New York University, School of Continuing and Professional Studies

# Inbound Update: Increasing Attention By I.R.S. To Foreign Taxpayers Doing Business In The U.S.

Advanced Topics in International Taxation
New York City
July 19, 2001

Stanley C. Ruchelman
The Ruchelman Law Firm
New York, New York

# Inbound Update: Increasing Attention By I.R.S. to Foreign Taxpayers Doing Business in the U.S.

Stanley C. Ruchelman*



---

* Mr. Ruchelman is a member of The Ruchelman Law Firm where his practice is concentrated in the area of tax planning for transnational business operations with emphasis on intercompany transactions. Mr. Ruchelman has represented companies in matters involving the I.R.S., and has counseled corporate clients on transfer pricing issues, worldwide reorganizations, and structuring investment in the United States. Mr. Ruchelman has authored numerous monographs on international taxation for a variety of publications and treatises and is a frequent lecturer on that subject.

* * * * *

1. Tax Haven Saga.

a. Tax Havens Identified.

The O.E.C.D. Committee on Fiscal Affairs identified 35 tax haven jurisdictions that have not cooperated with the organization's two-year global campaign to stamp out harmful tax practices. The blacklisted countries that promote harmful tax competition are:

Andora
Anguilla
Antigua and Barbuda
Aruba
The Bahamas
Bahrain
Barbados
Belize
British Virgin Islands
Cook Islands
Dominica
Gibraltar
Grenada
Guernsey (including Sark and Alderney)
Isle of Man
Jersey
Liberia
Liechtenstein
The Maldives
The Marshall Islands
Monaco
Montserrat
Nauru
The Netherlands Antilles
Niue
Panama
Samoa
The Seychelles
St. Lucia
St. Christopher & Nevis
St. Vincent and the Grenadines
Tonga
Turks & Caicos
U.S. Virgin Islands
Vanuatu.

The blacklisted countries were initially given one year to reform tainted practices. Until then, no retaliatory action is contemplated.

One week prior to the announcement, six tax advantaged jurisdictions reached agreement with the O.E.C.D. to work with the organization to avoid being blacklisted. The six countries are Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, and San Marino. They did not appear on the list.

At the same time that the O.E.C.D. identified the blacklisted countries, it identified tainted practices among its members. Many viewed this as an attempt to avoid the appearance of a double standard. The O.E.C.D. member states and their identified practices of unfair tax competition divided by industry segment are as follows:

<u>Insurance</u>
Australia (offshore banking units)
Belgium (coordination centers)
Finland (Aland captive insurance regime)
Italy (Trieste financial service and insurance centers)
Ireland (international financial centers)
Portugal (Madeira international business centers)
Luxembourg (provisions for fluctuations in reinsurance companies)
Sweden (foreign nonlife insurance companies)

<u>Finance and Leasing</u>
Belgium (coordination centers)
Hungary (venture capital centers)
Hungary (preferential regime for companies operating abroad)
Iceland (international trading companies)
Ireland (international financial service centers)

Ireland (Shannon airport zones)
Italy (Trieste financial services and insurance centers)
Luxembourg (finance branch regime)
Netherlands (risk reserve regime for international group financing)
Netherlands (intragroup financing regime)
Netherlands (finance branch regime)
Spain (Basque Country and Navarra coordination centers)
Switzerland (administrative companies)

Fund Management
Greece (mutual fund and portfolio investment companies)
Ireland (international financial service centers)
Luxembourg (management companies, 1929 holdings)
Portugal (Madeira international business centers)

Banking
Australia (offshore banking units)
Canada (international banking centers)
Ireland (international financial service centers)
Italy (Trieste financial service centers)
Korea (offshore activities of foreign exchange banks)
Portugal (external branches in Madeira business centers)
Turkey (Istanbul offshore banking regime)
Belgium (coordination centers)
France (headquarters centers)
Germany (monitoring and coordinating centers)
Greece (offices of foreign companies)
Netherlands (cost-plus rulings)
Portugal (Madeira international business centers)
Spain (Basque Country and Navarra coordination centers)
Switzerland (administrative companies)
Switzerland (service companies)

Distribution Activity
Belgium (distribution centers)
France (logistic centers)
Netherlands (cost-plus and resale minus rulings)
Turkey (Turkish free zones)

Service Centers
Belgium (service centers)
Netherlands (cost-plus rulings)

Shipping
Canada (international shipping regime)
Germany (international shipping regime)
Greece (shipping offices)
Greece (shipping regime law 27/75)
Italy (international shipping regime)
Netherlands (international shipping regime)
Norway (international shipping regime)
Portugal (international shipping register of Madeira)

Miscellaneous Activities
Belgium (ruling on informal capital)
Belgium (ruling foreign sales corporation activities)
Canada (nonresident-owned investment companies)
Netherlands (ruling on foreign sales corporation activities)
Netherlands (ruling on informal capital)
United States (foreign sales corporation regime)

The member states are to eliminate the foregoing practices by April 2003 and undertake to avoid adoption of similar regimes to replace the eliminated practices. In the case of the U.S., this may be a problem as the Administration has attempted to negotiate a replacement for the foreign sales corporation regime with the European Union, albeit to no avail.

b. O.E.C.D. Adopts Uniform Procedure in Discussions with Identified Tax Havens.

At the end of November 2000, the O.E.C.D. approach to identified tax havens was tempered as the O.E.C.D. adopted a less aggressive approach to identified tax haven jurisdictions. The new approach adopts a uniform set of standards that will be applied across the board in an attempt to provide evenhanded treatment. Moreover, the period has been lengthened for the adoption of rules of compliance by the identified countries.

Under the revised approach, the identified countries would participate in a 4-stage approach to cooperation. The stages would be consecutive and each would last for one year, beginning with 2001, except for the final stage, which would last for two years. In the first stage, the identified jurisdictions would be required to adopt an action plan for achieving transparency and effective programs for the exchange of information for all tax matters. The action plan would also address the elimination of internal tax regimes that attract business without substantial local business activity. In the second stage, the action plan would be adopted for local regulatory purposes. Thus, beneficial ownership information and financial books kept in accordance with generally accepted accounting principles would be made available to domestic regulatory agencies and tax authorities. In the third stage, information regarding criminal tax matters would 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 would be available for exchange with O.E.C.D. members. The identified jurisdictions would be required 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.

c. Arguments Raised Challenging O.E.C.D. Attack on Tax Havens.

Conservative think tanks have begun a challenge to the O.E.C.D. attack on tax havens. The challenge is relatively simple. The O.E.C.D. is characterized as a cartel. Its goal is to keep tax rates high around the world so that business and individuals cannot avoid a heavy tax burden by moving to a low-tax jurisdiction. This hampers moves toward global tax reduction. Under this view, there is little difference between the O.E.C.D. and the Organization of Petroleum Exporting Countries, except that the latter primarily consists of developing countries and its purpose relates to the maintenance of a floor beneath price of petroleum. Because the O.E.C.D. consists of developed countries, an argument is also made that high taxes are a form of cultural imperialism.

It is not clear whether the challenge will be successful. For the countries involved, the penalties of remaining on the list of identified countries may be too great to mount a challenge. Moreover, not all low-tax jurisdictions attract the same type of clientele and the arguments of those challenging the O.E.C.D. would seem to benefit most the jurisdictions that attract those who practice the worst aspects of tax avoidance. It is likely that some countries will take heart in the challenge. The Channel Islands are reported to be examples. However, in the last analysis the issue is political and financial. It is reported that 23 of the 35 countries that are on the list have made some effort to cooperate with the O.E.C.D. Those who fail to cooperate may view themselves as champions of a good cause; however, the reward may be the complete loss of business from all but the most egregious tax evaders.

d. O.E.C.D. and Tax Havens Agree to the Establishment of a Forum to Review Issues.

On January 9, 2001, representatives of the O.E.C.D. met with representatives of the identified tax haven jurisdictions and agreed to the establishment of a forum to address the issue of harmful tax competition. The forum members will consist of representatives of 13 countries from both sides, including six from the O.E.C.D. (Australia, France, Ireland, Japan, the Netherlands, and the United Kingdom), two from the Commonwealth Secretariat (Malaysia and Malta), two Caribbean Community and Common Market nations (Antigua and Barbuda/Barbados), two from the Pacific Islands Forum (the Cook Islands and Vanuatu), and the British Virgin Islands.

The first meeting of the forum took place in London at the end of January. The participants included Antigua, Barbuda, Australia, Barbados, the British Virgin Islands, the Cook Islands, France, Ireland, Japan, Malaysia, Malta, the Netherlands, the U.K., and Vanuatu. After expressing a desire to mutually work through the issue, the participants failed to adopt substantive procedures to implement resolve the differences in opinion.

e. Political Pressure In the U.S.

Developments in the battle between the O.E.C.D. and identified tax havens heated up during February and March. The tax havens obtained support from various political corners and action committees.

Rep. Major Owens (D. New York) wrote the Treasury Department commenting that the O.E.C.D. attack threatens the Caribbean target nations with financial protectionism and other economic sanctions simply because these jurisdictions have tax policies that are attractive to foreign investors. According to Mr. Owens, this is a fundamental violation of sovereignty and undermines the ability of these nations to develop and maintain financial services industries.

Sen. Don Nickles (R. Oklahoma) wrote the Treasury Department commenting that the O.E.C.D. attack is contrary to the economic interests of the U.S. According to the Senator, tax competition is a phenomenon that keeps politicians in check and enhances economic growth.

Treasury Secretary O'Neill was quoted in April as saying that the Bush Administration has reserved its decision on whether to support the O.E.C.D. attack. This was denied by the O.E.C.D., which contended that the position of the Bush Administration was not any different from that of the Clinton Administration.

Rep. Richard K. Armey (R. Texas), the House Majority Leader, lobbied the national economic adviser to the Bush Administration and the Assistant Treasury Secretary (Tax Policy) of the Treasury urging the U.S. to withdraw support for the O.E.C.D.'s initiative against harmful tax competition. Lindsey was reportedly taken by surprise, as he thought the day's talks were going to focus on tax cuts. Mr. Armey's position is that the initiative is intended to benefit high-tax European countries that are opposed to lower tax rates. Mr. Armey again urged the Administration to change its stance and oppose the position.

In correspondence to the Treasury Department, the Congressional Black Caucus expressed concern that the targets of the O.E.C.D. were mostly small countries in the Caribbean that were populated by persons of color. Thus, a hint of racism by the O.E.C.D. was voiced.

House Majority Leader Richard K. Armey (R. Texas) wrote the Treasury Department requesting a prompt reversal of the position of the prior Administration which supported the O.E.C.D. initiative. According to Rep. Armey, the O.E.C.D. initiative is misguided and is designed to benefit a small number of high-tax nations seeking to impede the flow of global capital and the U.S. economy.

Donna M. Christensen (D. V.I.), a non-voting delegate to the House of Representatives from the U.S. Virgin Islands, wrote the Treasury Department to express concern over the O.E.C.D. initiative. According to Ms. Christensen, the O.E.C.D. position will impose serious economic harm on developing nations that have an association with or have long-established friendly ties with the U.S. The free flow of capital plays a critical role in improving economic conditions in poorer nations. Workers benefit from increased job opportunities and higher wages. Governments also benefit because, even at low rates of tax, there are both direct and indirect increases in revenue. These are funds that are critically needed to provide education, health care, and other social services. The O.E.C.D. is acting in bad faith by ignoring the principles of transparency and fairness.

f. Treasury Capitulates.

The Treasury withdrew its support for the O.E.C.D. initiative against harmful tax competition. Treasury Secretary Paul O'Neill expressed concern for any policy that presumes low tax rates are suspect. Hence, the initiative must be refocused on the need for countries to obtain specific information from other countries upon request in order to prevent the illegal evasion of tax laws by the dishonest few. In its current form, the project is too broad and is not in line with the current Administration's priorities. Nonetheless, the U.S. Government continues to hold discussions with the O.E.C.D. and it is believed that some form of common ground will be reached under which low-tax jurisdictions will not be singled out and the focus will shift to exchanges of information.

In a letter to five G-7 finance ministers in June, Treasury Secretary Paul H. O'Neill reiterated the position of the Administration with regard to the O.E.C.D. initiative against identified tax haven jurisdictions. In part, the Administration believes that a country should be free to establish whatever tax regime it desires without being the subject of innuendo that it facilitates tax evasion in other jurisdictions. Nonetheless, the U.S. will continue to hold discussions with the O.E.C.D. and Financial Action Task Force's ongoing anti-money-laundering work to promote an overall agreement identifying the circumstances in which bank secrecy and confidentiality will be suspended in order to promote exchanges of information is specific cases.

2. Regulations Projects.

a. I.R.S. Adopts Final Foreign Tax Credit Regulations.

The I.R.S. adopted final foreign tax credit regulations regarding the way in which the Alternative Minimum Tax ("AMT")foreign tax credit is applied in the context of a dividend from a possessions corporation and distributions from a controlled foreign corporation ("C.F.C.") that is not eligible for look-through treatment – viz., the dividend is not categorized for foreign tax credit purposes by reference to the nature of the income which gives rise to the dividend.

Regarding a possessions corporation, the exempt portion of the dividend is included in adjusted current earnings ("ACE") for purposes of computing the alternative minimum taxable income of the dividend recipient. To the extent a portion of the dividend is included in income, it does not qualify for look-through treatment in connection with the foreign tax credit. Rather, such amounts are treated as foreign source passive income.

For taxable years beginning after December 31, 1993, dividends from a possessions corporation are subject to a separate AMT foreign tax credit limitation. For earlier years, the portion of the dividends that were added back into AMT income as ACE adjustments were subject to the separate limitation for passive income for alternative minimum tax foreign tax credit purposes. Because of the ACE adjustment, the AMT and regular tax foreign tax credit systems do not operate exactly alike with respect to dividend income from possessions corporations.

The final regulations continue to exclude possessions corporations from the affiliated group for purposes of allocating expenses in determining the amount of the group's foreign source alternative minimum taxable income, which affects the AMT foreign tax credit. This change has the effect of increasing the amount of interest and other expenses apportioned to dividend income from a possessions corporation. According to the I.R.S., the enactment of a separate limitation category for AMT purposes for portions of dividends from possessions corporations demonstrates that, because of the ACE adjustment, the AMT and regular tax foreign tax credit systems cannot operate exactly alike.

Regarding distributions from a C.F.C., the dividend is treated as having been received from a noncontrolled §902 corporation if the underlying earnings and profits were accumulated before the distributing corporation became a C.F.C. Because earnings and profits are now pooled – each dividend comes from each layer in the pool on a pro rata basis – the characterization applies to all distributions as long as the pool remains in existence.

The final regulations continue a rule that applies to distributions before August 6, 1997. Under the rule, a dividend paid to a new U.S. shareholder by a C.F.C. out of earnings and profits accumulated while it was a C.F.C., but before the recipient became a U.S. shareholder, would be treated as dividends from a noncontrolled section 902 corporation. This rule applies only to new U.S. shareholders that acquire more than 90% of a C.F.C. It relaxes the statutory limitation to the extent necessary to avoid the administrative burdens that would arise if more than one U.S. shareholder were entitled to look-through treatment on distributions of post-1986 undistributed earnings.

The final regulations contain a new rule that applies when a new shareholder acquires stock in a controlled foreign corporation after income has been included in the prior shareholder's income under Subpart F, but before the income is distributed and subjected to additional foreign tax. Initially, the proposed regulations provided that new shareholders entitled to look-through treatment on distributions of pre-acquisition earnings would place the additional taxes in the general limitation category. However, new shareholders who were not entitled to look-through treatment would place the taxes in the general limitation or noncontrolled Code §902 corporation category, depending on whether or not the associated income inclusion of the prior shareholder was high-taxed income. The final regulations adopt the view that this provision added unnecessary complexity to the regulations. Consequently, a shareholder not entitled to look-through treatment on pre-acquisition earnings must treat the additional taxes as allocable to the noncontrolled Code §902 corporation dividend category. The revised rule applies to taxable years beginning after December 31, 1991. However, taxpayers may rely on the proposed regulations for taxable years beginning before January 1, 2001.

b. Final Regulations Adopted on Hyperinflationary Currencies.

The I.R.S. adopted final regulations defining the circumstances in which a currency will be considered hyperinflationary for purposes of Code §988. Under the final regulations, a currency is viewed to be hyperinflationary if the inflation rate for the 3-year period ending with the current year exceeds 100%. Thus, if a country's annual inflation rates for the 3-year period ending in 19998 are 6% for 1996, 11% for 1997, and 90% for 1998, the cumulative inflation rate for the three-year base period is 124% (1.06 x 1.11 x 1.90 = 1.24). Accordingly, the currency is hyperinflationary for the 1998 taxable year. This rule does not apply to any transaction covered by Code §988 for a RIC or a REIT.

c. Broad Regulations Proposed for Space and Ocean Activity.

The I.R.S. has issued a broad and controversial set of regulations designed to control the taxation of income from space and ocean activity. The provision has extremely broad application beyond customary space and ocean activity businesses and will limit certain foreign tax credit benefits claimed by companies that manufacture in the U.S. and sell abroad to distribution subsidiaries.

The term "space or ocean activity" means any activity conducted in space or on or under water not within the jurisdiction of the U.S., a foreign country, or a U.S. possession. These include:

i. The performance and provision of services in international water,

ii. Leasing of equipment or other property located in international water,

iii. Licensing of technology or other intangibles for use in international water,

iv. The production, processing, or creation of property in international water

v. The sale of property in international water,

vi. The sale of inventory under international water,

vii. The leasing of a vessel if such vessel does not transport cargo or persons for hire between ports-of-call (research),

viii. Antarctic activity,

ix. Leasing of drilling rigs,

x. Extraction of minerals, and the performance and provision of services related thereto, to the extent the mines, oil and gas wells, or other natural deposits are not within the jurisdiction of a political territory, and

xi. Underwriting income from the insurance of risks on activities that produce income derived from ocean activity.

The following activities are not space or ocean activities:

xii. Those giving rise to transportation income,

xiii. Those giving rise to international communications income, and

xiv. Those which relate to mines, oil and gas wells, or other natural deposits. Code §863(d)(2)(B).

For U.S. persons, any income derived from a space or ocean activity is U.S. source income. For foreign persons, any such income is foreign source income. However, exceptions are provided which will cause a certain foreign corporations to have U.S. source income from activities carried on outside the U.S. Thus, a foreign corporation that is more than 50% owned by U.S. persons, will have U.S. source income from space or ocean activity is U.S. source. A similar result will apply to a foreign corporation engaged in U.S. business. In such circumstances, a presumption exists that the income is U.S. source income and subject to U.S. tax. This presumption is rebut table and subject to the application of a treaty providing a different result.

The regulations are controversial, as indicated in written submissions and comments by the tax bar and affected parties.

Arthur Andersen commented that the regulations go beyond addressing source of income and are a disguised attempt to expand U.S. tax jurisdiction through manipulation of source rules. When the Tax Reform Act of 1986 modified the source rule for income derived from activities in space or in international waters, and from communication activities, the primary impetus was the concern over U.S. taxpayers obtaining inappropriate foreign tax credit advantages under the source rules then in effect. U.S. taxpayers with excess foreign tax credits could use low-tax income from space, ocean, and international communication activities to generate low-tax foreign source income to absorb other items of high tax income.

According to the Arthur Andersen submission, foreign corporations were not the target of the legislative concern. Yet, the proposed regulations apply to foreign corporations and affect them in a jurisdictional sense – not merely a credit sense. Source rules determine whether or not income earned by a foreign corporation is subject to U.S. tax. There is no indication that the regulatory authority granted by Congress was intended to effect a far-reaching expansion of U.S. taxing authority over foreign corporations. On the contrary, the very modest revenue estimates attached to the legislation suggest that Congress did not expect large increases in taxable income.

Arthur Andersen also commented that the proposed regulations provide that space/ocean income and international communication income earned by a foreign corporation are from U.S. sources if U.S. persons own 50% or more of its stock, unless the foreign corporation is a controlled foreign corporation. This rule imposes U.S. tax directly on the foreign corporation at either a 30% rate on gross income or up to a 35% rate on net income, depending on whether the income is effectively connected to a U.S. trade or business of the corporation. This rule has several flaws. First, it expands the scope of U.S. taxing jurisdiction beyond the apparent intent of Congress. Second, it requires all affected

foreign corporations to determine their U.S. ownership, down to each individual share -- a requirement that will be impossible for any publicly traded corporation (and many private corporations) to meet. Third, it will prevent U.S. shareholders from claiming U.S. foreign tax credits or other benefits for taxes paid by the foreign corporation, resulting in double taxation. Finally, it imposes withholding obligations on foreign corporations that in most cases cannot be administered or enforced, and raises the possibility that multiple withholding will occur.

The proposed regulations provide that space/ocean income and international communication income earned by a foreign corporation are presumed to be from U.S. sources if the corporation is engaged in a U.S. trade or business. The regulations allow an allocation of some income to foreign sources, but only if the taxpayer can establish the factual basis for such an allocation to the satisfaction of the Commissioner. Like the proposed regulation governing U.S. owned foreign companies, this rule gives rise to several issues. First, it potentially applies to all affected income, whether or not related in any way to the U.S. trade or business or a taxpayer's U.S. office, again expanding U.S. taxing jurisdiction beyond what Congress intended. Second, it provides no guidance other than a general "facts and circumstances" test for allocating income to foreign sources, generating uncertainty when the taxpayer's return is filed and unwarranted contention when it is audited. Third, it will often impose U.S. tax on foreign activities of a non-U.S. taxpayer to a degree that is far out of line with existing U.S. policy and settled international norms.

Consequently, Arthur Andersen suggested that the source rule should not be included in the final regulations. Alternatively, objective standards consistent with existing rules for effectively connected income should be included to ensure that the taxed income has a meaningful connection with the taxpayer's U.S. office or fixed place of business. In the absence of objective standards, taxpayers should be permitted to apply a reasonable allocation method on a consistent basis.

Bracewell & Patterson, a Washington, D.C. law firm, urged that the regulations should be repealed because inherent biases as to the source of income will adversely affect bandwidth that supports telecommunication.

According to Bracewell & Patterson, Code §863(d) sources space/ocean income according to the residence of the recipient. As a result, primary taxing jurisdiction over space/ocean income of U.S. residents is retained by the U.S. government because space/ocean income is generally outside the taxing jurisdiction of any foreign country. To eliminate any incentive for U.S. taxpayers to conduct space/ocean income-generating operations through controlled foreign corporations, space/ocean income is treated as foreign base company shipping income and is placed in the shipping income basket for foreign tax credit purposes. International communications income is excluded from the definition of space/ocean income in recognition of the potential for the imposition of foreign tax.

With regard to international communications income, 50% is deemed to arise from U.S. and 50% is deemed to arise from foreign sources in the hands of a U.S. person. In comparison, in the hands of a

foreign person, international communications income is deemed to be completely foreign unless attributable to a U.S. office. The proposed regulations inappropriately expand the ambit of Subpart F to cover active business telecommunications income that is likely to be subject to foreign tax. Combined with the presumptions in the source rules, the proposed regulations set the stage for double taxation of income from an inherently global industry, even including income from sales of internet access and I.P. networks outside the U.S. Such unfair taxation of bandwidth markets will limit the ability of carriers and end-users to manage bandwidth price risks. By making resales of bandwidth potentially subject to cascading U.S. withholding obligations, the proposed regulations substantially undermine, if not negate entirely, the efforts of bandwidth market participants to achieve international bandwidth market liquidity through contract standardization and efficient interconnection.

In addition, Bracewell & Patterson commented that the proposed regulations would disproportionately impact U.S. bandwidth intermediaries by treating income from telecommunications activity other than international communications activity as Subpart F income, placed in the shipping basket, where such activity takes place in space or international waters even to a de minimis extent. As a consequence, U.S. Shareholders of C.F.C.s would be faced with accelerated realization of income from purely foreign active business transactions such as foreign-to-foreign satellite capacity or foreign-to-foreign private line sales that happen to touch international waters. The expansion of Subpart F by regulation is not supported by the legislative history and upsets the competitive balance that Congress had in mind in limiting the scope of Subpart F.

At the hearing in May, the representative for a coalition consisting of AT&T, Global Crossing, Quest Communications International, Sprint, Worldcom, and 360 Networks requested that the proposed regulations should be withdrawn because of its potentially harmful effect on competitiveness. According to the testimony, potential foreign joint venture partners would be reluctant to grant a U.S. company a 50% interest for fear that the joint venture would be subject to these rules. Such reluctance could have a devastating effect on growth in light of the significant global infrastructure investments required by telecommunications companies and the state of the capital markets.

The coalition's representative testified that the proposed regulations depart significantly from international norms and extend U.S. taxing jurisdictions inappropriately. They invite foreign governments to institute similar or retaliatory tax provisions. To illustrate how the proposed rules create a significant likelihood of double taxation, the representative of the coalition posited the following hypothetical fact pattern. Assume that Brazil Telecom, a hypothetical Brazilian company that provides a broad range of telecommunication services to Brazilian companies, is 50% percent U.S. owned. A Brazilian customer pays it to transmit a call from Brazil to the U.S. The call is routed to a seabed cable and is handed off outside the U.S. One would expect that, because Brazil Telecom is a foreign company without any U.S. nexus, all of its income would be treated as foreign sourced. However, because it is 50% U.S. owned, under the proposed regulations, its income is treated as U.S. sourced in its entirety.

Now, assume that the Brazilian customer is aware of U.S. tax law. It would be required to withhold U.S. tax on the gross payment from Brazil to Brazil Telecom. The Brazilian government would also impose tax on its income, most likely without a credit for the U.S. tax. In addition, when Brazil Telecom pays a dividend to its U.S. shareholders, its earnings will be subject to a third layer of tax. Again, without a foreign tax credit, because the income will be deemed to be U.S. sourced.

In these circumstances, a U.S. investor cannot hope to compete against others in Brazil who are not subject to the proposed regulations. It's obvious that Congress did not intend U.S. source treatment and multiple taxation for income that is unambiguously international communications income.

The proposed regulations also create a significant administrative and compliance burden for telecommunications providers. This burden arises in several contexts. The most compelling may be in the default rule, which applies when providers cannot identify the origin and termination of a communication. For many of the services offered by the companies affected by these regulations, the points where transmission originates and terminates are not relevant for any other business purpose, and are not tracked. In some instances, these points cannot be identified using existing technology. Developing the necessary technology required to track these endpoints, would require a significant capital outlay and would result in no productivity gain for the industry.

The representative for Boeing commented that current rules applicable to a U.S. taxpayer which exports products manufactured in the U.S. are fundamentally changed by the proposed regulations. The current rules have been negotiated over the years. Given that the legislative history of Code §863(d) and (e) is completely silent as to the intent to modify the source rules with respect to spacecraft, aircraft, and property sold while aboard aircraft in international airspace, the proposed source rule in the regulations is unwarranted.

Under the proposed regulations, sales of property located in space will give rise to space/ocean income. Space is defined to include not only outer space but also any area not within the jurisdiction, as determined under principles recognized by the U.S., of a foreign country, or a U.S. possession, or the U.S. Because space includes international airspace, sales of property located in international airspace will give rise exclusively to U.S. source income when the seller is a U.S. person. In addition, property that is sold for use in space will be considered to be sold in space, regardless of where it actually is located when it is sold. Accordingly, an exporter such as Boeing will no longer be able to determine the source of income under the 50-50 rule of Code §863(b) in connection with sales of spacecraft or aircraft reasonably expected to be operated in international airspace. Because this conclusion is not warranted, Boeing requested that sales of inventory property should be removed from the source rule for sales taking place in space.

Boeing also commented that the definition of international communications income is inappropriate as it includes only income that is attributable to transmissions between the U.S. and another country. Thus, it appears that international communications income does not include income derived from transmissions

between a foreign country and a point in space, or between two foreign countries, or within a single foreign country. Code §863(e) provides that international communications income includes income derived from the transmission of communications or data from the U.S. to any foreign country. It does not limit the transmission to those facts. Indeed, the legislative history makes reference to transmissions between any two countries.

Finally Boeing commented that the record-keeping requirement of the proposed regulations is onerous. A taxpayer is required to allocate gross income between different categories of activity. Such allocations must be made on an original return, and modifications would not be permitted on an amended return or pursuant to a discretionary grant of relief under Code §9100. Boeing requested that the rule should be eliminated as neither the statute nor the legislative history contains any hint that Congress intended such rules to be promulgated. Moreover, no policy consideration would justify singling out this the telecommunications industry for a uniquely burdensome record keeping requirement.

d. Reporting Obligations Proposed for Bank Deposit Interest Paid to Foreign Persons.

The I.R.S. proposed regulations that provide guidance on the reporting requirements for interest on deposits maintained at the U.S. office of certain financial institutions and paid to nonresident, non-citizen individuals.

Existing regulations provide for the reporting of information concerning interest paid on deposits from U.S. bank accounts to residents of Canada. These regulations are designed to further I.R.S. compliance efforts. The proposed regulations extend the reporting obligations to residents of other foreign countries. The I.R.S. cites two justifications for that extension. First, requiring routine reporting to the I.R.S. of all bank deposit interest paid within the U.S. is viewed to aid in promoting voluntary compliance by U.S. taxpayers. It minimizes the possibility of avoidance of the U.S. information reporting system through false claims of foreign status. Second, countries that have tax treaties or other agreements which provide for the exchange of tax information have requested information concerning bank deposits of individual residents of their countries. The U.S. attaches significant importance to exchanges of tax information as a way of encouraging voluntary compliance and furthering transparency.

Under the proposal, if any joint account holder is a U.S. non-exempt recipient – which means that the recipient is subject to 31% back-up withholding tax – the U.S. bank must report the entire payment to that person. If all joint account holders are foreign persons, the bank must report the payment to the nonresident alien individual that is a resident of a country with which an income tax treaty or a tax information exchange agreement exists. If more than one of the joint account holders meets the foregoing requirement, bank must report the payment to the person that is the primary account holder, as well as to any account holder who requests a statement.

These regulations have been universally challenged by representatives of the banking industry who have submitted comments.

The American Bankers Association urged withdrawal of the regulations because of the administrative burden placed on the banking industry and the potential impact on global competitiveness within the financial services market. It was feared that the unilateral imposition of the information requirements on U.S. banks would drive low cost bank deposit funding to foreign banks with no corresponding increase in voluntary compliance in the depositor's country of residence.

Banco Atlantico, S.A., New York and Miami Agencies, commented on the hardship that the proposed regulation will have throughout the banking community. The bank pointed out that nonresident alien deposits constitute 100% of its deposits representing over $678 Million as of December 31, 2000. Approximately 37% of those deposits are from banks and the remaining 63% from individual customers residing in Mexico, Argentina, Colombia, Ecuador, and Panama. It expressed concern regarding personal safety once interest payments are reported to home country governments. It pointed to kidnaping and extortion that exists in epidemic proportions throughout Latin America. Bank customers consider it essential that financial wealth information be maintained in strict confidence. There is no assurance that sensitive financial information coming into the hands of a Latin American government will remain strictly confidential.

The New York Clearing House Association L.L.C. strongly opposed to the information reporting obligation of the proposed regulations. It expressed the view that the proposed regulations are inconsistent with the purposes of the withholding tax exemption for interest earned by nonresident aliens on bank deposits. It also believed that the loss of confidentiality will discourage potential foreign depositors from maintaining funds in the U.S. to almost the same extent as the imposition of a withholding tax. As a result, it cautioned that the proposed regulations would likely cause a large outflow of foreign deposits from U.S. banks. That loss of funds would reflect lost confidence in the confidentiality of the U.S. banking system, which may not be restored easily.

Commercebank of Coral Gables, Florida, voiced opposition to the proposed regulations because its customer base would likely close their accounts and move them to jurisdictions that do not collect and disseminate depositor information. Commerce bank estimated that three-quarters of its $1 billion in deposits come from nonresident individuals. These depositors have legitimate fears of corruption, crime, and political instability in their home countries. Unauthorized leaks of financial and tax information would likely result in exposure to kidnaping, extortion, armed robbery, and other threats to their personal and family security.

The Florida International Bankers Association commented that the proposal was imperfect. If adopted, the proposal would impose onerous documentation and reporting requirements on U.S. commercial banks which are not justified under the circumstances, produce no benefits for the U.S., and which may imperil the safety of individual customers resident abroad. Ensuring foreign tax compliance by overseas clients is not the duty of the U.S. banking industry. Moreover, while the U.S. government might require the production by a particular U.S. bank of otherwise confidential client information in an appropriate specific case at the specific request of a foreign governmental agency, it is not the function of the I.R.S.

to compile and maintain a comprehensive and expensive database of non-taxable bank interest paid by U.S. banks to foreign individuals who might or might not be declaring such income in their home country. The I.R.S. cannot ensure that information will not be misused once it is turned over to foreign authorities. It estimates that between 20,000 and 30,000 kidnapings now occur each year. There is a strong and justified fear among many foreign individuals that any information about their U.S. bank account holdings may be misused once it is placed in foreign hands.

e. Regulations proposed for Hedging Transactions.

The I.R.S. proposed regulations on the treatment of hedging transactions in conformity with changes to U.S. tax law that were adopted in 1999. These changes broadened the scope of ordinary treatment arising from the gains attributable to the disposition of certain assets.

Under prior law, a capital asset was defined to mean property other than (i) stock in trade or other types of assets includable in inventory, (ii) real property and depreciable property used in a trade or business that is real property or property subject to depreciation, (iii) certain copyrights (or similar property), (iv) accounts or notes receivable acquired in the ordinary course of a trade or business, and (v) U.S. government publications. The change in law provides ordinary treatment for hedging transactions that are clearly identified as such before the close of the day on which they were acquired, originated, or entered into. A hedging transaction is generally defined to include a transaction entered into in the normal course of business primarily to manage risk of interest rate, price changes, or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings of the taxpayer.

With certain exceptions, the proposed regulations generally will apply to the international provisions of U.S. tax law. The exceptions include Code §988 transactions, the hedging exceptions to the Subpart F rules of Code §954(c) and certain hedging rules in the interest allocation regulations under Code §864(e). In addition, Regs. §1.482-8 will address risk management activities in the context of a global dealing operation of a financial institution.

Among other things, the proposed regulations retain a single-entity approach. That is, they treat the risk of one member of the group as the risk of the other members, as if all the members were divisions of a single corporation. Thus, a member of a consolidated
group that hedges the risk of another member by entering into a transaction with a third party may receive ordinary gain or loss treatment on that transaction if the transaction otherwise qualifies as a hedging transaction.

Under the single-entity approach, intercompany transactions are neither hedging transactions nor hedged items. Because they are treated as transactions between divisions of a single corporation, intercompany transactions do not manage the risk of that single corporation and, therefore, fail to qualify as hedging transactions. The proposed regulations also retain a separate-entity election, thereby permitting a

consolidated group to treat its members as separate entities when applying the hedging rules. The election is made by attaching a statement to the group's federal income tax return.

For a group that elects separate-entity treatment, an intercompany transaction is treated as a hedging transaction if and only if (i) it would qualify as a hedging transaction if entered into with an unrelated party and (ii) it is entered into with a member that, under its method of accounting, marks its position in the intercompany transaction to market.

The proposed regulations contain rules for identifying certain types of hedging transactions. For inventory, the identification must specify the type or class to which the hedge relates. If particular inventory purchases or sales transactions are being hedged, the taxpayer must also identify the expected date and the amount to be acquired or sold. In the case of hedges of aggregate risk, the identification requirement is satisfied if a taxpayer's records contain a description of the hedging program and if there is a system for identifying transactions as entered into as part of that program. The intent underlying this rule is to provide verifiable information with respect to the item being hedged without requiring the taxpayer to identify individually the many items that give rise to the aggregate risk being hedged.

The identification of the hedge must identify that it is being made for tax purposes. In lieu of separately identifying each transaction, however, a taxpayer may establish a system in which identification is indicated by the type of transaction or the manner in which the transaction is consummated or recorded.

f. Proposed Regulations Issued Regarding Check-the-Box Entities.

The I.R.S. issued proposed regulations addressing the treatment of an entity wholly owned by a foreign government and a nonbank entity wholly owned by a foreign bank.

Existing regulations provide that a business entity wholly owned by a State or any of its political subdivisions may not elect to be disregarded for U.S. income tax purposes. However, the regulations do not cover entities owned by a foreign government. To achieve parallel tax treatment, the proposed regulations provide that a business entity wholly owned by a foreign government cannot elect to be treated as a disregarded entity. In a similar vein, the check-the-box regulations provide that a bank cannot treat a wholly owned nonbank entity as a disregarded entity for purposes of applying the special rules of U.S. tax law applicable to banks. For technical reasons, the regulations do not extend to wholly owned nonbank entities owned by foreign banks. Foreign banks are not defined as banks under the definition used in the existing regulations. The proposed regulations would provide comparable treatment to nonbank entities that are wholly owned by foreign banks.

g. Foreign Tax Credit Regulations Proposed to Address Pooling Issues.

The I.R.S. proposed regulations which address the multi-year pools of post-1986 undistributed earnings and post-1986 foreign income taxes of a foreign corporation. Consistent with U.S. law, the proposed

regulations provide that these pools are determined by taking into account only periods beginning on and after the first day of the foreign corporation's first taxable year in which a domestic corporation exists that is a qualifying shareholder. A corporation is a qualifying shareholder if it owns 10% or more of the voting stock of the foreign corporation or owns indirectly at least 5% of the voting stock of a lower-tier corporation.

The rule limiting the multi-year pools of earnings and taxes to post-1986 taxable years beginning with the year in which a foreign corporation first has a qualifying shareholder alleviates the administrative difficulties such shareholders face in reconstructing accumulated earnings and taxes accounts in connection with their acquisition of stock in a pre-existing foreign corporation. While Code §902 provides that pooling of earnings and taxes begins only when the foreign corporation first has a qualifying shareholder entitled to compute a credit for deemed-paid taxes, the statute does not provide for any change in a foreign corporation's post-1986 undistributed earnings and taxes pools following a stock disposition or other transaction after which the foreign corporation no longer has a qualifying shareholder.

The proposed regulations extend the policy underlying the rule deferral of pooling to a situation where a foreign corporation once had, but no longer has, a qualifying shareholder. Consequently, the formerly pooled earnings would be considered pre-1987 accumulated profits that are exempt from pooling.

The proposed regulations also modify the treatment of rents and royalties as passive or active income for foreign tax credit basket purposes. Currently, such income is treated as active only if received from unrelated parties. The proposed regulations eliminate the distinction between royalties received from related and unrelated payors in applying the active rents and royalties exception for foreign tax credit basket purposes, but not for purposes of Subpart F. This change is proposed to apply to rents and royalties paid or accrued more than 60 days after the date that regulations are published in final form.

h. Regulations Proposed on Reverse Hybrid Entities.

A reverse hybrid is an entity that is treated as a partnership or a pass-through entity by a treaty partner, but as a corporation by the U.S. An example would be a domestic limited partnership that elects corporate status under the check-the-box regulations.

In February, the I.R.S. issued proposed regulations relating to the eligibility for treaty benefits of items of income paid by reverse hybrids. Proposed Reg. §1.894-1(d)(2). The proposal addresses the overall U.S. tax treatment for a reverse hybrid that receives a dividend from a subsidiary and makes a payment to a related foreign person resident in a treaty jurisdiction.

Under the proposal, the payment to a “related person” will be treated as a dividend, notwithstanding ordinary rules of U.S. tax law, if the rate of U.S. withholding tax on dividends under an applicable treat

is greater than the rate of tax for the deductible payments. As a result of this treatment, the payment is nondeductible and is subject to the withholding tax rate for dividends under the treaty.

The amount treated as a dividend is capped at the amount of the dividend received by the reverse hybrid from the subsidiary. Adjustments are made to take into account actual dividend payments made previously by the reverse hybrid.

The provision applies only to payments made to related persons by the reverse hybrid, not to unrelated persons. A person is related if the degree of ownership exceeds 80% between the parties. The preamble to the proposed regulations states the view of the Treasury Department that it is inappropriate for related parties to use domestic reverse hybrid entities for the purpose of converting higher taxed U.S. source income to lower taxed, or untaxed, U.S. source items of income. That defeats the purpose of the treaty, which is the elimination of double taxation.

This is the second leg of an attack on reverse hybrid entities by the I.R.S. Previously, the I.R.S. ruled that a payment received by a reverse hybrid entity that is treated as a domestic corporation will prevent its foreign shareholder from qualifying for treaty benefits even though the entity is a pass-through for foreign tax purposes. Now, payments by the reverse hybrid may lose the benefit of a deduction.

3. Legislative Proposals and Administrative Items.

a. O.E.C.D. Releases Reports on E-Commerce.

The O.E.C.D.'s Committee on Fiscal Affairs released a series of reports and discussion papers addressing the effect of global e-commerce on international taxation. The reports follow a consensus reached in January of this year on whether computer hardware should constitute a permanent establishment for tax treaty purposes. The basic findings in January were that web sites and web site hosting arrangements alone do not constitute permanent establishments and that internet service providers generally do not constitute dependent agents or permanent establishments. However, the location of computer network equipment, including servers, could constitute a permanent establishment when servers perform a significant function that is an essential element of a taxpayer's business activity. The reports were prepared by various technical advisory groups.

In connection with the collection of tax from e-commerce, it was recommended that a tax-at-source option appeared to be the best overall collection method when combined with a trusted third-party clearinghouse system. A self-assessment option is viable for business-to-business transactions, but is not practical for business-to-consumer transactions. Also, registration of nonresident vendors is problematic as to the identification of consumers and their residence. E-retailers likely cannot verify claims that customers reside in a particular jurisdiction.

The report addressed the general conditions reflected in the O.E.C.D. consensus for e-commerce taxation, viz., neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. Neutrality means that businesses should not make decisions based on taxation effects, but for economic reasons. Efficiency means that neither consumers nor businesses should have large expenses stemming from compliance with tax administration rules. Certainty and simplicity means that taxpayers should know in advance the amount of tax that will be due and the timing and methodology for payment. Effectiveness and fairness address the manner in which compliance will occur and the appropriate amount of tax will be paid. Flexibility suggests that the tax laws themselves will change to suit the times.

Regarding the place of consumption of digitally delivered services, the report discusses the place of consumption for e-commerce transactions. Historically, a pure consumption test was applied. Under a pure consumption test, intangible services would be defined as consumed in the place where the customer actually consumes or uses the services. However, the global nature of e-commerce, combined with the mobility of communications, puts in question the practicability of a pure consumption test. For example, assume that a U.S. business consultant signs a contract with a U.K. company to provide services to a branch in Japan. The consumption may be viewed to take place in the U.K. where the customer is headquartered or in Japan where the branch is located. Where there is a choice, the business presence should be considered as the establishment of the recipient to which the supply is made.

The report suggests that a reverse-charge (self assessment) option for a business-to-business transaction would be a simple and reliable way to collect consumption taxes. Identifying the place of consumption becomes problematic in a business-to-consumer transaction. For these transactions, the definition of place of consumption might be determined by a consumer's permanent address or place of residence, or by his center of vital interests, or by nationality. The problem is that the selling company likely would not have any way to know or verify a private customer's center of vital interests or nationality.

b. International Issues Included in Tax Code Simplification Proposals.

The Staff of the Joint Committee on Taxation has been charged with the task of recommending simplification proposals that will be applied to the Internal Revenue Code. The goals included the promotion of fairness, the elimination of complexity, the elimination of duplication, the enhancement of predictability in U.S. tax law, and the administrative feasibility of any change.

In the international area, the Staff made the following recommendations:

i. The rules applicable to foreign personal holding companies and foreign investment companies should be eliminated.

ii. Foreign corporations should be excluded from the application of the personal holding company rules which impose a tax on undistributed personal holding company income.

iii. Subpart F foreign personal holding company income should be expanded to include certain personal services contract income targeted under the present-law foreign personal holding company rules.

iv. The Subpart F de minimis rule should be modified to be the lesser of 5% of gross income or $5 million, increased from the present-law dollar threshold of $1 million.

v. For foreign tax credit limitation purposes, the look-through approach should be immediately applied to all dividends paid by a 10/50 company regardless of the year in which the earnings and profits were accumulated.

vi. A domestic corporation should expressly be entitled to claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or U.S. partnership, provided that minimum ownership levels are maintained.

vii. If the credits provided under Code §30A and Code §936 are extended beyond 2005, the credits should apply across all possessions of the U.S. and should be placed in a single section of the law.

viii. For purposes of determining a foreign person's earnings and profits and subpart F income, costs incurred in producing property or acquiring property for resale should be capitalized using U.S. generally accepted accounting principles in lieu of the uniform capitalization rules.

ix. Secondary withholding tax with respect to dividends paid by certain foreign corporations engaged in a U.S. trade or business but not subject to the branch profits tax should be eliminated.

x. The 30% tax on certain U.S.-source capital gains of nonresident individuals should be eliminated.

xi. The Treasury should update and publish U.S. model tax treaties at least once each Congress.

xii. The Treasury should report to the Congress on the status of older U.S. tax treaties at least once each Congress. The recommendation would establish a process for renewing older U.S. tax treaties that may not reflect current policy and that provide different tax outcomes than do more recent U.S. tax treaties.

c. Elimination of U.S. Withholding Tax Proposed for Foreign Income of RICs.

Rep. Phil Crane (R. Ill.) has proposed legislation designed to eliminate U.S. withholding tax on dividends paid to foreign investors by a regulated investment company, to the extent that the dividend arises from foreign income of the RIC. The thrust of the bill is to attract foreign investors to use U.S. RICs as a vehicle to make investments outside the U.S. The goal is to make a U.S. RIC as attractive to foreign investors wishing to invest outside the U.S. as a foreign mutual fund.

d. I.R.S. Announces Business Plan.

The I.R.S. announced its business plan for fiscal 2001, which will end on June 30, 2002. The international items on the plan are as follows:

i. Subpart F/Deferral

(1) Proposed regulations regarding mark-to-market procedures for passive foreign investment companies.

ii. Inbound Transactions

(1) Proposed regulations on the disallowance of deductions under Code §§882(c)(2) and 874(a) relating to the need to file tax returns.

(2) Final regulations under Code §§892 and 7701 relating to foreign governments.

(3) Guidance relating to the reporting obligations of nonqualified intermediaries.

(4) Guidance concerning U.S. real property interests.

(5) Other guidance regarding withholding on payments to foreign persons.

(6) Guidance under Code §1503(d) concerning triggering events for recapture of losses tentatively claimed as deduction under an exception to the dual consolidated loss rule.

iii. Outbound Transactions

(1) Guidance on international restructuring.

(2) Final regulations under Code §684 involving gain recognition on transfers to foreign trusts.

(3) Final regulations under Code §679 involving transfers by U.S. persons to foreign trusts having U.S. beneficiaries.

(4) Guidance relating to the Extraterritorial Income Exclusion Act.

(5) Guidance under Code §1504(d) regarding contiguous country corporations formed to comply with foreign law.

(6) Guidance concerning certain extraordinary transactions involving disregarded entities under the check-the-box regulations.

iv. Sourcing and Expense Allocation

(1) Guidance relating to the source of income from employee fringe benefits.

(2) Guidance concerning the allocation and apportionment of expenses.

(3) Final regulations on the treatment of losses from dispositions of personal property under Code §865.

(4) Guidance under Code §883 relating to exempt shipping income.

(5) Update Rev. Proc. 97-31 listing countries and types of excluded income under Code §883.

v. Application of U.S. Income Tax Treaties

(1) Guidance concerning the relief from double taxation and adjustments to taxpayers accounts receivable or payable arising from transfer pricing allocations.

(2) Final regulations relating to the application of the income tax treaties to payments from reverse hybrid entities.

(3) Guidance under the Canadian treaty relating to Canadian Registered Retirement Savings Plans.

(4) Update Rev. Proc. 96-13 relating to the procedures for requesting competent authority assistance.

(5) Guidance relating to the reporting of bank deposit interest.

vi. Other

(1) Guidance relating to the conduct of cross-border, securities dealing operations ("global dealing").

(2) Guidance on the treatment of cross border services under Code §482 and related provisions.

(3) Guidance under Code §954(i) relating to the determination of appropriate foreign loss payment patterns and interest rates.

(4) Guidance concerning the treatment of currency gain or loss.

(5) Guidance under Code §4374 regarding the excise tax on insurance policies issued by foreign insurers.

(6) Guidance concerning the international activities of partnerships.

e. Pre-filing Program Made Permanent.

In Rev. Proc. 2001-22, the I.R.S. made permanent its pre-filing, agreement program. Under this program, the I.R.S. and taxpayers agree in advance as to the proper treatment of specified issues. The goal is to reduce controversy at the time of an audit. The international issues that are included in the pre-filing program include the following:

i. The valuation of specified assets, but not a retrospective change in the method of valuation or a determination of appropriate valuation methodology;

ii. The proper SIC code for a line of business;

iii. Whether the taxpayer's apportionment of deductions, including general and administrative expenses, that are related to all gross income properly reflects the factual relationship between deductions and gross income as required by the regulations;

iv. Whether, as a factual matter, an expense relates to fewer than all members of an affiliated group;

v. The verification of amounts of foreign taxes paid and the applicable exchange rates, but not whether such taxes are creditable; and

vi. Whether the taxpayer must recapture a dual consolidated loss following a triggering event under Code §1503(d).

f. Existing Treaties to be Renegotiated.

The I.R.S. announced that the income tax treaties between the U.S. and each of Australia and Hungary will be renegotiated to reflect changes in the tax laws of the U.S. and both such countries. In the case of Hungary, the revision will eliminate an avenue for investment in the U.S. that has recently been attractive to persons who do not otherwise benefit from an income tax treaty. The existing treaty between the U.S. and Hungary has no limitation on benefits provision. Any new treaty will contain that type of provision. The U.S. and Bangladesh have announced agreement on the text of an income tax treaty.

g. Captive Insurance Company Concept Abandoned by I.R.S.

In Rev. Rul. 2001-31, the I.R.S. announced that it will no longer invoke the "economic family theory" first enunciated in Rev. Rul. 77-316 to deny deductions for premiums paid to captive insurance companies. The economic family theory" is that a captive insurance company and its affiliates are part of a single economic family. Consequently, when insurance was obtained through a captive, the I.R.S. contended that the transaction involved insufficient risk shifting and risk distribution to constitute insurance for Federal income tax purposes. In other words, the premium payment was disregarded and the insurance coverage retained by the captive could be properly treated as nondeductible self-insurance.

No court has fully accepted the economic family theory. Consequently, the I.R.S. will no longer invoke it in the context of captive insurance transactions. However, it will continue to review insurance transactions through captives, and where appropriate, it will raise challenges based on facts and circumstances.

h. I.R.S. Begins Transfer Pricing Documentation Survey.

The I.R.S. has begun a random survey of 1,400 business taxpayers with assets of $50 million or more to evaluate the transfer pricing documentation required under Code §6662(e) as a means of avoiding a transfer pricing penalty. The survey is being conducted by a private research company in order to ensure impartiality, confidentiality, and anonymity of the taxpayers involved.

i. Competent Authority Agreement Reached Regarding French Social Security payments.

The Treasury Department announced in June that an agreement was reached with its counterpart in France regarding the treatment of contributions to, and distributions from, the French social security regime (Basic Plan and Complementary Plans). The agreement clarifies the application of Article 18 (Pensions) of the France-U.S. Income Tax Treaty.

Subparagraph (a) of Article 18(1) of the treaty provides that, in general, distributions from private pension and other retirement arrangements derived and beneficially owned by a resident of one of the two treaty partners in consideration of past employment is taxable only in that person's state of residence. Subparagraph (b) provides that pensions and other payments made under the social security legislation of one of the two treaty partners to a resident of the other jurisdiction is taxable only in the state making the payment. Hence, if the payment is made by the French government, only France can impose tax.

Apparently, the I.R.S. has fielded questions concerning the treatment of contributions to, and distributions from, the French social security regime (basic plan and complementary plans) by, and to, individuals residing in the U.S. The competent authorities met to discuss the these questions and have agreed that the treaty will be applied in the following manner.

i. The French social security regime does not generally correspond to a pension or other retirement arrangement that is recognized for tax purposes by the U.S. Accordingly, both mandatory and voluntary contributions by individuals who are resident in the U.S. are not deductible or excludible for purposes of determining the individuals' taxable income in the U.S.

ii. Distributions from the French social security regime to individuals who are residents of the United States are taxable only by France and not by the United States, regardless of whether contributions were made on a voluntary or mandatory basis.

iii. The reporting requirement of Code §6114 is waived with regard to taxpayers taking the position that a U.S. treaty reduces or modifies the taxation of income derived from public or private pensions or social security. Accordingly,

taxpayers claiming exemption for French social security benefits pursuant to Article 18(1)(b) of the Treaty are not required to disclose this position on their income tax return for the year in which the distributions are received.

The foregoing agreement is applicable to tax years beginning on or after January 1, 1996.

j. National Foreign Trade Counsel Urges Elimination in Cross-Border Withholding Taxes.

In a letter to the Treasury Department, the National Foreign Trade Counsel urged that the elimination of withholding taxes on interest income should be adopted as a goal of the U.S. in the negotiation of a protocol of the existing income tax treaty with Canada.

According to the counsel, a number of reasons exist for eliminating the tax. First, it is borne by domestic business or individuals. It raises minimal new net revenue, but serves as a disincentive to new investment, which lowers future economic output. Second, it is a regional barrier to the free movement of goods, services and capital. As such, its retention is inconsistent with the goals of the North American Free Trade Agreement. Finally, it discriminates against new investment in North America at a time when the Canada-U.S. bilateral economic relationship has become more important to both economies.

k. Reporting Exceptions Continue for Payments by Service-Recipients.

In Notice 2001-38, the I.R.S. announced that reporting obligations imposed on U.S. persons making payments to foreign persons for services rendered will continue to be deferred. Thus, they will not be in effect for payments made in the year 2001. The exception applied for payments made in the year 2000. The principal beneficiary of the exception are foreign partnerships such as law firms that provide services to U.S. persons. Without the exception, information would be required identifying all members of the foreign partnership unless a check the box election were made on behalf of the service provider.

4. Rulings and Other I.R.S. Pronouncements.

a. Stock Option Expense Must be Considered in Cost Sharing.

In FSA 200103024, the Office of Associate Chief Counsel (International) concluded that compensatory stock option expense must be included in the pool of expenses that are taken into account in computing a qualified cost sharing arrangement.

The issue presented was whether a stock option for which no out-of-pocket expenditure is made by a corporation is nonetheless a cost which reflects the economic activity of the parties to the agreement. The taxpayer argued that the expense cannot be attributed to any activity under generally accepted accounting principles applicable at the time. However, the I.R.S. concluded that differences exist between the financial accounting rules and the tax rules. The cost-sharing regulations specify that the

costs of developing intangibles under a qualified cost sharing arrangement must include all of the costs incurred that are related to the intangible development area. These costs include operating expenses which means all expenses not included in cost of goods sold except for interest expense, income taxes and any other expenses not related to the operation of the relevant business activity. Compensation is an operating expense and stock options represent compensation. Hence, the expense must be included in income.

b. Sale to Foreign Customer Produces Foreign Source Income.

In Field Service Advice 200052002, the Office of Associate Chief Counsel (International) concluded that a sale to customers outside the U.S. produced foreign source income for the U.S. company involved.

In the circumstances presented, a U.S. company received orders from customers around the world. The standard procedure of the company was to confirm acceptance of the order and to issue terms and conditions of the sale. The terms were somewhat inconsistent, calling for sales f.o.b. at a specified port of embarkation in the U.S., but also providing that title passed outside the U.S. and that during the voyage, the goods would be covered by the company's insurance policy. An f.o.b. sale within the U.S. suggests that the sale took place in the U.S.; however, the specific reference to title passage and the insurance coverage suggested that title passed outside the U.S. In some confirmations, the location of the f.o.b. sale was struck through by hand and the name of a foreign city was inserted.

The income tax regulations provide that, as a general rule, title to inventory passes where risk of loss passes to the customer. The regulations caution against terms that are inserted primarily to obtain tax benefits; however, such cautionary statements have always been thought to mean that the terms must make sense in light of the subject matter of the sale; not merely that a company understands that it may obtain a benefit from drafting the terms a certain way.

The question presented was to identify the place where title passed to the customer. The Field Service Advice concluded that, on balance, title passed outside the U.S. In reaching its decision, the Office of Associate Chief Counsel (International) applied the income tax regulations in light of the company's the acceptance terms and conditions viewed in light of the U.N. Convention on Contracts for the International Sale of Goods, the Uniform Commercial Code, and the International Chamber of Commerce Incoterms. Of particular importance to the I.R.S. were the terms of the company's insurance coverage and the statement that risk of loss continued until delivery outside the U.S. Because risk of loss was retained until the port of entry of the inventory, title passed outside the U.S., consistent with the terms of the acceptance. These terms and conditions brought with them legitimate business responsibilities and were not mere shams.

c. ESOP Trust, Not Participants, Entitled to Foreign Tax Credits.

In Field Service Advice 200105001, the Office of Associate Chief Counsel (International) advised that foreign taxes imposed on dividend income received by a trust formed under an employee stock ownership plan were properly claimed as credits by the trust, not the plan participants.

In the Field Service Advice, a domestic corporation adopted a plan to provide its employees a source of retirement income from a combination of accumulated employee contributions, corporation contributions, and investment returns. The corporation received a determination letter as to the qualification of the plan and the trust formed in connection with the ESOP was determined to be exempt from tax. The plan included an employee stock ownership program that was invested primarily in the stock of the corporation.

Under the plan, the trustee was required to distribute to each participant all dividends payable on the corporation shares allocated to his or her account. The distributions were reported to the plan participants on Form 1099-DIV as taxable dividend distributions.

The corporation participated in a merger with a U.K. resident corporation and became an indirect, wholly-owned subsidiary of the U.K. corporation. In the merger, each share of the corporation's common stock was converted into the right to receive a specified number of ADSs representing ordinary shares of Corporation C. The ADSs were to be listed on the New York Stock Exchange.

After the merger was completed, the participants' ESOP Program accounts held the ADSs. The trust received cash dividends with respect to the ADSs and distributed those dividends directly to the participants.

The question addressed in the Field Service Advice was the identification of the shareholder of the ADSs. Was it the trust or the plan participants? The Advice concluded that the trust was the shareholder. Consequently, the participants could not claim a credit for any U.K. taxes that might be imposed on the payment of dividends. Indeed, because the trust was exempt, no benefit was obtainable under the foreign tax credit.

Under Subchapter J of the Code, amounts distributed to the beneficiaries of a trust have the same character in their hands as in the hands of the trust. Hence, it is fair to state that current distribution trusts are conduits to beneficiaries. However, the provisions of Subchapter J do not apply to employee trusts. Employee trusts are not conduit trusts and amounts distributed to the beneficiaries of an employee trust do not have the same character in their hands as in the hands of the trust. Consequently, dividends paid to an employee trust become part of the trust assets and lose their identity as dividends. As a result, the dividends distributed to the participants with respect to the ADSs held by the trust were treated as plan distributions and not as dividends. Because the employee trust is not a conduit for income, it is not a conduit for foreign taxes paid by the trust.

d. Employees of Foreign Government are Exempt from U.S. Tax.

In Private Letter Ruling 200111010, the I.R.S. ruled that the individual employees of a foreign government that has in effect an income tax treaty with the U.S. were not subject to U.S. income tax on compensation received from the government.

In the private letter ruling, the employer was an instrumentality of the government of a specific foreign country. Under the terms of the income tax treaty between the U.S. and that country, wages paid by, or out of funds to which contributions are made by the government of the country or by a local authority to an individual who is a national of the country for labor or personal services performed in the discharge of a governmental function are not subject to U.S. tax. This exemption does not apply to U.S. citizens or persons who are permanent residents of the U.S. for immigration purposes.

The instrumentality of the foreign government represented that it was not engaged in industrial or commercial activities and did not carry out functions of a bank. Rather, it was engaged in advertising activities, making contacts in the financial community, and serving as a liaison with U.S. government agencies. The annual profits of the instrumentality were paid into the treasury of the foreign country. The I.R.S. ruled that the instrumentality was part of the government and that the article regarding government compensation applied.

e. Canadian Pensions and Charities are taxed on Investment Income.

In Private Letter Ruling 200111027 and Private Letter Ruling 200111037, the I.R.S. revoked two rulings in which it concluded that U.S. source interest and dividend income derived by exempt Canadian pension funds and charitable organizations through a pooled investment fund were exempt from U.S. taxation.

In each ruling a pooled fund was organized under the laws of Canada. The trustee of the pooled fund was an independent trust company. The pooled fund was segregated into 15 sections. Some of the sections were permitted to invest in U.S. stocks and interest-bearing obligations. Under the indenture for the pooled fund, interest and dividend income was the only U.S. source income that could be generated. For Canadian legal and tax purposes, each section of the pooled fund was considered to be a separate trust. The pooled fund was not engaged in the conduct of a U.S. trade or business and had no U.S. permanent establishment.

Participation in the pooled fund was limited to (1) trusts maintained with respect to a registered pension plan that were tax exempt in Canada, (2) trusts maintained with respect to a retirement or other employee benefit or profit sharing plan that were tax exempt in Canada; or (3) tax-exempt persons, including funds for hospitals, educational, religious, or other charitable institutions. Although the pooled fund was potentially liable for Canadian income tax, it did not pay any Canadian tax because all of its income was currently distributed to its investors and it was entitled to a deduction for amounts distributed.

Article XXI (Exempt Organizations) of the Canada-U.S. Income Tax Treaty provides that, subject to certain exceptions, income derived by a Canadian religious, scientific, literary, educational or charitable organization is exempt from U.S. tax to the extent that such income is exempt from tax in Canada. In addition, a Canadian trust, company, organization or other arrangement that is generally exempt from Canadian income tax and that is operated exclusively to administer or provide pension, retirement or employee benefits is exempt from U.S. income tax. Also exempt is a Canadian trust, company, organization or other arrangement that is generally exempt from Canadian tax provided that it is operated exclusively to earn income for the benefit OF a Canadian charitable organization.

The I.R.S. observed that the legislative history of the treaty indicated that the foregoing provision was intended to provide mutual exemption for organizations acting exclusively as conduits for tax exempt pension funds. Unfortunately, the pooled fund in each ruling contained both tax exempt and taxable entities. This precluded application of the treaty exemption on investment income. In reaching its decision, the I.R.S. ignored the manner in which Canadian law treats each separate section of the pooled fund. They are treated as separate trusts.

The likely result of the conclusion is that mirror pooled funds must be availed of by a Canadian tax exempt entity that wishes to take advantage of the exemption provided by the treaty. Formation of a separate section of an existing pooled fund in which only tax-exempt entities may participate will not be allowed.

f. U.K. Windfall Tax on Privatized Utilities not a Creditable Tax.

In Field Service Advice 200112011, the Office of Associate Chief Counsel (International) concluded that the windfall tax on privatized utilities is not a creditable income tax for foreign tax credit purposes in the U.S. It is an expense that reduces earnings in the year paid, not the year accrued.

During the 1980's, certain government-owned public utilities in the U.K. were privatized through public offerings of shares. Several such utilities were acquired by U.S. utilities for huge amounts. These acquisitions were unpopular in Britain because privatization was intended to result in reduced utility costs not windfalls to private shareholders.

As a result, the U.K. enacted the windfall tax in 1997. The tax is a one-time tax on privatized utility companies. It is based on 23% percent of the amount by which the value of the company in profit making terms exceeds the value placed on the company at the time of the stock flotation to the public, sometimes referred to as the flotation value. The value of a utility company in profit making terms is generally defined as 9 times the utility company's average annual earnings, as reported for U.K. tax purposes, during the four years immediately following its flotation date.

The Office of Chief Counsel (International) concluded that the windfall tax did not meet the definition of a creditable income tax. Under the regulations, a payment to a foreign country is an income tax only

if (1) it is a tax, (2) the predominant character is that of an income tax in the U.S. sense, and (3) it is compulsory, being imposed pursuant to the authority of a foreign country to levy taxes. Here, there was no doubt that the payment was compulsory and that it was a tax. However, it was not an income tax in the U.S. sense.

The predominant character of a tax is that of an income tax if it is likely to reach net gain in the normal circumstances. This will exist if three conditions are satisfied. These are the realization, gross receipts, and net income conditions. The Office of Associate Chief Counsel (International)believed that none of the conditions were met.

The realization condition means that the tax (i) is imposed upon the occurrence of a realizable event under U.S. concepts, *viz*., a sale, or at a subsequent time, or (ii) is imposed prior to a realizable event, but reflects the recapture of a benefit, or reflects an increase in value or an event such as processing and the tax is not again imposed on a subsequent realized event. Here, the tax was imposed prior to any realized event and there was no provision in U.K. tax law to prevent a second imposition of tax at a later time, even though the tax was imposed on a one-time basis. Presumably, the I.R.S. was concerned that the utility might sell its business to another purchaser and income tax would be imposed on that sale with no offset for the amount subject to the windfall tax.

In addition, the gross receipts condition was not met because a realizable event must precede the generation of gross receipts. The windfall tax did not require the generation of gross receipts from a sale. Although gross receipts from operations were taken into account, they were used to measure deemed value, not to trigger realization of income. If the gross receipts condition was not met, the net income condition could not be met. Under that condition, allowances must be allowed for the recovery of significant costs and expenses under reasonable principles.

Once the Office of Associate Chief Counsel (International) concluded that the windfall tax was not an income tax, earnings can be reduced only when all events fixing the liability occur, the liability can be reasonable determined, and economic performance takes place. In the case of a non-creditable tax, economic performance takes place at the time of payment, not the time of accrual.

g. Bulgarian Withholding Tax is Creditable.

In Private Letter Ruling 200110021, the I.R.S. ruled that Bulgarian withholding tax imposed on fees received by a U.S. software firm were creditable as in-lieu-of taxes.

In the ruling, a U.S. corporation entered into a multi-year License and Implementation Agreement with a Bulgarian company. Pursuant to the terms of the agreement, the customer acquired a nonexclusive license to use the software for its business. The licensed rights including rights to software operating manuals, future modifications, enhancements, supplements, and alterations to the software. The U.S. corporation agreed to assist the Bulgarian customer in the selection, installation, and certification of the

hardware, system software, software security, third-party software, telecommunications, and operational procedures. In addition, the U.S. corporation was obligated to support the upgrades to the software and to make U.S. personnel available for telephone consultation or computer-to-computer diagnosis at all times. It was contemplated that employees of the U.S. corporation would conduct all software-related activities within the facilities of the Bulgarian customer.

In return for the foregoing, the Bulgarian customer undertook to pay royalties for the intellectual property and separately stated fees for the performance of technical services. Both the payment of fees and royalties were subject to the Bulgarian withholding tax.

The I.R.S. ruled that the withholding tax was a creditable income tax for foreign tax credit purposes. Key to the ruling was the representation that Bulgaria generally imposes a tax on realized net income on persons doing business in Bulgaria, but that the corporation will not be subject to the tax because it will not be engaged in business activities in Bulgaria. According to the I.R.S., the general income tax and the withholding tax were separate levies imposed by the Bulgarian government; the tax bases were different. The former tax was generally imposed on a realizable event and was intended to impose tax on net income. The withholding tax operated as a tax imposed in substitution for, and not in addition to, the otherwise generally imposed Bulgarian tax on realized net income. Finally, legal liability for the Bulgarian tax was imposed on the U.S. corporation, even though its customer was required to remit payment to the Bulgarian government.

In sum, the withholding tax was compulsory, was imposed in recognition of Bulgaria's authority to impose a tax, and was imposed in lieu of a tax of general application on realizable net income. Hence the tax was creditable.

h. I.R.S. Refuses to Apply Appeals Court Decision in G.M. Trading.

In FSA 200123008, the Office of Associate Chief Counsel (International) refused to acquiesce in the Appeals Court decision in G.M. Trading Corp. v. Commr., 121 F.3d 977 (5th Cir. 1997) revg. 103 T.C. 59 (1994). The case held that a U.S. corp. did not realize taxable gain on the exchange of Mexican foreign debt for restricted Mexican pesos.

The Field Service Advice and G.M. Trading Corp each dealt with a debt-equity swap program adopted by Mexico to limit its currency reserve position as a result of U.S. dollar denominated debt issued by the Mexican government. The debt was trading on the secondary markets at steep discounts. The debt-equity swap program allowed Mexico to retire its dollar-denominated debt through private investment. It worked as follows. The debt would be acquired from the secondary market by a potential investor in Mexico. The investor would exchange the debt for Mexican currency at a favorable rate of exchange. The currency was transferred to the subsidiary for investment in Mexican capital and operating assets. The currency could not be used for other purposes.

Here, the taxpayer entered into two debt-equity swaps. Upon examination, the I.R.S. asserted that gain should have been recognized on the swaps. The taxpayer paid the tax, but subsequently filed a claim for refund. The taxpayer's principal office was located within the appellate jurisdiction of the Fifth Circuit, the circuit that reversed the Tax Court and held no gain is recognized on the swap. Ordinarily, the rule in the circuit court of appeals that has jurisdiction over the taxpayer will be followed as a matter of administrative convenience. That circuit court will follow its decision rather than the I.R.S. view.

The I.R.S. refused to follow the opinion of the Fifth Circuit Court of Appeals because it viewed the opinion as erroneous. According to the Office of Associate Chief Counsel (International), both the Tax Court and the Fifth Circuit characterized the debt-equity swap transaction in G.M. Trading as having two essential steps: (1) The purchase of the Mexican debt by the U.S. parent and its transfer to the Mexican government in exchange for restricted pesos; and (2) a contribution of those pesos to the Mexican subsidiary. Under the Tax Court's view, the parent must recognize gain on step one of the transaction to the extent the fair market value of the pesos exceeds its basis in the debt. However, the Fifth Circuit held that the restricted pesos received for debt extinguishment had no readily ascertainable value, and as a result, the basis of the pesos was equal to the basis in the debt exchanged. Accordingly, no gain was realized on such exchange. The court further held that the value of any other restricted pesos received was a non-taxable contribution to capital. The I.R.S. disagreed with the latter point. If the parent was considered to have acquired pesos with a zero basis and to have transferred them to the Mexican subsidiary, the parent was taxable at the time of the transfer on any gain inherent in the pesos under Code §367(a).

i. Withholding Tax on Consent Dividend Must Be Paid by the Due Date of the Return, Determined Without Regard to Extensions.

In ILM 200123061, the Office of Associate Chief Counsel (International) concluded that withholding tax arising from the making of a consent dividend must be paid by the due date of the return, determined without regard to extensions.

In the matter, the corporate taxpayer declared a consent dividend to its shareholders. Under Code §565, a consent dividend allows a U.S. corporation to avoid being subject to the personal holding company tax by reason of the making of a hypothetical dividend to shareholders. The hypothetical dividend eliminates undistributed personal holding company income. All shareholders must consent to the hypothetical dividend, as they are taxed as if a dividend were actually paid. The corporate taxpayer filed the consents with its corporate tax return, which was filed in September, pursuant to an extension to file. The initial due date for the return was March, but an extension was properly requested.

Because some of the corporate taxpayer's shareholders were foreign persons, a payment of withholding tax was made with regard to the consent dividends attributable to the foreign shareholders. The corporate taxpayer filed an amended Form 1042 to report the consent dividends and the I.R.S. assessed a late payment penalty and interest. The memorandum concluded that the assessments of

penalties and interest were proper. An extension of time to file is never an extension of time to pay tax. The tax should have been paid at the time the extension request was filed; that was in March.

5. Tax Shelter Transactions.

a. Canadian Continuation Company Attacked.

On September 18, 2000, the Treasury Department announced an intent to clarify a provision of the existing Canada-U.S. Income Tax Treaty relating to the residence status of corporations. The announced change responded to attempts by some U.S. corporations to use the provision in the current treaty to avoid taxes on the repatriation of earnings from subsidiaries in third countries.

The basis of the plan is as follows. The term "continuation" broadly means that the corporate charter of an existing company has ben registered in a new jurisdiction. The charter in the old company is not necessarily revoked. The procedure is intended to allow a corporation formed in a troubled jurisdiction to move its charter without the need for any act in the original country.

Under the existing income tax treaty, a company that "continues" from one country to the other is treated as resident in its new home country. Arguably, this allows a U.S. corporation continued into Canada to take inconsistent positions with respect to its status. By virtue of the treaty, the corporation could contend that it is a resident only of Canada. As a Canadian corporation, foreign source dividend income could be received free of U.S. income tax under the treaty. At the same time, its parent would contend that for other U.S. tax purposes, the corporation would retain its status as a U.S. corporation. As a result, dividends received by a U.S. parent company could benefit from the 100% intercompany dividends received deduction or can be eliminated in consolidation. In total, no U.S. tax would be due on the repatriation of earnings from foreign subsidiaries. In Canada, the dividends presumably would be considered to be paid from exempt surplus. Such dividends generally can be received free of tax in Canada. When the proceeds of the dividends are distributed to the parent company in the U.S., a 5% withholding tax would be imposed in Canada. The overall effect of this planning opportunity could be a reduction of total tax on the repatriation of profits of up to 30 percentage points. Hence the need to revise the treaty.

The revised provision will clarify that a company, incorporated in the U.S., which is continued into Canada, will be treated as a resident of the U.S. unless internal law no longer treats it as a resident. The effect will be to subject the dividends received from foreign subsidiaries to full U.S. tax. The proposed revision is to be effective from September 18, 2000.

The type of planning that resulted in the announced revision to the treaty is evidenced in Field Service Advice 200117019. There, a domestic corporation was the common parent of an affiliated group of corporations filing consolidated Federal income tax returns on a calendar year basis. One of the members of the group was a domestic holding company for foreign subsidiaries. The foreign subsidiaries

accumulated substantial earnings and profits that were required by the U.S. group to meet its debt service requirements and to fund its domestic operations.

To avoid substantial tax liability upon the repatriation of earnings that had not been previously taxed, a plan was devised and implemented to cause the domestic holding company subsidiary to be continued as a Canadian corporation, in order to take advantage of the planning opportunity described above. The corporate group continued to treat the holding company subsidiary as a domestic corporation and the holding company subsidiary treated itself as a foreign corporation. It filed a gain recognition agreement in connection with the continuation, as if it had transferred assets to a foreign entity in a transaction covered by Code §351.

The holding company subsidiary received a substantial dividend from the foreign corporations. Those corporations applied the withholding tax rate applicable to dividends paid to a Canadian corporation. The funds were lent or distributed as a dividend to the U.S. group. The U.S. group filed a U.S. income tax return showing the subsidiary as a member of the group; the dividends received by the holding company subsidiary were included in the return and then expressly excluded in light of the treaty. This likely was a protective device to avoid fraud penalties and to limit the application of a 6-year statute of limitations. The dividend was apparently eliminated in consolidation.

The group claimed a foreign tax credit for all taxes paid or deemed paid by the holding company subsidiary even though the income was removed from the return. The group's justification for claiming the foreign tax credits was that the treaty addressed the treatment of income, but was silent as to the treatment of credits.

The plan was discovered during the course of an examination and the I.R.S. examiner requested advice of the Associate Chief Counsel (International). In the Field Service Advice, the plan was attacked on several grounds.

First, the holding company subsidiary remained a U.S. corporation.

Second, the saving clause in the treaty was applicable and allowed the U.S. to impose full tax on a U.S. corporation as if the treaty were not in effect.

Third, the group cannot take inconsistent positions regarding the status of the company as both a U.S. corporation for domestic law purposes (the foreign tax credit) and a foreign corporation for treaty purposes (limitation on the scope of U.S. tax jurisdiction). The treaty and the domestic tax law cannot be combined to provide a result that is more favorable than the result under the domestic law or the result under the treaty. Because the holding company subsidiary chose to apply domestic law by joining the consolidated return as a domestic corporation that is liable to U.S. tax on its worldwide income, it should not be allowed simultaneously to obtain benefits under the treaty as a resident of the other country.

Fourth, the plan was abusive and can be disregarded as a sham. It had no business purpose other than tax reduction.

Fifth, to the extent that the holding company subsidiary is properly treated as a foreign corporation entitled to treaty benefits, the foreign tax credit for taxes paid or deemed paid by it should not be allowed. If the income is not included in a tax return, the foreign taxes should not be allowed as credits in the return. The purpose of the foreign tax credit is to avoid double taxation. Cases that allow a credit for taxes imposed on income that is not taxable under U.S. domestic law concepts such as pro rata stock dividends are distinguishable.

Sixth, the continuation of the holding company subsidiary into Canada may be an outbound transaction to which Code §367(a) applies.

Seventh, the continuation of the holding company subsidiary into Canada caused the company to become a controlled foreign corporation which would subject the members of the U.S. group to tax under Subpart F.

b. Lease Strip Transaction Challenged under Code §482.

In Technical Assistance 200121071, the Office of Associate Chief Counsel (International) advised that Code §482 applies when a partnership transfers high basis, low fair market value stock to a company in a tax-free transaction covered by Code §351, after which the stock is sold at a loss by the company in a transaction with a party related to the partnership. Ordinarily, a lease-strip transaction is part of a plan to allow the company to shelter a large capital gain.

The lease strip transaction is designed to allow a promoter to bridge the gap between a target company, whose shareholders wish to sell shares so that favorable capital gains tax rates will apply, and an acquirer that wishes to purchase assets in order to benefit from a step-up in asset values and the amortization of goodwill. The matter before the I.R.S. involved the following steps:

i. The promoters formed a partnership.

ii. The partnership formed an acquisition company.

iii. The acquisition company borrowed $60 million from an unrelated bank.

iv. The acquisition company purchased all the stock of the target.

v. The target and the acquisition company were merged.

vi. The partnership contributed high basis, low value assets to the target in a transaction covered by Code §351.

vii. The target sold its operating assets to the ultimate acquiring company, realizing a gain.

viii. The target repaid the borrowing that was made by the acquisition company.

ix. The target sold the high basis, low value assets and realized as loss sufficient to offset the earlier gain.

The I.R.S. concluded that Code §482 was applicable to the transaction and the loss could be apportioned to the partnership. According to the I.R.S., it is not necessary that the same person or persons own or control each controlled business before Code §482 can be applied. Rather, there must be a common design for the shifting of income in order for different entities to constitute the same interests. Here, even though the company and the partnership were independent, they acted in concert or with a common goal or purpose. That goal was the shifting of deductions arising from the sale of high basis, low value assets from the partnership to the target. Such shifting raises a presumption of control. Hence, the partnership and the company were controlled entities and the transactions were controlled transactions to which Code §482 is applicable. The I.R.S. is authorized to evaluate whether a nonrecognition transaction permitted by U.S. tax law should be adjusted to reflect economic substance. Here, no business purpose was cited other than the ability to wash the gain from the sale of the target's assets with the loss arising from the sale of assets transferred to the target by its shareholders.

6. Tax Cases.

a. Role of Antilles Finance Company Upheld.

In Ambase Corp., et al. v. Commr., T.C. Memo. 2001-122, a case involving a unique fact pattern, the U.S. Tax Court refused to ignore the role of a Netherlands Antilles finance company in raising funds in the Eurobond market. U.S. withholding tax was not appropriate in the circumstances.

The case involved a U.S. based group that raised funds in the Eurobond market prior to the adoption of the exemption for interest paid on items of portfolio debt. The U.S. parent formed a finance company and capitalized it in a fairly typical manner. Cash was contributed to the company and the funds returned almost immediately to the U.S. group as part of an overall financing in which most of the funds were raised in the Eurobond market. At all times relevant, the U.S. group took special care to respect the arrangement. Interest was paid when due, Forms 1042-S were issued to Finance and filed with the I.R.S., and filings with the S.E.C. reported the borrowings. Under the terms of the income tax treaty then in effect between the I.R.S. and the Netherlands Antilles, no tax was withheld in connection with the interest payment.

Upon examination, the I.R.S. disregarded the form of the transaction. It contended that the economic substance of the transaction was a borrowing by the U.S. parent through its issuance of debt in the Eurobond market. Once the finance subsidiary was ignored, the I.R.S. contended that 30% withholding tax should have been collected. A deficiency in tax was asserted and the U.S. group filed a petition for redetermination in the Tax Court. The Tax Court found for the taxpayer.

According the Court, the I.R.S. position, which was based on economic substance, was not relevant to the matter. When Congress adopted the exemption for interest on items of portfolio debt, it did so on a prospective basis. The exemption applied only to newly issued debt. Congress refused to extend the benefit to existing debt of U.S. companies issued to offshore finance subsidiaries. Instead, it provided that existing loans would be respected for U.S. income tax purposes provided that the finance companies met conditions of I.R.S. rulings issued under the interest equalization tax. Among the conditions of those rulings was the requirement that the debt-equity ratio could not exceed 5:1.

The I.R.S. contended that finance company did not have a 5:1 debt- equity ratio because the capital contributed to it was immediately lent to the U.S. group on an interest-free basis. The I.R.S. characterized this as a circular flow of cash in a suspect transaction. As a result, it urged the Court to disregard the capital contribution and to hold that the 5:1 requirement was not met. The Court dismissed the contention. In the Court's view, nothing existed in the rulings to mandate a substance over form conditions for equity capital. Moreover, the principles in the rulings were applied by the I.R.S. at the time in a pro-taxpayer and lenient manner. Thus, the I.R.S. permitted a subsidiary to be capitalized with parent company shares, a rather empty form of equity. The Court concluded that, when Congress adopted that provision, the rules under which substance takes precedence over form were abandoned for finance companies.

b. Dividend Strip Transaction Gives Rise to Deductible Loss.

In IES Industries Inc. v. U.S., __ F. 3d. __ (Docket No. 00-1221; No. 00-1535) (8th Cir. June 14, 2001), the Court of Appeals reversed a District Court decision disallowing capital losses arising from a dividend strip transaction.

In the case, IES realized a substantial capital gain. It was approached by an investment banker to consider entering a transaction that would produce a capital loss. The investment banker identified ADRs whose companies had announced dividends. IES purchased ADRs with a settlement date, or effective trade date, before the record date for the dividend. Thus, IES was the owner on the record date and therefore entitled to be paid the dividend. IES then promptly sold the ADRs, with a settlement date after the record date. The purchase and sale generally took place within hours of each other, and sometimes in Amsterdam when the U.S. and European markets were closed.

The sellers of the ADRs were tax-exempt entities, such as U.S. pension funds. These entities were taxable in foreign jurisdictions and were required to pay a 15% foreign tax on any ADR dividends

collected. Because they owed no U.S. tax, they could not benefit from the foreign tax credit. Thus, the foreign tax represented a real cost for the entity in the U.S.

Before the dividend record date, the holders of the ADRs loaned them to a counterparty selected by the investment banker. The counterparty then sold the ADRs short to IES, which then became the actual owner of the ADRs with full right, title, and interest in the ADRs. The counterparty bought back the ADRs after the dividend accrued to IES.

The purchase price of the securities was equal to market price plus 85% of the ADRs' expected gross dividends, that is, the same amount the ADR lender would have received after foreign tax was withheld had it been the record owner entitled to payment of the dividends. In addition, the lender received a deposit of cash (or equivalent) collateral, generally 102% of the market value of the ADRs on loan. The lender would have that collateral available to invest during the term of the loan of the ADRs, thus earning a profit on its loan.

IES generated a capital loss that was used to reduce capital gains generated in earlier years. At the same time, the transactions generated dividend income and IES made an overall profit which exceeded the capital losses. IES retained the dividends, which were ordinary income to the company, paid the 15% foreign tax, and claimed a 15% foreign tax credit in the U.S. The I.R.S. disallowed the claimed capital losses and the ADR-related foreign tax credit, and eliminated the reported dividend income.

The District Court affirmed the I.R.S. disallowance. The District Court viewed the issue as whether these transactions were a sham to be disregarded for tax purposes. A transaction will be characterized as a sham if it is not motivated by any economic purpose outside of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists (the economic substance test). The Court suggested that a failure to demonstrate either economic substance or business purpose would result in the conclusion that the transaction was a sham for tax purposes.

The Court of Appeals reversed. According to the Court, the ADR trades had both economic substance and business purpose. The economic benefit to IES was the amount of the gross dividend, before the foreign taxes were paid. IES was the legal owner of the ADRs on the record date. As such, it was legally entitled to retain the benefits of ownership, that is, the dividends due on the record date. While it received only 85% in cash, 100% of the amount of the dividends was income to IES. In so holding, the Court rejected the contention of the I.R.S. that economic benefit must be measured on a cash basis, excluding foreign tax credits. Under this view, IES would be entitled only to 85% of the dividend payable on the ADRs. The Court reiterated a view, often expressed in cases, that a taxpayer has a legal right to decrease taxes, or altogether avoid them, by means which the law permits. Hence, a taxpayer's subjective intent to avoid taxes will not by itself determine whether there was a business purpose to a transaction.

The I.R.S. argued that the transactions must be characterized as shams because there was no risk of loss. The Court disagreed. Although the risk was minimal, that was because IES did its homework before engaging in the transactions. Company officials met twice with Twenty-First representatives and studied the materials provided. It consulted outside accountants and securities counsel for reassurances about the legality of the transactions and their tax consequences. As the legal owner on the record date, IES bore the risk that the dividend would not be paid. Indeed, IES rejected some of the ADR trades that the investment banker proposed.

Finally, the Court pointed out that the transactions were not conducted by alter-egos of IES or straw entities created for the purpose of conducting the ADR trades. All of the parties involved -- the foreign corporations, the trusts issuing the ADRs, the tax-exempt ADR owners, the investment banker, other brokers involved, the counterparties -- were entities separate and apart from IES, doing legitimate business before IES started trading ADRs and continuing such businesses after the trades were concluded.

c. Captive Insurance Company Arrangement Respected.

In United Parcel Service of America, Inc. v. Commr., __ F. 3d __ (Docket No. 15993-95., 11th Cir., June 20, 2001), a taxpayer that instituted a captive insurance program in lieu of an existing self insurance plan was held to be entitled to a deduction for the premiums paid its captive.

UPS, whose main business was shipping packages, had a practice in the early 1980s of reimbursing customers for lost or damaged parcels up to $100 in declared value. Above that level, UPS would assume liability up to the parcel's declared value if the customer paid 25 cents per additional $100 in declared value. UPS turned a large profit on these excess-value charges because it never came close to paying as much in claims as it collected in charges.

UPS's insurance broker suggested that taxes on the lucrative excess-value business could be reduced if the program were restructured to include an overseas captive insurance affiliate. UPS implemented this plan by forming and capitalizing a Bermuda subsidiary. UPS purchased an insurance policy for the benefit of UPS customers from an unrelated company which entered a reinsurance treaty with the captive insurance affiliate of UPS.

The I.R.S. disallowed the deductions claimed for the premium payments and the U.S. Court affirmed the I.R.S. action. According to the Court, three major problems existed with the captive insurance arrangement entered into by UPS. First, the plan had no defensible business purpose, as the business realities were identical before and after. Second, the premiums paid for the policy were well above industry norms. Finally, contemporary memorandums and documents show that UPS's sole motivation was tax avoidance. The transaction was a sham and the revenue from the excess-value program was thus properly deemed to be income to UPS rather than to the captive insurance affiliate. The Court also imposed penalties.

The Eleventh Circuit reversed. the sham-transaction doctrine provides that a transaction ceases to merit tax respect when it has no economic effect other than the creation of tax benefits. Even if the transaction has economic effect, it must be disregarded if it has no business purpose and its motive is tax avoidance. In comparison, a transaction will have sufficient economic effect to be respected for tax purposes if, inter alia, the transaction creates genuine obligations enforceable by an unrelated party.

According to the Court, the restructuring of UPS's excess-value business generated just such obligations. There was a real insurance policy between UPS and the unrelated insurance company that gave the latter the right to receive the excess-value charges that UPS collected. And even if the odds of losing money on the policy were slim, that insurance company had assumed liability for the losses of UPS's excess-value shippers, again a genuine obligation. A history of not losing money on a policy is no guarantee of such a future. Insurance companies indeed do not make a habit of issuing policies whose premiums do not exceed the claims anticipated, but that fact does not imply that insurance companies do not bear risk.

Nor did the reinsurance contract with the captive insurance company formed by UPS completely foreclose the risk of loss. Reinsurance contracts, like all agreements, are susceptible to default. The tax court dismissed these obligations contending that the unrelated insurance company was no more than a "front" in what was a transfer of revenue from UPS to its captive. However, that conclusion ignored the real risk that was assumed. But even if the Tax Court's characterization is accurate, the captive is an independently taxable entity that is not under UPS's control. UPS really did lose the stream of income it had earlier reaped from excess-value charges. UPS genuinely could not apply that money to any use other than paying a premium to National Union; the money could not be used for other purposes, such as capital improvement, salaries, dividends, or investment. These circumstances distinguish UPS's case from the paradigmatic sham transfers of income, in which the taxpayer retains the benefits of the income it has ostensibly forgone.

The Appellate Court stated that the Tax Court's notion of business purpose stretches the economic-substance doctrine farther than it has been stretched. A business purpose does not mean a reason for a transaction that is free of tax considerations. In the context of a going concern like UPS, a transaction has a business purpose if it figures in a bona fide, profit-seeking business. U.S. tax law treats lots of categories of economically similar behavior differently. For instance, two ways to infuse capital into a corporation, borrowing and sale of equity, have different tax consequences; interest is usually deductible and distributions to equity holders are not. There may be no tax-independent reason for a taxpayer to choose between these different ways of financing the business, but it does not mean that the taxpayer lacks a business purpose. To conclude otherwise would prohibit tax-planning.

d. Netherlands Finance Company Disregarded.

In Del Commercial Properties, Inc. v. Commr., __ F. 3d __ (Docket No. No. 00-1313, D.C. Cir., June 8, 2001), a finance structure of a Canadian based multinational group was disregarded.

The taxpayer was engaged in the business of leasing industrial property. It required capital for the business. The parent company in Canada arranged for a double dip loan transaction in which it borrowed funds from a Canadian bank. The funds were invested in capital in an offshore company. The proceeds of the capital was ultimately loaned to the U.S. taxpayer through a Dutch finance company. The interest expense incurred in Canada in connection with the bank borrowing and in the U.S. in connection with the intra-group borrowing were deductible. The interest payment to the Netherlands bore relatively little tax in the Netherlands and was used to fund tax-free dividend payments to the Canadian parent company. In this way, a double dip of the interest expense was intended to take place.

Unfortunately, the taxpayer never actually followed the plan. The Canadian bank placed a mortgage on the U.S. property and the U.S. taxpayer provided the bank with financial statements during the term of the loan. Eventually, cash was transferred directly to the Canadian group, bypassing the structure that was put into place.

Upon examination, the I.R.S. contended that the Dutch finance company was a conduit to the Canadian group and that withholding tax was due on the interest payment. The withholding tax was limited to the rate provided by the Canada-U.S. Income Tax Treaty.

The Tax Court affirmed the position of the I.R.S. and the Court of Appeals for the D.C. Circuit affirmed the Tax Court. The arrangement in which funds were loaned from the Dutch finance company to the U.S. taxpayer was merely one step in an integrated transaction. Under the step transaction doctrine, the intermediary steps may be disregarded if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes. In other words, if the sole purpose of a transaction with a foreign corporation is to dodge U.S. taxes, the treaty cannot shield the taxpayer from the fatality of the step-transaction doctrine. For the taxpayer to enjoy the treaty's tax benefits, the transaction must have a sufficient business or economic purpose.

Moreover, the taxpayer ignored its own structure. Although the Dutch finance company may have recorded interest payments in its ledgers and reported them on its Dutch tax returns, there is no evidence that the U.S. company paid anything to the Dutch finance company during this period. The U.S.-Netherlands Tax Treaty does not apply to direct transactions between a U.S. corporation and a Canadian corporation.

e. Corporation is not Entitled to Possessions Credit.

In Medchem (P.R.) Inc. v. Commr., 116 T.C. __ No. 25 (MAY 18, 2001) the Tax Court held that a U.S. company was not entitled to claim a possessions tax credit under Code §936 because it was not engaged in an active trade or business in Puerto Rico. The active conduct of a trade or business is a condition that must be met in order to claim the credit.

In the case, the taxpayer, a U.S. corporation, acquired the equipment, technology, and other assets used to manufacture a particular pharmaceutical product. The seller was a pharmaceutical manufacturing concern. The concern retained ownership of its facility in Puerto Rico. As part of the sale, the manufacturing concern agreed to continue manufacturing the product for the taxpayer. The manufacturing concern furnished its own labor force and facility, but used raw material, equipment, and technology supplied by the taxpayer. The manufacturing concern was paid a fee equal to 110% of its manufacturing costs.

On its Federal income tax return, the taxpayer claimed a possessions credit in the amount of $1,993,264 under Code §936(a). The I.R.S. disallowed the credit on grounds that an active trace or business was not conducted in Puerto Rico. A petition to the Tax Court was filed.

During the proceedings, the taxpayer argued that it was engaged in an active trade or business through the operations conducted on its behalf by the manufacturing concern, acting as a contract manufacturer. It owned the raw material throughout the manufacturing process and furnished the equipment and technology to the manufacturing concern. Nonetheless, the Court held that the taxpayer did not actively conduct a trade or business in Puerto Rico. The taxpayer did not demonstrate that ir participated regularly, continually, extensively, and actively in the management and operation of a profit-motivated activity in that jurisdiction.

Because no standard was provided in the statute, the Court looked to regulations in other areas where the term "active conduct of a trade or business" is used. For example, regulations applicable to spin-off transactions, provide that a trade or business is actively conducted by a corporation if the corporation itself performs active and substantial management and operational functions. Such activities generally do not include activities performed by persons outside the corporation such as independent contractors. On this basis, a trade or business was not actively carried on.

f. Brazilian Withholding Tax Continues to be Noncreditable.

Riggs National Corp. v. Commr., T.C. Memo.2001-12, on remand from 163 F.3d 1363 (D.C. Cir. 1999), revg. and remg. 107 T.C. 301 (1996) is the latest episode in the saga of U.S. companies claiming foreign tax credits for Brazilian withholding tax. It should come as no surprise, that the U.S. Tax Court again disallowed a foreign tax credit for the tax. This time, the decision was grounded on a failure of the taxpayer to meet its burden of proof.

The case involved a net of tax loan extended by the taxpayer to the Central Bank of Brazil. The taxpayer was merely one of many banks that participated in extending restructuring loans to The Central Bank through a syndicate managed by another bank. The taxpayer received documentation from the managing bank explaining the amount of interest paid, the amount of withholding taxes, and the amount of subsidies received in consideration of the tax withheld. In the initial case, the Court held that the taxpayer was not "legally liable" for the Central Bank withholding tax payments because the Central Bank was not

required to pay withholding tax on its remittances of interest. The Court also held that the withholding tax was a noncompulsory payment rather than a tax. Thus, it was not a creditable tax for purposes of the U.S. foreign tax credit. The case was reversed on appeal. The Appellate Court concluded that the tax was compulsory because of the issuance of an order by the Brazilian tax authorities for the tax to be collected. The order was enforceable as a matter of law.

On remand, the Tax Court again found that no credit would be allowed. This time, however, it focused on the proof of payment of the tax. The Court held substantial inconsistencies existed in the evidence concerning the Central Bank's payment of withholding tax
on petitioner's behalf. In particular, the Central Bank reported that it was continuing to "receive" a subsidy for more than one year after the subsidy regime was repealed in Brazil. As a result, the Court concluded that the evidence that tax was withheld was not credible. Without proof that the tax was paid, no credit was allowed.

SCR/aw