INBOUND UPDATE: INCREASING ATTENTION BY THE I.R.S. TO FOREIGN TAXPAYERS DOING BUSINESS IN THE U.S.

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1. Exchanges of Information.

a. Antiterrorism Legislation Would Permit Disclosure of Taxpayer Return Information to Federal Agencies and to State and Local Law Enforcement Officials

The USA Patriot Act, combining two House bills, the Financial Anti-Terrorism Act and the Patriot Act, was signed by President Bush. With respect to the banking provisions, Treasury has been given considerable discretion in dealing with financial institutions and jurisdictions that engage in money laundering. Treasury is also empowered to support criminal financial investigations and to track foreign cash, foreign currency transactions and various suspicious activities in an effort to disrupt the use of the international financial system by terrorists.

Treasury will be able to look at a variety of factors, including the relationship between the size of the jurisdiction's economy and the volume of financial transactions, and the amount of secrecy afforded depositors. The money laundering provisions are not subject to the four-year sunset provisions found in other parts of the bill, but Congress could terminate them after the first day of fiscal 2005 with a resolution signed by both houses and the president.

As originally proposed by the Administration, return information was to be disclosed to apprise appropriate authorities of criminal activities or emergency circumstances. The I.R.S. could have disclosed returns or return information to the extent necessary to assist officers of employees of any Federal agency involved in the response to or the investigation of terrorist incidents, threats, or activities. In turn, the Federal agency could disclose the information to State or local law-enforcements officials who are part of a joint investigative team with Federal authorities. In addition, it was proposed that anyone in the Justice or

Treasury Departments who is appointed by the President and confirmed by the Senate, and anyone in the Senior Executive Service who is responsible for counterterrorism, may request return information from the I.R.S. without a Court order. These provisions did not make it into the final legislation. With the pressure to get something out quickly, the Senate did not believe it had enough time to consider including the taxpayer protections that the Senate Finance Committee as well as many Senators believed were necessary. A revised version became part of the Victims of Terrorism Tax Relief Act that was finally passed in late December 2001. In addition, language calling jurisdictions and financial institutions "suspect" if they offered special tax advantages to nonresidents and allowing Treasury to impose sanctions was removed. Similar language with respect to tax havens was also removed.

b. O.E.C.D. Reaches Accord with most Tax Havens

Beginning in 1998, the O.E.C.D. Fiscal Affairs Committee has been engaged in a running battle with tax haven jurisdictions that are uncooperative in exchanging information with developed countries. In 2000, 35 countries were identified as uncooperative tax havens. These countries, the U.S., and the O.E.C.D. have been engaged in an unofficial dialogue designed to establish a set of rules for tax haven jurisdictions to follow in connection with information requests by other countries.

In 2000, several compromises were reached. Identified tax haven countries could be taken off a black list if they agreed to participate in a 4-stage approach to cooperation. In the first stage, the identified jurisdictions were to adopt an action plan for achieving transparency and effective programs for the exchange of information for all tax matters. The action plan was to address the elimination of internal tax regimes designed to attract business without substantial local business activity. In the second stage, the action plan was to be adopted for local regulatory purposes. Thus, beneficial ownership information and financial books kept in accordance with generally accepted accounting principles were to be made available to domestic regulatory agencies and tax authorities. In the third stage, information regarding criminal tax matters was to be available for exchange with O.E.C.D. members. The tax authorities of O.E.C.D. member states would have access to banking information relevant to the investigation of financial crimes during this stage. In the final stage, information regarding civil tax matters was to be made available for exchange with O.E.C.D. members. The identified jurisdictions were to eliminate local rules that depart from accepted laws and practices, such as the issuance of secret rulings or the ability of investors to elect or negotiate the rate of tax. In addition, transfer-pricing rules would have to be adopted that would not deviate materially from the O.E.C.D. transfer pricing guidelines.

By November 2001, additional compromises were reached. One compromise related to the elimination of provisions designed to attract businesses having "no substantial activities" within an identified country. This provision was identified by pundits to be too broad – that most developed countries have provisions designed to attract the money of offshore investors without necessarily imposing tax on specified profits. In the U.S., those provisions included the exemption from tax for most forms of interest earned by foreign persons and for most forms of capital gains. Consequently, commitments were to be sought only with respect to transparency and effective exchange of information.

Defensive measures regarding tax havens were to be put in place at the same time as the application of defensive measures on member countries with harmful preferential regimes. Originally, member countries were to have a longer grandfather period.

As a result of the compromises, tax haven jurisdiction must now agree that non-transparent features, such as rules that depart from established laws and practices, secret tax rulings, and the ability of persons to negotiate tax rates will be eliminated from their tax regimes. Accounts must be prepared in accordance with generally accepted accounting standards and must be either audited or filed. The only exceptions will be if the transactions are *de minimis* or the entity's activities are exclusively local and it has no foreign ownership, beneficiaries or management. Governmental authorities must have access to beneficial ownership information for all types of entities and to bank information relevant to both criminal and civil matters. All information maintained to meet transparency criteria should be available for exchanges of information.

Also, an identified jurisdiction must agree to establish a mechanism for an effective exchange of information. The mechanism must allow information to be given to the tax authority of another country in response to a request that may result from a specific tax inquiry. Appropriate safeguards are to be put in place to ensure that the information obtained is used only for the purpose for which it was sought. Taxpayers' rights and the confidentiality of their tax affairs must be protected. With respect to criminal tax matters, the information should be provided without a requirement that the conduct would be criminal in the jurisdiction to which the request is addressed. In civil tax matters, information should be provided whether or not the jurisdiction providing the information has an interest in the information for its own domestic tax purposes. The jurisdiction making the commitment must agree that it will put in place administrative practices to monitor the mechanism to ensure that it is functioning properly.

c. Almost Universal Sign-up

As of April 18, 2002, all but seven identified tax haven jurisdictions have agreed to come into compliance with the transparency and exchange of information provisions of the O.E.C.D. initiative. The members of the "Gang of Seven" are: (i) Andorra, (ii) The Principality of Liechtenstein, (iii) Liberia, (iv) The Principality of Monaco, (v) The Republic of the Marshal Islands, (vi) The Republic of Nauru, and (vii)The Republic of Vanuatu.

The OECD said that it hoped to have a continuing dialogue with those countries and that it would monitor the emergence of new uncooperative tax havens. Secretary O'Neill took credit for the O.E.C.D.'s gains because of his efforts to limit the project to transparency and information exchange.

d. Model Exchange of Information Agreement

The O.E.C.D. released its model tax information exchange agreement for both bilateral and multilateral transactions. The introduction stresses that "it is not in the interest of the participating economies that the implementation of the standard contained in the agreement should lead to a migration of business to economies that do not cooperate in the exchange of information."

Article 5 (Exchange of Information Upon Request) is the heart of the agreement. Under that provision, each party is obligated, upon request, to provide information that is possibly relevant to the determination, assessment and collection of taxes, the recovery and enforcement of tax claims, or the investigation or prosecution of tax matters. The information is to be exchanged even if the conduct being investigated would not constitute a crime under the laws of the requested State.

If the information in its possession is not, the requested State is obligated to use all relevant information gathering measures even if it does not need the information for its own tax purposes. To the extent allowable under its domestic laws, the requested State is obligated to provide the information in the form of depositions of witnesses and authenticated copies of original records.

Each State is to take steps to ensure that the tax authorities can obtain information held by banks, other financial institutions, agents, fiduciaries, nominees and trustees regarding the ownership of companies, partnerships, trusts, foundations, *Anstalten*, including all persons in a chain of ownership. Power to obtain comparable information would have to exist with regard to settlors, trustees and beneficiaries of trusts and founders, members of the foundation council and beneficiaries of *Anstalten*. Each State is to adopt procedural rules calling for prompt responses regarding any deficiency in the request for information (60 days) and notice of the reasons for any noncompliance with the request (90 days).

The model agreement also contemplates cross border examinations of witnesses and documents, provided the witness or holder of the document approves. Limitations are provided so that only information obtainable in the requesting state can be requested, and trade, business, industrial, commercial or professional secrets or trade processes are not obtainable. Lawyer-client communication is not obtainable where the communication related to legal advice with regard to a particular transaction or advice regarding litigation. Information that is exchanged is generally confidential, but may be introduced at a public court hearing.

e. U.S. Exchange of Information Agreements.

The U.S. has entered into information exchange agreements with the Cayman Islands, Antigua and Barbuda, the Bahamas, the British Virgin Islands and the Netherlands Antilles. The agreement with the Netherlands Antilles is typical of the U.S. agreements that have been negotiated.

Article 4 (Exchange of Information) of that agreement is the heart of the exchange of information obligation in the agreement with the Netherlands Antilles. In particular, it provides that the requested State (i.e., the Netherlands Antilles) must take all relevant measures, including compulsory measures, to provide the U.S. with requested information that is not in the files of the tax authority in the Netherlands Antilles. As a result, the Netherlands Antilles tax authority will examine books, papers, records, or other tangible property which may be relevant or material to the U.S. inquiry. In addition, the Netherlands Antilles tax authority will question any person having knowledge or in possession, custody or control of information which may be relevant or material to such inquiry. Moreover, the Netherlands Antilles tax authority will have power to compel any person having knowledge or possession, custody or control of information which may be relevant or material to appear at a stated time and place and for purposes of testifying under oath and to produce books, papers, records, or other tangible property. The tax authority will be empowered to take testimony under oath.

When it carries out the foregoing undertakings, privileges under the laws or practices of the requesting State (i.e., the U.S.) will not apply in the execution of a request, but will be preserved for resolution by the requesting State at a later time.

2. <u>Inversion Transactions</u>

a. <u>Corporate Inversion Bill Introduced in Senate</u>

Senate Finance Committee Chair Max Baucus, D-Mont., and ranking Republican Charles E. Grassley, R-Iowa, introduced legislation to restrict corporate inversions. The bill is the second piece of legislation and has a slightly different emphasis than two earlier provisions introduced in the House in March.

An inversion transaction involves a U.S.-based group that moves the location of the parent holding company to a tax advantaged jurisdiction and transfers ownership of foreign subsidiaries to the foreign holding company. All transactions involved in the inversion are generally taxable by reason of Code §367(a), but gain is either not significant or the transferor has excess foreign tax credits available to offset the tax, or the transferor is not a taxpayer.

Companies that have recently undergone an inversion are publicly traded companies that have significant foreign subsidiaries or branches. In the inversion transaction, the public shareholders transfer their shares in the U.S. company to a company incorporated in Bermuda or the Cayman Islands. Since the Bermuda or Cayman Islands corporation is widely held, it is not a controlled foreign corporation ("C.F.C."). This means that the U.S. shareholders are not subject to current taxation on certain types of income earned by the C.F.C. In addition, since the Bermuda or the Cayman Islands corporation owns active companies in the U.S. and in foreign jurisdictions, the U.S. shareholders are not subject to current taxation under what is called the Passive Foreign Investment Company ("P.F.I.C.") regime.

The transfer of the shares of the U.S. company to a Bermuda or the Cayman Islands company is a recognizable transaction for the shareholders of the U.S. corporation. Thus, the transaction is potentially subject to U.S. taxation. However, since the general market is down right now, U.S. shareholders have recognized little gain on the inversion transaction. In addition, shareholders of a public company that are pension funds, charities, foreign entities, and insurance companies generally will not pay any U.S. tax on recognized gain.

Once the inversion is completed, the U.S. company sells its foreign subsidiaries or branches to the Bermuda or the Cayman Islands company. This transfer will normally be considered a taxable event for the U.S. company. However, if the value of the subsidiaries or branches is low, the gain is minimal. If there are accumulated earnings and profits in the foreign subsidiaries, the gain is converted into dividend income, at least in part, and foreign tax credits may accompany the deemed dividends from the foreign subsidiaries. The result is the future earnings of the foreign subsidiaries or branches are no longer subject to U.S. taxation.

Thereafter, the public companies obtain the following tax benefits.

- Most U.S.-based multinational companies are unable to obtain the full benefit of the foreign tax credit. That is because the rules for allocating and apportioning expenses between foreign and domestic source income are designed to promote allocations of interest expense and G&A expenses to foreign source income. As a result, the portion of the U.S. tax that can be offset by foreign taxes can be severely limited. Where that occurs, foreign income can be taxed twice – once by the foreign jurisdiction and a second time by the U.S. when the tax return does not permit full offset for the foreign taxes under the foreign tax credit. When ownership of the foreign operations is removed from the U.S. company, the allocation and apportionment rules become irrelevant. There is no investment in foreign subsidiaries or branches any longer.

- Where the foreign operations are located in low-tax countries, dividends can be passed through to ultimate shareholders without subjecting the income to an intermediate level of U.S. tax. That is because the foreign operations do not have a U.S. parent. Before the inversion, all profits had to be channeled through the U.S. tax return of the U.S. parent before distribution to shareholders. The elimination of U.S. tax as a result of the inversion enhances the earnings per share of the public company.

- Finally, the inversion allows shares of foreign subsidiaries to be sold without the imposition of U.S. tax. This enables a greater amount to be available for future reinvestment abroad or in the U.S. The full amount of the gain can be reinvested into property, plant and equipment.

The Senate bill would require the I.R.S. to look at where recently expatriated corporations or partnerships are really controlled. If a company remains controlled in the United States, the bill would require the company to pay its fair share of taxes.

The legislation would curtail the tax benefits sought by U.S. companies in two types of inversion transactions. Each inversion would be subject to different regimes under the proposal. Both types of inversion transactions that take place on or after March 21, 2002 would be subject to the respective rules.

The first type of inversion would be a pure or nearly pure inversion, in which:

- A U.S. corporation becomes a subsidiary of a foreign corporation or otherwise transfers substantially all of its properties to a foreign corporation;

- The former shareholders of the U.S. corporation end up with 80% or more (by vote or value) of the stock of the foreign corporation; and

- The foreign corporation, including its subsidiaries, does not have substantial business activities in its country of incorporation.

The legislation would deny the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Internal Revenue Code.

For purposes of this proposal, corporations with no significant operating assets, few or no permanent employees, or no significant real property in the foreign country of incorporation would not be treated as meeting the substantial business activities test. In addition, companies would not be considered to be conducting substantial business activities in the country of incorporation by merely holding board meetings in the foreign country or by relocating a limited number of executives to the foreign jurisdiction.

The second type of inversion covered by the legislation would be a transaction in which the 80% ownership threshold is not met. If the former shareholders of the U.S. company end up with 50% or more of the shares of the foreign corporation measured by vote or value, the inversion transaction would be respected, but the corporate-level "toll charge" for establishing the inverted structure would be strengthened, and restrictions would be placed on the company's ability to reduce U.S. tax on U.S.-source income going forward. These measures generally would apply for a 10-year period following the inversion.

In addition, no deductions or additions to basis or cost of goods sold for transactions with foreign related parties would be permitted unless the taxpayer concludes an annual pre-filing agreement, advance pricing agreement, or other agreement with the IRS, a "preapproval agreement", to ensure that all related-party transactions comply with all relevant provisions of the Code, including Code §§482 (transfer pricing), 845 (insurance), 163(j) (earnings stripping), and 267(a)(3) (accrual of unpaid interest expense). Similarly, the transfer or license of intangible property from a U.S. corporation to a related foreign corporation would be disregarded, and cost-sharing arrangements would not be respected unless approved under such an agreement.

The second set of measures also includes modifications to the "earnings stripping" rules of section 163(j). These provisions deny or defer deductions for excess interest paid to foreign related parties that are not subject to full U.S. withholding tax and for excess interest on debt guaranteed by a foreign related party. The legislation would eliminate the debt-equity threshold generally applicable under that provision (1.5:1 or less are acceptable ratios) and reduce the income related threshold for application of the provision. Under the current interest stripping rules, net interest expense is not deductible currently to the extent that adjusted taxable income is reduced by 50%. The bill would reduce the threshold to 25%. Consequently, once adjusted gross income is reduced by 25% as a result of a company's net interest expense, the disallowance provision would be applicable.

b. Treasury Issues Inversion Report.

In May, the Treasury Department issued a report summarizing its view on inversion transactions. According to the Treasury, inversion transactions can have significant adverse effects on the U.S. economy in the long term, as decisions affecting the future location of new investment, operations and facilities, and employment opportunities are made by what is a foreign-based company rather than a U.S.-based company. Any policy response should be broad enough to address the underlying differences in the U.S. tax treatment of U.S.-based companies and foreign-based companies, without regard to how foreign-based status is achieved. Measures designed simply to halt inversion activity may address these transactions in the short run, but there is a serious risk that measures targeted too narrowly would have the unintended effect of encouraging a shift to other forms of transactions to the detriment of the U.S. economy in the long run.

Consequently, the Treasury recommended a prompt and thoroughly reasoned response is needed to address the U.S. tax advantages that are available to foreign-based companies through the ability to reduce the U.S. corporate-level tax on income from U.S. operations. Of major concern to the Treasury and Congress are the opportunities of a group to shift income from the U.S. to affiliates. As Subpart F does not apply to the inverted group once foreign subsidiaries are shifted to the foreign parent, tax revenue is lost to the extent that operations abroad are conducted in low-tax jurisdictions or intangible property holding companies are located abroad. Also, it is reported that inverted companies are loading U.S. subsidiaries with substantial amount of interest bearing debt and are using the inverted company to provide current deductions for what amounts to unfunded deferred compensation plans for U.S. executives.

Inappropriate shifting of income from the U.S. companies in the corporate group to the foreign parent or its foreign subsidiaries represents an erosion of the U.S. corporate tax base. It provides a competitive advantage to companies that have undergone an inversion or otherwise operate in a foreign-based group. It creates a corresponding disadvantage for their U.S. competitors that operate in a U.S.-based group. Moreover, exploitation of inappropriate income-shifting opportunities erodes confidence in the fairness of the tax system.

In the view of the Treasury, changes to the applicable statutory and regulatory rules are needed to ensure that any transaction that results in a new foreign parent of a corporate group with U.S. operations does not serve to facilitate an inappropriate decrease in tax on the U.S. income of the U.S. operations.

Areas that have been identified for tax law revision include the rules limiting deductions for interest paid on foreign related party debt, the rules requiring arm's length pricing and valuations on transfers of assets, including intangible assets, to foreign related parties, and the rules regarding cross-border corporate reorganizations.

Treasury also believes that it is important to address the U.S. tax disadvantages that have caused U.S.-based companies to consider undergoing an inversion. The U.S. international tax rules can operate to impose a burden on U.S.-based companies with foreign operations that is disproportionate to the tax burden imposed by other countries on the foreign operations of their companies. Examples include the use of a foreign tax credit to avoid double taxation instead of a dividends received deduction and an exemption for foreign business operations carried on in branch form. The problem is exacerbated by the rules which accompany the foreign tax credit such as the interest expense allocation rules and the basket rules.

The competitive disadvantage caused by those rules is thought to be a serious issue with significant consequences for U.S. businesses and the U.S. economy. Consequently, the Treasury called for a comprehensive reexamination of the U.S. international tax rules and the economic assumptions underlying them. The report concludes that the U.S. system of international tax rules should not be allowed to disadvantage U.S.-based companies competing in the global marketplace.

c. Ways & Means Introduces Restructuring Bill

In July, the Ways & Means Committee introduce a bill that would address the W.T.O. problem with the F.S.C. and the E.T.I. Act as well as the perceived causes for corporate inversions transactions. The bill, H.R. 5095, the American Competitiveness and Corporate Accountability Act, is thought to have a good chance of passage. It:

- Repeals anti-deferral foreign base company sales and services rules under Subpart F;
- Reforms interest allocation rules;
- Reduces foreign tax credit baskets to three;
- Extends the foreign tax credit carryover period from 5 to 10 years;
- Repeals the 90% limitation on the use of foreign tax credits for AMT purposes;
- Recharacterizes overall domestic losses;
- Increases first year write-off provisions for small business expensing from $24,000 to

$40,000 and increases eligible investment limits from $200,000 to $325,000;

- o Provides look-through treatment for payments between related controlled foreign corporations for purposes of determining whether an item of income is removed from classification of foreign personal holding company income and for foreign tax credit basket purposes;

- o Provides look-through treatment for sales of partnership interests to eliminate automatic Foreign Personal Holding Company treatment;

- o Repeals the primarily duplicative Foreign Personal Holding Company and Foreign Investment Company Rules;

- o Applies look-through rules to dividends from non-controlled Code §902 companies (10/50 companies);

- o Provides deferral for pipeline transportation income;

- o Provides for attribution of stock ownership through partnerships to determine section 902 and 960 credits;

- o Provides deferral for commodity hedging income for materials used in manufacturing operations;

- o Does not include in the U.S. Property certain assets acquired by dealers in ordinary course of business;

- o Provides for equitable treatment of certain mutual fund dividends;

- o Provides an election not to use average exchange rate for foreign tax paid other than in functional currency;

- o Repeals withholding tax on dividends from Certain Foreign Corporations;

- o Provides that U.S. parent corporations would not have to recalculate E&P of foreign subsidiaries under Unicap rules; and

- o Repeals the ETI rules

Regarding interest stripping, the bill would provide that the 1.5 to 1 debt-to-asset safe harbor is eliminated. Related party interest expense would be disallowed to the extent that the U.S. subsidiary of a foreign owned company's debt-to-asset ratio exceeds the foreign company's worldwide debt-to-asset ratio. In order to alleviate unintended consequences that these rules could impose on companies with significant financial operations, the provision provides a separate comparison of U.S. financial operations to worldwide financial operations. The bill would reduce allowable interest expense from 50% to 35% of adjusted taxable income. Current law allows foreign owned U.S. subsidiaries to reduce their U.S. tax liability by over 50% by making interest payments to a related foreign company. This provision does not limit a company's interest payments to unrelated entities. The carryforward period for disallowed interest expense is to be limited to 5 years; it is currently unlimited. These changes would have a delayed effective date for non-inverted companies. The effective date of these provisions will be delayed until taxable years after December 31, 2003 for non-inverted foreign owned companies. This delay allows companies to adjust their debt structures to reflect the new law.

Regarding inversions, the bill would imposes the full income tax on the transfer of assets to a foreign entity without giving the company the opportunity to reduce tax by foreign tax credits, net operating losses, or other tax attributes to reduce or eliminate the tax on the transfer of assets. This proposal is intended to reduce the incentive to transfer U.S. owned assets to a foreign jurisdiction. In addition, the bill would impose a 20% excise tax on the value of all stock options and stock based compensation held by insiders, top executives and directors when a company inverts. Under current law, insiders are not subject to the gain recognition rules under Code §367(a). The provision will equalize the tax treatment of shareholders and corporate insiders. It also will give company executives a financial stake in the decision to invert, thereby aligning management's interests with shareholder interests. Finally, a 3-year moratorium would be imposed for “mailbox” inversions. These transactions will be disregarded. The inverted company remains subject to U.S. tax and is treated as if it were incorporated in the U.S. A mailbox inversion occurs when a U.S. company switches only its place of incorporation to a low tax foreign jurisdiction (such as Bermuda) but does not change its overall corporate structure, its operations, or the location of its employees. For all purposes, other than tax, the company continues to be and act like a U.S. company. The moratorium is intended to give Congress and Treasury time to carefully and thoughtfully examine the effects of the bill on corporate behavior.

The bill also contains a tax shelter section with provisions designed to raise the stakes for those who enter into shelter transactions.

The first thing this section does is to codify the economic substance doctrine. Transactions will be required to have a substantial non-tax business purpose and involve a meaningful change (apart from Federal income tax effects) in the taxpayer’s economic position. This change is intended to eliminate inconsistent application by courts of the economic substance doctrine and to ensure that taxpayers enter into transactions for legitimate economic and business reasons and not for tax avoidance.

Next, the bill imposes taxpayer penalty for failure to report a “listed” transaction. A listed transaction is a transaction that the Treasury has specifically identified as an abusive transaction. The penalty is $100,000 for individuals and $200,000 for all others. It also imposes a penalty for failure to disclose a “reportable” transaction. A reportable transaction is a transaction that may or may not be abusive, but Treasury requires its disclosure based on objective factors such as differences in tax and book amounts. The penalty is $10,000 for individuals and $50,000 for all others.

The bill imposes strict liability penalties for transactions that lack economic substance. The penalty is 40% of the understatement in tax attributable to non-disclosed "listed" or "reportable" transactions and 20% for disclosed transactions. These strict penalties will discourage taxpayers from entering into tax avoidance transactions and encourage taxpayers to report transactions that may be close to the line. The frivolous return penalty is increased from $ 500 to $ 5,000. A $5,000 penalty would be imposed for the failure to report an interest in a foreign financial account. Finally, written tax shelter communications between a taxpayer and accountant would not be privileged.

Penalties are proposed for promoters and others who are materially involved with "reportable" or "listed" transactions. These persons must file transactions reports with the I.R.S. Failure to file the report would result a $50,000 penalty for a reportable transaction and a penalty of $200,000, or if greater, 50% of fees for a "listed" transaction. Another penalty would be imposed for those who fail to maintain a list of investors to whom the transactions were offered. Failure to provide the list to the I.R.S. within 20 business days of request would result in $10,000 per day fine until the list is provided. Loophole Closers

Finally, the bill contains several loophole closers. One closer is designed to prevent executives from deferring tax on compensation and providing further that they will be categorized as general creditors of the company in the event of bankruptcy. Under current law, employees have a preference over other unsecured creditors with regard to compensation that is owed by a bankrupt company. Another closer is designed to prevent taxpayers from improperly generating foreign tax credits, creating immediate tax losses, and converting ordinary income into deferred capital gain. A final closer is intended to prevent the same partnership loss from being deducted more than once.

3. <u>Income Tax Treaties</u>

a. <u>U.S. and Australia Sign Protocol to 1982 Treaty After Negotiations on New Treaty Stalled</u>

In 2001, the U.S. and Australia signed a protocol reducing tax in several circumstances.

The most important revision is that there will be no withholding on dividends paid to persons that (i) have owned, for 12 months or more at the time of the declaration of the dividend, 80% of the voting power of the payor, (ii) are residents of a Contracting State, and (iii) and meet the limitation on benefits provisions. If a company directly owns 10 percent of the voting stock of the payor, withholding on dividends is reduced to 10%. All other withholding on dividends remains at 15%.

No branch profits tax will be imposed with respect to a permanent establishment located in one Contracting State owned by a company resident in the other Contracting State if the company meets the public company requirements of the limitation on benefits provisions. Otherwise, the branch profits tax is limited to 5%. The Protocol also contains new rules for withholding on dividends paid by U.S. Real Estate Investment Trusts and Regulated Investment Companies. For dividends paid by those entities, the withholding tax rate is 15%.

The standard rate of withholding tax on interest is 10%. There are exceptions. For example, financial institutions and government entities generally will be exempt from withholding tax on interest. However, the withholding tax rate will be 10% if the interest is paid to a financial institution involved in a back-to-back loan or other similar arrangement. Withholding tax on interest that is determined by reference to profits will be 15%.

Withholding taxes on royalties have been reduced from 10% to 5%. The term royalty does not include amounts derived from leasing equipment, such as shipping containers. Generally equipment leasing is categorized as business profits.

The Protocol has added a full limitation on benefits provision to the Treaty. Under the provision, each State and its subdivisions are qualified individuals as are individual residents, exempt organizations, and certain pension funds. Also qualified are publicly traded corporations and companies that are at least 50% owned by one or more publicly traded companies that qualify for treaty benefits. If an entity is not publicly traded, it will qualify for benefits if (i) at least 50% of its equity is owned by one or more qualifying persons previously described and (ii) less than 50% of its gross income for the year is paid or accrued, directly or indirectly, to persons who are not residents of either of the two states. With regard to the payment requirement, certain payments are excluded such as arm's length payments incurred in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a local branch of a foreign bank. Finally, a recognized headquarters company of a multinational corporation will be a qualified person if, among other things, it provides a substantial portion of the overall supervision and administration of the group. A group is a multinational group if it operates within at least five countries or groupings of countries, each of which generates at least 10% of the group’s total revenue. Most importantly, the headquarters company must have and exercise independent discretionary authority to carry out its various functions. Finally, if a company does not otherwise qualify in general, it may qualify (i) with regard to specific streams of income that are related to a business actively carried on in its country of residence or (ii) pursuant to the discretion of the competent authority of the country in which the income arises.

The protocol clarifies that Australia's tax on capital gains is covered by the existing treaty and will constitute Australian source income for purposes of computing the foreign tax credit limitation in the U.S. Such treatment reduces the risk of double taxation for U.S. taxpayers. The protocol retains the existing rules under which most forms of capital gains are taxed in the country in which the property is located, and in the case of a disposition of shares, is taxed in the country of residence of the issuer.

b. U.S. and Luxembourg Agree on Interpretation of Tax Treaty Transition Rules for New Treaty.

The competent authorities of the U.S. and Luxembourg have agreed on the interpretation of the transition rules set forth in Article 30 of the income tax treaty that entered into force on December 20, 2000 (the "1996 Treaty").

As a matter of background, paragraph 2 of Article 30 provides that for taxes withheld at source, the Treaty generally is effective for amounts paid or credited on or after January 1, 2001. In the case of taxes on other income and on capital, paragraph 2 provides that the 1996 Treaty generally has effect for fiscal periods beginning on or after January 1, 2001. However, paragraph 3 of Article 30 provides that if a person who was entitled to the benefits of the former treaty would receive greater benefits under that treaty, it may elect to have the former treaty remain in effect for an additional taxable year.

Regarding calendar year taxpayers, the two countries have agreed that, as long as the taxpayer was in existence on December 19, 2000, it may elect to continue the former treaty through December 31, 2001. Regarding fiscal year taxpayers, the two countries have agreed that, as long as the taxpayer was in existence on December 19, 2000, it may elect to continue to the former treaty through the last day of the taxpayer's first fiscal year beginning on or after January 1, 2001. Thus, for a taxpayer in existence on December 19, 2000, with a fiscal year ending on November 30th, the former Treaty will continue to apply through November 30, 2002, if an election is made.

Taxpayers that did not exist prior to the date of entry into force of the 1996 Treaty will not be entitled to claim the benefits of the former treaty beyond December 31, 2000.

c. The U.S. and The Netherlands Schedule Treaty Negotiating Session

The U.S. and the Netherlands announced that they will meet in Washington in April to negotiate revisions to the existing income tax treaty. The treaty, which at the time, was viewed to have the most favorable – if not the most understandable – limitations on benefits provision, has become woefully dated and unattractive. The derivative benefit provision is too complex and restrictive and the withholding tax for direct investment dividends detracts from making the Netherlands the location of a holding company. The discussions will likely seek to modify both provisions by adopting provisions in other more recent treaties. For example, the withholding tax provision could take into account the zero withholding tax rules that appear in the U.S.-U.K. treaty proposed in 2001 and the limitation on benefits provision could take into account the derivative benefits provision in the U.S.-Luxembourg income tax treaty.

d. U.S. and Japan Continue to Negotiate New Treaty

Japan and the U.S. have been negotiating a new income tax treaty since October 2001, to bring the 1972 Treaty more in conformity with more recent treaties and changes in domestic tax law. The U.S. is insisting that withholding taxes on dividends, interest, and royalties must be reduced or abolished. The U.S. is pushing for changes that reflect either the O.E.C.D. Model or more recent U.S. treaties with O.E.C.D. countries.

The current treaty has a 10% withholding tax on direct investment dividends. The U.S. would like the rate reduced to 5%. With respect to interest, the U.S. would like the withholding tax eliminated or reduced to 5%. Current U.S. treaties with many O.E.C.D. countries provide for a zero withholding on interest, although the O.E.C.D. Model continues to have a 10% tax rate. The possibility of including an arbitration clause is also under discussion. The current treaty does not have any provision addressing income not mentioned in the treaty. Many tax treaties provide that income not specifically addressed is taxed only by the taxpayer's residence state. Japan and the United States are considering adding that clause.

e. <u>Other Treaty Matters</u>

It is reported that the Israeli Government has broached the possibility of opening treaty negotiations to modify some of the existing rules in the treaty in order to make the treaty more attractive to U.S. businesses investing in Israel. The U.S. and Canada are rumored to continue negotiations with an intent to eliminate withholding tax on direct investment dividends. The conduit provision of the proposed U.S.-U.K. treaty continues to be controversial and several commentators have requested clarification on the scope of the overly broad language. The problem has been identified by U.S. practitioners and likely reflects the language differences between U.S. and U.K. English.

f. <u>List Of Countries Published Granting Equivalent Shipping Exemption</u>

In Rev. Rul. 2001-48, the I.R.S. published an updated list of countries that grant U.S. persons equivalent exemptions from income tax for the international operation of ships and aircraft. See Code §§872(b) and 883. The equivalent exemption may be provided by diplomatic note, domestic law, or income tax treaty. Bahrain, Ethiopia, Saudi Arabia, Bolivia, and the United Arab Emirates have been added to the list of countries that have exchanged diplomatic notes with the United States. Aruba, Peru (with respect to aircraft), and the Republic of Surinam have been added to the list of countries whose domestic law has been determined to provide an equivalent exemption. Estonia, Latvia, Lithuania, Slovenia, South Africa, Thailand, Turkey, the Ukraine, and Venezuela have been added to the list of countries that have signed income tax treaties with the U.S. Austria, Denmark, Ireland, Luxembourg, and Switzerland have had income tax treaties replaced. Taxpayers claiming an exemption from U.S. Federal income must file a return and otherwise comply with the relevant provisions of section 8 of Rev. Proc. 91-12.

g. <u>Lottery Winnings not Exempt Under Treaty</u>

In Field Service Advice 200141020, the Associate Area Counsel (Small Business/Self-Employed) ruled that the winner of a State lottery was subject to U.S. tax and that nothing in the Israel-U.S. Income tax treaty mandated a different conclusion.

In the facts presented, a particular state conducted a lottery in the U.S. The lottery called for 20 payments with no lump sum payment feature. The payment stream was funded by the acquisition of zero coupon bonds by the State. An individual resident of the U.S. won the lottery. He then moved to Israel. The individual contended that the lottery payment spread over 20 years was an annuity, and accordingly, tax exempt in the hands of a non-citizen with regard to the U.S., residing in Israel.

The Office of Associate Area Counsel (Small Business/Self-Employed) reached a contrary conclusion. Gambling winnings are considered to be income that is subject to withholding tax in the U.S. and annual payments received from a lottery are properly classified as gambling winnings. Regardless of payment structure, lottery winnings retain their classification as gambling income and, as such, are subject to a 30% withholding tax under Code §§ 871 and 1441.

To qualify as an annuity under the Treaty, the annuitant must have paid adequate and full consideration for the periodic payments received. The sum of one dollar paid for the lottery ticket is not adequate and full consideration for a large lottery payout. See e.g., Perkins v. Commr., 40 T.C. 330 (1960), acq., 1964-1 C.B. 5 (treaty with Italy); Lamm v. Commr., 34 T.C.M. 473 (1975) (treaty with Sweden). In both cases, the Court focused on the consideration provided and held it to be insufficient given the "adequate and full" requirement in the respective treaty definitions of an annuity. Thus, even if the lottery winnings did not retain their classification as gambling winnings, the annuity provision of the Treaty does not apply.

h. Competent Authority Statistics Released.

The I.R.S. released competent authority statistics covering the fiscal year ending September 30, 2001.

- During that year, 189 competent authority cases were completed, of which 34 involved bilateral advance pricing agreements, 72 involved matters other than transfer pricing for inventory, such as limitation on benefits issues, and 83 involved inventory transfer pricing adjustments.

- As of September 30, 2001, the I.R.S. had 499 cases in its inventory. Of that amount, 141 involved bilateral advance pricing agreements, 125 involved matters other than transfer pricing for inventory, such as limitation on benefits issues, and 233 involved inventory transfer pricing adjustments.

- Fewer than two dozen tax law specialists are working on competent authority cases.

- o The average processing time for closed cases was 796 days if the matter involved inventory transfer pricing adjustments initiated by the U.S. and 693 days if the matter was initiated by foreign jurisdictions. The average processing time was 429 days for other matters initiated by the U.S. and 553 for other matters initiated by foreign jurisdictions. The average processing time for bilateral advance pricing agreements was 645 days in 2001, up from 240 days in 1997.

- o Relief in the form of a correlative adjustment or a withdrawal of the initial adjustment was granted covered over 73% of the aggregate tax adjustments reviewed by competent authority. Partial relief was granted over 2.5% of the aggregate tax adjustments reviewed by competent authority. In the balance of tax adjustments reviewed, no relief was granted. This was a nonrecurring statistic and reflected the withdrawal of one particular case involving significant tax adjustments.

- o Of the transfer pricing cases involving inventory adjustments, 35 competent authority cases were initiated by the U.S. and 78 were initiated by foreign countries.

4. <u>F.I.R.P.T.A. and Other Inbound Matters</u>

a. <u>Transfer of stock in U.S. Real Property Holding Corporation ("U.S.R.P.H.C.") for Foreign Corporation Stock Qualifies for Nonrecognition</u>

In International Legal Memorandum 200137037, the Office of Associate Chief Counsel (International) ruled that a foreign corporation could exchange shares of stock of a U.S.R.P.H.C. for shares of stock in a foreign corporation in a transaction that is tax-free under Code §§351 and 897(e)(1).

In the fact pattern considered, foreign corporation A owned 100% of foreign corporation B, which in turn owned 100% of foreign corporation C. All the corporations were resident in the same foreign country, none engaged in a U.S. trade or business, and each owned shares in a U.S. Real Property Holding Company ("U.S.R.P.H.C"). The U.S.R.P.H.C. also issued a class of shares to the public. In a proposed transaction, foreign corporation A was to transfer its shares in the U.S.R.P.H.C. to foreign corporation B in exchange for additional shares of B. The transfer was characterized to be free of tax under Code §351(a). Neither foreign corporation had any intent to dispose of the shares involved in the transaction. Country X has a comprehensive income tax treaty with the US and has an exchange of information provisions. The I.R.S. was requested to rule that the transaction could be effected free of any tax under F.I.R.P.T.A. The I.R.S. concurred.

Ordinarily, gain must be recognized when a foreign person exchanges a U.S. Real Property Interest ("U.S.R.P.I.") for other property, meaning property that is not a U.S.R.P.I. For the general rule, see Regs.

§1.897-5T(d)(1)(iii). However, an exception when a foreign person transfers a U.S.R.P.I. to a foreign corporation in exchange for the stock of the foreign corporation if a subsequent disposition of the U.S.R.P.I. by the foreign corporation would be subject to U.S. tax. The exception is provided in Regs. §1.897-6T(b)(1).

The regulations contain five conditions, any one of which must be met before the exception applies. The conditions are: (i) the interests exchanged would not be U.S.R.P.I. if the corporations involved in the exchange were domestic corporations; (ii) the foreign transferee is incorporated in a foreign country that maintains an income tax treaty with the U.S. containing an information exchange provision, however, to meet this condition, the transferee must submit a binding waiver of all benefits of the income tax treaty; (iii) the transferee foreign corporation is a qualified resident as defined in Code §884(e) of the foreign country in which it is incorporated; (iv) the transferee foreign corporation is incorporated in the same foreign country as the transferor foreign corporation and an income tax treaty is in force that contains an exchange of information provision; and (v) the transferee foreign corporation is incorporated in the same foreign country as the transferor foreign corporation; and the transfer is incident to a mere change in identity, form, or place of organization of one corporation under Code §368(a)(1)(F).

If one of the conditions is met, the exception will apply only to a transaction that provides for a complete carryover of basis in the U.S.R.P.I. by the transferee. Thus it applies to a transfer covered by Code §361(a) that is made pursuant to reorganization described in Code §368(a)(1)(D) or (F). In such case, the asset transfer must be accompanied by an exchange of the transferor corporation stock for the transferee corporation stock under Code §354(a). It also applies to an exchange is made by a foreign corporation pursuant to Code §361(a) in a reorganization described in Code §368(a)(1)(C). Finally, it applies to an exchange involving stock in a U.S. real property holding corporation covered by Code §351(a), or in the case of a reorganization, an exchange covered by Code §354(a) (pursuant to in a reorganization described in section 368(a)(1)(B). In either version of the last type of transaction, there can be no shift of ownership interests among the members and the stock received must be held for three years.

The regulations provide that the foregoing procedure is the only exception to the general rule when there is a transfer of a U.S.R.P.I. by a foreign person to a foreign corporation in exchange for stock in a foreign corporation. Thus, no exception is provided where the exchange is made pursuant to a Code §351 transaction and the U.S. real property interest transferred is not stock in a U.S. real property holding corporation.

The I.R.S. concluded that the exception applied. The U.S. corporation was a U.S.R.P.H.C.; the proposed transfer of shares in the U.S.R.P.H.C. was covered by Code §351(a); the transfer was also covered by Code §897(e); all of the requirements of were met.

b. Financing Interest Derived Through Pass-through Certificate Held to Qualify as Portfolio Debt of C.F.C. when the Underlying Obligor is Unrelated to the C.F.C.

In Private Letter Ruling 200203026, the Office of Associate Chief Counsel (International) ruled that interest derived from pass-through certificates acquired by a C.F.C. subsidiary from a grantor trust could qualify for an exemption from tax when the certificate is in registered form and the payor of interest to the trust is unrelated to the C.F.C.

The U.S. financial institution held securitized debt backed by liens on consumer durable goods. It formed a grantor trust to which it transferred the consumer loans in issue. An affiliate formed a C.F.C. and transferred cash to the C.F.C. Thereafter, the C.F.C. purchased trust certificates of beneficial interest from the grantor trust. It was specifically represented as a condition of the ruling that the certificates were pass-through certificates within the meaning of Regs. §1.871-14(d) and that they were in registered form. None of the consumers were related to the C.F.C.

Portfolio interest is any interest (including original issue discount) that would be subject to U.S. withholding tax in the hands of a foreign person which is paid on an obligation that is, *inter alia,* in registered form. The withholding agent must receive a statement that the beneficial owner of the obligation is not a U.S. person. If the foreign person is a C.F.C., the interest will not be considered to be paid on an item of portfolio debt if the recipient is related to the lender.

To meet the registration requirement, Regs. §1.871-14(d)(1) provides that the pass-through certificate must be in registered form even if the underlying debt held by the trust is not in registered form. However, to meet the requirement that the interest cannot be paid by a related party, the focus is directed to the C.F.C. and the underlying debtor of the trust – that person must be unrelated to the C.F.C. Thus, the related party requirement is tested by looking at the C.F.C. and the underlying borrowers whose loans are held by the trust.

Here, the pass-through certificates were represented to be in registered form and consumer borrowers were represented to be unrelated to the C.F.C. Consequently, the interest derived by the C.F.C. was exempt from tax under the portfolio debt provisions of U.S. law.

c. Accrued but Unpaid Interest to Foreign Lender is not Deductible.

In Square D Co. v. Commr., 118 T.C. ___, No. 15, the Tax Court upheld the validity of Regs. §1.267(a)-3, and held that accrued but unpaid interest is not currently deductible by a U.S. company when the lender is a foreign corporation.

In the case, the taxpayer was a U.S. corporation that reported income under the accrual method of taxation. It was owned by a French-based group of companies. In the year in issue, it accrued but did not pay interest owed to related group members in France. Nonetheless, it claimed deductions for the interest accruals.

The I.R.S. disallowed the deduction of the interest accrual to the extent no payment was made. Its position was based on Regs. §§ 1.267(a)-3(c)(2) and 1.267(a)-3(b)(1), which require a taxpayer to use the cash method of accounting in deducting amounts of interest, which is U.S. source and not income effectively connected with a U.S. trade or business, owed to a related foreign person, whether or not the foreign person is exempt from U.S. tax on such interest under a treaty.

The taxpayer appealed the disallowance to the U.S. Tax Court, which previously held that the regulation was invalid. Tate & Lyle, Inc. v. Commr., 103 T.C. 656 (1994), revd. and remanded 87 F.3d 99 (3d Cir. 1996). In that case, the Tax Court reasoned that the regulations adopted an approach that was different from the approach of the statute in a sister provision of Code §267(a)(3). The sister provision (Code §267(a)(2)) states that where the interest is never taxable, the matching requirement of the provision is not applicable. Code §267(a)(3), however, is expressly applicable to interest payments to foreign persons. It grants to the I.R.S. the authority to issue regulations. The issued regulations deny deductions for interest expense until payment is made to the foreign lender. The Tax Court abandoned its previous position, which was reversed by the Third Circuit Court of Appeals, and held that the regulation was valid.

The Tax Court applied cases that establish rules of construction for statutory provisions. It determined that Code §267(a)(3) was not a clear and unambiguous expression of legislative intent. Once it reached that conclusion, The Court reasoned that the regulation was a permissible construction of Code §267(a)(3), and not manifestly contrary to the statutory language.

The Court then held that the provision does not violate the nondiscrimination provision of Article 24(3) of the France-U.S. Income Tax Treaty. Article 24(3) prevents other or more burdensome tax treatment for a U.S. corporation owned by residents of France. The Tax Court determined, however, that Article 24(3) does not apply when there is no connection between the residence of the owners and the different tax treatment that results under U.S. law. The basis for deferring the interest deduction under the regulation is dependent entirely on the U.S. tax treatment of the payment in the hands of the foreign corporation, not the identity or nationality of the owner of the payor.

5. Form of Transaction Challenged

a. Circular Flow of Cash – Investment in U.S. Property Ignored Resulting in loss of Foreign Tax Credits

Sometimes, taxpayers become so enamored with the benefits of a plan, that they overlook simple risks inherent in the transaction. This was evidenced in the tax plan underlying International Legal Memorandum 200137037, in which the Office of Associate Chief Counsel (International). There, the I.R.S. advised a field office that a taxable investment in U.S. property specifically engineered by the taxpayer should be disregarded because in substance a loan from a controlled foreign corporation was merely a circular flow of cash that began and ended within a U.S. group.

In the circumstances, a member of a U.S. group of corporations owned all the shares of the parent of a U.K. group of companies. For undisclosed tax planning reasons, the group wanted to engineer an investment in U.S. property by a lower-tier corporation within the U.K. group. To effect the transaction, one member of the U.S. group loaned funds to one member of the U.K. group, which in turn loaned funds to the U.K. company that was to make the investment in U.S. property. On December 29th of the year in issue, that corporation made a loan to a second member of the U.S. group. The loan was in existence at year-end and constituted an investment in U.S. property within the meaning of Code §956. The income event was reported as going directly from the lending U.K. company to the U.S. Shareholder of the U.K. group. Foreign tax credits were claimed in the U.S. for the U.K. income tax paid by the lending entity. Immediately thereafter, dividends were distributed within the U.K. group and to the U.S. group. These dividends were treated as coming from previously taxed income generated by the investment in U.S. property.

The memorandum concluded that the transaction was, in substance, a back-to-back loan between two domestic corporations and that the U.K. intermediary corporations were interposed solely for the purpose of claiming foreign tax credits. Consequently, the transactions involving the intermediary entities in the U.K. should be collapsed so the incidents of taxation reflect the true economic substance of the transaction.

What was the U.S. group attempting to accomplish by the plan? It could have obtained a foreign tax credit if the loan were not made as long as dividends were paid. However, the amount of the foreign tax credit that would attach to a taxable dividend might have been significantly lower. While the memorandum is silent, it is conceivable that the effective foreign tax rate at the level of the lending entity was greater than at the level of the U.K. parent company. Several reasons could exist for this. First, the parent might have benefited from group relief. Second, the lending entity might be engaged in a business for which capital allowances might be limited. The result would be a mismatch of depreciation for U.S. and U.K. tax purposes, a greater effective tax rate in the U.K. Whatever the reason, the taxpayer ignored the I.R.S. position on circular flows of funds, and the anticipated benefit of the tax plan was put at risk.

b. Circular Flow of Cash – Dividend Ignored, Foreign Tax Credit Disallowed

In Field Service Advice 200135020, the Office of Associate Chief Counsel (Corporate) of the I.R.S. concurred with an examining agent that a distribution funded by a capital contribution is not properly treated as a dividend and as a result, no foreign tax credit could be claimed.

In the case, several transactions took place in close proximity, all of which were properly documented. First, a domestic parent corporation made a capital contribution to a foreign subsidiary that was formally accepted by that subsidiary. Second, the directors of the foreign subsidiary declared the payment of a dividend. Finally, the dividend was paid. The unaudited financial statement of the subsidiary described the substance of these transactions as a transfer of retained earnings to paid-in capital. Nonetheless, they were reported as separate transactions on the statement of cash flows to these financial statements.

The I.R.S. examiner contended that the purported dividend should not be respected as such for U.S. Federal income tax purposes. Because the dividend was paid only days after the capital contribution, and because the amounts were identical, the transactions should be collapsed into an integrated transaction. The effect of the combined transactions was a capitalization of retained earnings which should be treated as a nontaxable stock dividend under Code §305. When viewed in that light, no dividend would exist to trigger an indirect foreign tax credit.

The Office of Associate Chief Counsel (Corporate) concurred on several grounds. First, based on several published revenue rulings, it was clear that the cash was transferred and returned in transactions that should be disregarded for income tax purposes. It was a circular flow of cash. See Rev. Rul. 83-142, 1983-2 C.B. 68 and Rev. Rul. 74-564, 1974-2 C.B. 124. However, because the foreign subsidiary actually issued shares of stock in connection with capital contribution leg of the transaction, the stock cannot be disregarded. Giving effect to the issuance of this stock, it is clear that it merely represents a stock dividend that is tax-free under Code §305(a).

Alternatively, the step transaction doctrine could apply to achieve the same result. Under the step transaction doctrine, a series of formally separate steps may be collapsed and treated as if they constitute a single integrated transaction. Three tests are used to determine if the doctrine applies – (i) the binding commitment test, (ii) the mutual interdependence test, and (iii) the end result test. Under the binding commitment test, a series of formally separate transactions are collapsed if, when the first step is taken, there is a binding commitment to take the later steps. Under the mutual interdependence test, a series of formally separate transactions are collapsed if they are so interdependent that the legal relations created by one transaction would be fruitless without completion of the series. Under the end result test, a series of formally separate transactions are collapsed if they appear to be prearranged parts of a single transaction intended from the outset to reach the ultimate result. The Office of Associate Chief Counsel (Corporate) conclude that a court would apply at least one of the tests in the facts examined to determine the actual substance of the transaction – a non-taxable stock dividend under Code §305(a).

The taxpayer argued that the foreign corporation had the financial liquidity to pay a cash dividend absent the capital contribution. However, the I.R.S. expressed the view that cash liquidity should not be considered to support characterization of the transaction as a cash dividend. Although several cases have considered the lack of cash to conclude that that a stock dividend took place, the test is a one-way street. The existence of liquidity does not support the proper characterization of a transaction.

c. Absence of Business Purpose – Code §351(a) Ignored

In Field Service Advice 200135001, the I.R.S. Assistant Chief Counsel (Field Service) concluded that no business purpose existed for a transfer to a controlled corporation. Therefore, the nonrecognition provisions of Code §351 were inapplicable and gain would have to be recognized.

In the case, a corporation was in the business of developing and managing facilities for customers. It formed a R.E.I.T. and agreed to sell and leaseback certain facilities. Before the transaction, however, the corporation transferred facilities, which had built-in gain, to one of its subsidiaries in return for the issuance of voting stock. At the same time, a foreign individual transferred interests in various trusts with high basis and low value to the subsidiary in return for nonvoting preferred stock. The transaction was cast as tax-free under Code §351(a) since the transferor group controlled the subsidiary. Upon receiving the assets, the subsidiary sold the facilities to the R.E.I.T., and the assets received from the foreign individual to a third party. The losses from the latter sale was used to offset the gain. The high likelihood is that the foreign individual was introduced to the transaction by a financial intermediary.

The question presented to the Assistant Chief Counsel was whether the transfer to the subsidiary was properly exempt from tax under Code §351(a). The conclusion was no, the transaction produced a recognized gain. In reaching its conclusion, the I.R.S. examined the purpose for Code §351 and determined that the purpose would not be achieved if nonrecognition treatment was extended.

Code §351(a) provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation. Under Regs. §1.351-1(a)(1) and Code §368(c), the transferors are in control of the transferee corporation if, immediately after the transfer, they own stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of share of all other classes of stock of such corporation. The ownership interests of all transferors participating in a single transaction are aggregated to determine whether the control test is met.

If the transferor in a transaction subject to Code §351 receives not only the transferee corporation's stock but also other property or money ("boot"), gain must be recognized. The amount of gain is limited to the amount of money received plus the fair market value of other property received. Any loss is not recognized. If Code §351 does not apply, the transfer of property is a taxable exchange.

Courts have held that a transaction meeting the statutory elements of Code §351 will not qualify for nonrecognition if it lacks a non-tax, business purpose. See Caruth v. U.S., 688 F. Supp. 1129, 1138-1141 (N.D. Tex. 1987), aff'd on other issues, 865 F.2d 644 (5th Cir. 1989); Stewart v. Commr., 714 F.2d 977, 992 (9th Cir. 1983). In this context, courts consistently look to several factors to evaluate the existence of a valid, non-tax business purpose. These factors include (i) whether the transfer fulfilled its stated purpose, (ii) the extent to which the transferor, rather than the transferee, benefited from the transfer, (iii) the extent to which the transferee needed the property, (iv) the length of time between the transfer and subsequent events, (v) the number of similar transfers, (vi) the taxpayer's expertise in tax matters, and (vii) the transaction's form. Courts also examine any explicit indicators of a taxpayer's intent, such as documents or negotiations that confirm or belie the existence of a prearranged plan.

The I.R.S. Assistant Chief Counsel (Field Service) concluded that tax avoidance on the sale and leaseback was the only purpose for the transfer of assets by the corporation and the foreign individual. Hence, Code §351(a) was not applicable. The assets received in the transaction were sold within days after their receipt in a transaction that was. The assets that produced the loss – which were received from the foreign individual – had no relationship to the business of the corporation or the subsidiary. They produced a loss that offset the gain from the transfer of business assets. The given business reasons were not persuasive in light of the Federal tax benefit.

In addition, the I.R.S. Assistant Chief Counsel (Field Service) expressed the view that the corporation was the true seller to the R.E.I.T. under concepts first enunciated in Commr. v. Court Holding Co., 324 U.S. 331 (1943*)*, because the underlying business transaction was agreed to prior to the introduction of the foreign individual and his assets. Finally, the I.R.S. suggested that Code §482 might be applicable and that information regarding the basis of the property transferred by the individual might be lacking.

d. I.R.S. Ignores Status of a C.F.C. as a Contract Manufacturer to Prevent Code §863(b) Allocation.

For U.S.-based groups that have foreign tax credit limitation constraints, Code §863(b) provides a planning opportunity to increase foreign source income. In broad terms, it allows all or a portion of the income from the manufacture and sale of a product to be allocated to the place where manufacturing activities occur. Thus, if a U.S. company were to manufacture in Mexico to supply the U.S. market, the manufacturing profits could create foreign source taxable income, thereby increasing the foreign tax credit limitation. The planning opportunity becomes less certain when the manufacturing operations are carried on by an affiliate of the U.S. taxpayer. The U.S. company is not clearly the manufacturer – it does not have its name on the plant, nor is it registered to carry on business in Mexico. Nonetheless, many taxpayers have been advised to apply Code §863(b) if the Mexican affiliate is a contract manufacturer, merely supplying a labor component to manufacturing operations carried on under the overall control of the U.S. company. The I.R.S. opposes this view and in Field Service Advice 200141010, the Office of Associate Chief Counsel (International) advised the examining agent to disallow application of Code §863(b).

In the Field Service Advice, a U.S. company owned several C.F.C.'s organized in Mexico. The C.F.C.'s assembled products for under the Maquiladora program. The U.S. company entered into an assembly agreement, administrative and technical assistance agreement, and a consignment agreement with each C.F.C. After the products were assembled in Mexico, the U.S. company sold them to an affiliate in a transaction calling for the passage of title in the U.S. In its consolidated tax return, these sales were reported as foreign source income in part as a result of an allocation under the formula that appears in Code §863(b). The basis for this position was that the agreements entered into by the U.S. company made it the producer of the products assembled in Mexico. It owned and controlled the tooling, machinery, plant, and equipment located at the C.F.C.'s premises in Mexico and maintained title to raw materials, work-in-process, and ending inventory throughout the manufacturing process. As a final point, it supplied the technology used in the manufacturing process, dictated design specifications, production volumes, and scheduling, and bore the economic risk of loss with regard to production.

Both on the facts and its view of the law, the Office of Associate Chief Counsel (International) disagreed. To apply Code §863(b), inventory property must be produced by the taxpayer and the taxpayer's production activities occur, in whole or in part, outside the United States. These tests must be applied in a manner that is consistent with the statutory purpose. As a result, a U.S. company must actively create or transform property in Mexico in order for it to come within the ambit of the provision.

The taxpayer failed to demonstrate that it actively produced inventory in Mexico. First, it was not clear that the U.S. company, itself, engaged in production processes. The U.S. company did not provide detailed information on the roles of U.S. personnel in connection with the products, or on the location of such personnel. No information was provided on whether U.S. personnel made any contributions to relevant functions performed, risks assumed, or assets employed in any production process. Second, the activities of the C.F.C.'s, cannot be attributed to the U.S. company. The U.S. company must participate in the process. The statute refers exclusively to inventory property produced "by the taxpayer" and does not provide for the attribution of third party production activities such as contract manufacturer. The I.R.S. refused to look at the economic substance in determining whether the U.S. company could be viewed to be the manufacturer of the property. Strangely, the I.R.S. cited as authority for its position Phillips Petroleum Co. v. Commr., 101 T.C. 78 (1993), a case in which the activities or a third party were attributed to a principal in order to avoid Subpart F income.

As a back-up argument, the I.R.S. expressed the view that the all the income from performing assembly operations in Mexico was generated by the C.F.C.'s and reported by them in the form of their fees. When the U.S. company outsourced the assembly function to the C.F.C. and paid an arm's length fee for the services supplied, the C.F.C. was properly considered to have earned all the income from activities carried on in Mexico. Since those activities had nothing to do with the U.S. Company, the income of the C.F.C. should not be attributed to the U.S. company. Viewed this way, the U.S. company had income only from U.S. sources. Although not addressed in the Field Service Advice, this line of reasoning can provide a bonanza to foreign companies engaging agents in the U.S. who receive arm's length fees. Taken to its logical conclusion, a foreign company can arrange for manufacturing or services in the U.S. in connection with a sale to a foreign customer without incurring U.S. tax.

Finally, the Office of Associate Chief Counsel (International) ruled that the U.S. company could not rely on Rev. Rul. 75-7, to conclude that the activities of an agent can be attributed to its principal. That ruling was issued with regard to Subpart F, and characterizes the principal in a contract manufacturing context as the manufacturer of the product. The procedure and administration regulations caution taxpayers that they cannot rely on rulings unless the facts are substantially the same. Treas. Regs. §601.601 (d)(2)(v)(e). Because that ruling dealt with Subpart F and the matter under consideration dealt with Code §863(b), the facts are not substantially similar.

e. Code §863(b) -- I.R.S. Lists Factors Used to Determine Whether a Principal is Engaged in Production Activities.

For taxpayers that qualify, Code §863(b) allows an entity that manufactures property in one jurisdiction and sells it in another jurisdiction to apportion the income from those activities on a 50-50 basis between two baskets – income from production and income from sales. To qualify, a taxpayer must engage in production activities and a contentious issue often is raised when a company engages a contract manufacturer to carry on activities on its behalf – are the activities of the agent attributed to the principal. The I.R.S. position is that attributed activities are not taken into account. However, where the principal oversees the activities of the agent, there may be room for the principal to be engaged in the production process by reason of its own activities. In Field Service Advice 200152006, the I.R.S. provided some guidance on what activities it would look at to determine whether the principal was engaged in production activities by reason of its oversight activities at the production premises.

In the FSA, a U.S. company ("USCO") had several Maquiladora subsidiaries with which it had production agreements. USCO shipped component parts produced in the U.S. to the Maquiladoras for the final stage of production. The inventory property was then shipped back to USCO for sale within the U.S.

USCO maintained a hands-on approach during the manufacturing activities that took place in Mexico.

- It retained title to the inventory property throughout the production process until the point of final sale.
- It owned a majority of the property and equipment used in the Maquiladoras' activities as well as all intangibles related to the Maquiladoras' operations.
- All research and development activities, including product design, were conducted in the U.S. by USCO.
- The Maquiladoras did not perform any research and development activities and did not have any design engineers on their payrolls.
- Original plant layout and processes were developed by USCO.
- USCO employees performed all day-to-day on-site management at the Maquiladoras.
- USCO was responsible for the overall strategic decisions regarding development, design, and production at factories of the Maquiladoras.

- o USCO employees located on the premises of the Maquiladoras were responsible for ordering and shipping raw materials to the Maquiladoras.

- o USCO employees regularly traveled to the Maquiladoras to monitor quality standards.

- o Production scheduling was overseen and approved by USCO employees, and the production process at the Maquiladoras plant was overseen by USCO engineers.

For Code §863(b) to apply, the inventory property must be produced by the taxpayer and the taxpayers production activities must occur, in whole or in part, outside the U.S. Although the Office of Associate Chief Counsel (International) was unable to conclude whether those tests were met, it provided a list of factors that would be used to control that determination. The factors are intended to shed light on the location of the specific functions performed, assets used, and risks assumed, and the role of the employees of USCO with regard to each of those factors. Consequently, the examiner was instructed to obtain the following facts:

- o Specific details as to the activities and functions involved in the day-to-day on-site management of the Maquiladoras, the USCO employees who perform them, the locations where these activities and functions were performed, and information as to the time spent in Mexico.

- o The USCO employees were responsible for overall strategic decisions regarding development, design, and production for the Maquiladoras, specific details as to the activities and functions involved in such strategic decision-making, the locations where these decisions were made, and information as to the time spent in Mexico.

- o Specific details as to the activities and functions involved in ordering and shipping raw materials to the Maquiladoras, the USCO employees who perform them, the locations where those activities and functions were performed, and information as to the time in Mexico.

- o The USCO employees who oversee and approve production scheduling and planning, the nature of their production-related activities and functions, the locations where these activities and functions were performed, and information as to the time spent in Mexico.

- o The areas of the Maquiladoras' operations overseen by USCO employees, the employees involved, specific details as to the activities and functions performed by these employees, the locations where these activities and functions were performed, and information as to the time spent in Mexico.

- The content and nature of the reports reviewed by USCO personnel in the U.S., the persons responsible for generating those reports, and the place where those reports were produced.

- Specific details as to the activities and functions performed by the USCO employees directly responsible for all costs related to sales, raw material purchases, inventory value, capital expenditures, and human resources expenditures, the locations where these activities and functions were performed, and information as to the time spent in Mexico by the USCO employees.

- The nature of the discretionary testing functions performed by USCO technical personnel at the Maquiladoras and the frequency with which these tests were performed.

- The nature of the activities and functions involved in the control of the Maquiladoras by USCO, the USCO employees who perform these activities and functions, the locations where these activities and functions were performed, and information as to the time spent in Mexico.

f. <u>Tax Court Disallows Bad Debt Deduction for Intercompany Advances to an Offshore Subsidiary</u>

In planning for a cross border investment, taxpayers often wish to characterize cash advances to a subsidiary as debt. If debt, the principal can be repaid without withholding tax; if the company fails, the debt can be written off as a bad-debt expense. Whether an advance is properly treated as debt is a question of fact. Taxpayers fail to craft the characteristics of debt to their instruments often find that they have created equity rather than debt. This was recently illustrated in Flint Industries Inc. v. Commr., T.C. Memo. 2001-276.

In this case, a U.S. corporation was the sole shareholder of a German subsidiary. In earlier years, the German subsidiary was an industry leader in air bag sensor technology. During the year in issue, new products superseded its technology and its patents had little or no value. At some point, the subsidiary was unable to pay its bank loans and trade payables currently out of cash flow generated from operations. Consequently, the U.S. corporation advanced the necessary funds to prevent a default on certain bank loans.

The group used an intercompany account to record various charges and credits among the different companies. Intercompany account balances were recorded in the books and records of the companies as accounts receivable/payable and accrued interest at a market rate. The intercompany account balance of the German subsidiary during the years in issue in the case consisted of: (a) corporate charges; (b) interest charges; (c) allocations of expenses incurred on a group basis for the parent; (d) intercompany purchases;

and (e) cash advances; i.e., cash paid directly to banks by the U.S. corporation or advanced to the subsidiary for the purpose of meeting other short-term financial obligations, such as payroll.

The German subsidiary made no payments on its intercompany account balance during the years in issue and the U.S. parent corporation did not expect advances it made to be repaid. Indeed, the financial condition of the subsidiary was so bad that the U.S. corporation could have forced it to file for bankruptcy simply by withholding additional financial support. Eventually, the U.S. corporation wrote-off its equity in the company and attempted to deduct the amount of advances that were outstanding in the intercompany account. The I.R.S. challenged both deductions and the Tax Court sustained the I.R.S. with regard to the bad debt deduction, but not with regard to the worthless stock deduction.

Code § 166 authorizes a taxpayer to deduct any debt that becomes worthless within the taxable year. Business bad debts are deductible as ordinary losses to the extent of the taxpayer's adjusted basis in the debt. To prevail, a taxpayer must establish that, as of the years the advances were made, (i) a bona fide debt existed to pay a fixed or determinable sum of money, (2) the debt was created in connection with the taxpayer's trade or business, and (3) the debt became worthless in the year the bad debt deduction was claimed. Because the U.S. corporation failed to demonstrate that a bona fide debt existed, it was denied a bad debt deduction.

The Court applied relatively standard criteria in evaluating the status of the advances through the intercompany account. The Court's analysis in the taxpayer's circumstances may be summarized as follows:

- <u>The name given to the certificate</u> – because the advances were not memorialized by any promissory note or other documentation, the factor was not relevant;

- <u>The presence or absence of fixed maturity date</u> – the intercompany account was an open account with a running balance and no fixed date for repayment, an indication of equity;

- <u>The source of the repayments</u> – the source of repayment was contingent upon earnings or a restricted source, such as a judgment recovery, dividends, or profits, an indication of equity;

- <u>The right to enforce repayment</u> – no evidence was introduced that the U.S. corporation had a right to enforce the repayment of amounts advanced to the subsidiary, another indication of equity;

- <u>Increase in management participation</u> – where participation in management is increased as a necessary part of an effort to prevent a debtor's financial collapse from becoming public, the factor is neutral;

- <u>A status equal or inferior to other creditors</u> – an advance that is subordinated to regular creditors suggests that an equity investment was intended, as does the failure to demand timely repayment;

- <u>The intent of the parties</u> – because the taxpayer made the advances to keep the subsidiary from defaulting on its bank loans and other obligations, it could not have reasonably intended the advances to be bona fide debt;

- <u>The identity of interest between creditors and shareholders</u> – advances made by a sole shareholder are more likely to be committed to the risk of the business and indicative of an equity investment than are advances made by creditors who are not shareholders of the corporation;

- <u>The payment of interest only out of profits</u> – the failure to insist on interest payments indicates that the payors expect to be paid out of future earnings or through the increased market value of their equity interest;

- <u>The ability to obtain funds from outside lending institutions</u> – the record contained no evidence tending to demonstrate that the subsidiary could have obtained comparable loans from unrelated financial institutions, an indication of equity;

- <u>The extent to which the advances were used to acquire capital assets</u> -- here the advances were used primarily to service existing bank loans and, therefore, was not relevant; and

- <u>The failure to repay on the due date</u> – because the advances were made pursuant to an open account arrangement with no fixed date for repayment, this factor was not relevant.

Once the Court decided that the advances amounted to equity, the U.S. corporation was entitled to increase the amount deductible as a result of the worthless of the stock of the subsidiary. See Code §165(g)(3). Corporations may claim an ordinary loss deduction if the worthless stock is that of an affiliate. Otherwise, the worthless stock deduction produces a capital that cannot be used by a corporation to reduce taxable income from operations.

g. <u>Canadian Tax Plan for Funding U.S. Subsidiary Upheld – Inconsistent Treatment of Interest Payment Allowed</u>.

In Field Service Advice 200146013, the Office of Office of Associate Chief Counsel (International) concluded that a U.S. corporation properly deducted interest expense even though its foreign parent treated the interest payment as dividend income for purposes of the tax in its country of residence.

In the case, a U.S. corporation was owned by a Canadian parent company. The Canadian parent arranged for two of its Canadian subsidiaries to form an L.L.C. in the U.S. to which funds were contributed. The

L.L.C. engaged in the business of funding the U.S. corporation and members of its group. In that regard, it loaned funds to the U.S. corporation.

At some point, the two Canadian subsidiaries were liquidated into the Canadian parent. As a result, it owned a 100% membership interest in the L.L.C. The L.L.C. did not elect to be treated as a corporation for U.S. tax purposes. According to the final U.S. partnership return of the L.L.C., the liquidation caused the technical termination of the L.L.C., resulting in a deemed distribution of all of the assets to the Canadian parent corporation. Immediately following the liquidation of the two Canadian subsidiaries, the Canadian parent contributed its ownership interest in the L.L.C. to the U.S. corporation in exchange for stock and debt of the U.S. corporation. Except for the principal amount, many of the terms of the old debt held by the L.L.C. and the new debt issued by the U.S. corporation were the same. They both (i) called for the accrual of interest at the same rate (the interest was compounded and payable semi-annually), (ii) matured in six years, and (iii) contained provisions identical with respect to prepayment and events of default.

The taxpayer paid interest on the debt held by the Canadian parent company and withheld the rate of tax for interest. Under the terms of the U.S.-Canada Income Tax Treaty, interest payments are generally subject to a 15% rate of withholding tax. The Canadian Parent corporation treated the payment as a dividend from exempt surplus for Canadian tax purposes. Such dividends are not taxed in Canada under terms of Canadian domestic law. Under the terms of the U.S.-Canada Income Tax Treaty, direct investment dividend payments from a subsidiary to its parent are generally subject to a 5% rate of withholding tax.

Upon examination, the I.R.S. examiner contended that the U.S. corporation was not entitled to deduct the interest expense accrued and paid on the debt. The examiner contended that the contended that the U.S. corporation had effectively disavowed the form of its transaction when the parent company treated the payment as a dividend for Canadian tax purposes. Alternatively, the examiner contended that the U.S. corporation and its parent had a joint duty to treat the payment consistently. Finally, the I.R.S. examiner contended that the U.S. corporation recognized forgives of indebtedness income when the old note was effectively contributed to it at the time the L.L.C. interest was transferred by the Canadian parent.

The Office of Associate Chief Counsel (International) disagreed on all points. The fact that the Canadian parent company characterized the payment as a dividend for Canadian tax reporting purposes, rather than interest, is not sufficient by itself to conclude that the U.S. corporation disavowed form it chose for the transaction. Regarding the duty of consistency, that doctrine is designed to prevent a taxpayer from recharacterizing a transaction after the statute of limitations closes a year; the taxpayer is bound by the earlier characterization. Here, however, the taxpayer is not acting inconsistently with a position taken in an earlier year. Even if it did, that year has not been closed by the running of the statute of limitations. Thus, there is no duty of consistency that applies to the U.S. corporation.

As to cancellation of indebtedness income, Code §108(e)(10)(A) provides generally that a debtor is treated as having satisfied a debt with an amount of money equal to the issue price of a new debt where the debtor issues a new debt instrument in satisfaction of the old debt instrument. Where neither the new nor the old indebtedness is publicly traded and Code §1274 does not apply, the issue price of a debt instrument issued for property is its stated redemption value at maturity.

A solvent corporate debtor does not realize taxable cancellation of indebtedness income on the issuance of stock in exchange for its debt obligation unless there is a difference between the amount of debt discharged and the value of the stock. Thus, if there was a deemed issuance of stock of the U.S. corporation with a fair market value equal to the outstanding balance of the old debt – taking into account the issuance of the new debt – the old debt is considered to be repaid in full and no cancellation of indebtedness income exists. Only if the deemed issuance of stock is not respected will there be cancellation of indebtedness income, and then, only to the extent of the difference between the amount of the new and old notes.

h. Note Payable in Debtor's Shares of Stock is not True Debt for U.S. Income Tax Purposes.

In Field Service Advice 200145005, the Office of Associate Chief Counsel (Corporate) held that a note payable solely in shares of stock of the debtor corporation is not considered to be true debt for U.S. income tax purposes. The taxpayer's treatment of the transaction as an equity investment was proper.

In the case, a foreign subsidiary of a U.S.-based group borrowed a fixed amount of dollars from a bank. The terms of the borrowing provided that principal was due at maturity, but that interest was due and payable periodically. The foreign subsidiary was a disregarded entity for U.S. income tax purposes that was owned by a U.S. corporation.

The foreign subsidiary/disregarded entity used the proceeds of the bank loan to enter into a currency swap agreement with an affiliate in the U.S. The foreign subsidiary received an equivalent amount of foreign currency, was obliged to pay interest on its bank borrowing denominated in terms of U.S. dollars, and was obliged to return the foreign currency denominated principal amount at maturity in return for the face amount of the initial bank loan.

The foreign subsidiary used the foreign currency received in the swap to purchase a promissory note of a second foreign corporation that was an affiliate. The note provided for annual interest payments to be made by the issuance of voting common stock of the debtor. The note also provided for repayment of principal by the second foreign corporation on or before the maturity of the currency swap previously described. At the same time, the foreign subsidiary/disregarded entity entered into a stock purchase agreement with second foreign corporation mandating the purchase of shares in the second corporation on or before the due date of the promissory note. Under the terms of the stock purchase agreement, the foreign subsidiary/disregarded entity could acquire shares in the second corporation by tendering the note if it were not timely paid. In addition, the second corporation could issue shares in full payment of the note.

Ultimately, the note was tendered in exchange for voting common. Because the foreign subsidiary was a disregarded entity, the note was treated on the U.S. consolidated return as a direct equity investment in the second foreign corporation by the U.S. shareholder. That U.S. shareholder did not report any payments received by the foreign subsidiary/disregarded entity as interest income. Nonetheless, for foreign tax purposes, the note was treated as debt and interest as interest income and expense were reported by the two foreign entities.

Upon examination, the I.R.S. examiner proposed to treat the note as true debt. However, the Associate Chief Counsel (Corporate) concluded that the taxpayer's treatment of the instrument was correct. Under the note, as modified by the purchase agreement, second foreign corporation was in substance required to repay the entire principal amount due by issuing shares of its own stock. This type of arrangement lacked a significant indicia of debt – no unconditional promise existed to pay a sum certain on demand or on a specified maturity date. Instead, all payments of interest and principal were to be made in shares of voting common stock of the issuer of and the number of shares was fixed on the date the note was issued regardless of the value of such shares. Hence, the note and purchase agreement, together, caused the instrument to be properly treated as equity. An earlier ruling that allowed a comparable instrument to be treated as equity (Rev. Rul. 85-119, 1985-2 C.B. 60) was not followed – there, the value of the shares at maturity controlled the number of shares that would be required to satisfy the obligation.

6. Foreign Tax Credit

a. Blocked Service Fees Properly Accrued, but Withholding Taxes Could not be Accrued until Paid

The foreign tax credit is intended to assist companies in avoiding double taxation by allowing U.S. tax on foreign source income to be reduced by foreign taxes. The timing of the credit is often – but not always – dependent on the method of accounting used by the taxpayer. In light of the purpose of the credit, that rule makes a great deal of sense. Unfortunately, there are times when the I.R.S., ignores the forest for the trees and adopts a highly technical position that ignores the purpose of the statute. This was evidenced in Field Service Advice 200139008.

The matter involved a U.S. corporation that provided services to its wholly owned foreign subsidiaries. Under the laws of the foreign country where located, the subsidiaries were prohibited from making payments for services to any person domiciled abroad. Nonetheless, for U.S. income tax purposes, the U.S. corporation accrued an arm's length amount of fee income from the subsidiaries and deducted the costs associated there with. The U.S. corporation computed U.S. tax and claimed a direct foreign tax credit for withholding taxes that would have been due had the service fees actually been paid.

After two years in which no fees were paid, the foreign subsidiaries distributed dividends to the U.S. corporation. A portion of the dividends was characterized by the U.S. corporation as payment of an account receivable arising from the performance of services. Withholding taxes were paid on the dividend distribution and the U.S. corporation claimed a foreign tax credit only for taxes in excess of the amounts previously accrued.

On examination, the I.R.S. originally disallowed the inclusion of the service fees and the deduction of service costs. It also disallowed the treatment of a portion of the dividend payments as service fees and disallowed the claim for foreign tax credits made when the service fees were accrued. Instead of having accrued service fee income every year, U.S. Corp would have dividend income only when the dividends were actually paid. On the surface, this is not a disadvantageous position for the company, as long as the performance of services resulted in the accrual of net income as it deferred the income event and the foreign tax credits.

The matter was forwarded to the Office of Associate Chief Counsel (International) who concluded that modified treatment was required. According to the Field Service Advice, the U.S. corporation properly accrued service fee income and expenses as reported in the return. However, the direct foreign tax credits could not be accrued prior to the taxable year in which the foreign withholding tax was actually paid. Since the withholding tax was paid more than two years after the accrual of the service fee income, the tax could not be carried back to the tax returns of the earlier years in the event foreign tax credit limitation was insufficient in the year paid. Finally, it was acknowledged that the I.R.S. could agree with the U.S. corporation pursuant to the terms of a closing agreement that a portion of dividends in subsequent years could be characterized as an account receivable payment, rather than taxable dividend income.

The Field Service Advice distinguished the holding in Proctor & Gamble v. Commr., 961 F.2d 1255 (6th Cir. 1992), where the taxpayer had no expectation of receiving its royalty and technical service payments. Here, the U.S. corporation had a reasonable expectation that it would receive dividends so it would have been required to accrue the service fees.

b. French Research Credit Does Not Reduce Foreign Taxes of Subsidiary.

In Technical Advice Memorandum 200146001, the National Office of the I.R.S. concluded that a research credit offered by the French Government did not reduce the pool of taxes available to be claimed as a foreign tax credit at the time a dividend was distributed to a U.S. parent company.

In the facts under consideration, a U.S. corporation operated a business in France through several corporations, each of which was a controlled foreign corporation ("C.F.C."). The C.F.C.'s were subject to the generally imposed French corporate income tax. During the year in issue, the U.S. corporation received a dividend from the C.F.C.'s and claimed an indirect foreign tax credit for the French corporate income taxes that were paid by the C.F.C.'s. For the years in issuer, the French C.F.C.'s joined in the filing of an integrated tax return in France, the equivalent of a consolidated tax return.

The subsidiaries claimed the benefit of a research credit in France. The credit reduced the income taxes payable by the French group. Initially, the U.S. corporation computed its foreign tax credit by treating the French research credit as a reduction in French taxes. Subsequently, the U.S. corporation decided the French research credits should not be treated as reducing creditable foreign taxes but rather should be treated as increasing income for purposes of the French CFCs' earnings and profits. The change in treatment enhanced the foreign tax credit benefits claimed by the U.S. corporation.

The National Office of the I.R.S. agreed with the taxpayer that the research credit was not a reduction in tax, but was additional income to the subsidiaries of the taxpayer. In reaching that decision, the National Office focused on the refundable nature of the credit. The credit was refundable, although from 1992 forward, the benefit of the refund was delayed. For most corporations, unused research credit could be carried forward for up to three years, and if not fully used after the close of the carryforward period, the credit was refundable in cash. The National Office reasoned that this feature prevented the credit from being an income tax related item.

The income tax regulations implementing the foreign tax credit, Regs. §1.901-2(e)(2)(i), provide that a foreign levy is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven. However, the regulations are silent with regard to refundable credits that are designed to be an alternative to a cash subsidy. Consequently, the regulations were not controlling and the purpose of the credit and the manner of its operation would have to be taken into account.

Here, the credit was designed to be a less intrusive form of subsidy to French companies performing research. There was no doubt that taxpayers would obtain benefit from the credit, either as a tax reduction or as a subsidy in the event of losses. Approximately 20% of the credits claimed in France took the form of cash refunds. The I.R.S. viewed the refund aspect of the credit as not insubstantial. In these circumstances, it reasoned that, because the subsidy would be income, the refundable credit is income, too.

c. <u>Regulations Issued on Foreign Tax Credit Limitation and Loss Allocation from Sales of Personal Property and Stock</u>.

In January 1999, final regulations were issued addressing the allocation of loss on the disposition of stock (Regs. §1.865-2) and amending the foreign tax credit passive limitation grouping rules (Regs. §1.904-4(c)) together with temporary regulations relating to the allocation of loss on the disposition of personal property other than stock (Regs. §1.865-1T). These regulations provide a special matching rule with respect to the allocation of certain stock losses (Regs. §1.865-2T). Treasury has finalized the temporary regulations substantially as proposed and has added clarifying amendments to Regs. §1.865-2.

The general rule of Regs §1.865-1(a) is that loss is allocated to the class of gross income to which gain from the sale of such property would give rise in the seller's hands, i.e., on a reciprocal-to-gain basis. The generally rule will expressly apply to bad debt losses and losses on property that is marked-to-market, unless expressly excluded, as in the case of inventory property and certain derivative contracts. The general rule also applies to losses on the disposition of a partnership interests, on a reciprocal-to-gain basis. However, loss on a debt instrument that has unamortized bond premium is allocated by reference to interest on the instrument, but only to the extent the amount of bond premium that could have been, but was not, amortized by the taxpayer before the loss was recognized.

The final regulations apply to losses recognized on or after January 8, 2002. A taxpayer may choose to apply the regulations to losses recognized in taxable years beginning on or after January 1, 1987, subject to certain conditions.

Regarding losses arising from stock transactions, the temporary regulations provided that the loss is allocated and apportioned against foreign source income to the extent a taxpayer previously recognized such income and the recognition of income resulted in the creation of a corresponding loss. No intent was required for this rule to apply. The final regulations modify that rule so that it will only apply if a taxpayer engages in a transaction with a principal purpose of recognizing foreign source income that results in the creation of a corresponding loss. The provision is targeted at fast-pay stock arrangements described in Regs. §301.7701(l)-3.

The dividend recapture period has been revised in the final regulations to provide that the 24-month period ends on the date on which a loss is recognized by a taxpayer with respect to shares of stock. In addition, the recapture period is expanded if the assets of the corporation are converted to low-risk investments with a principal purpose of enabling the taxpayer to hold the stock without significant risk of loss until the recapture period would otherwise have expired. Finally, the dividend recapture rule applies to a dividend paid after the date a loss is recognized, if the loss is incurred after the dividend was declared (i.e., when the stock is sold ex-dividend).

The final regulations retain an effective date of January 11, 1999, except that the effective date for any amendments will apply to losses recognized on or after January 8, 2002. A taxpayer may choose to apply the regulations to loss recognized in any taxable year beginning on or after January 1, 1987, subject to certain conditions.

d. Fifth Circuit Reverses Tax Court and Allows Foreign Tax Credit in *ex dividend* tax plan – Plan had Profit Opportunity.

In U.S. tax jurisprudence, the concept of economic substance is almost as old as the tax law itself. Transactions entered into by individuals must have economic substance in order to be recognized for U.S. income tax purposes. Transactions having appropriate form but no substance risk being ignored by the I.R.S. and Courts.

Recently, investment banks and accounting firms have aggressively marketed financial products to large corporations having capital gains and other types of income. The products are designed to create large capital losses that eliminate U.S. tax on actual capital gains. These products have been developed by the firms, often without a particular client in mind. Once the product is completed, it is marketed to potential clients, including those having regular contacts with the firm and those with whom the firm has had little or no prior history.

In response, the I.R.S. has attempted to extend the concept of substance over form to large corporations. The basis of the argument is that the transaction generating the gain has no substance or business purpose other than the reduction of U.S. income tax and no reasonable likelihood of generating a profit. Such transactions have no economic substance according to the I.R.S.

The matter has now been addressed by several courts in the U.S. These cases reflect conflicting views between the U.S. Tax Court and several Appellate Courts and at least one District Court. Compaq Computer Corporation v. Commr., ___ F. 3d ___ (5th Cir., Docket No. 00-60648, December 38, 2001), revg. 113 T.C. 214 (1999) is an example of the conflict among Appellate Courts having a lower threshold for economic substance and the Tax Court and the I.R.S.

The taxpayer in Compaq Computer Corporation derived a long-term capital gain, which would have been subject to a 35% tax in the absence of planning. Twenty-First Century Securities provided Compaq with a financial vehicle that was designed to produce a technical loss. In the transaction, Compaq purchased ADRs "cum dividend," followed by the immediate resale of the same ADRs "ex dividend." "Cum dividend" refers to a purchase or sale of a share of stock or an ADR share with the purchaser entitled to a declared dividend (settlement taking place on or before the record date of the dividend). "Ex dividend" refers to the purchase or sale of stock or an ADR share without the entitlement to a declared dividend (settlement taking place after the record date).

Twenty-First Century Securities personnel met with the Compaq's assistant treasurer, and treasurer for one a hour meeting to discuss the investment opportunity. The meeting was followed by a brief internal discussion among Compaq's financial executives and a decision was reached to go forward with an ADR transaction. Compaq purchased 10 million ADRs of Royal Dutch Petroleum Company, cum dividend, for $887,577,129. It immediately sold the ADRs ex dividend for $868,412,129. At the same time Compaq became entitled to a dividend of $22,545,800, subject to a 15% withholding tax.

On its tax return, Compaq reported a short term loss that offset the capital gain, foreign source dividend income, and a foreign tax credit. The loss and the foreign tax credit were disallowed by the I.R.S. Compaq appealed to the Tax Court.

The Tax Court affirmed the notice of deficiency issued by the I.R.S. Every aspect of Compaq's ADR transaction was deliberately predetermined and designed to yield a specific result and to eliminate all economic risks and influences from outside market forces on the purchases and sales in the ADR transaction. Compaq had no reasonable possibility of a profit from the ADR transaction without the anticipated Federal income tax consequences. No business purpose existed for the purchase and sale of the ADRs apart from obtaining a Federal income tax benefit in the form of a foreign tax credit while offsetting the previously recognized capital gain.

The Tax Court had no difficulty in describing the investment opportunity as a tax shelter transaction. Compaq used a minimal commitment of funds to secure a disproportionate tax benefit. The Tax Court favorably quoted from Saviano v. Commr., 765 F.2d 643 (7th Cir. 1985), affg. 80 T.C. 955 (1983):

> The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along. The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of transactions to their economic substance and to apply the tax laws accordingly.

Compaq argued that the transaction was not a tax shelter. Rather, its taxable income increased by approximately $1.9 million as a result of the ADR transaction and that its worldwide tax liability increased by more than $640,000, illustrated by the following analysis.

ADR purchase trades	($887,577,129)
ADR sale trades	868,412,129
Net cash	($19,165,000)
Royal Dutch dividend	22,545,800
Transaction costs	(1,485,685)
Pretax Profit	$1,895,115

Compaq also argued that , the reduction in U.S. income tax received was not the result of a reduction in income tax paid by Compaq. Each dollar of income tax paid to the Netherlands was just as real, and was the same detriment to Compaq, as each dollar of income tax paid to the U.S. A “tax benefit” can be divined from the transaction only if the income tax paid to the Netherlands with respect to Royal Dutch dividend is ignored for purposes of computing income taxes paid, but is included as a credit in computing Compaq's U.S. income tax liability.

The Tax Court adopted the I.R.S. view that Compaq was not entitled to the benefits of the capital loss and the foreign tax credit because the ADR transaction had no objective economic consequences or business purpose other than reduction of taxes.

In so holding, the Tax Court evaluated the profit motive of Compaq by looking at its return, treating the foreign tax credit as an expense. In other words, the profit motive analysis was performed on a financial accounting basis rather than a tax return basis. According to the Court, the tax reporting strategy of Compaq was designed to produce an economic gain when — and only when — the foreign tax credit was claimed. By reporting the gross amount of the dividend, when only the net amount was received, Compaq created a fictional \$1.9 million profit as a predicate for a \$3.4 million tax credit. Looked at in this way, Compaq lost money and could not have done other than lose money when gains, losses, dividends, taxes and other expenses are taken into account. The Tax Court rejected Compaq's argument that pretax income is the standard and on that basis, almost \$2.0 million was made. The Tax Court reasoned that if Compaq's logic were followed to conclusion, the \$2.0 million of profit was subject to a combined Dutch and Federal income tax of \$4.0 million. This made no sense.

According to the Court, Compaq incurred an inevitable economic detriment to petitioner from engaging in the ADR transaction, as demonstrated by the following cash-flow analysis:

ADR purchase trades	(\$887,577,129)
ADR sale trades	868,412,129
Net cash from trades	(\$19,165,000)
Gross dividend	\$22,545,800
Netherlands withholding tax	(3,381,870)
Net cash from dividend	\$19,163,930
Cash shortfall	(\$1,070)
Commissions	(1,000,000)
Adjustment for give-back	1,071
SEC fees	(28,947)
Margin write-off	37
Interest	(457,846)
Net cash from transaction	(\$1,485,685)

The cash-flow deficit arising from the transaction, prior to use of the foreign tax credit, was predetermined by the careful and tightly controlled arrangements made between Compaq and Twenty-First Century Securities. The Tax Court viewed the investment as an attempt to "capture" a foreign tax credit by timed acquisition of ADRs cum dividend and the sale of ADRs ex dividend. The taxpayer's goal was to acquire a foreign tax credit, not substantive ownership of Royal Dutch ADRs.

The purchase and resale prices of the trades were predetermined and the executing floor brokers did not have authority to deviate from the predetermined prices even if a price change occurred. In addition, the ADR transaction was divided into 23 corresponding purchase and resale cross-trades that were executed in succession, almost simultaneously, and within an hour on the floor of the NYSE. There was virtually no risk of price fluctuation. Special next-day settlement terms and large blocks of ADRs were also used to minimize the risk of third parties breaking up the cross-trades, and, because the cross- trades were at the market price, there was no risk of other traders breaking up the trades. None of the outgoing cash-flow resulted from risks.

To satisfy the business purpose requirement of the economic substance inquiry, the transaction must be rationally related to a useful non-tax purpose that is plausible in light of the taxpayer's conduct and economic situation. This inquiry takes into account whether the taxpayer conducts itself in a realistic and legitimate business fashion, thoroughly considering and analyzing the ramifications of a questionable transaction, before proceeding with the transaction. According to the Tax Court, Compaq could not meet that test.

On appeal, the holding was reversed. The Appellate Court disagreed with the methodology used by the Tax Court in determining whether the transaction had economic substance. In Frank Lyon Co. v. U.S., 435 U.S. 561, 583-584 (1978), the Supreme Court stated that a transaction will have substance and will not be treated as a sham if either one of two tests are met. The first is that the taxpayer was motivated by a business purposes in addition to obtaining tax benefits. The second is that a reasonable possibility of a profit exists with regard to the transaction.

According to the Appellate Court, the Tax Court's conclusion that no reasonable opportunity for profit existed apart from the income tax consequences of the transaction resulted from a curious calculation of net "cash flow." The Tax Court assessed neither the transaction's pre-tax profitability nor its post-tax profitability. Instead, the Tax Court assessed profitability by looking at the transaction after Netherlands tax had been imposed but before considering U.S. income tax consequences. The Tax Court subtracted Compaq's \$20.7 million in capital losses, not from the \$22.5 million gross dividend, but from the \$19.2 million net dividend. The Tax Court then ignored the \$3.4 million U.S. foreign tax credit that Compaq claimed corresponding to the \$3.4 million Netherlands tax. In that manner, the Tax Court treated the Netherlands tax as a cost of the transaction, but did not treat the corresponding U.S. tax credit as a benefit of the transaction. The result of this half pre-tax, half after-tax calculation was a net loss figure of roughly \$1.5 million. This approach was erroneous.

If the effects of tax law, domestic or foreign, are to be accounted for when they subtract from a transaction's net cash flow, tax law effects should be counted when they add to cash flow. To be consistent, the analysis should either count all tax law effects or not count any of them. To count them only when they subtract from cash flow is to stack the deck improperly against finding the transaction profitable.

The Appellate Court also disagreed that the tax-saving motivation of Compaq necessarily tainted the transaction as a sham. The standard applied by the Tax Court did not properly apply the two-step analysis of the Supreme Court and was struck down in IES Industries Inc. v. U.S., 253 F. 3d. 350 (8th Cir. 2001). As in IES Industries, the ADR transactions were not conducted by alter egos or by straw entities created by the taxpayer simply for the purpose of facilitating the transactions. Instead, all of the parties involved were entities separate and apart from the taxpayer, doing legitimate business before the trades in issue and continuing that business after the trades were completed. There is no reason to believe that the transaction did not have substance.

7. Transfer Pricing -- I.R.S. Wins on Principles, DHL Wins on Money

The I.R.S. has adopted a position in matters involving transfer pricing issues that independent parties can be under common control – the basic threshold for a transfer pricing adjustment – if they engage in a transaction that has a common business goal. The validity of this position was recently affirmed in DHL Corp. v. Commr., ___ F.3d ___ (Ninth Cir., Docket No. 99-71580, April 11, 2002), although significant portions of the adjustment were reversed and the entire amount of the penalties was abated.

DHL was formed in late 1960s to operate a courier service between San Francisco and Hawaii. It rapidly grew to serve Los Angeles-San Francisco documents and Southeast Asia. Asian operations were controlled by a then subsidiary, DHLI, formed in Hong Kong; foreign persons acquired over a 25% interest in the company. To comply with the letter of C.A.B. ownership limitations, DHLI was sold to foreign shareholder group.

Until a sale to institutional foreign investors, DHLI and DHL were operated as affiliates; DHL controlled U.S. business and DHLI controlled international business. Local operations around the world were conducted by affiliates or subsidiaries of DHLI. A mixture of operational independence and cooperation was the hallmark of the network. Thus, (a) physical locations were shared; (b) common use was made of the DHL trademark and logo; (c) a network-wide compensation arrangement existed; (d) network-wide seconding of senior executives took place; and (e) interlocking management of DHL and DHLI existed.

The basic business arrangement was simple – pick up in one country and delivery in the second country. Through 1987, the originator received entire customer fee. To the extent there is a balance of pick-up volume and delivery volume, system provided fair results. Indeed, it was similar to international postal arrangement through 1969. Foreign affiliates within foreign network paid DHLI a processing fee as reimbursement for the maintenance of central organization.

Beginning in 1987 and 1988, an imbalance fee was implemented between DHLI and DHL. The inbound (U.S.) and outbound pick-up and delivery volumes were tracked. The entity having greater delivery volume received a payment equal to the cost of the net difference plus 2%.

DHL owned the trademark in the U.S. from the beginning. All companies in the network were required to use the trademark. However, logos varied around the world, on a country-by-country basis, until a common logo was commissioned and paid for by DHLI. A cooperative corporate identity manual was drafted by DHL and DHLI. A massive 10-year spending campaign in the U.S. by DHL ($150MM) and abroad by DHLI ($380MM) on advertising and brand awareness.

A memorandum of understanding existed which acknowledged that DHL was owner of trademark and that limitations existed on DHLI's use. Under the agreement, upon termination of agreement, DHLI prohibited from using trademark for 5 years. Nonetheless, the DHL trademark was registered in foreign countries by DHLI, at its cost, with no mention of DHL's beneficial ownership or DHLI's function as agent. DHL received virtually no royalties for the network's use of trademark and logo. DHLI monitored use of trademark by international network members.

DHL's financial position in the U.S. was precarious. In 1987, merger discussions with UPS proved unsuccessful. UPS valued the overseas network but did not place significant value on the DHL trademark. In 1988, discussions began with a consortium consisting of JAL, Lufthansa, and Nissho Iwai who were interested in trademark and international network of DHLI. A sale of an interest in DHLI was ultimately agreed to in 2-step transaction. Initially, purchasers obtained 12.5% of shares of stock and control of board of directors, subject to certain super-majority provisions. Ultimately, the purchasers could acquire an additional 45% of DHLI shares.

The ownership and value of the DHL trademark became a major issue in the negotiations. From purchaser's viewpoint, ownership of the trademark provided control over DHL, which was perceived as an unreliable network member. From DHL's viewpoint, the sale would provide badly need cash to be used in business or to repay debt. Various prices considered for DHL trademark, ranging from $25 million, to $50 million, to $100 million. Ultimately the following was agreed to: (i) $20 million purchase price for U.S. and foreign trademarks; (ii) a license allowing for 15-year royalty-free use of the U.S. trademark; and (iii) a royalty of 0.75% of sales after royalty-free period. Once the $20 million purchase price was agreed, the price was supported by a comfort letter of an economic consulting firm used by DHL. The transaction was agreed to before the foreign investors acquired shares of DHLI and control of Board of Directors, but was contingent on the sale of the controlling shares to those investors.

Ultimately, the operations of DHL were examined by the I.R.S. in a contentious examination. The I.R.S. determined that the trademark was owned exclusively by DHL prior to the sale and that royalties should have been paid over the years by DHLI in connection with its use outside the U.S. The I.R.S. also determined that the arm's length value of the trademark was $100 million and that, as DHL and DHLI were under common control, Code §482 applied. The $20 million purchase price was less than arm's length. Income was adjusted, tax was increased, and penalties were asserted. The I.R.S. determination was appealed to the U.S. Tax Court.

The Court affirmed the I.R.S. assertion that DHL and DHLI were under common control and that Code §482 was applicable to intercompany transactions. Although the foreign investors controlled DHLI at the time of the purchase, the transaction was negotiated and agreed to when DHL and DHLI were under common control. The foreign investors had no significant interest in making sure that the sales price was arm's length as they were purchasing a foreign business and the allocation of values was not material to their tax position. Consequently, the Court determined that the amount received for the sale of the trademark was too low to be arm's length and that the adjustment in income was appropriate. The Court dismissed arguments raised by DHL that the substantial investment in the trademark made by DHLI made it the developer of the item of intangible property under the developer/assister rules of the regulations. These rules provide that the single developer of the intangible must be identified when a group of related companies joins in the funding of the development of the item of intangible property. It is usually the party that takes on the most risk and expends the greatest amount of funds. Once the developer is identified, all other parties are assisters. Their expenditures are generally treated as loans to the developer. The imposition of penalties was also affirmed.

DHL appealed part of the Tax Court's decision regarding the application of Code §482 and the Ninth Circuit reversed in part.

Initially, the Ninth Circuit came to the same conclusion as the Tax Court regarding the existence of common control. Common control between DHL and DHLI existed up to December 7, 1990; while that control existed, DHL and DHLI set the price term of the option to purchase the DHL trademark. Consequently, the Ninth Circuit found that Code §482 applied here. This transactional approach for determining common control under 482 comports with common sense, and the regulations, which state that "[i]t is the reality of the control which is decisive, not its form or the mode of its exercise." (Regs. 1.482-1(a)(3).)

The Ninth Circuit concluded that the time when the taxpayers (DHL and DHLI) were dealing with each other was when they set the terms of the option agreement, which controlled the price at which the trademark would be sold. DHL argued that the presence of the Consortium on the other side of the negotiating table precluded a finding that income was shifted between DHL and DHLI. Unlike the usual case of two controlled taxpayers making a deal with each other, the deal in this case was made between two controlled taxpayers and an entity not controlled by the taxpayers.

The Ninth Circuit did not find the Consortium's presence sufficient ground to preclude a transfer pricing adjustment, in light of the Tax Court's factual findings as to the Consortium's indifference to the specific trademark price term. Where a third party is indifferent to the terms of the transaction affecting the allocated items, its involvement does not interfere with the application of Code §482. The one outside party in this case, the Consortium, would be neither advantaged nor disadvantaged by the income shifting between DHL and DHLI, as long as the total price it paid for DHLI and the trademark rights remained the same.

Under Regs. §1.482-2(d)(1)(i), where intangible property is transferred between commonly controlled entities, the I.R.S. may make appropriate allocations to reflect arm's length consideration for the property or its use. The Tax Court found that $100 million ($50 million for the U.S. rights, $50 million for the foreign rights), rather than $20 million, was the arm's length value of the trademark. The Ninth Circuit did not find the Tax Court's valuation, a factual determination, to be clearly erroneous, thus it upheld the $100 million value. DHL argued that the valuation was arbitrary and unreasonable and that the Tax Court failed to articulate its reasoning.

The Ninth Circuit found that the Tax Court had complied with established standards by giving a step-by-step account of its reasoning. The Ninth Circuit found that although the Tax Court painted with a broad brush, it was to be expected given the imprecise art of valuing an intangible asset. DHL could dispute the exact figures used by the Tax Court, but it did not demonstrate clear error, either in the Tax Court's methodology or in its final result. The Ninth Circuit affirmed the Tax Court's valuation of the trademark at

$100 million, based on a $50 million figure for the domestic rights and a $50 million figure for the overseas rights.

After affirming the application of 482 to the trademark sale and the $100 million valuation for the trademark, the Ninth Circuit asked whether the tax court properly allocated the full $100 million to DHL. DHL did not appeal the Tax Court's finding that it was the legal owner of both the domestic and foreign trademark rights. Rather, DHL asserted that the Tax Court erred in applying the developer-assister regulations, which preclude the allocation to DHL of the $50 million value of the foreign trademark rights. The Ninth Circuit agreed and reversed the Tax Court on this point.

DHL contended that DHLI was the developer of the overseas trademarks. Consequently, the Tax Court's allocation for the foreign trademark value was erroneous because the transfer was not by the developer to a related entity, but rather from a related entity (DHL) to the developer (DHLI). The Tax Court found that DHLI was neither a developer nor an assister. The Ninth Circuit held the Tax Court applied the wrong legal tests under the developer-assister regulations in reaching its conclusions.

It held that DHLI was the developer of the international trademark, in which case no allocation to DHL for the value of the foreign trademark rights was appropriate, or, alternatively, that DHLI provided assistance to DHL's development, thereby entitling DHL to a complete setoff against the $50 million allocation.

The Tax Court upheld deficiencies based on allocated imputed income for the tax years 1990-1992 from uncharged royalties. The royalties were those the Tax Court held that DHL should have charged to DHLI for use of the DHL trademark from 1982 through 1992. Applying the same developer-assister regulations as above the Ninth Circuit reversed the allocation of unpaid royalties to DHL.

Finally, the Ninth Circuit reversed the Tax Court with regard to the imposition of penalties. By obtaining a comfort letter as to valuation from a noted firm of consultants who were provided full access to information, DHL acted reasonably and in good faith.

8. U.S.-E.U. Areas of Trade and Tax Dispute

a. Ongoing Travails of the F.S.C. and its Replacement

On August 20, 2001, the Word Trade Organization ("W.T.O.") publicly released the report of its panel on the controversy between the U.S. and the E.U. The panel concluded that the Extraterritorial Income Exclusion Act ("E.T.I.") violated the W.T.O. free trade rules. The report attacked the E.T.I. on several points.

- The E.T.I. is inconsistent with the Subsidies and Countervailing Measures Agreement ("SCM") because the E.T.I. subsidies were contingent on export and were not available for other sales.

- o The E.T.I. is not designed to avoid double taxation.

- o The subsidies to both scheduled and unscheduled agricultural products are inconsistent with the Agreement on Agriculture.

- o The E.T.I. regime is inconsistent with the foreign articles/labor limitation of GATT 1994 as it affords less favorable treatment to imported products than to similar products produced in the U.S.

- o The U.S. has not fully withdrawn the prohibited FSC subsidies. Finally, the panel concluded that because of these violations, the benefits accruing to the E.U. had been nullified or impaired.

On August 21, the E.U. announced that it would seek $4 billion in trade sanctions if the U.S. did not make the necessary changes to its "corporate tax" structure.

On November 26, 2001, the U.S. presented oral arguments in its appeal of the ruling. The basic argument was that if the decision is upheld, tax systems throughout the world would be undermined. The only way the U.S. could remain on equal footing with other tax systems would be a structural revision of U.S. tax law. That would violate U.S. sovereignty and put at risk the sovereignty of other countries, as well.

The U.S. also attacked the report of the panel. In its view, the report included many newly created rules, most of which were vague and subjective, and in some cases, the rules were contradictory. The result is that the report provides no guidance on the scope of an acceptable tax system. The U.S. insisted that the E.T.I. is not a subsidy because it is consistent with the longstanding normative benchmark rules of U.S. taxation. Income benefiting from the exclusion is not export-contingent either as a matter of law or as a matter of fact because it may be earned without regard to whether the goods are exported or produced abroad.

On January 14, 2002, the Dispute Settlement Body ruled against the U.S. in its appeal. It is possible there will be no sanctions imposed if Congress makes the legislative changes necessary to comply with the W.T.O. Arbitrators were to begin work by the end of the month to determine the amount that will be owed should the requisite changes not be forthcoming or some compromise is reached. The E.U. sought $4 billion in import preferences.

Early in February, the E.U. explained how it calculated the slightly more than $4 billion it said was owed to its members because of harm caused by F.S.C. and E.T.I. illegal export subsidies. The E.U. estimated that the value of the F.S.C. subsidy in 2002 was estimated to be about U.S. $7.5 billion. The nullification and impairment suffered by the E.U. was estimated to be U.S.$6.0 billion. Accordingly, the E.U. was entitled to claim sanctions of U.S.$13.5 billion, suggesting that the request for $4.0 billion was conservative and moderate.

The U.S. characterized the demand as a gross overstatement that was inconsistent with W.T.O. principles, the facts, and common sense. According to the U.S., the E.U.'s basic approach was improper because it bore no relationship to the level of nullification or impairment suffered as a result of the F.S.C. repeal and the creation of E.T.I. The U.S. also suggested that the wrong standard was used – that the proper standard was the one established in the Agricultural Agreement. The proper amount should be U.S. $956 million, an amount linked to the purported impact of the F.S.C on the E.U.'s actual trade interests. According to the U.S., an appropriate method of calculating the trade impact on the E.U. is to allocate to the E.U. a portion of the total amount of the F.S.C. subsidy based on the E.U.'s share of total non-U.S. global goods production. Applying this method, the appropriate amount of sanctions is no more than U.S. $956 million. Ultimately, the U.S. revised its number upward to between U.S. $1.05 billion based on 2001 data and U.S. $1.11 billion based on 2000 data because the harm to E.U. businesses included the value of U.S. exports of services.

If the arbitrators find that the E.U. is entitled to countermeasures in some amount, the E.U. would be in position to ask for W.T.O. authority to impose countermeasures sometime in May. However, there is no deadline by which the EU must request authority to impose countermeasures, nor is there any deadline by which the EU must impose countermeasures once the authority is received. If the E.U. decides to utilize the authority from the W.T.O. to impose countermeasures, it would likely move to seek approval from the E.U. Council of Ministers to impose increased tariffs on selected imports from the U.S. The timetable for sanctions is not clear.

b. E.U. VAT Proposal for E-Commerce

The E.U. Council of Economic and Finance Ministers has given its political agreement to the European Commission's June 2000 proposals for a Directive and a Regulation on the application of Value-Added Tax ("VAT") to digital products. The rules will apply to products such as computer games and software, delivered on line as opposed to in a physical form, as well as to subscription-based and pay-per-view radio and television broadcasting. Member States are due to implement the new rules by July 1, 2003.

The new rules will ensure that E.U. suppliers will no longer be obliged to levy V.A.T. when selling these products on markets outside the E.U. Current V.A.T. rules, drawn up before e-commerce existed, subject electronically delivered services originating within the E.U. to V.A.T. irrespective of the place of consumption, while those from outside the E.U. are not subject to V.A.T. even when delivered to consumers within the E.U. The new rules will also eliminate an existing competitive distortion by subjecting non-E.U. suppliers to the same V.A.T. rules as E.U. suppliers when they provide electronic services to E.U. customers, something which E.U. businesses have been actively seeking.

Under the new rules, no obligations will be imposed on non-E.U. suppliers selling to business customers in the Union. B2B sales are estimated to constitute at least 90% of the market. The V.A.T. will be paid by the importing company under self-assessment arrangements. However, the rules will require that suppliers of digital products from outside the E.U. will have to charge V.A.T on sales to private consumers, B2C sales. Non-E.U. suppliers will be required to register using special simplified arrangements with a V.A.T authority in any Member State of their choice, and to levy V.A.T. at the rate applicable in the Member State where the customer is resident. The country of registration will re-allocate the V.A.T. revenue to the country of the customer. This system will be applied for three years initially and may then be extended or revised.

The U.S. has expressed serious concern about the proposal. E.U. companies that sell digitally-delivered products to E.U. consumers would continue to charge V.A.T. at the rate applicable in the country of establishment regardless of where in the E.U. the consumer is resident.

In addition, U.S. sellers could be subject to more onerous administrative and compliance requirements than are placed on their E.U. competitors. V.A.T. on digitally-delivered products may be imposed at a rate higher than on physically-delivered equivalents, such as physical books, newspapers and magazines.

9. Withholding Tax Procedures

a. I.R.S. Issues Industry Specialization Paper on Crew Withholding Taxes.

The I.R.S. issued a revised industry specialization paper on crew withholding taxes in light of changes in U.S. tax law made in 1997. The paper concludes that in cases involving international transportation other than transportation to a U.S. possession, foreign employers paying wages should uniformly withhold employment tax from wages under Code §3402 rather than Code §1441.

The issue involves foreign corporations that are engaged in a trade or business in the U.S. through the operation of ships or aircraft. The ships or aircraft typically sail or fly around the world, transporting cargo and/or passengers. In issue are wages for the transportation that occurs between the U.S. and foreign destinations. Typically, the foreign corporations employ nonresident alien individuals as crew on the vessels or aircraft. Many of these crew employees do not have a U.S. social security number.

Code §3402(e) provides, in pertinent part, that if the remuneration paid by an employer to an employee for services performed during more than one-half of any payroll period does not constitute wages, then none of the remuneration paid by such employer to such employee for such payroll period shall be deemed wages. Income tax regulations (Regs. §31.3401(a)(6)-1(b)) specifically provide that remuneration paid to a nonresident alien individual for services performed outside the U.S. is excepted from wages and is not subject to withholding under section 3402. Since nonresident alien crew members employed on trips between U.S. and foreign destinations provide the greater portion of services outside the United States during any given payroll period, a literal application of Code §3402(e) to nonresident aliens earning compensation for performing services within and without the U.S. would result in none of the compensation paid the nonresident alien crew as being classified as wages subject to withholding.

However, in a 1995 industry specialization paper, the I.R.S. concluded that a literal interpretation of the statute was in appropriate in light of a revenue ruling involving social security taxes (Rev. Rul. 79-318, 1979-2 C.B. 352) and an earlier case (Inter-City Truck Lines, Ltd. v. U.S., 408 F.2d 686 (Ct. Cl. 1969)). The ruling and the case stand for the proposition that the exemption under the social security tax rules is inapplicable if the compensation within the payment period is performed outside the U.S. by a foreign person and is exempt merely because of the source of the compensation income. As a result, the paper concluded that employers are required to withhold employment taxes on the portion of compensation that is attributable to days worked in the U.S., generally on a time apportionment basis.

In 1997, U.S. law was revised for crew members of vessels; all compensation income paid to foreign crew members of vessels engaged in international transportation is now deemed to be foreign source income and is exempt from U.S. income tax. The I.R.S. announced, therefore, that, beginning in 1998, the 1995 paper is no longer applicable to foreign crew members of foreign vessels in international trade. However, the I.R.S. will continue to apply its position with regard to foreign members of aircraft in international transportation. Except to the extent that an income tax treaty provides otherwise, compensation for services performed in the U.S. must be identified and employment tax must be collected.

b. <u>Temporary and Proposed Regulations Issued on Expedited ITIN's For Foreign Persons.</u>

The I.R.S. has issued temporary and proposed regulations under Code §1441 that will enable withholding agents to obtain an Individual Tax Identification Number ("ITIN"). The intended beneficiary of this provision is a foreign person entitled to benefits under income tax treaties who receive an unexpected payment prior to the issuance of an ITIN by the I.R.S.

Payments of U.S. source income to foreign persons re subject to a 30% tax on certain items of income including interest, dividends, and royalties. The tax is generally collected through withholding at the source. The rate of tax can be reduced under an income tax treaty, but under current regulations, the benefit does not reduce withholding tax unless the withholding agent is provided with a Form W-8BEN, (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding). A taxpayer identifying number must be on the Form W-8BEN in order for it to be effective with regard to the treaty benefit. For those who qualify, the taxpayer identification number is a social security number. If an individual does not qualify for a social security number, the taxpayer identification number is an Individual Taxpayer Identification Number ("ITIN"). This is a special number obtained from the I.R.S. rather than the Social Security Administration.

If a foreign individual receives an unexpected payment without having a taxpayer identifying number, the withholding agent cannot rely on the treaty rate in computing the withholding tax. The foreign individual must file a tax return after the close of the year to seek to obtain a refund in tax.

To alleviate this filing burden, the I.R.S. has adopted administrative procedures that will allow certain withholding agents to apply for and obtain an ITIN on an expedited basis when an unexpected payment is made to a foreign individual. The new procedure applies to withholding agents who also are "acceptance agents" for Form W-7 (Application for IRS Individual Taxpayer Identification Number). If the ITIN cannot be secured before payment is made, the temporary regulations allow withholding agents, in limited circumstances, to rely on a Form W-8BEN that does not include a taxpayer identification number so that withholding can be effected at the reduced treaty rate. The application for the ITIN must be submitted to the I.R.S. on the first day following payment to the foreign individual.

10. Miscellaneous Items

a. I.R.S. Outlines Arguments Against "Basis Shifting" Tax Shelters Involving Foreign Tax Neutral Party

In a Chief Counsel Notice (CC-2002-001), the I.R.S. discussed ways that Chief Counsel attorneys could assist field personnel in developing cases involving transactions that are described in Notice 2001-45, 2001-33 I.R.B. 129 ("Code §302 Basis Shifting Tax Shelters"), one of numerous capital loss generators that have been peddled by accounting firms in recent years. The users of these financial products are generally interested in creating a capital loss – without significant economic costs – that will offset a pre-existing capital gain. It that way, capital gains taxes are eliminated.

A Code §302 Basis Shifting Tax Shelter involves the redemption of stock that is legally owned by a foreign person. In the transaction, dividend treatment is claimed, and for U.S. income tax purposes, the basis of the redeemed stock is transferred to stock held by a U.S. taxpayer. The Notice concludes that even if the transaction is respected, the redemption should be treated as a distribution in part or full payment in exchange for stock and not as a dividend. If the distribution is treated as a payment in exchange for stock, the basis of the redeemed stock should not be transferred to the basis of stock owned by the U.S. taxpayer. A basis shift would not be a proper adjustment contemplated by Regs. §1.302-2(c).

The Notice also states that any basis transferred to stock owned by the U.S. taxpayer, or any loss claimed with respect to the transfer of such basis, must be reallocated to the redeemed shareholder (the tax neutral foreign person) under Code §482, even if the U.S. taxpayer and the foreign person are otherwise independent of each other. Any loss claimed with respect to the transfer of the basis should be disallowed for reasons that may include, but are not limited to, Code §§165, 269 and 465, and the lack of economic substance.

o Typical Transaction

Code §302 basis shifting transactions have been widely marketed, primarily to individuals. While there are some variations in the steps, the typical pattern is as follows:

The taxpayer is a U.S. individual with substantial capital gains that he desires to shelter from tax. He purchases a small number of shares of the stock of a foreign bank on the open market. The foreign bank is not subject to U.S. tax and its shares are widely held and publicly traded. In addition, the taxpayer purchases from a foreign corporation that is not subject to U.S. tax, a warrant to acquire at least 50% of the foreign corporation's outstanding stock. The remaining issued and outstanding stock of the foreign corporation typically is owned by a foreign person who also is not subject to U.S. tax. The warrant allows the taxpayer the option to put the warrant back to the foreign corporation. Under this put option, the taxpayer may surrender or settle the warrant for a nominal amount of cash based on a percentage of the foreign corporation's net asset value.

In the next series of steps, the foreign corporation borrows an amount of money from the foreign bank that is approximately equal to the taxpayer's capital gain. With the proceeds of the loan, the foreign corporation purchases bearer shares of stock of the foreign bank. The shares are pledged to secure the loan and remain in the foreign bank's possession. Settlement on the acquisition contract for the foreign bank stock is set for a date at least 30 days in the future. At the same time, the foreign corporation purchases a put option from the foreign bank, obtaining the right to sell the bearer shares if the price falls below the initial purchase price, insulating itself from significant loss. The put is out of the money.

In addition, the foreign corporation sells a call option to the foreign bank with a strike price reset feature, giving the foreign bank the right to purchase its bearer shares at a price below their initial purchase price and limiting the foreign corporation's opportunity for significant gain. The call includes an integrated forward feature that, in the event of a change in the value of the foreign bank stock may result in income or gain to the foreign corporation. The call option is in the money.

On the settlement date, the foreign bank redeems the stock purportedly owned by the foreign corporation through the exercise of its call option. The foreign corporation uses the redemption proceeds to repay the loan it received from the foreign bank. Simultaneously, the taxpayer purchases an option to acquire a number of foreign bank bearer shares that is approximately equal to the number of foreign bank shares that the foreign corporation contracted to purchase. The taxpayer's option is deep out of the money and acquired at little cost.

In some variations of the transaction, the taxpayer subsequently transfers its foreign bank stock (and possibly its foreign bank options) to a partnership. The taxpayer (or the partnership) then sells all or a significant portion of the foreign bank stock. At some point before or after the stock sale, the taxpayer also surrenders the foreign corporation warrants. The taxpayer (or the partnership) either sells the foreign bank options or allows them to lapse with a relatively insignificant amount of gain or loss. In other variations, other derivative products are used instead of stock or option. Some transactions are structured to reduce gain rather than generate loss. Generally, the series of transactions is accomplished within several months or at most, within one year.

Typically, a promoter not only markets the plan, but also makes the necessary arrangements to accomplish the various steps and monitors the entire transaction to ensure that the steps within the transaction are done in a timely fashion and in accordance with the plan.

o Tax Consequences Claimed by Taxpayers

Taxpayers have increased basis by reason of the foregoing steps. As a result, when the transaction unwinds through the sale of shares, loss is recognized. The reasoning behind the taxpayer position is as follows.

Pursuant to Code §318(a)(4), the warrants result in a basis shift so that the taxpayer is treated as owning the stock that would be received upon exercise of foreign corporation warrants and the foreign bank options. Moreover, pursuant to Code §318(a)(3)(C), the foreign corporation is treated as owning the stock owned or treated as owned by the taxpayer. As a result, the foreign corporation is treated as owning the same number of foreign bank shares before and after the redemption of the foreign bank shares. Consequently, the redemption fails to satisfy any of the criteria of Code §302(b) under which it would be treated as a sale or exchange of shares. Consequently, under Code §302(d), the redemption is treated as a distribution of property to which Code §301 applies, and is treated as a dividend.

Dividend treatment is inconsequential to the foreign corporation because it is not subject to U.S. tax. Because the foreign corporation holds no foreign bank stock directly after the redemption, the foreign corporation's basis in its foreign bank stock is added to the taxpayer's basis in its foreign bank stock in accordance with Regs. § 1.302-2(c). The taxpayer's basis in its foreign bank stock greatly exceeds the stock's value and the disposition of the stock will result in the recognition of a substantial loss (in an amount approximately equal to taxpayer's original gain in need of shelter).

In addition, under proposed Regs. §1.465-22(c)(1), the foreign corporation's amount at risk is increased by the purported dividend resulting from the redemption of the foreign bank stock. The foreign corporation's increased amount at risk is added to taxpayer's amount at risk in accordance with Prop. Treas. Reg. section 1.465-68.

o I.R.S. Response

The Notice provides a set of uniform attacks that can be made by I.R.S. attorneys across the country. It includes the arguments discussed above – that the redemption is not a dividend, and even if it were, it does not trigger a basis shift because the foreign corporation is not a true shareholder. Other arguments available to challenge the claimed tax consequences of the transaction are (i) the losses are not *bona fide* losses and do not reflect the actual economic consequences of the transactions, (ii) the losses are disallowed under Code §269 because the taxpayer acquired control of the foreign corporation with a principal purpose of avoiding or evading federal income tax,(iii) the losses are limited under section 465 to the amount for which the taxpayer is at risk and that amount is not increased by the dividend distribution, and (iv) any foreign bank stock basis or loss claimed that is attributable to the foreign corporation's basis in the foreign bank stock must be reallocated by reason of Code §482 to the foreign corporation, reflecting a current I.R.S. position that, when two independent parties join together for a common purpose, the parties are under common control and a transfer pricing adjustment can be made.

b. Insurance Company Group Requests Revision of Reporting Obligations for Foreign Subsidiaries.

The American Council of Life Insurers ("ACLI") has requested of the Treasury Department that regulations applicable to C.F.C. subsidiaries should be relaxed because of the negative effect they have in foreign markets. The ACLI is the principal trade association representing the life insurance industry.

Under withholding tax regulations that went into effect for the year 2001, C.F.C. subsidiaries must obtain information regarding their overseas customers. The regulations are intended to ensure that U.S. persons cannot hide behind life insurance policies to avoid reporting investment income. The regulations do not apply to foreign insurance companies that are not C.F.C.'s.

Because of the presumptions that exist under those rules, a C.F.C. is required either to file an annual information report on Form 1099 for all customers failing to provide documentation or to insert a legend on all application forms relating to U.S. information reporting requirements. The first option is extremely expensive to implement and the second option may not be possible because the face of insurance contracts is often regulated and cannot be changed prior to a full hearing by regulators and a favorable decision. Either way, C.F.C.'s will suffer a competitive disadvantage because they will be identified as U.S.-owned. Often, policy holders have preferences for locally owned insurance companies.

Consequently, the ACLI has requested the following relief:

- Life insurance policies sold by C.F.C.'s outside the U.S. should not be subject to information reporting or relaxed backup withholding requirements, in view of the small amounts of reportable income, if any, that they generate.

- In the case of annuity and endowment contracts, no reporting or backup withholding requirements should apply if the CFC's business office that issues the policy is located in the country or region where the customer is located (based on the customer's mailing address), provided that the CFC does not have actual knowledge that the customer is a U.S. citizen or a U.S. resident.

- In the case of annuity and endowment contracts that do not fall within the above description, in order to identify U.S. citizens or residents, either (i) the C.F.C.'s representative (e.g., agent) who signs up a customer would be required to certify that the customer is not a U.S. citizen or a U.S. resident based on its communications with that customer or (ii) the C.F.C. would be required to include on the application a legend confirming only that the applicant is not a U.S. citizen or a U.S. resident.

c. Proposed Regulations Address Mergers Involving Disregarded Entities.

The I.R.S. has issued proposed regulations under Code §368(a)(1)(A) providing nonrecognition treatment to the merger of a target corporation into a disregarded entity owned by a second corporation where the transaction qualifies as a "statutory merger." However, the merger of a disregarded entity into an acquiring corporation would not qualify as a statutory merger, and therefore, would not be entitled to nonrecognition treatment. Under a previous version of the proposed regulations, neither merger would qualify as a statutory merger.

The proposed regulations address tax consequences of a transaction that is frequently authorized by State law – the merger of a limited liability company with another limited liability company or with a corporation. Tax-free treatment for that type of transaction is consistent with the general treatment of a disregarded entity as a division of its owner.

The proposed regulations permit nonrecognition treatment under Code §368(a)(1)(A) for a merger or consolidation effected pursuant to the laws of a state, provided that certain events occur simultaneously. The events are that (1) all of the assets and liabilities of the transferor entity – including the L.L.C., the corporation that is its sole member, and any other wholly owned L.L.C. owned by that corporation or the L.L.C. – become the assets and liabilities of the transferee entity – such as a corporation or an L.L.C. that is wholly owned by the corporation – and (2) the transferor entity as previously defined ceases its separate legal existence for all purposes.

The proposed regulations do not permit the merger of a disregarded entity into a member of an acquiring group unless the owner of the entity also merges into a member of the acquiring group. Where the owner of the L.L.C. is not involved as a transferor of assets, all of the combined assets of the disregarded entity, its sole member, and any wholly owned L.L.C. owned by either will not be transferred to the acquiring group. Hence, the transaction cannot be a statutory merger, although it might qualify as a reorganization under another provision of the Code.

d. Final Regulations Amend Check-the-Box Rules.

The IRS has published final regulations that address the application of Code §332 to a deemed liquidation of an association electing to be classified as a partnership or disregarded entity under the check-the-box rules. The final regulations adopt the January 2001 proposed regulations without modification. Those proposals addressed certain requirements of Code §332 when an association elects to be classified as a partnership or a disregarded entity.

The regulations (Regs. §301.7701-3(g)(1)) provide that an election by an association (i.e., an eligible entity that is treated as a corporation for U.S. income tax purposes) to be treated as a partnership is deemed to encompass a two-step transaction. In the first step, the association is deemed to make a liquidation distribution to its shareholders of all assets and liabilities. The second step, which is deemed to occur immediately thereafter, entails a contribution of all previously distributed assets and liabilities to a newly formed partnership.

An election by an association to be treated as a disregarded entity of its sole owner is treated as a liquidation distribution of all assets and liabilities to its single owner in liquidation. Code §332 may be relevant to the deemed liquidation where the owner group includes a corporation. No gain or loss is generally recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation if the first corporation owns shares representing at least 80% percent of the voting power and 80% of the value of the liquidating corporation at the time the plan of liquidation is adopted. However, a formal plan of liquidation is incompatible with a deemed liquidation that arises from a check-the-box election. The regulations allow the entity to remain in existence, legally, after the election is made. To avoid conflict, the final regulations provide that a plan of liquidation is deemed to have been adopted immediately before the deemed liquidation incident to an elective change in entity classification, unless a formal plan of liquidation that contemplates the filing of the elective change in entity classification is adopted on an earlier date.

The final regulations apply to elections filed on or after December 17, 2001. Taxpayers may apply the amendments retroactively if the corporate owner claiming treatment under Code §332 and its subsidiary take consistent positions with respect to the Federal tax consequences of the election.

e. I.R.S. Announces Procedures For Late Entity Classification Elections.

A common problem for many persons making a check-the-box election for a newly formed foreign entity is that the election is not always made at the time intended. This frequently reflects a misunderstanding on the part of the accountants for the company or the person assigned the ministerial task of filing the Form 8832 (Entity Classification Election) on which the election is made. To its credit, the I.R.S. has had in place a rather lenient policy in granting discretionary relief under Regs. §301.9100, so that late elections are treated as if made on a timely basis. However, to obtain relief under Regs. §301.9100, a private letter ruling must be submitted to the I.R.S. national office. In Rev. Proc. 2002-15, the I.R.S. announced a simplified procedure for those seeking relief in the event of a late election.

The new procedure applies only to late classifications of a newly formed entity. Under the new procedure, the entity or its U.S. shareholder must file a statement explaining that: (i) the entity failed to obtain its desired classification as of the date of its formation solely because Form 8832 was not timely filed; (ii) the due date for the tax return of year in which the was formed has not passed; and (iii) the entity has reasonable cause for its failure to timely make the initial entity classification election.

The statement is filed with the I.R.S. Center to which the taxpayer's return is filed. The statement must be filed within six months of the original due date for the initial classification election, generally 75 days after formation. Because the relief does not involve the issuance of a private letter ruling, there is no user fee for seeking the relief. The taxpayer may seek a private letter ruling from the I.R.S. if relief is not granted or the taxpayer is not eligible under the new procedure.

f. <u>Temporary and Proposed Regulations Provide Relief for Late Tax Returns of Foreign Persons</u>.

The I.R.S. has issued temporary regulations dealing with the treatment of foreign corporations and individuals who file late tax returns. For this purpose, a return is late when filed more than 16 months after the due date of the return. If a return is filed late, deductions and credits that might otherwise be available are lost, except when the failure to file a return on a timely results from a rare and unusual set of circumstances. The ruling position of the I.R.S. is that the threshold for coming within the exception is extremely high.

Under the temporary and proposed regulations, the I.R.S. can waive deadlines if the taxpayer establishes that it acted reasonably and in good faith when it did not file a return. This is a much lower threshold than previously existed. Factors that will be considered in demonstrating reasonable cause and good faith include:

- Whether the individual voluntarily identifies himself or herself to the I.R.S. as having failed to file a U.S. income tax return before the I.R.S. discovers the failure to file;

- Whether the individual did not become aware of his or her ability to file a protective return (as described in §1.874-1(b)(6)) by the deadline for filing the protective return;

- Whether the individual had not previously filed a U.S. income tax return;

- Whether the individual failed to file a U.S. income tax return because, after exercising reasonable diligence (taking into account his or her relevant experience and level of sophistication), the individual was unaware of the necessity for filing the return;

- Whether the individual failed to file a U.S. income tax return because of intervening events beyond the individual's control; and

- o Whether other mitigating or exacerbating factors existed.

g. <u>I.R.S. Adds New Protection on Privileges for Those Making Disclosures on Tax Shelters</u>.

In late December, the I.R.S. announced a 120-day period during which the taxpayers could disclose tax shelters and any other questionable items on their returns. Taxpayers making disclosure can avoid accuracy penalties for underpayment of taxes attributable to one or more of the following: (a) negligence, (b) substantial understatement of income tax, (c) certain substantial valuation misstatements, or (d) substantial overstatement of pension liabilities. The disclosure initiative does not apply to taxpayers involved in fraud, criminal conduct, the concealment of a foreign financial account or foreign trust, or the treatment of personal expenses as deductible business expenses. By late February, 21 taxpayers are reported to have disclosed more than $1 billion in claimed losses.

About halfway through the period, the I.R.S. took certain steps to protect the rights of taxpayers to assert attorney and work-product privileges when they make such voluntarily disclosures. Some taxpayers had evidently indicated that they wanted to make a disclosure, but were concerned that the production of certain documents and opinions might constitute a waiver of the attorney-client and work-product privileges. The I.R.S. has developed an agreement to address this concern.

The I.R.S. believes that information obtained through disclosures helps it identify tax shelter promoters who have not registered and other taxpayers who have not disclosed their participation in a tax shelter. A taxpayer is not required to agree that the disclosed tax shelter or item resulted in an underpayment of taxes in order to avoid penalties. Taxpayers are required to (i) describe the material facts of the transaction, (ii) provide the names and addresses of the promoters who solicited participation, (iii) provide, upon request, copies of materials and, (iv) sign penalties of perjury statements regarding the accuracy of the information provided.