentioned above.

e. Tax Shelter Registration Regulations Tightened

The temporary and proposed regulations that have been issued under Code §§6011, 6111, and 6112 provide for disclosure, registration, and list maintenance of potentially abusive transactions. These rules are intended to bring these transactions to the attention of the I.R.S. so that they may be reviewed. In October, the I.R.S. modified the temporary and proposed regulations to address compliance issues with certain taxpayers who adopted inappropriate interpretations.

The amended temporary regulations revise the categories of transactions that must be disclosed on returns and require organizers and sellers (including material advisors) to maintain lists of persons for transactions required to be registered under Code §6111 and for reportable transactions subject to disclosure.

Regs. §1.6011-4T generally provides that certain taxpayers must disclose their direct or indirect participation in reportable transactions. Prior to the revised regulations, a partnership or an S-corporation that participated in a listed transaction was required to disclose its participation. A

reportable transaction was either(i) a listed transaction, or (ii) a transaction that met two of five characteristics, satisfied a projected tax effect test, and did not satisfy any of the exceptions provided in the regulations.

The revised temporary regulations provide more objective rules for determining whether a transaction is reportable. A transaction is reportable if it satisfies any one of six categories of transactions. The projected tax effect test and the general exceptions have been eliminated. Consequently, the six categories of reportable transactions are (i) listed transactions, (ii) confidential transactions, (iii) transactions with contractual protection, (iv) loss transactions, (v) transactions with a significant book-tax difference, and (vi) transactions involving a brief asset holding period.

A confidential transaction is a transaction that is offered under conditions of confidentiality, unless written authorization exist to disclose the structure and tax aspects of the transaction, effective without limitation of any kind from the commencement of discussions. A taxpayer's privilege to maintain the confidentiality of a communication relating to a reportable transaction, including a taxpayer's confidential communication with the taxpayer's attorney, is not itself a condition of confidentiality.

A transaction with contractual protection is a transaction for which the taxpayer been provided with contractual protection against the possibility that part or all of the intended tax consequences from the transaction will not be sustained. Examples are rescission rights, the right to a full or partial refund of fees paid to any person, fees that are contingent on the taxpayer's realization of tax benefits from the transaction, insurance protection with respect to the tax treatment of the transaction, or a tax indemnity or similar agreement other than a customary indemnity provided by a principal to the transaction that did not participate in the promotion or offering of the transaction to the taxpayer.

A loss transaction is any transaction resulting in, or that is reasonably expected to result in, a loss under Code §165 of certain specified minimum amounts. The amounts vary with the status of the taxpayer. The triggering levels are:

i. $10 million in any single taxable year or $20 million in any combination of taxable years for corporations;

ii. $5 million in any single taxable year or $10 million in any combination of taxable years for partnerships or S corporations, whether or not any losses flow through to one or more partners or shareholders;

iii. $2 million in any single taxable year or $4 million in any combination of taxable years for individuals or trusts, whether or not any losses flow through to one or more beneficiaries; and

iv. $50,000 in any single taxable year for individuals or trusts, whether or not the loss flows through from an S corporation or partnership, if the loss arises with respect to a Code §988 transaction.

In determining whether the thresholds have been met, the amount of a Code §165 loss is adjusted for any salvage value and for any insurance or other compensation received. However, losses are not reduced by offsetting gains or other income or by limitations imposed on the loss.

A Code §165 loss includes an amount deductible by virtue of a provision that treats a transaction as a sale or other disposition, or otherwise results in a deduction under Code §165. Included are a loss resulting from a sale or exchange of a partnership interest and a loss resulting from a Code §988 transaction. However, casualty losses and losses resulting from involuntary conversions are not subject to the disclosure requirements. Also, under consideration are two additional exceptions. One relates to losses from a sale of securities on an established securities market when the amount of basis underpinning the loss is equal to the amount of cash paid by the taxpayer for the securities. The other relates to losses claimed under Code §475(a) or Code §1296(a), each of which relates to marked-to-market treatment. In the case of a taxpayer that is a foreign person, only assets that are U.S. assets under the branch profits regulations and transactions that give rise to effectively connected income or to losses, expenses, or deductions allocated or apportioned thereto will be taken into account.

A transaction with a significant book-tax difference is a transaction where the treatment for Federal income tax purposes in any taxable year of any item differs, or is reasonably expected to differ, by more than $10 million on a gross basis from the treatment of the item for book purposes. When making this determination, offsetting items are not netted for either tax or book purposes. Book income is determined by applying U.S. generally accepted accounting principles for worldwide income. This category of transaction generally applies to taxpayers that are reporting companies under the Securities Exchange Act of 1934 and to business entities that have $100 million or more in gross assets. The mere fact that an item may be reported by different persons for tax and book purposes (e.g., on the taxpayer's U.S. tax return and on the entity's books and records), without more, is not considered a significant book-tax difference in such cases. Instead, the taxpayer must test such items for a book-tax difference in the same manner as items from a transaction in which the taxpayer participated directly.

A transaction involving a brief asset holding period is a transaction resulting in, or that is reasonably expected to result in, a tax credit exceeding $250,000 if the underlying asset giving rise to the credit is held by the taxpayer for less than 45 days.

The revised temporary regulations require disclosure of participation in reportable transactions by all direct and indirect participants. Disclosure must be made on Form 8886, "Reportable Transaction Disclosure Statement."

The revised regulations allow a taxpayer to request a ruling as to whether a transaction must be disclosed under Regs. §1.6011-4T. The regulations are effective from January 1, 2003.

f. Inversion Transaction Information Reporting Requirements

Temporary regulations (T.D. 9022) were published that require information reporting if the control of a domestic corporation is acquired or if the corporation has a substantial change in its capital structure. These reporting corporations must file Form 8806 with the I.R.S. as an attachment to their annual Federal income tax returns. In addition, these corporations must issue Form 1099-CAP's to their shareholders reporting the amount of cash and fair market value of property provided to the shareholders in the transaction.

There is an acquisition of control (determined under §304(c)(1)) of a domestic corporation if:

i. The stock representing control of a corporation is distributed by another corporation to its shareholders and the fair market value of the stock on the date of distribution is at least $100 million; or

ii. The stock representing control of a corporation is acquired by another corporation who previously does not have control of the target corporation and (i) the fair market value of the stock acquired is at least $100 million and (ii) the shareholders of the target corporation receive cash, stock or other property pursuant to the acquisition.

There is a substantial change in capital structure of a corporation if it has a change in capital structure and the amount of cash and the fair market value of any property (including stock) paid to the shareholders pursuant to the change in capital structure is at least $100 million. The following five types of transactions constitute a change in capital structure:

iii. Recapitalizations;

iv. Redemptions of stock (including deemed redemptions);

v. Mergers, consolidations or other combination with another corporation or transfers of all or substantially all of the assets to one or more corporations;

vi. Transfers of all or part of the corporation's assets to another corporation in a Title 11 or similar case and, in pursuance of the plan, the stock or securities of the corporation are distributed; and

vii. Changes in identity, form or place of organization.

A successor entity must satisfy the reporting obligation if the predecessor entity does not. The predecessor and the successor entities are jointly and severally liable for any applicable penalties for failure to comply with the reporting requirements.

The penalty for failure to file is governed by § 6652(l). The information returns required to be filed under these temporary regulations are treated as one return for purposes of § 6652(l) and therefore, the penalty does not exceed $500 for each day the failure continues (up to a maximum of $100,000) with respect to any acquisition of control or any substantial change in capital structure.

The temporary regulations apply to any acquisition of control and any substantial change in capital structure occurring after December 31, 2001.

g. Boca Investerings Partnership Tax Shelter Struck Down

In Boca Investerings Partnership, et. al. v. U.S., 314 F. 3rd 625 (D.C. Cir. 2003), the Court of Appeals reversed the decision of the District Court, and held that the partnership in question did not have a non-tax business purpose and should not be recognized for tax purposes.

American Home Products ("AHP") sold a subsidiary, Boyle-Midway, for a capital gain of more than $605 million in 1990. Prior to the sale, Merrill Lynch approached AHP with an investment plan which would enable AHP to claim paper losses of a comparable amount while generating only about $8 million in actual losses. Pursuant to Merrill Lynch's advice, the following steps were taken:

AHP and a subsidiary (the "AHP partners") contributed $110 million to a partnership, Boca Investerings Partnership ("Boca") for a 10% partnership ownership interest, and two Netherlands Antilles special purpose corporations, Addiscombe and Syringa contributed $990 million for 90% ownership in Boca.

i. Boca purchased $1.1 billion of private placement floating-rate notes ("PPNs").

ii. Within one month of the purchase of the PPNs, Boca sold over $1 billion of the PPNs for $880 million in cash and London Interbank Offering Rate notes ("LIBOR notes"). This sale generated transaction costs of $13 million, which was ultimately borne by AHP.

iii. AHP purchased 45% of Syringa's interest in Boca at a $2.5 million above-the-book value premium. Boca the distributed $175 million in cash to the foreign partners and nearly $220 million in LIBOR notes to the AHP partners.

iv. The AHP partners sold the LIBOR notes distributed by Boca and triggered a loss of more than $770 million, which was used to offset capital gains of AHP from the sale of Boyle-Midway and other gains from 1990 to 1993.

v. Foreign partners were bought out entirely at a premium of $2.2 million above book value.

The Circuit Court ruled that while taxpayers were free to structure their business transactions in such a way as to minimize their tax, these transactions must have a legitimate non-tax avoidance business purpose to be recognized as legitimate for tax purposes. The Circuit Court then pointed out that there was no evidence of any non-tax purpose in the use of the partnership and that AHP's participation in Boca defied common sense from an economic standpoint since it could have purchased the PPNs and the LIBOR notes directly and avoided millions in transaction costs. The only logical explanation for the partnership's formation was for AHP to generate a paper loss and to absorb the capital gains from the sale of its subsidiary. As such, Boca's partnership status was not recognized for tax purposes.

h. Ernst & Young and others Sued for Selling Listed Tax Shelter

In a law suit that demonstrates greed knows no limit, Ernst & Young, Brown & Wood, and Jenkins & Gilchrist, including named partners of each firm, are being sued by tax shelter clients who invested in a financial product designed to produce a capital loss that would offset gains recognized from the sale of a business.

According to the complaint filed in the Federal District Court for the Southern District of New York, the plaintiffs recognized substantial capital gains of about $70 million in 1999. They were approached by Ernst & Young and "lured" into investing in a scheme to produce an offsetting capital loss. The gist of the scheme involved simultaneously buying and selling offsetting long and short
currency options; transferring them and some additional assets to a partnership and then to a single purpose S-corporation; increasing the basis of the S-corporation by the amount paid for the long option, while ignoring the almost identical amount received for selling the short option; and then selling the assets of the S-corporation, and recognizing a capital loss in the amount paid for the long option. Ernst & Young arranged for the issuance of a legal opinion by Jenkins & Gilchrist. The fee charged was 4.5% of the loss, or more than $3.5 million, split two-thirds to Jenkins & Gilchrist and one-third to Ernst & Young.
The shelter transaction promoted by Ernst & Young became a listed transaction tax shelter transaction and the I.R.S. announced that losses resulting under the scheme are not allowable. In the course of an examination of Ernst & Young financial products, the I.R.S. issued administrative summonses to Ernst & Young, seeking the names of its clients who invested in this product. The names were turned over to the I.R.S.

The action has been brought under the Federal racketeering statutes and plaintiffs are seeking trebled damages and $1.0 billion in punitive damages.

i. Tax Fraud Scheme Involving Bogus Foreign Banks

In December, the U.S. government indicted two individuals, of one count each of conspiracy to defraud the Internal Revenue Service, 14 counts each of wire fraud and eight counts each of mail fraud. The two were indicted by a Federal grand jury in San Francisco in connection with their alleged marketing and sales to U.S. taxpayer investors of offshore international banks or

corporations and causing those entities to be "decontrolled." This is a process used by the investors to attempt to conceal the U.S. taxpayer investor's ownership in the offshore bank or corporation.

According to the indictment, the two individuals are charged with operating a scheme to have the stock of Nauru trading corporations licensed as international banks and other offshore corporations sold to U.S. persons who then purportedly sold the banks to straw men posing as independent foreign owners. That sale was made in exchange for a promissory note in an amount large enough to make it appear as if there was a bona fide and negotiated sale of the offshore entity. The amount of the promissory note was arbitrarily set by the defendants. There were no negotiations between the U.S. taxpayer investor and the foreign purchaser as to the sale price of the offshore entity. The defendants advised the U.S. taxpayers that they could receive back the funds they had transferred to the offshore entity through tax free loans.

j. Nauru and Ukraine Identified as Money Laundering Centers

In December 2003, the Treasury identified Nauru and Ukraine as money laundering centers. This designation subjects banking transactions involving those countries to special measures.

Section 311 of the U.S.A. Patriot Act authorizes Treasury to designate a foreign jurisdiction, financial institution, class of transactions, or type of account as being of "primary money laundering concern" and to impose one or more of five "special measures." Four of the special measures impose information-gathering and record-keeping requirements upon those U.S. financial institutions dealing either directly with the jurisdiction designated as one of primary money laundering concern, or dealing with those having direct dealings with the designated jurisdiction. Under the fifth special measure, a U.S. financial institution may be prohibited from opening or maintaining in the U.S. a
correspondent account or a payable-through account for a foreign financial institution if the account involves the designee. The Treasury advised that the first four special measures will be applied with regard to Ukraine, but that the fifth special measure will be applied to Nauru.

k. Regulations Define Foreign Personal Holding Company Income

Final regulations have been issued to provide that (i) gain or loss arising from certain commodities hedging transactions ("qualified hedging transactions") entered into on or after January 31, 2003 and (ii) currency gain or loss arising from certain interest-bearing liabilities entered into on or after January 31, 2003 do not constitute foreign personal holding company income under Regs. §1.954-2. The reasoning is that the applicable commodities hedging transactions and interest-bearing liabilities typically offset transactions that do not generate Foreign Personal Holding Company Income.

A qualified hedging transaction means a bona fide hedging transaction with respect to one or more commodities transactions reasonably necessary to the conduct of any business by a producer, processor, merchant or handler or commodities in a manner in which such business is customarily and usually conducted by others. A controlled foreign corporation that regularly uses commodities in a manufacturing, construction, utilities, or transportation business qualifies as a producer,

processor, merchant or handler or commodities; however, a controlled foreign corporation does not qualify as a producer, processor, merchant or handler or commodities if its principal business is making a market in notional principal contracts based on a commodities index.

Under Regs. §1.954-2(g)(2)(ii), foreign currency gain or loss directly related to the business needs of the controlled foreign corporation is excluded from Foreign Personal Holding Company Income. Transactions in dealer property entered into by a controlled foreign corporation that is a regular dealer in such property in its capacity as a dealer will be treated as directly related to the business needs of the controlled foreign corporation.

The new regulations provide that an interest-bearing liability incurred by a controlled foreign corporation that is denominated in (or determined by reference to) a non-functional currency will be treated as dealer property if the liability, by being denominated in such currency, reduces the controlled foreign corporation's currency risk with respect to dealer property, and the liability is identified on the controlled foreign corporation's records as a liability treated as dealer property before the close of the day on which the liability is incurred.

l. Foreign Insurance Company Effectively Connected Income

Rev. Rul. 2003-17 provides that the amount of the effectively connected income ("ECI") of a U.S. trade or business of a foreign life insurance company is determined solely under Code §864(c) and the accompanying regulations. While due regard will be given to the National Association of Insurance Commissioner's annual statement ("NAIC statement") filed with a state insurance regulatory body, the NAIC statement is not determinative of the foreign life insurance company's ECI amount. Accordingly, income on non-trusteed assets is not necessarily excluded from ECI simply because it does not appear in the NAIC statement.

m. Retroactive Q.E.F. Election Permitted

In Private Letter Ruling 200245034 (November 8, 2002), the I.R.S. granted its consent for the taxpayers to make a retroactive Qualified Electing Fund ("Q.E.F.") election for the 1987 taxable year.

The Taxpayers were calendar year, cash basis taxpayers. They purchased shares of a foreign company before 1987. They were not tax professionals and had no knowledge of the passive foreign investment company ("P.F.I.C.") regime. The Taxpayers had a qualified tax professional prepare their Federal income tax returns for all years during which they owned the stock of the foreign corporation, but the tax professional failed to identify the foreign corporation as a P.F.I.C. and did not advise the taxpayers of the consequences of making or not making the Q.E.F. election. In a later year, the tax professional determined that the foreign corporation was a P.F.I.C. while performing consulting work related to one of the holdings of the foreign corporation and also determined that no Q.E.F. election had been made.

The I.R.S. granted relief under Treas. Reg. § 1.1295-3(f) for the taxpayers to make a retroactive Q.E.F. election because all four requirements established in the regulations were satisfied:

i. The taxpayers reasonably relied on a qualified tax professional within the meaning of Regs. §1.1295-3(f)(1);

ii. The taxpayers entered into a closing agreement with the I.R.S. and paid an amount sufficient to eliminate any prejudice that would have resulted from the taxpayers' inability to file amended returns for closed taxable years. As a result, the interests of the U.S. government were not prejudiced by allowing the taxpayers to make a retroactive Q.E.F. election;

iii. The taxpayers have requested the I.R.S.'s consent before the I.R.S. raised the issue of the P.F.I.C. status of the foreign corporation on audit; and

iv. The Taxpayers submitted affidavits describing the tax professional's failure to inform the taxpayers of their need to make a Q.E.F. election and other procedural requirements have otherwise been met.

n. Dual Resident Corporation – Late Certification Permitted

In Private Letter Ruling 200321008, the taxpayer was an affiliated group that formed an entity overseas. A check-the-box election was made and the entity was disregarded for U.S. income tax purposes. The foreign entity incurred a loss.

Under Code §1503(d), the loss was a dual consolidated loss. A dual consolidated loss is a loss incurred by (i) a dual resident corporation, i.e., a domestic corporation that is subject to income tax on its worldwide income in a foreign country on a residency basis; (ii) a foreign branch of a domestic corporation; or (iii) an interest held by a domestic corporation in a partnership or trust that conducts a trade or business in a foreign country. Dual consolidated losses are given the character of a " separate return limitation year" item. As a result, those losses can offset only income of the dual resident corporation and not the income of the other members of its group. This treatment prevents losses from being deducted in two jurisdictions, especially "double dips" of interest expense.

If a dual consolidated loss exists, a taxpayer may claim elective relief by agreeing that the loss will not be made available to another foreign person. It does this by filing an election with a timely filed tax return for the taxable year in which the dual consolidated loss arises. See Regs. §1.1503-2(g). Certain stringent conditions are imposed to ensure that the losses cannot be used outside the U.S. by foreign persons affiliated to the dual resident corporation.

In the ruling, the taxpayer's accounting firm never advised the company of the need to elect relief and to annually certify that the losses of the dual resident have not been made available to a foreign entity. The taxpayer requested Section 9100 relief to make a late election. Under Regs. §301.9100-1(c),the I.R.S. has discretion to grant a taxpayer a reasonable extension of time to make a regulatory election.

The I.R.S. determined that the taxpayer acted reasonably and in good faith, and that a late election under the dual consolidated loss regulations would not prejudice the interests of the Government. The relief was granted.

Similar relief was granted in Private Letter Ruling 200320012. There, the director of taxes of the affiliated group determined that losses of two overseas affiliates were not dual consolidated losses under a misreading of an exception to the definition. At a later point, the group hired an international tax manager who determined that the losses were dual consolidated losses and that relief should have been sought under Regs. §1.1503-2(g). The taxpayer requested Section 9100 relief to file a late election and the relief was granted.

Relief was also granted in Private Letter Ruling 200318068, where the I.R.S. merely noted that relief was requested voluntarily and was unrelated to any tax examination.

o. Municipal Bond Interest Taxable Under Subpart F

In I.L.M. 200305016, the I.R.S. concluded that interest income of a C.F.C. arising from otherwise tax exempt municipal bonds is Foreign Personal Holding Company Income that is taxable under Subpart F.

Prior to 1987, U.S. municipal bond interest income described in section 103(a) did not constitute foreign base company income. See Rev. Rul. 72-527, 1972-2 C.B. 456. Then, in temporary regulations, the I.R.S. acknowledged an alternative minimum tax benefit could be achieved if an investment in tax-free municipal bonds were channeled through a C.F.C. Those regulations reserved on the treatment of municipal bond interest. In final regulations issued in 1996, the I.R.S. treated municipal bond interest income as Foreign Personal Holding Company Income for the first time. According to the I.R.S., the change in policy was made for simplicity. The I.R.S. wanted one rule that would apply under Subpart F and in the computation of earnings and profits. Because earnings and profits are increased when a corporation receives municipal bond interest, the I.R.S. reasoned that Foreign Personal Holding Company Income could be increased as well. The earnings give rise to taxable dividend income to shareholders and the I.R.S. could no longer see a reason to have one rule for dividends and a second rule for Subpart F inclusions.

p. LILO Transactions

In Rev. Rul. 2002-69, the I.R.S. attacked rental deductions claimed by investors in Lease-In/Lease-Lease-Out transactions. These are lease transactions in which foreign municipalities enter into offsetting transaction involving municipal facilities. The goal is to provide financing to the municipalities and accelerated tax deductions for the investor group.

In the ruling, the foreign municipality entered into a long-term lease transaction (the "Headlease") with a special purposes entity ("SPE") and immediately leased the facility back from the entity (the "Sublease"). The term of the Headlease is 40 years and the primary term of the Sublease is 20 years. However, the Sublease may be renewed for a term of 10 years at the option of the special purpose

entity. The Headlease calls for two rental payments during its 40-year term: an $89 million prepayment at the beginning of the first year and a postpayment at the end of the 40th year. The postpayment had a discounted present value of $8 million. The parties allocated the prepayment ratably to the first six years of the Headlease and the future value of the postpayment ratably to the remaining 34 years of the Headlease.

The Sublease calls for the municipality to make fixed, annual rental payments over both the primary term and, if exercised, the renewal term. The fixed, annual payments during the put renewal term are equal to 90% of the amounts projected to be the fair market value rental amounts for that term.

To partially fund the $89 million Headlease prepayment, SPE borrowed $54 million from one bank and $6 million from a second bank. Both loans were nonrecourse, had fixed interest rates, and provided for annual debt service payments that would fully amortize the loans over the 20-year primary term of the Sublease. The amount and timing of the debt service payments mirrored the amount and timing of the Sublease payments during the primary term of the Sublease. The remaining $29 million prepayment was separately funded by SPE.

The municipality deposited $54 million into a deposit account with an affiliate of the bank making the $54 million loan to SPE and $6 million into a deposit account with an affiliate of the bank making the $6 million loan to SPE. The deposits earned interest at the same rate as the loans to SPE. The municipality directed the affiliate banks to pay the creditor banks directly; for accounting purposes, however, the parties treated the fund flow as going to the municipality, to SPE, and then to the creditor banks.

The municipality pledged the deposit account to SPE as security for its obligations under the Sublease. In turn, SPE assigned its right under the pledge to the creditor banks as security for their loans.

At the end of the Sublease primary term, the municipality had a fixed-payment option to purchase the residual value in the Headlease for a fixed exercise price equal to 105% of the projected fair market value of the Headlease residual. If municipality exercises the option, the LILO transaction would be terminated and SPE would receive the exercise price of the option. In addition, SPE would not be required to make any portion of the postpayment due under the Headlease. However, if the municipality does not exercise the option, SPE had three potential courses of action. It could elect to use the property itself for the remaining term of the Headlease, or it could lease the property to another person for the remaining term of the Headlease, or it could compel the municipality to lease the property for the 10-year put renewal term of the Sublease. If SPE exercises the third option and forces the municipality to lease the property, it will receive rents equal to 90% of the projected fair market rents for that term. If the actual fair market rents turn out to be less than the amount specified in the put renewal option, the municipality will be forced to lease the property for rents that are greater than the then fair market rental value.

Looked on as a whole, the foregoing transactions effected the following: (i) SPE, as sublessor, had an obligation to make the municipal facilities available to the municipality during the term of the Sublease; (ii) SPE's obligation was entirely offset by SPE's right to use the facilities under the Headlease granted by the municipality; (iii) SPE's obligation to make debt service payments on its borrowings were completely offset by its right to receive Sublease rentals from the municipality; (iv) SPE's exposure to the credit risk that of the municipality, that it will not make the rent payments, was limited by the repayment funding arrangements between the affiliated banks and the creditor banks;(v) Neither bank required an independent source of funds to make the loans; and (vi) Neither bank bore a significant risk of nonpayment. Comparable offsetting provisions existed with regard to the renewal period.

SPE claimed deductions for interest on the loans and for the allocated rents on the Headlease. It included in gross income the rents received on the Sublease. In the event the fixed-payment option is exercised, SPE would include the option price and the recaptures rent deductions taken during the primary Sublease term that are attributable to the postpayment it would no longer be required to make. The transaction was structured to comply with I.R.S. regulations in effect prior to 1999 so that the foregoing result were not inconsistent with the regulations. Consequently, the issue presented in the ruling was whether the LILO arrangement had sufficient substance to justify the anticipated tax treatment. The ruling concludes that the arrangement on paper did not have sufficient economic substance to allow the anticipated rental and interest expense deductions.

The I.R.S. viewed the offsetting positions in the arrangement as problematic for the anticipated tax benefits. Citing cases such as Rogers v. U.S., 281 F.3d 1108 (10th Cir. 2002), and Bussing v. Commr., 88 T.C. 449, reconsideration denied, 89 T.C. 1050 (1987), the ruling concludes that courts have collapsed transactions involving offsetting obligations and recharacterized the two transactions as a single transaction. These cases involve loans and options collapsed into a sale and loans and lease payments. In the LILO transaction, the municipality retains the right to possession of the underlying facilities as part of the same transaction in which it purports to transfer the right to possess. Its Sublease rent payments, which entitle it to occupancy, are funded with the cash received in the Headlease prepayment. During the first 20 years of its term, the Headlease confers to SPE a right to use the property that is immediately reversed by the Sublease grant to the municipality of substantially the same right to use property. In the LILO transaction, the Sublease interest retained by the municipality is of the same nature as the Headlease interest conveyed to SPE. Once the transfer and retransfer of the right to possess the property for the first 20 years are disregarded as offsetting obligations, the transaction that remains is, at best, a transfer of funds from SPE to the municipality in exchange for the municipality's obligation to repay those funds and provide SPE with the right to begin to lease the property in 20 years. Because SPE does not acquire a current leasehold interest in the property, it is not entitled to current deductions for rent. The $29 million "equity" portion of the Headlease prepayment is a payment to obtain the right to lease the property beginning 20 years in the future for a term of 20 years. Consequently, the equity portion of the Headlease prepayment is deductible over the 20-year residual term of the Headlease . In the event the municipality exercises its fixed-price option at the end of the primary term of the Sublease, SPE will have gain or loss equal to the difference between the option price and the cost of acquiring a right to the Headlease residual term.

During the week of October 20, 2003, the I.R.S. reportedly held settlement discussions with taxpayers' representatives affected by the LILO position of the I.R.S. It is understood that little progress was made as neither side offered significant concessions. In part, the lack of movement resulted from a coordinated issues paper released by the I.R.S. on October 17, 2003. A coordinated issue paper advises field examiners on the treatment of certain identified issues. The paper extends the position enunciated in Rev. Rul. 2002-69 by suggesting that the 1999 regulations requiring a spread of the deduction for rental expense over the balance of the lease can apply to pre-1999 transactions. The paper also advises that interest expense deductions are not allowed in the LILO because no loan exists in the disregarded portion of the transaction and that transaction costs cannot be amortized.

2. Individuals

a. Contribution Does Not Reduce Taxable Estate of Canadian

In Estate of Silver v. Commr., 120 T.C. 430 (2003), the Tax Court disallowed an estate tax deduction for a charitable gift bequeathed to a Canadian charity. The gift was not required to be paid from assets located in the U.S.

The decedent was a citizen and resident of Canada, not the U.S. At the time of death, the decedent owned property in the U.S. that was subject to U.S. estate tax. His will provided for charitable bequests to Canadian-registered charities. Under the Canada-U.S. Income Tax Treaty, deductions are allowed for bequests to those institutions. However, the bequests were paid solely out of funds and located outside the United States. Under U.S. domestic law, the taxable estate of a nonresident, non-citizen can be reduced by charitable gifts, but only if the recipient is a U.S. charity. Moreover, the deduction cannot exceed the value of the transferred property included in the U.S. gross estate, *viz*., U.S. situs property. The estate reduced the gross estate by the full amount given to Canadian charities to the extent that amount did not exceed the value of the U.S. gross estate. The I.R.S. disallowed the deduction on the basis that there was no direction in the will to satisfy the gift from U.S. assets; therefore, the gross estate is reduced only by a proportional amount of the gift. Because less than one percent of the estate was located in the U.S., less than one percent of the gift reduces the U.S. estate.

The Tax Court agreed with the I.R.S. According to the Court, the terms of the treaty and the provision of U.S. tax law should be interpreted to the greatest extent possible to be consistent with each other. While the treaty expanded the definition of a charitable organization to include Canadian entities, it did not modify U.S. estate tax law in any other manner. Under U.S. domestic law, the gross estate of a decedent who is neither a U.S. citizen nor a U.S. resident may be reduced by expenses and charitable gifts, but only on a proportional basis that compares the U.S. gross estate with the worldwide gross estate. The Court was not prepared to accept the view that the treaty modified this provision of U.S. estate tax law.

b. Offshore Insurance/Investment Company Attacked

In Notice 2003-34, the I.R.S. questioned the economic substance of an insurance product designed to allow U.S. persons to defer tax on investment gains and to convert ordinary income into capital gain.

The typical arrangement involves a U.S. person who invests in the equity of a foreign corporation. The corporation is organized as an insurance company and complies with the applicable local laws regulating insurance companies. It issues insurance or annuity contracts or contracts to reinsure risks underwritten by insurance companies. Some of the contracts do not cover insurance risks. Other contracts significantly limit the risks assumed through the use of retrospective rating arrangements, unrealistically low policy limits, finite risk transactions, or other similar devices. The insurance activities are relatively small compared to its investment activities, which typically involve hedge funds or investments in which hedge funds typically invest. That portfolio generates investment returns that substantially exceed the needs of the insurance business. All investment profits are retained and reinvested.

For reporting purposes, the U.S. person treats the foreign corporation as an insurance company engaged in the active conduct of an insurance business and not a passive foreign investment company. When the company is sold, the gain as a capital gain, rather than as ordinary income.

Acknowledging that insurance companies generate large amounts of investment income, the I.R.S. warned that it will question these arrangements in appropriate circumstances if the foreign corporation is not an insurance company within the general meaning of U.S. tax law.

Insurance involves both risk shifting and risk distribution. Risk shifting occurs if a person facing the possibility of an economic loss resulting from the occurrence of an insurance risk transfers some or all of the financial consequences of the potential loss to the insurer. The effect of such a transfer is that a loss by the insured will not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the law of large numbers to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim.

Whether a corporation qualifies as an insurance company for income tax purposes depends on its actual activities during the year. To qualify as an insurance company, a corporation must use its capital and efforts primarily in earning income from the issuance of contracts of insurance. The I.R.S. cautioned that if the foreign corporation were not an insurance company under the foregoing standard, it would likely be a passive foreign investment corporation and excess distributions (including gains) would be subject to the P.F.I.C. tax regime of the Code.

c. Bank Interest Reporting Proposals

In the last days of the Clinton Administration, proposed regulations were issued requiring U.S. banks to collect information on depositors and interest payments and to report the information to the I.R.S. with the intent that the information would be transferred automatically to tax authorities in foreign countries. Under existing regulations, reporting of U.S. bank deposit interest is required only if the

interest is paid to a U.S. person or a resident of Canada. The regulations were controversial and were withdrawn in August 2002, replaced by a modified reporting proposal. Under the modification, reporting would be required only for nonresident alien individuals that are residents of certain designated countries with whom the I.R.S. has working exchange of information programs in place. These countries include Australia, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, and the U.K. A bank would have an option to report bank deposit interest paid to all nonresident individuals or to any nonresident alien who is a resident of a country other than the listed countries.

The proposals remain controversial. The following comments are typical of those submitted to the I.R.S.:

i. The proposal as exceeding statutory authority because the I.R.S. does not have general authority to collect information about income that is not subject to tax and no specific authority was granted by Congress.

ii. The proposal would negate anticipated capital inflows from Europe once the E.U. savings directive is implemented.

iii. The reporting requirements are contrary to well-established U.S. policy of encouraging foreign individuals to place deposits with U.S. banks, thereby providing additional liquidity to the U.S. banking system.

iv. The proposal would destroy the expectation of confidentiality that U.S. banks enjoy among foreign clientele.

In May 2003, a group of 24 members of the House wrote Treasury Secretary Snow requesting that the proposal be withdrawn permanently. According to the members the proposal has been opposed at several levels. The Federal Deposit Insurance Corporation is worried it could undermine the safety and soundness of our banking system. Taxpayer groups and think tanks fear it will undermine tax reform. The financial services industry does not want a costly regulatory burden that will make them less competitive. The Small Business Administration is concerned that important regulatory procedures have been ignored. Most importantly, the proposal will hurt our economy. When first proposed at the end of the Clinton Administration, foreigners responded in the first quarter of 2001 by withdrawing more than $ 40 billion (on an annualized basis) from U.S. savings accounts.

d. American Samoan Source Income is Exempt From U.S. Tax

In Francisco v. Commr. 119 T.C. 317 (2002), the I.R.S. held that American Samoan source income qualifies for exemption under Code §931 even though implementing regulations have never been adopted by the I.R.S.

In the case, the taxpayer, a U.S. citizen, was a resident of American Samoa. The taxpayer was a fisherman, based in American Samoa, but spending most of his time in international waters. The

taxpayer filed a U.S. tax return claiming exemption for the fishing income. The claim was disallowed by the I.R.S. Code §931 authorizes the I.R.S. to issue regulations under which U.S. citizens would be exempt from U.S. tax. Because no regulations were ever issued, the I.R.S. asserted a deficiency.

The Tax Court allowed the taxpayer to claim the benefit of the exclusion. To do otherwise would violate the Congressional policy expressed in Code §931. However, the Court concluded that the source of income from the performance of services in international waters is U.S. source income if the service provider is a U.S. person. Since most of the taxpayer's time was spent in international waters, most of his income was taxable. Only a pro rata portion of his fishing income qualified for the exemption.

e. Treas. Reg. § 1.1441-6 Withholding Regulations

The I.R.S. published final regulations (T.D. 9023) which, among other things, provide rules for withholding agents to obtain an individual taxpayer identification number ("I.T.I.N.") on an expedited basis for foreign individuals who are claiming reduced rates of withholding under an income tax treaty when they receive an unexpected payment from the withholding agent and do not possess the required I.T.I.N.'s.

A withholding agent generally cannot rely on a beneficial owner withholding certificate if such certificate does not include the beneficial owner's I.T.I.N.. However, the final regulations provide that if certain requirements are met and the unexpected payment could not reasonably be delayed, the withholding agent may make such a payment to a foreign payee if the withholding agent submits a Form W-7 (Application for I.R.S. Individual Taxpayer Identification Number) on behalf of the foreign payee during the first business day following the payment.

An unexpected payment is defined as a payment that, because of the nature of the payment or the circumstances in which it is made, could not reasonably have been anticipated by the paying withholding agent or beneficial owner during a time when the paying withholding agent or the beneficial owner could obtain an I.T.I.N. from the I.R.S.

The new regulations for unexpected payments apply to payments made after December 31,2001.

f. Joint Committee Report on Expatriation

In February 2003, the Joint Committee Staff released a study on the workings of the alternative tax imposed on persons who relinquish citizenship or long term residence where tax avoidance is a principal purpose of that action. The following is a synopsis of the conclusions in the report:

i. There is little or no enforcement of the special tax and immigration rules applicable to tax-motivated citizenship relinquishment and residency termination. According to the G.A.O., the I.R.S. did not, as of the year 2000, have a systematic compliance effort in place to enforce the present-law

alternative tax regime. Since that time the I.R.S. generally has ceased all compliance efforts directly relating to the income, estate, and gift tax obligations of former citizens and former long-term residents under the alternative tax regime, other than compiling a Certificate of Loss of Nationality ("CLN") database for such individuals and publishing their names in the Federal Register as required by section 6039G. In addition, the INS and the Department of State have not denied reentry into the United States to a single former citizen under the 1996 special immigration rule. Although the INS has begun drafting guidelines to implement the immigration provision, it is unclear whether the guidelines will have any significant effect on enforcement.

ii. A key reason for inadequate enforcement of the alternative tax regime is the inability to obtain necessary information from individuals: (1) at the time of citizenship relinquishment or residency termination; and (2) during the 10-year period following citizenship relinquishment or residency termination, for those individuals who are subject to the alternative tax regime. These enforcement difficulties begin at the time individuals notify the Department of State of their intent to relinquish citizenship.

iii. For the period 1995 through 1999, only one-third of individuals, relinquishing citizenship provided information statements that contained a social security number. For 2000 and 2001, there was significant improvement in the number of information statements provided by individuals relinquishing citizenship, but it is not clear how many of these statements were fully completed and included social security numbers. Without a social security number, the I.R.S. cannot attempt to match the former citizen or former long-term resident to other I.R.S. databases without a labor-intensive manual search.

iv. For the period 1995 through 1999, 182 former citizens identified themselves as exceeding the thresholds provided under the alternative tax regime for being treated as having relinquished their citizenship for tax avoidance purposes. For 2000 and 2001, 76 former citizens who provided information statements identified themselves as meeting one or more of the monetary thresholds or included a social security number. Except for these individuals, the I.R.S. does not appear to have sufficient information (e.g., social security numbers) for these periods to identify other individuals who might be subject to the alternative tax regime. Furthermore, with respect to those individuals who have been identified, the I.R.S. currently makes no attempt to monitor and enforce the 10-year income tax return filing requirement for those individuals subject to the alternative tax regime.

v. Enforcement of the immigration provision also is hindered by several factors, specifically lack of access by the Attorney General to the I.R.S. records to identify former citizens who renounce citizenship for tax reasons, lack of access by the I.R.S. to INS databases, differing interpretations between the INS and the Department of State as to what it means to officially renounce U.S. citizenship, and the lack of coordination between the tax rules and the immigration rules relating to individuals who relinquish citizenship or terminate their residency.

vi. In light of the apparent difficulties in the enforcement of the provisions of current law, the Joint Committee Staff recommended the adoption of objective rules to replace the subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination under present law. A former citizen or former long-term resident would be subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident establishes that his or her average annual net income tax liability for the five preceding years does not exceed $122,000 (adjusted for inflation) and his or her net worth does not exceed $2 million, or alternatively satisfies limited exceptions for dual citizens and minors who have had no substantial contact with the United States. The exception would apply only if an individual certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the five preceding years and provides such evidence of compliance.

vii. The alternative tax regime would not apply to a former citizen who is a dual citizen or a minor with no substantial contacts with the United States prior to relinquishing citizenship.

viii. An individual should continue to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes until (a) notification of an expatriating act or termination of residency is provided to the Department of State or the INS, and (b) a complete and accurate I.R.S. Form 8854 (i.e., a tax information statement) is filed. In addition, the Department of State (including U.S. consular offices) should be required to provide a uniform tax information statement (i.e., I.R.S. Form 8854) to all individuals who relinquish citizenship.

ix. A former citizen or former long-term resident who is subject to the alternative tax regime and who is present in the United States for more than 30 days in any calendar year during the 10-year period following citizenship relinquishment or residency termination should be treated as a U.S. resident for U.S. Federal tax purposes for that calendar year.

x. Gifts of certain closely held stock of a foreign corporation by an individual subject to the alternative tax regime be subject to U.S. gift tax to the extent that the foreign corporation holds U.S. situated assets.

xi. Former citizens and former long-term residents who are subject to the alternative tax regime would be required to file an annual return that provides, among other things, information on the permanent home of the individual, the individual's country of residency, the number of days the individual was present in the United States, and detailed information about the individual's income and assets. The annual return would be required even if no U.S. tax is due. This recommendation would enable the I.R.S. to monitor more effectively both the income generated by assets as well as any dispositions of assets that may be subject to U.S. tax.

xii. The INS databases would be made accessible to the I.R.S. and other appropriate Federal agencies for purposes of administering the special immigration provision relating to tax avoidance. These databases also should be modified to include social security numbers, if available, among other modifications. This recommendation would facilitate the interagency cooperation needed to enforce the special immigration provision. Similar information sharing would be allowed for information maintained by the I.R.S.

g. Proposals to Modify Expatriation Rules

In May, the Senate approved legislation to discourage expatriation. The proposal is based on the Canadian model. Although the provision was deleted from H.R. 2, the Jobs and Growth Tax Relief Reconciliation Act of 2003, the prevision has been approved several times by the Senate. If enacted, the legislation will be retroactively effective from February 5, 2003.

Under the general rule of the proposal, all property of a covered expatriate is treated as sold for fair market value on the day before the expatriation date. With exception of wash sale rules, the loss is taken into account for the taxable year of the sale, as provided by tax law. Gain taken into account is reduced by $600,000. This amount will be adjusted for inflation, rounded down to nearest $1,000.

The gain arising from the deemed sale is taken into account for the taxable year of expatriation. A tentative tax is imposed on the day prior to expatriation. The tentative tax is based on rules for short taxable years. The due date for paying the tax is the 90th day after the date of expatriation.

Two methods are provided for a taxpayer to elect to defer the hypothetical gain. Under the first election, an expatriate continues to be subject to U.S. income tax with regard to his property in the same manner as a U.S. citizen. Thus, the amount of gain that is taxable will vary with fluctuations in the value of the property. The election applies to all property and is irrevocable. Continued U.S.

tax jurisdiction applies to property acquired after expatriation if the property has a substituted basis and the transferred property was owned at the time of expatriation. To make the election, the expatriate must provide security for payment of tax and must consent to the waiver of any right that may exist under any treaty that would preclude imposition of tax. In addition, the expatriate must comply with such other requirements as may be prescribed by the I.R.S.

Under the second election, the gain is determined as of the date of expatriation, but payment is deferred. This election is made on an item-by-item basis. In comparison to the first election, the gain is quantified immediately. The tax is payable on the due date of the return for the taxable year in which such property is actually disposed of. If the property is disposed of in a transaction in which gain is not recognized, the tax becomes due on the date prescribed by the I.R.S. The additional tax attributable to any property is determined on a pro rata basis. The multiplicand is the total additional tax imposed by the expatriation provisions. The multiplier is a ratio in which the numerator is the gain taken into account with respect to a particular item of property and the denominator is the total gain taken into account under the expatriation provisions. To make the election, adequate security must be provided in the form of a bond in the face amount of the additional tax and the expatriate must waive of any right that may exist under any treaty that would preclude imposition of tax. Interest is due on the deferred tax, computed at the short-term A.F.R. rate plus 5 points. The deferral is terminated at the date of death of the expatriate or the date on which security no longer confirms and is not corrected within a specified period.

If any tax is deferred, the U.S. has a lien on all property of the expatriate that is located within the U.S. The lien equals the tax, penalties, interest, and collection costs. The property may be after-acquired property. The lien lasts until the liability is satisfied become unenforceable by reason of lapse of time.

Exceptions are provided to coverage under the Senate proposal. An individual is not covered by the proposed mark-to-market regime if (i) he or she was a dual citizen (U.S. and another country) at birth and continues to be a citizen and a tax resident of the other country as of the date of expatriation or citizenship is renounced before reaching the age of 18 ½ years and (ii) the expatriate has not been a resident of the U.S. under the substantial presence test during the five taxable years ending with the year of expatriation.

The mark-to-market rule applies when an individual holds an interest in a trust, other than "a qualified trust," on the day before the expatriation date. The trust interest is treated as a separate share. The separate share is treated as a separate trust consisting of the assets allocable to the share. The separate trust is treated as having sold its assets for fair market value on the day before the expatriation date, distributed all of its assets to the individual, received a contribution of the assets from the individual. On the other hand, if the expatriate has an interest in a qualified trust, a withholding tax is imposed on each distribution. A "qualified trust" is a "domestic trust" as defined in Code §7701(a)(30)(E). The withholding tax is capped at the level of the deferred tax account ("D.T.A."), which is the tax that would be due if assets allocable to the expatriate's vested and unvested interests were sold and the gain allocated to the expatriate. The D.T.A. is increased by an

interest factor and decreased by previously imposed taxes on distributions from vested and unvested interests.

A beneficiary's interest in a trust is based upon all relevant facts and circumstances. These include: (i) the terms of the trust instrument, (ii) the terms of any letter of wishes or similar document, (iii) historical patterns of trust distributions, and (iv) the existence of and functions performed by a trust protector or any similar adviser. If a beneficiary of a trust is a corporation, partnership, trust, or estate, the shareholders, partners, or beneficiaries are deemed to be the trust beneficiaries.
In order to enforce the tax liability where a trust is involved, a back-up tax is imposed on the trust. The back-up tax applies in several circumstances. Examples are: (i) the expatriate is a resident of a tax-treaty jurisdiction, the treaty prevents imposition of tax on the expatriate and the expatriate fails to waive treaty benefits, (ii) the trust ceases to be a qualified trust, (iii) the covered expatriate disposes of an interest in a qualified trust, or (iv) a covered expatriate dies. If the back-up tax is applicable, the trustees are personally liable. In addition, other beneficiaries are given right to recover tax from the expatriate.

Other rules apply to pension trusts. The current value of a nonforfeitable, vested interest in a pension plan is deemed distributed on the date of expatriation. Once actual distributions exceed the current value, the excess is taxed.

U.S. Real Property Interests are excluded, except for shares of a U.S. Real Property Holding Corporation that fails to hold sufficient U.S. real property on the date before expatriation.

If the mark-to-market rules apply, restrictions are placed on the provisions of U.S. tax law that allow recipients of gifts to avoid paying income tax on the gift. The exclusion from gross income provided by Code §102 will not apply to the value of any property acquired by gift, bequest, devise, or inheritance from a covered expatriate after the expatriation date. An exception is provided for gifts or bequests of property that has its situs in the U.S., is subject to gift and estate tax, and a gift or estate tax return has been timely filed.

As under current law, an expatriate is a U.S. citizen who relinquishes citizenship. It also includes a long–term resident of the U.S. who ceases to be a lawful permanent resident or commences to be treated as a resident of a foreign country under the provisions of a tax treaty of the U.S. and who does not waive the benefits of that treaty. Any expatriate who is not in compliance with expatriation revenue provisions is not eligible for a visa or for admission to the U.S. Communication between the I.R.S. and the I..N.S. is authorized to implement visa restriction.

The House of Representatives is considering its own revisions to the expatriation rules. In broad terms, the House proposal retains the existing rules but adds a provision aimed at expatriates who spend more than 30 days in the U.S. Under the provision:

i. These individuals will be treated as residents for income tax purposes. Consequently, they will be taxed on worldwide income and provisions such as Subpart F will apply. (This treatment could adversely affect other U.S.

persons who invest in foreign entities with an expatriate spending 30 days or more in the U.S.)

ii. The worldwide assets of these individuals will be subject to estate tax in the event of death during a year in which more than 30 days are spent in the U.S.

iii. U.S. gift and estate tax will be imposed on transfers of shares of stock of closely held corporations that own U.S. situs assets.

h. Retroactive Tax Reduction Bill

Culminating a process that began with the mid-term elections, the President signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 on May 28, 2003. The legislation provides $350 billion of tax relief and $20 billion of aid to state governments.

The following are the major provisions of the Act

i. The Act reduces the top bracket for individuals to 35% and decreases the interim brackets. Under prior law, these revisions were scheduled to be implemented over several years. The Act accelerates the effective date of the lower rates to January 1, 2003. Under pre-Act law, the maximum rate of tax was 38.6% and the brackets were 10% (for income up to $12,000), 15% (income up to $47,450), 27% (income up to $114,650), 30% (for income up to $174,700), 35% (for income up to $311,950), and 38.6% thereafter. The Act also increases the amount of income subject to the 10% rate. The Act reduces the top bracket by 3.6 points and makes 2 point reductions to the 27%, 30%, and 35%. The rate reductions are effective at the beginning of 2003. No change is made to the rate in the 15% bracket.

ii. The maximum capital gains tax rate is reduced to 15% for most taxpayers and 5% for those taxpayers whose tax does not exceed the 15% bracket (income up to $47,450). Under pre-Act law, long term capital gains for assets other than collectibles were subject to a maximum tax of 20% for most taxpayers. The rate was 10% for those taxpayers who reported less than $47,450 of total income and gains. The Act reduces maximum tax rates as indicated and the 5% tax will be eliminated after 2007.

iii. The rate of income tax on dividends is reduced to the rate of tax imposed on capital gains, 15% or 5%. Under pre-Act law, dividends received by an individual shareholder were taxed at the marginal rate for ordinary income, up to 38.6%. Under the Act, dividends are taxed at the same rates that apply to net capital gain. The reduced rate for dividends applies to the regular tax and the alternative minimum tax. To be eligible for the reduced rates, the dividend must be paid with regard to a share of stock held for more than 60

days during the 120-day period beginning 60 days before the ex-dividend date.

The reduced rate will apply to dividends from a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the U.S., provided that the Treasury Department determines that the treaty is satisfactory, and provided further that the treaty includes an exchange of information program. The treaty between the U.S. and Barbados is expressly unsatisfactory in light of the corporate inversion transactions that have used Barbados as the place to reincorporate. Dividends from a foreign corporation will qualify if (i) the foreign corporation is eligible for treaty benefits for substantially all of its income in the taxable year in which dividend is paid or (ii) the foreign corporation's stock is readily tradable on an established securities market in the United States.

Dividends received from a foreign corporation that was a foreign investment company (Code §1246(b)), a passive foreign investment company (Code §1297), or a foreign personal holding company (Code §552) in either the taxable year of the distribution or the preceding taxable year are not qualified dividends.

If a dividend from a foreign corporation qualifies for the reduced rate, 57% of the dividend income will be characterized in part as U.S. source income to reflect the difference in tax rates between the dividends (15%) and ordinary income (35%).

iv. The Act increases the AMT exemption amount for married taxpayers filing a joint return and surviving spouses to $58,000, and for unmarried taxpayers to $40,250 for taxable years beginning in 2003 and 2004. The alternative minimum tax is designed to ensure that all persons pay tax notwithstanding the deductions and other tax benefits to which they are entitled. If the income tax is less than the tentative alternative minimum tax, the taxpayer owes the difference as alternative minimum tax. The alternative minimum tax was designed to counter tax strategies of the wealthy; however, its scope has now begun to cover substantial numbers of middle class taxpayers.

For an individual, the tentative minimum tax is 26% of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of an exemption and (2) 28% of the remaining AMTI. The maximum tax rate on net capital gain is 20%. Under current law, the exemption amounts are$49,000 ($45,000 in taxable years beginning after 2004) in the case of married individuals filing a joint return and surviving spouses and $35,750 ($33,750 in taxable years beginning after 2004) in the case of other unmarried individuals.

v. The Act increases the amount that all businesses may claim as bonus first-year depreciation to 50% of the basis in a qualifying asset. The Act also increases the amount that small businesses can expense for equipment to $100,000. Pre-Act law allowed business to claim an additional farced-year depreciation deduction equal to 30% of the adjusted basis of qualified property. The balance of the adjusted basis is reclaimed under general tax depreciation rules. Under the Act, the 30%-ceiling is increased to 50% for property acquired after Mary 6, 2003. The property will not qualify for the enhanced deduction if a binding contract for its purchase existed on that date. The property must be placed in service before January 1, 2005. Thereafter, the enhanced depreciation benefit terminates.

Regarding the expensing of equipment, Pre-Act law provided that up to $25,000 of asset acquisitions may be expensed. If a taxpayer acquired more than $200,000 of qualifying property, the amount eligible for the expense deduction was phased out dollar-for-dollar basis for each dollar of investment in excess of $200,000. The Act increases the amount that can be expensed to $100,000 and increases the level at which the phase-out is triggered to $400,000. These amounts are indexed for inflation. The provision will terminate after 2005.

Notable by their absence from the Act, but likely to be resurrected are provisions that were adopted in the Senate, including:

vi. Mark-to-market rule for expatriating citizens and long-term residents;

vii. Provisions to discourage corporate inversions;

viii. Determination of basis for amounts paid from foreign pension plans;

ix. Repeal of the earned income exclusion for citizens or residents living abroad;

x. Minimum holding period for foreign tax credit with respect to withholding taxes on income other than dividends;

xi. Clarification of the economic substance doctrine;

xii. Enhanced penalties for understatements of tax arising from transactions lacking economic substance;

xiii. A response to the WTO decision regarding foreign sales corporations and the extraterritorial income exclusion;

xiv. A limitation on the scope of foreign rabbi trusts;

xv. Anti-tax shelter provisions such as the adoption of an exception to confidentiality privileges relating to taxpayer communications and mandatory disclosure of reportable transactions by material advisors;

xvi. Enhanced penalty for failure to report interests in foreign financial accounts;

xvii. Expanded authority to disallow tax benefits under Code §269;

xviii. Modification of controlled foreign corporation / passive foreign investment company coordination rules;

xix. Modification of treatment of closely-held REITs; and

xx. Denial of deduction for punitive damages.

In light of all the provisions that were proposed but not acted upon, the tax legislative agenda may be extremely active in the third and fourth quarters of this year.

i. Proposal to Limit Social Security Coverage

Rep. Ron Paul, R-Texas, introduced legislation under which future wages and self-employment income of individuals who are not citizens or nationals of the United States would not be credited for coverage under Social Security's old-age and disability programs. The bill also would authorize the President to enter into agreements with other nations that take into account this limitation. The intent is to reduce coverage under totalization agreements. According to Mr. Paul, these agreements result in a net outflow of benefits to persons who do not fully pay into the Social Security System.

j. Expatriation

Several rulings issued in May and June 2003, illustrate the way in which the I.R.S. now approaches rulings for persons who expatriate.

Code §877 generally provides that a citizen who loses U.S. citizenship or a U.S. long-term resident who ceases to be taxed as a lawful permanent resident will be subject to the special regime of tax for a period of 10 years from the close of the year in which the expatriation event occurs if a principal reason of expatriation is to avoid U.S. taxes. This means that the expatriate will be taxed at rates normally applicable to a resident on items of U.S. source income if that tax is greater than the tax normally applicable to nonresident individuals who are not citizens of the U.S. For this purpose, source income has an enhanced meaning and covers gains from the sale of shares of corporations .

A former citizen or former long term-resident will be treated as having expatriated with a principal purpose to avoid taxes if the individual's average income tax liability or the individual's net worth

on the date of expatriation exceeds certain thresholds based on income tax liability or net worth. In 2003, the threshold based on income tax liability is $122,000 – average annual net income tax, after credit, for the 5 years preceding expatriation exceeds that amount; the threshold based on net worth is $608,000 – the individual's net worth exceeds that amount.

If either threshold has been exceeded, the statute allows for rebuttal of the presumption if the individual is described within certain statutory categories and timely submits a request for a ruling that the expatriation did not have as one of its principal purposes the avoidance of taxes.

In Private Letter Ruling 200321011, the individual was a long term resident of the U.S. who returned to her country of birth. Because her net worth exceeded the threshold amount, tax avoidance was presumed. She time filed a request for a ruling to rebut the presumption and submitted substantial documentation, as required by this provision. The I.R.S. ruled that the submission was complete and was submitted in good faith. Consequently, the presumption was no longer effective. However, the I.R.S. refused to rule substantively on the reason for expatriation. The information submitted did not clearly establish either the existence or the absence of a principal purpose to avoid taxes. This remained an issue of audit. A similar conclusion was reached in Private Letter Ruling 200321014.

In comparison, In Private Letter Ruling 200318055 and Private Letter Ruling , the taxpayer was a long term resident of the U.S. and either an employee who was assigned to the U.S. by his employer or the person's spouse. Upon termination of employment, the taxpayer returned to his or her country of origin and relinquished residence status for immigration purposes. In each instance, either the tax or the net worth threshold was exceeded and the presumption applied. However, based on the submissions of the taxpayer, the I.R.S. ruled that the taxpayer rebutted the presumption. Moreover, the I.R.S. ruled that tax avoidance was not a principal purpose for relinquishment of residence status.

For high net worth individuals wishing to expatriate, these rulings present the horns of a dilemma. On one hand, the individual may wish to rebut the presumption by making a good faith submission. However, to pursue this path, a significant amount of information must be gathered and submitted to the I.R.S. The combination of legal and accounting fees in support of the submission are quite high. At the end of the process, the I.R.S. may rule that the presumption is rebutted, but the facts are not sufficient to rule that tax avoidance is not present. In that instance, the individual is left to ponder his or her fate until the 10-year period runs out.

3. Transfer Pricing

a. Qualified Cost Sharing Agreements – Regulations on Stock-based Compensation

In July 2002, the I.R.S. issued proposed regulations addressing the effect of stock-based compensation on qualified cost sharing agreements under Regs. §1.482-7. A hearing was held in November 2002, and final regulations were adopted in August 2003.

The regulations provide that a controlled participant's operating expenses taken into account in a qualified cost sharing agreement include all costs attributable to compensation. Those costs include all compensation provided to an employee or independent contractor in the form of equity instruments, options to acquire stock, or rights with respect to equity instruments or stock options, including but not limited to property to which Code §83 applies and stock options to which Code §421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

The determination of whether stock-based compensation is related to an intangible development area is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the qualified cost sharing arrangement and is related at date of the grant to the development of intangibles covered by the arrangement is included as an intangible development cost. The amount of the stock-based compensation that is taken into account is the amount allowed as a deduction for Federal income tax purposes. If the participant is not a taxpayer, for purposes of this provision, principles apply as if the entity were a entity. The effect of the provision is that the party granting the option – usually the parent of a high tech company – must be reimbursed for an item with regard to which there is no cash outlay and the amount of which need bear no relation to the value of the services, only the increase in value of the shares.

In November, the I.R.S. held a hearing on the regulations which were then in proposed form, and not too surprisingly, most witnesses attacked the proposal. One witness commented that the provision contradicted I.R.S. arguments raised in several court cases and in Congressional testimony. The regulations require that taxpayers follow the specified methodology – anything else is not arm's length. In the court cases and in the testimony, the I.R.S. stated that the relationship between stock-based compensation and a deduction is one of fact. The thrust of the comment was that the I.R.S. should not be able to take both sides of the argument as to whether the relationship is fact-based or mandatory, depending on which produced greater tax revenue. The witness also pointed out that trading partners of the would not likely treat stock-based compensation as a deduction that should be reimbursed because it is not "paid" for the performance of specific services.

Another witness commented that the I.R.S. should postpone finalizing the regulations until there is an international consensus. It was pointed out that the O.E.C.D. has a working group addressing whether corporate deductions for stock options should be taken into account as a reimbursable cost. The witness also suggested that the I.R.S. should adopt a uniform policy for the treatment of employee stock options for all transfer pricing purposes, not just cost-sharing agreements.

A third witness commented that the regulations should focus on the costs that independent parties would share under the same circumstances and the methodology they would use to measure and share the costs. In her experience, independent parties would not share amounts based on a valuation of employee stock options under the methods outlined in the proposed regulations. Those costs are unmeasurable and unpredictable.

The I.R.S. was not swayed by the arguments. When the regulations were adopted, the Preamble stated that the regulations is consistent with the legislative intent underlying Code §482 and with the arm's length standard (and therefore with the obligations of the United States under its income

tax treaties and with the OECD transfer pricing guidelines). Congressional intent at the time of the Tax Reform Act of 1986 indicates that cost sharing arrangements were to be allowed, if and to the extent that the participants' shares of income reasonably reflected actual economic activity. undertaken by each." See H.R. Conf. Rep. No. 99-481, at 11-638 (1986). The regulations treat costs as a proxy for actual economic activity. Costs must be determined on a comprehensive basis.

At the heart of the regulations is an administrative concern over the inherent difficulty that exists in measuring the value of high profit intangible property when independent parties are not present. Stock based compensation for persons developing the intangible is one method of overcoming that difficulty.

b. Related Party Status under § 6038A for Form 5472 Reporting

In ITA 200247045, the I.R.S. concludes that two domestic corporations were not related parties under Code §6038A, and as a result, sales between these two entities were not reportable on Form 5472 (Information Return of a 25% Foreign-Owned Corporation or a Foreign Corporation Engaged in a Trade or Business).

In the ruling, Individual A, a foreign individual, owned 100% of the stock of a domestic corporation, 1. Individual C, a resident, owned 100% of the stock of another domestic corporation, 2. FC1 was a foreign manufacturing corporations owned by unrelated parties. FC2 was a foreign corporation owned by individuals A, B, C and D (A, B, C and D were distant family members) and other unrelated parties. FC3 was also a foreign corporation and was owned by individuals A, B and C.

1 was the principal supplier of goods to 2. Prior to the formation of US1, 2 principally purchased goods directly from FC1, FC2 and FC3. In addition, 1 and 2 have entered into inter-company loans at below-market interest rate of interest. No interest was paid by 2 to 1 with respect to these intercompany loans.

The issue was whether 1 and 2 were related so that the sales of goods from 1 to 2 were reportable on Form 5472. The I.R.S. concluded that the two corporations were not related.

2 is treated as a related party to 1 if it is (i) a 25% foreign shareholder of 1; (ii) related to 1 or A under §§ 267(b) or 707(b)(1); or (iii) related to 1 within the meaning of § 482. Because 2 is a domestic corporation, it could not be a 25% foreign shareholder of 1. Second, A owned directly 100% of the stock of 1 but did not own directly any stock in 2. Similarly, C owned directly 100% of the stock of 2 but did not own directly any stock in 1. The stock owned directly by either A or C cannot be attributed to the other under the stock attribution rules and therefore neither A nor C owned stock of more than 50% in both 1 and 2 and these two corporations cannot be members of the same controlled group under Code §1563(a). Finally, the facts were not sufficiently developed for the I.R.S. to reach a conclusion that A and C acted in concert to arbitrarily shift income for Code §482 purposes.

Because 1 and 2 were not related parties under § 6038A, no Form 5472 reporting requirements apply to any transactions between these corporations.

c. I.R.S. Examiners will Review of Transfer Pricing Studies

In January 2003, examiners in the Large and Mid-size Business ("LMSB") Division were directed to request and taxpayer's transfer pricing studies and to forward the studies to international examiners or economists for analysis. It is not clear whether this is a new mandate to audit transfer pricing issues; it may simply be an attempt to identify those instances where taxpayers are not in compliance with the contemporaneous documentation rules so that I.R.S. resources may be directed towards these companies. For companies that are foreign owned, an I.R.S. examination almost always begins with a request for the international group structure, the intercompany transactions, the methodology used to price the transactions, and documents that comply with the contemporaneous documentation rule.

4. Treaties

a. Barbados

In October, representatives of the U.S. and Barbados met in Washington to discuss modifications to the existing income tax treaty. Barbados has stumbled into Congressional "cross hairs" recently because it has been used in inversion transactions as a place to have a finance company located which lends funds to the inverted U.S. affiliate, thereby driving down taxes. Once targeted, Barbados has had difficulty removing itself from exposure. When the U.S. tax rate of individuals for dividend income was reduced to 15%, the reduced rate was extended to dividends received from foreign corporations organized in certain tax treaty jurisdictions. However, the legislative history expressly excluded dividends paid by companies formed in Barbados. The reason given was that companies organized in Barbados are not necessarily taxed in Barbados, causing Congress to question whether the treaty with Barbados promotes an absence of taxation, rather than the elimination of double taxation. (Of course, with the exception of the U.S., few countries impose tax on dividend income derived by a corporation from a member of its group.) When the I.R.S. published Notice 2003-69, listing countries that had in effect qualifying treaties, Barbados was excluded.

b. Mexico

A protocol to the Mexico- Income Tax Treaty was signed in November. Under the protocol, the will eliminate withholding tax on certain parent-subsidiary. To be eligible, the parent company must own directly 80% or more of the voting power of the dividend paying subsidiary for at least 12 months. In addition, if the parent company is not a qualified resident of its country of residence under the test for public companies, it must have held the shares prior to October 1, 1998. This restriction was viewed to be necessary because this is only the third time a treaty provides for a zero rate of withholding tax on intercompany dividends and the Treasury wanted to deter companies from reorganizing in order to become eligible for the zero rate of withholding tax in circumstances where the Limitation on Benefits provision does not provide sufficient protection against treaty-shopping.

Examples would be companies that qualify for treaty benefits by virtue of the tests regarding active trades or businesses, ownership and base erosion, and subsidiaries of publicly traded companies resident in N.A.FTA. countries.

Dividends from a REIT or a RIC are subject to a 10% withholding tax. However, in the case of a REIT this rate applies only if one of the following tests are met: (i) the shareholder is an individual or a pension trust owning not more than 10% of the REIT shares, or (ii) the dividends are paid with respect to a class of stock that is publicly traded and the person beneficially entitled to the dividends owns an interest of not more than 5% of any class of the REIT's stock, or (iii) the person beneficially entitled to the dividends owns an interest of not more than 10% in the REIT and the gross value of no single interest in real property held by the REIT exceeds 10% of the gross value of the REIT's total interest in real property.

c. U.S.-Switzerland Tax Information Exchange Agreement Reached

On January 23, 2003, the and Switzerland entered into a mutual agreement regarding exchange of information under Article 26 (Exchange of Information) of the -Switzerland Income Tax Treaty.

Highlights of the information exchange agreement include:

i. In determining whether the requested information will be provided, the requested state will apply the statute of limitations of the requesting state.

ii. The requested state will exchange information with respect to matters that the requesting state is pursuing, or may pursue, on a civil or criminal basis.

iii. The following will be considered to constitute tax fraud under the tax treaty:

(1) Conduct that is established to defraud individuals or companies, even though the aim of the behavior may not be to commit tax fraud;

(2) Conduct that involves the destruction or non-production of records, or the failure to prepare or maintain correct and complete records to establish the amounts required to be shown in any tax return, if the person has not properly reported such amounts in any such tax return; and

(3) Conduct by a person subject to tax in the requesting state that involves the failure to file a tax return and an affirmative act to make the non-filing of tax returns difficult to detect.

iv. The requested state is required to exchange information when the requesting state has a reasonable suspicion that a conduct constitutes tax fraud. The

suspicion of tax fraud may be based on documents, testimonial information from the taxpayer, credible information from third parties and circumstantial evidence.

Fourteen hypothetical examples are also provided to illustrate conduct constituting tax fraud.

d. Tax Information Exchange Agreement with Jersey

A tax information exchange agreement was signed on November 4, 2002 between the and Jersey. The preamble to the agreement provides that the has determined that Jersey's "know your customer" rules to be acceptable for purposes of the Qualified Intermediary regime, which provides simplified withholding and reporting obligations for payments of income from the to an account holder through a foreign intermediary.

The agreement covers all federal taxes and all Jersey insular taxes. Under the agreement, information that is foreseeably relevant to the administration and enforcement of the domestic laws of the requesting party is to be provided upon request. In addition, information may be exchanged without regard to whether the conduct being investigated would constitute a crime under the law of the requested party if such conduct had occurred in the territory of the requested party or whether the person to whom the requested information relates is a resident of a party. If the requested information is not in the tax file of the requested party, the requested party must take relevant information gathering measures to provide such information.

Each party must also ensure that it has the authority to obtain and provide the (i) information held by banks or other financial institutions or by persons acting in an agency or fiduciary capacity or (ii) information regarding the beneficial ownership of companies, partnerships, investment funds and trusts.

The agreement will enter into force when each party has notified the other of the completion of its necessary internal procedures for entry into force, and will be effective immediately for criminal tax matters and effective January 1, 2006 (or other agreed-upon date) for all other tax matters.

e. Czech and Slovak Students Not Exempt on Camp Counselor Income

In a legal memorandum, the I.R.S. concluded that amounts received by students resident in the Czech and Slovak Republics could not apply the student and trainee provision of either treaty to exclude compensation received as summer camp counselors.

The taxpayers were students in their home countries. They were all participants in the Council on International Educational Exchange. The program was open to foreign university students, youth workers, and other specifically qualified individuals at least 18 years of age and proficient in English. Under the program, the students came to the for up to four months in the summer for the purpose of promoting understanding between the two cultures. As participants in the Camp

Counselor category of the exchange program, they interacted directly with groups of American youth by overseeing activities in a camp setting during the summer season. Presence in the was limited to four months. Extensions were not permitted.

The students all held J-1 visas. They received a small stipend while serving as summer camp counselors under the program. Each person filed all applicable tax forms claiming treaty benefits.

The I.R.S. explained that the treaty exemptions in the two treaties for students and trainees were not applicable to the stipends received from the program. For the treaty provisions to apply, a student must be in the for the primary purpose of study, research, or training at an accredited institution. If so, up to $5,000 is exempt from tax. Both treaties are identical on this point. The "primary purpose" requirement is meant to describe individuals participating in a full-time program of study, training, or research. The provision was not intended to exclude full-time students, who, in accordance with their visas, may hold part-time employment jobs. Here, the individuals were not participating in a full-time program of study at an accredited educational institution, or of securing professional training, or study or research.

f. Foreign Dividends – 15% Rate

The tax reform legislation enacted in the summer generally provides that a dividend received by an individual shareholder from either a domestic corporation or a "qualified foreign corporation" is subject to tax at a reduced rate of 15%. A qualified foreign corporation includes a foreign corporation that is eligible for benefits of a comprehensive income tax treaty that is determined by the I.R.S. to be satisfactory in connection with the reduced rate. The treaty must include an exchange of information program. (Alternatively, the dividend paid by the foreign corporation must relate to stock that is readily tradable on an established securities market in the U.S.) In Notice 2003-69, the I.R.S. listed the jurisdictions that had in place satisfactory income tax treaties. In essence, all but a few jurisdictions qualified. Bermuda and The Netherlands Antilles do not qualify because the tax treaties are not comprehensive. C.I.S. states that continue to benefit from the income tax treaty between the U.S. and the Soviet Union do not qualify because no exchange of information provision exists in that treaty. Barbados does not qualify because the treaty may provide for a complete elimination of taxation rather than the elimination of double taxation.

5. Foreign Tax Credit

a. Advice Given on 10/50 Basket Computations

In Notice 2003-5, the I.R.S. provided guidance on the computation of the foreign tax credit limitation in connection with dividends received by corporations from "10/50" foreign corporations.

Prior to the Taxpayer Relief Act of 1997, Code §904(d)(1)(E) required a domestic corporation meeting the stock ownership requirements of Code §902(a) to compute a separate foreign tax credit limitation basket for dividends received from each 10/50 corporation. The 1997 Act eliminated that requirement, and instead provided that dividends paid by a 10/50 corporation out of earnings and

profits accumulated in post-2002 taxable years would generally be treated as income in a separate basket based on the separate basket of the underlying earnings and profits being distributed. This is often referred to as "look-through" treatment.

Dividends paid by 10/50 corporation that are not passive foreign investment companies ("P.F.I.C."s) out of earnings and profits accumulated in taxable years beginning before January 1, 2003, are assigned to a single 10/50 dividend basket. Dividends paid by each 10/50 corporation that is a P.F.I.C. out of pre-2003 earnings are to be assigned to a separate 10/50 dividend basket.

The 1997 Act amendments provide look-through treatment to qualifying shareholders for dividends paid by a 10/50 corporation in a manner similar to the treatment of dividends paid by a controlled foreign corporation ("C.F.C."). Dividends paid by a C.F.C. to a corporation that is a 10% or greater shareholders are entitled to look-through treatment if the distribution is out of earnings and profits accumulated during periods in which the foreign corporation was a C.F.C. A dividend paid by a C.F.C. out of earnings accumulated when the foreign corporation was not a C.F.C. but was a 10/50 corporation is treated as a dividend from a 10/50 corporation. Accordingly, that dividend receives look-through treatment if paid out of post-2002 earnings, but is treated as income in the single 10/50 dividend basket if paid out of pre-2003earnings. The look-through treatment extends to interest, rents, and royalties paid to a shareholder by a C.F.C. as well as to inclusions of income under Subpart F. To the extent that existing proposed regulations provided otherwise, the I.R.S. may revise the proposals. In the case of a 10/50 corporation, however, only dividends paid out of post-2002 earnings are eligible for look-through treatment.

The I.R.S. is authorized to prescribe regulations regarding the treatment of distributions by a 10/50 corporation out of earnings and profits accumulated in periods prior to the taxpayer's acquisition of the stock. The I.R.S. announced that it will issue regulations that will apply look-through treatment to dividends paid to a new qualifying shareholder by a 10/50 corporation out of post-2002 earnings accumulated during periods when the foreign corporation was either a 10/50 corporation with respect
To any qualifying shareholder or a C.F.C. but before the recipient became a shareholder of the corporation. The regulations also will provide that dividends paid by a 10/50 corporation out of post-2002 earnings accumulated in periods when the 10/50 corporation was neither a 10/50 corporation with respect to any qualifying shareholder nor a C.F.C. is assigned to the single 10/50 dividend basket in the case of a distribution from a 10/50 corporation that is not a P.F.I.C., and to a separate 10/50 dividend basket in the case of a 10/50 corporation that is a P.F.I.C.

Because 10/50 corporation will be treated as look-through entities with respect to certain dividends paid in post-2002 taxable years, deductible expenses of a 10/50 corporation will reduce the corporation's pools of post-1986 undistributed earnings. The I.R.S. announced that the regulations will generally provide that expenses of a 10/50 look-through corporation will be allocated and apportioned in the same manner as expenses of a C.F.C. However, the regulations will not extend the special allocation rule for related person interest expense (*viz*., the interest is allocated farced to passive income). Accordingly, all interest paid by a 10/50 corporation will be apportioned to reduce the payor's pools of post-1986 undistributed earnings under the rules applicable to unrelated person

interest expense.

Regs. §1.964-1(c)(3) permits "controlling shareholders" of a C.F.C. to make or change tax accounting elections on behalf of the C.F.C. The controlling shareholders must meet several requirements before an election is deemed made on behalf of the C.F.C. The I.R.S. announced that the regulations will apply similar rules in order to provide a mechanism for shareholders of a 10/50 corporation to make or change tax elections on behalf of the corporation for purposes of computing the 10/50 corporation's earnings and profits for tax purposes. Specifically, the regulations will permit the majority domestic corporate shareholders of a 10/50 corporation to make or change tax elections on behalf of the corporation. The term "majority domestic corporate shareholders" means those domestic corporations that meet the ownership requirements of Code §902(a) with respect to the 10/50 corporation that, in the aggregate, own directly or indirectly more than 50% of the combined voting power of all of the voting stock of the 10/50 corporation that is owned directly or indirectly by such domestic.

The I.R.S. announced that, to the extent a taxpayer has pre-2003 excess credits in any non-P.F.I.C. separate 10/50 dividend basket and these credits are carried forward to post-2002 taxable years, the regulations will provide that the credits may be used to the extent that the single 10/50 dividend basket has excess foreign tax credit limitation. This treatment is consistent with consolidating in the single 10/50 dividend basket dividends paid by all non-P.F.I.C. 10/50 corporations out of pre-2003 accumulated earnings. The I.R.S. does not believe that it is consistent with the statute to carry forward excess credits in the separate 10/50 dividend baskets, on a look-through basis, to the baskets to which dividends paid by a 10/50 corporation out of post-2003 earnings are assigned. Excess credits in separate 10/50 dividend baskets should be carried forward to the single 10/50 dividend basket and not the look-through baskets because such excess credits are most appropriately associated with pre-2003 earnings, dividends out of which are allocated to the single 10/50 dividend basket.

The I.R.S. announced that, with respect to carrybacks of excess credits from post- 2002 taxable years to pre-2003 taxable years, the regulations will apply a rule similar to the carryforward rule discussed above: to the extent a taxpayer has post-2002 excess credits in the single 10/50 dividend basket and these credits are carried back to pre-2003 taxable years, the credits will reduce excess limitation in separate 10/50 dividend baskets (other than 10/50 dividend baskets with respect to P.F.I.C.'s). If the amount of credits carried back to the 2001 or 2002 taxable year is smaller than the aggregate excess limitation in all of the taxpayer's separate 10/50 dividend baskets for the year, the regulations will provide that the amount will be allocated pro rata among the non-P.F.I.C. separate 10/50 dividend baskets based on the relative amount of excess limitation in each such basket.

Rules will also be provided for the computation and application of separate limitation losses and overall foreign losses.

b. Costa Rican Taxes not Creditable

Rev. Rul. 2003-8 provides that the withholding taxes referred to in Article 61 of the Costa Rican Income Tax Law are not creditable taxes under Code §§ 901 or 903 because the withholding taxes are imposed only in the event that a credit for the taxes is available from the country in which the recipient operates or resides. The revenue ruling states that it serves as an official confirmation by the I.R.S. that the withholding taxes referred to in Article 61 are not creditable in the

Costa Rica's income tax law imposes a withholding tax on various types of income paid to persons operating or residing outside Costa Rica. The Costa Rican Tax Administration has authority to grant a total or partial exemption from withholding taxes on profits, dividends, social participation, interest, commissions, financial expenses, patents, royalties, reinsurance, consolidation and insurance premium of all types referred to in Costa Rican Income Tax Law Article 59. This exemption can be given if it is proven that the recipient of such income is not granted any credit for the Costa Rican withholding tax in its country of operation or residence.

The revenue ruling concludes that because the Costa Rican withholding tax liability depends on the availability of a credit from the recipient's country of operation or residence, its predominant character is not an income tax in the sense. Therefore, these withholding taxes are not creditable under Code §§ 901 or 903.

c. Fair Market Value Analysis for Interest Expense Apportionment

In computing the foreign tax credit limitation (*viz*., the portion of the U.S. that is tax attributable to foreign source taxable income), a taxpayer must identify items of foreign source income and expense. Interest expense is one of the expense items taken into account. As a general rule, interest expense is allocated on the basis of tax book value of assets, although a taxpayer may elect to apportion interest expense based on fair market values. See generally Regs. §§1.861-8T(c)(2) and 1.861-9T(g)(1)(ii). Clearly, computations based on tax book values are easier to complete because the numbers are generated in the course of preparing a tax balance sheet. However, this method skews interest expense to newly acquired assets and away from assets held for long periods of time, especially depreciable or amortizable assets. Where companies are expanding abroad, a tax book value apportionment tends to allocate excessive amounts of interest to foreign source income, thereby reducing the foreign tax credit limitation. For those taxpayers, allocations based on fair market value may produce a more favorable result. In Rev. Proc. 2003-37, the I.R.S. provided taxpayers that apportion interest expense on the basis of fair market value with guidance on information that must be included with the income tax return. If the taxpayer fails to comply with the guidance, the I.R.S. may use different values or may require the taxpayer to allocate income on the basis of tax book values. The Rev. Proc. applies to all years ending after May 7, 2003.

The taxpayer must make available to the I.R.S. a narrative statement describing the apportionment of interest expense under the fair market value method in sufficient detail such that the I.R.S. can reconcile the information on Form 1118 with the apportionment methodology. The narrative must address how the taxpayer calculated the aggregate value of assets, including shares of publicly traded stock, on the last day of the taxable year. Tangible assets must be described in detail, and in the case of real estate, the description must include location, zoning, and square footage. A

description of the valuation techniques used must be provided which includes the reasons for selecting that technique over alternatives and which explains discount rates, obsolescence factors, and risk adjustments. If computer programs are used for making the calculation, the underlying codes must be made available to the I.R.S. upon request. Procedures are outlined for taxpayers who elect to use fair market value at or after the start of the examination.