THE AMERICAN JOBS CREATION ACT OF 2004

AN ANALYSIS OF SELECTED PROVISIONS

IVINS, PHILLIPS & BARKER
CHARTERED

1700 PENNSYLVANIA AVENUE, N.W. SUITE 600
WASHINGTON, D.C. 20006

TELEPHONE (202) 393-7600

FACSIMILE (202) 393-7601

IPB@ipbtax.com

1925 CENTURY PARK EAST, SUITE 2140
LOS ANGELES, CA 90067

TELEPHONE (310) 551-6633

FACSIMILE (310) 551-1188

IPB@Ivinswest.com

Highlights

- A technical corrections bill could be introduced as early as this week.
- The ETI regime has been repealed effective January 1, 2005. Benefits will be phased out thereafter, but this phase-out is the subject of continuing controversy (*see* p. 2).
- The corporate tax rate applicable to production activities is effectively reduced to 31.85% (when fully effective) (*see* p. 2).
- During the phase-out, the same transaction, including one that is exempt from ETI repeal under the binding contract exception, can qualify for both the new production deduction and for exclusion under the ETI regime (*see* p. 2).
- Information systems and record keeping practices may have to be modified to track the information necessary to calculate the new production deduction, especially for taxpayers who both purchase and produce inventory or who source inventory from both the U.S. and abroad (*see* p. 6).
- The new dividend repatriation provision provides an opportunity to repatriate foreign earnings at a 5.85% rate of tax during a short period of time (*see* p. 7).
- The repatriation provision offers particular advantages to taxpayers with overall foreign losses, and such taxpayers should carefully consider whether and how this new provision can benefit their foreign tax credit position (*see* p. 9).
- Dividends from 10/50 companies now are entitled to look-through treatment regardless of the year in which the underlying earnings were generated (*see* p.11).
- Certain dispositions of CFC stock now are subject to OFL and SLL recapture regimes if the taxpayer owned more than 50 percent of the stock of the CFC before the disposition (*see* p.16).
- Corporate taxpayers failing to disclose their reportable transactions under section 6011 now face a $50,000 penalty. In the case of listed transactions, the penalty increases to $200,000 and cannot be rescinded (*see* p. 25).
- Unlike the standard substantial understatement penalty, the new accuracy-related penalty imposed on reportable transactions is levied on a transaction-by-transaction basis, and so can apply even if the taxpayer has an overall loss (*see* p. 25).
- No matter how strong a taxpayer’s position, if the failure-to-disclose penalty is imposed with respect to a reportable transaction, the 30 percent accuracy-related penalty also will be imposed, unless the taxpayer prevails on the merits with respect to the transaction (*see* p. 25).
- Interest on underpayments attributable to undisclosed reportable transactions is no longer deductible under section 163 (*see* p. 26).
- When persons not subject to U.S. tax transfer property with a net built-in loss to a corporation, the new anti-loss importation rule adjusts the basis of such property to fair market value. It is unclear whether all persons not subject to U.S. tax are aggregated or treated separately for this purpose (*see* p. 27).

TABLE OF CONTENTS

Page

I. Background 1

II. Repeal of the Extraterritorial Income Exclusion (Act § 101, I.R.C. §§ 941-943) 2

III. Deduction Relating to Domestic Production Activities (Act § 102, I.R.C. § 199) 2
- A. Introduction 2
- B. "Domestic Production Gross Receipts" 4
  - 1. How much value must be added before an item is considered manufactured "in significant part" by the taxpayer? 4
  - 2. Can taxpayers obtain a deduction with respect to manufacturing activities carried on by a contract manufacturer? 4
  - 3. To what extent will gross receipts from services qualify if they are provided in connection with the disposition of qualifying production property? 5
- C. Cost Allocation 6

IV. Elective One-Year Repatriation Provision (Act § 422, I.R.C. § 965) 7
- A. In General 7
- B. Foreign Tax Credit Implications 9

V. International Tax Relief 10
- A. Clarification of Treatment of Certain Transfers of Intangible Property (Act §406, I.R.C. § 367) 10
- B. Look-through Rules to Apply to Dividends from Noncontrolled Section 902 Corporations (Act § 403, I.R.C. § 904) 11
- C. Equal Treatment of Interest Paid by Foreign Partnerships and Foreign Corporations (Act § 410, I.R.C. § 861) 13
- D. Prevention of Mismatching of Original Issue Discount ("OID") and Income Inclusions in Transactions with Related Foreign Persons (Act § 841, I.R.C. §§ 163, 267) 14
- E. Effectively Connected Income to Include Certain Foreign Source Income (Act § 894, I.R.C. § 864) 15
- F. Recapture of Overall Foreign Losses on Sale of Controlled Foreign Corporation (Act § 895, I.R.C. § 904) 16
- G. Attribution of Stock Ownership through Partnerships in Determining Section 902 and 960 Credits (Act § 405, I.R.C. §§ 901, 902) 18
- H. Minimum Holding Period for Foreign Tax Credit for Withholding Taxes on Income other than Dividends (Act § 832, I.R.C. § 901) 19
- I. Election Not to Use Average Exchange Rate for Foreign Tax Paid Other Than in Functional Currency (Act § 408, I.R.C. § 986) 21

VI. Tax Shelter Provisions 23
A. Administrative Provisions 23
1. Information Reporting by Material Advisors (Act § 815, I.R.C. § 6111) 23
2. Penalty for Non-Reporting by Material Advisors (Act § 816, I.R.C. § 6707) 24
3. Penalties Related to Other Failures to Disclose (Act §§ 811, 812, 817, I.R.C. §§ 6662A, 6707A, 6708(a)) 25
4. Other Consequences (Act §§ 811, 814, 838, I.R.C. §§ 163(m), 6501(c), 6707A) 26
B. Substantive Provisions 27
1. Anti-Loss Importation (Act § 836, I.R.C. §§ 334(b), 362(e)(1)) 27
2. Anti-Loss Duplication (Act § 836, I.R.C. § 362(e)(2)) 28
3. Partnership Anti-Loss Provisions (Act §§ 833, 834, I.R.C. §§ 704(c), 743, 743, 755(c)) 30
C. Provisions Not in the Final Version of the Act 30

Ivins, Phillips & Barker
The American Jobs Creation Act of 2004
An Analysis of Selected Provisions

This memorandum provides our initial impressions of selected provisions of the American Jobs Creation Act of 2004 (the "Act"). Rather than discuss the entire Act, we have targeted for review and explanation the sections we think are the most important for our clients to focus on today. We have chosen some provisions because of their immediate or retroactive effective date and others because they require significant analysis and, in light of their effective date, current action. We intend to provide subsequent analysis of additional provisions in the near future.

I. Background

On October 22, 2004, President Bush signed the Act into law. The Act represents the latest chapter in a decades-long trade dispute between the United States and the European Union regarding the use of export-contingent tax subsidies by the two sides.

In 1999, a panel of the World Trade Organization ("WTO") ruled that the U.S. foreign sales corporation ("FSC") regime violated two WTO agreements. Based upon this ruling and the threat of European Union trade sanctions, the United States replaced the FSC regime with the extraterritorial income ("ETI") exclusion on November 15, 2000. In January 2002, the WTO again ruled against the United States, holding that the ETI exclusion, similar to the FSC regime, provided a prohibited export subsidy. In March 2004, the European Union began to impose tariffs totaling 5 percent of the amount authorized by the WTO—$4 billion. The sanctions were to increase by 1 percentage point per month, reaching a maximum of 17 percent by March 2005.

When Congress replaced the FSC regime with the ETI exclusion, one tacit objective was to avoid creating so-called "winners" and "losers." The ETI exclusion was intended to duplicate the benefits of the FSC regime without creating a prohibited export subsidy. However, the WTO panel examining the ETI exclusion, composed of the same trade economists who had staffed the prior FSC panel, largely ignored the legal differences between the two regimes and focused on their economic substance, which they viewed as identical.

To avoid yet another defeat, and in the face of increasing European Union sanctions, Congress took a different approach to the Act. From the beginning, it was recognized that the ETI replacement legislation *would* create winners and losers. The legislative approach was to provide enough broad-based business tax relief and targeted international tax relief to overcome resistance from current ETI beneficiaries, while attracting new supporters for the legislation. This approach, however, greatly increased its projected cost. Congress introduced a variety of revenue raisers, primarily targeted at corporate tax shelters, to offset the projected cost.

In summary, therefore, the Act repeals the ETI regime and, subject to continuing disputes with the European Union about transition relief, resolves the longstanding transatlantic trade dispute regarding export-contingent tax subsidies. Apart from ETI repeal, the four primary components of the Act are (1) broad-based tax relief, in the form of a deduction for domestic

manufacturing activities, (2) an incentive for U.S. multinational corporations to repatriate foreign earnings at a favorable tax rate in order to provide an economic stimulus, (3) targeted international tax relief intended to rationalize the international tax rules and reduce complexity, and (4) revenue raisers targeted at corporate tax shelters. We address each of these components below. We note here (and, where appropriate, in our discussion below) that it is our understanding that a technical corrections bill could be introduced as early as this week, and the bill may be enacted very quickly.

II. Repeal of the Extraterritorial Income Exclusion (Act § 101, I.R.C. §§ 941-943)

The Act repeals the ETI regime for transactions entered into after December 31, 2004. Benefits will continue to be fully available for pre-2005 transactions, even if those benefits extend beyond 2004.

Repeal of ETI is subject to two transition rules, which allow taxpayers to claim benefits for transactions occurring after 2004. First, the Act provides a two-year phase-out period. For transactions occurring in 2005, 80 percent of the ETI benefit is available. For transactions occurring in 2006, 60 percent of the ETI benefit is available.

Second, under the "binding contract" exception, ETI benefits continue to be fully available for transactions entered into *at any time* in the ordinary course of business pursuant to a binding contract in effect on September 17, 2003, between the taxpayer and an unrelated person. The exception for binding contracts protects companies that negotiated the pricing terms of long-term contracts, such as long-term leases and long-lead sales or supply contracts, with the assumption that FSC or ETI benefits would continue indefinitely. For example, an option to purchase at the end of a long-term lease taking place in 2005 or later would be eligible for ETI benefits under the "binding contract" exception. This transition rule is similar to the provision that excluded long-term contracts from repeal of the FSC regime in 2000.

Another transition rule generally allows foreign corporations that have elected to be treated as U.S. corporations for ETI purposes to revoke their election without the recognition of gain or loss. This revocation must be made by October 22, 2005.

The European Union again has challenged in the WTO the Act's two-year phase-down of ETI benefits and the binding contract exception. A WTO panel decision on these matters should be handed down within the next few months. Past WTO panels, including the FSC-ETI panels, generally have rejected the use of extended transition relief, and final resolution of this issue remains highly uncertain.

III. Deduction Relating to Domestic Production Activities (Act § 102, I.R.C. § 199)

A. Introduction

The Act replaces the ETI exclusion with a new deduction equal to 9 percent of a taxpayer's income from "domestic production activities." As noted above, the ETI exclusion phases out as the new deduction phases in. The deduction, contained in new section 199, starts at

3 percent for tax years beginning in 2005 and 2006, increases to 6 percent for tax years beginning in 2007 through 2009, and reaches 9 percent for tax years beginning in 2010 and subsequent years. When fully implemented, the 9 percent deduction will be equivalent to a rate reduction of 3.15 percentage points.

The phase-out of ETI benefits turns on when a “transaction” occurs. By contrast, any qualified production activities income accruing in a tax year beginning after 2004 can give rise to the new deduction, even if the income is attributable to a pre-2005 transaction.

The Act fails to address the overlap between the ETI exclusion and the new deduction during the transition period. The Act’s silence suggests that, during this period, the same transaction can qualify for both benefits. Thus, the portion of income that is not excluded foreign trade income under the ETI regime may be eligible for the domestic production deduction. More surprising, however, is the absence of any rule disallowing the new deduction with respect to transactions exempt from ETI repeal under the binding contract exception. Because the Senate bill did exclude such grandfathered transactions from the new deduction, the omission of a similar provision in the Conference Agreement would seem intentional.

Activities that qualify for the new deduction extend far beyond those that qualified for FSC and ETI benefits. Domestic production gross receipts generally are gross receipts that are derived from any lease, rental, license, sale, exchange, or other disposition of any tangible personal property (including computer software or sound recordings) that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States. The deduction is also available for income from the production of motion picture films and videotape; construction, engineering, and architectural activities performed in the United States for U.S. construction projects; and the extraction and production (but not distribution) of gas, potable water, and electricity.

The new deduction is limited to the lesser of income from domestic production activities or taxable income (determined without regard to the deduction itself). The deduction also is limited to 50 percent of the employer’s W-2 wages paid for the year, including wages paid in connection with non-production activities. Taxpayers with net operating loss carryforwards must include them in the computation of domestic production activities income. At least on its face, the statutory language does not authorize taxpayers to perform a transaction-by-transaction analysis or to group less than all of the transactions for purposes of determining whether the taxpayer has qualifying income, as did the ETI and FSC statutes.

Even if a taxpayer has no regular taxable income, however, the deduction does offset income under the alternative minimum tax (“AMT”). For AMT purposes, the deduction is based upon the lesser of domestic production activities income or AMT income (again determined without regard to the deduction itself).

In computing the deduction, all the members of an “expanded affiliated group” are treated as a single corporation. The statute defines the term “expanded affiliated group” to include domestic but not foreign corporations with 50-percent common ownership. There is speculation that a future technical amendment may increase the threshold to *greater-than*-50-

percent common ownership. The taxable income and wage limitations apply only at the expanded-affiliated-group level and not again at the separate-member-company level. Once the taxpayer computes the group-wide deduction, it is allocated among group members in proportion to each member's relative amounts of qualified income. If a member within an expanded affiliated group has no separate company taxable income, the deduction allocated to that member increases the member's net operating loss for the year.

The deduction is available to a wide variety of taxpayers, from corporations and partnerships to sole proprietorships and estates and trusts. More activities will qualify for the new deduction than qualified for FSC or ETI. The new deduction is not limited to exporters but instead applies to all businesses with domestic production income. Thus, the controlling element is the *situs of the production activity* and not the source of the income derived from the transaction.

The new deduction is not available for income generated from the performance of services (other than certain architectural and construction services) or from the mere resale or distribution of property. As discussed below, taxpayers therefore will be required to differentiate manufacturing income from income attributable to services and resale activities.

B. "Domestic Production Gross Receipts"

The first step in calculating income from domestic production activities is determining the amount of a taxpayer's "domestic production gross receipts." The statutory definition of this key concept raises a number of questions that are discussed below.

1. How much value must be added before an item is considered manufactured "in significant part" by the taxpayer?

For the sale of property to generate domestic production gross receipts, the property must be manufactured "in significant part" in the United States. The Senate bill states that property is produced "in significant part" in the United States if the taxpayer incurred more than 50 percent of the aggregate production and development costs in the United States. Under this approach, it is possible that goods that are manufactured in the United States may not qualify if the intellectual property underlying the products was developed outside the United States and licensed to the U.S. manufacturer. This provision, however, does not appear in the Act. Treasury therefore is considering whether to adopt this approach or some other test, such as the "substantial transformation" test for whether goods are manufactured under subpart F. That test focuses on the transformation of the property rather than its development. Under that test, activities such as testing, assembling component parts, or repackaging items would not qualify as manufacturing.

2. Can taxpayers obtain a deduction with respect to manufacturing activities carried on by a contract manufacturer?

The UNICAP rules of section 263A treat a taxpayer as a producer with respect to any property produced by a contract manufacturer for the taxpayer. Treasury personnel, however,

have intimated that UNICAP establishes too low a threshold for taxpayer manufacturing under section 199. In light of controversy regarding contract manufacturing in the international area, it is unclear what, if any, contract manufacturing activities the IRS or Treasury will allow to be attributed to the taxpayer.

If a taxpayer cannot claim a deduction for the production activities of its contract manufacturer, will the contract manufacturer itself be able to claim the deduction? Treasury may conclude that no more than one taxpayer should get a deduction for activities performed under contract manufacturing arrangements—but at least *one* party should obtain the deduction for otherwise qualifying activities.

The Act defines qualifying gross receipts as those derived from the "lease, rental, license, sale, exchange, or other disposition" of the manufactured property. This language could be interpreted to exclude contract manufacturers performing production activities pursuant to a tolling arrangement; *i.e.*, one in which the contract manufacturer is viewed merely as providing a manufacturing service to the principal. In this type of arrangement, the contract manufacturer would not own the manufactured property and therefore could not lease, rent, license, sell, exchange, or otherwise dispose of the property. Even if the IRS were to seek to deny the deduction in a tolling arrangement, the result arguably should be different in a "consignment" manufacturing arrangement, in which the contract manufacturer obtains title to the property. Clarification of this issue awaits formal guidance.

3. To what extent will gross receipts from services qualify if they are provided in connection with the disposition of qualifying production property?

Services generally are excluded from the domestic production deduction. However, gross receipts allocable to the provision of services should qualify if the services are *inextricably linked* to the production activity. With the exception of water, gas, and electric utilities, an integrated producer of property can earn qualifying gross receipts from its distribution activities. Thus, significantly, an integrated producer's gross receipts from the sale of qualifying production property generally should equal the property's retail sales price.

The bundling of other services, such as warranties, financing, installation, and consulting may require an allocation of gross receipts between goods and services. Under the FSC and ETI regimes, taxpayers could receive full benefits for related and subsidiary services if they comprised less than 50 percent of the value of the goods sold. Section 199 provides no such allowance.

More generally, Treasury has raised the possibility that certain lease arrangements may be recharacterized in their entirety as service contracts, such as leases for a short duration or with a significant service component. Taxpayers who manufacture and then lease high-tech equipment, or lease space on high-tech equipment, such as a computer server, may face such a challenge.

Nonetheless, taxpayers will have an incentive to bundle services with qualifying property and characterize all of the related gross receipts as derived from the sale of the property. Where

bundling is not possible, taxpayers may seek to increase the sales price for goods and reduce that for related service contracts.

C. Cost Allocation

Once a taxpayer has identified its domestic production gross receipts, it must identify the associated costs. Under the statute, domestic production activities income equals gross receipts from domestic production, reduced by the sum of (1) the cost of goods sold allocable to such receipts, (2) other deductions directly allocable to the receipts, and (3) a ratable portion of other deductions not directly allocable to another class of income. The requirement of identifying gross receipts, costs, and deductions associated with qualified production activities likely will increase the cost of compliance and ultimately lead to disputes with the IRS.

Our tax system generally does not require an allocation of deductions to particular categories of business income. Administering this aspect of the new deduction probably represents the biggest challenge for taxpayers and the IRS. The Act directs Treasury to promulgate rules for the allocation of items of deduction, expense, and loss. The Conference Report states that such rules, "[w]here appropriate," shall be similar to and consistent with present-law rules under sections 263A and 861.

The rules for allocating the cost of goods sold between qualifying and nonqualifying dispositions generally should follow the principles of section 263A. Many taxpayers, such as those on the simplified production method, however, only capitalize their "additional section 263A costs" to ending inventory at the end of the year. Such taxpayers will have to begin allocating such costs to units in cost of goods sold throughout the year. Some mechanism also will have to be devised to allocate non-product-specific adjustments, such as annual LIFO effects, to the cost of goods sold associated with qualifying and nonqualifying dispositions.

In addition, according to the legislative history, for the purpose of determining the cost of goods sold, an item imported into the United States without an arm's length transfer price will be treated as acquired by purchase for a price of not less than the item's customs value at the time of importation. When domestic work-in-process is exported for further manufacture and then re-imported, the increase in cost cannot exceed the difference between the property's value when exported and its customs value when re-imported.

For below-the-line direct and indirect expenses, the regulations should resemble those under section 861. Thus, expenses factually related to domestic production activities, such as certain selling and marketing expenses, will be directly allocated to those activities. If the regulations under section 861 are followed, most expenses that are not directly related to domestic production activities or another class of income, such as general and administrative expenses, will be apportioned on the basis of gross income or on some other basis. However, interest would be allocated on the basis of assets; research and experimental expenses would be allocated on the basis of sales or gross income, at the taxpayer's election; and income taxes would be allocated on the basis of the gross income which is subject to the particular tax being allocated.

Treasury has promised swift guidance interpreting the new domestic production deduction. Until this guidance appears, many taxpayers likely will be required to adopt reasonable interpretations of these provisions, consistent with the legislative intent to provide broad-based tax relief for U.S. manufacturers.

IV. Elective One-Year Repatriation Provision (Act § 422, I.R.C. § 965)

A. In General

New section 965 allows U.S. corporations to elect to claim an 85 percent dividends-received deduction with respect to certain cash dividends received from their controlled foreign corporations ("CFCs") during the year of the election. The election only is available for the corporation's last taxable year beginning before October 22, 2004, or its first taxable year beginning within one year of October 22, 2004.

Only "cash dividends" (a new term of art) are eligible for the deduction.[1] Amounts treated as dividends under sections 302 or 304 are eligible, while constructive dividends under sections 78, 367, or 1248, as well as subpart F income and section 956 inclusions, are ineligible.[2] Distributions of previously taxed income ("PTI") also are ineligible, except to the extent the income became PTI because it was distributed to the U.S. corporation through a chain of CFCs and became subpart F income on the way. Presumably, the distribution of an amount in the CFC's functional currency (other than the U.S. dollar) would constitute a "cash dividend, " but future guidance hopefully will confirm this point.

Eligible dividends are limited to the excess of dividends received during the taxable year from CFCs over the annual average during three base period years of dividends received from CFCs (including distributions of PTI) and investments in U.S. property subject to section 956. The base period years are the three taxable years among the last five ending before June 30, 2003, determined by disregarding the years of highest and lowest dividends and investments in U.S. property. If a taxpayer has fewer than five such years, then all taxable years ending on or before June 30, 2003, are included in the base period.

Eligible dividends also are limited to the greater of $500 million or the amount shown on the company's most recently audited financial statements as earnings permanently reinvested outside the United States.[3] If the financial statements only show the amount of tax attributable to such earnings, that amount is grossed up by a factor of 1/.35 to equate roughly with the income

[1] The rationale for the use of the term "cash dividend" was to preclude taxpayers from claiming the deduction for intercompany notes. It also precludes taxpayers from using other forms of non-cash property.

[2] However, "inbound liquidations," triggering a section 1248 dividend inclusion under section 367(b), generally qualify. By contrast, a "check-the-box" liquidation is not covered because no actual cash is distributed.

[3] The financial statements must have been certified on or before June 30, 2003, as being prepared in accordance with GAAP and used for a substantial nontax purpose. In the case of a publicly traded corporation required to file financial statements with the SEC, the financial statements used for purposes of section 965 must have been filed on or before June 30, 2003.

that generated the tax. This gross-up ignores the effects of foreign tax credits, which may reduce the reported tax liability. Thus, the gross-up factor may be too small, and the taxpayer may have less income potentially available for the deduction. A Senate floor colloquy suggests that Congress should revisit this issue and encourages Treasury to address the problem in the meantime through guidance.

The taxpayer must invest eligible dividends in the United States pursuant to a "domestic reinvestment plan" approved by a senior executive *before* payment of the dividends and subsequently approved by the Board of Directors or a similar body. It is not clear whether the reinvestment plan must have a time limit or whether a taxpayer must trace funds repatriated, and, if so, for how long. The Act disallows the use of the repatriated funds for executive compensation, but this provision may not represent a serious restriction, given the fungibility of money. The Act provides a non-exclusive list of permissible uses. The list includes worker hiring and training, infrastructure projects, research and development, capital investment, or the "financial stabilization of the corporation for the purposes of job retention or creation." It is not entirely clear whether plans for the retirement of debt or the repurchase of stock are permissible.

Eligible dividends are reduced by any increase in the total indebtedness to related parties of all CFCs (treated as one CFC) in which the taxpayer is a U.S. shareholder. The period during which a debt increase causes this adverse effect runs between October 3, 2004, and the end of the taxable year for which treatment under section 965 is elected. This rule does not prevent borrowing between CFCs, or from third parties, to fund dividend distributions. However, taxpayers wishing to take advantage of the deduction should strictly limit any increases in other related party obligations of its CFCs during the relevant period.

Section 965(d)(2) disallows any deduction for expenses "properly allocated and apportioned" to the deductible portion of any dividend. The mechanism for this allocation remains unclear. House and Senate floor colloquies state that only expenses directly related to the generation of underlying earnings will be allocated to eligible dividends for this purpose. A Senate floor colloquy states that such directly related expenses should include stewardship expenses and legal and accounting fees directly related to the dividends in question, but not interest, research and development costs, depreciation, amortization, sales and marketing costs, and state and local income taxes. It is our understanding that only amounts directly related to planning for the dividend in question would be allocated to the repatriated amount. It remains to be seen whether these rules will be codified in some form, possibly in the imminent technical corrections bill.

Finally, neither NOLs nor tax credits other than foreign tax credits and AMT credits can be used to reduce the U.S. tax on the non-deductible 15 percent portion of the eligible dividends.[4]

---

[4] With respect to the operation of the AMT, (1) the tax on the non-deductible portion of a qualifying dividend cannot reduce the AMT that otherwise would be owed; (2) the dividends-received deduction is not treated as a preference item for purposes of computing the AMT, and (3) the dividends-received deduction is allowed in computing AMT income.

B. Foreign Tax Credit Implications

The interaction of section 965 and the foreign tax credit raises both ambiguities and tax planning issues.

Section 965(d)(1) denies foreign tax credits for the payment of direct or indirect taxes with respect to the deductible 85 percent portion of the eligible dividends. On its face, however, the statute does not deny the use of foreign tax credits, including excess foreign tax credits from other income, to offset U.S. tax on the non-deductible 15 percent portion of eligible dividends. Congress or Treasury may change this rule, but it now appears that taxpayers in certain foreign tax credit positions can achieve a full exemption with respect to their qualifying dividends.

There is some uncertainty as to how the disallowance of foreign tax credits in section 965(d)(1) interacts with the section 78 gross-up required for claiming section 902 credits. Because 85 percent of the deemed paid credits attributable to eligible dividends are disallowed, one might expect that the corresponding section 78 gross-up also would be reduced by 85 percent. The Act, unfortunately, contains no such provision. Taxpayers repatriating funds from low- or no-tax jurisdictions will not regard a section 78 gross-up as a serious obstacle. If they pay no foreign taxes, there will be no section 78 gross-up. Taxpayers with CFCs in high-tax jurisdictions, by contrast, could face a significant inclusion with no corresponding credit. It is our understanding that the technical corrections bill will correct this oversight.

With respect to tax planning, section 965(d)(3) allows taxpayers to identify specifically the dividends with respect to which they are claiming a deduction. Taxpayers therefore can maximize their use of foreign tax credits by distributing high-taxed dividends to the extent of their base-period average, and distributing low-taxed dividends in excess of their base-period average. However, the effects of distributing dividends through upper-tier CFCs should be taken into account. Distribution of low-taxed earnings through a high-taxed CFC may attract additional credits potentially subject to the disallowance. Restructuring transactions (*e.g.*, section 304 cross-chain sales) should be considered to enable the distribution of the low-taxed earnings directly to the U.S. shareholder. If the restructuring transaction involves a tax-free reorganization, the taxpayer should be able to use qualification for section 965 benefits as the business purpose for the reorganization.[5]

Lastly, section 965 offers particular advantages to taxpayers with overall foreign losses ("OFLs"), and such taxpayers should carefully consider whether and how this new provision can benefit their foreign tax credit position.

---

[5] The House Report notes the following in connection with changes to the treatment of aircraft leasing and shipping income: "[C]ourts have recognized the validity of structuring operations for the purpose of obtaining the benefit of tax regimes expressly intended by Congress. It is intended that structuring or restructuring of operations for the purpose of adapting to the repeal of the ETI exclusion (or the FSC regime) will be considered to serve a valid business purpose and will not constitute tax avoidance, where the restructured operations conform to the requirements expressly mandated by Congress for obtaining tax benefits that remain available." Similar reasoning should apply to the maximization of benefits under the new repatriation provision.

V. International Tax Relief

A. Clarification of Treatment of Certain Transfers of Intangible Property (Act §406, I.R.C. § 367)

When a U.S. person transfers intangible property to a foreign corporation in a non-recognition transaction, section 367(d) treats the transfer as a sale in exchange for payments "contingent upon the productivity, use, or disposition" of the intangible. The amount of the payments is determined using the commensurate-with-income standard of section 482. Before the Tax Reform Act of 1997 (the "TRA"), section 367(d)(2)(C) treated these deemed payments as U.S.-source income.

This treatment was considered unduly punitive. If the taxpayer transferred the intangible property to the foreign corporation in exchange for *actual* payments, those payments could produce foreign-source income and reduce the foreign tax base. The effect of the prior rule, therefore, was to reduce the transferor's foreign tax credit limitation, relative to a taxable exchange for actual payments, without allowing any foreign tax reduction. To address the perceived source of income inequity, the TRA struck the portion of section 367(d)(2)(C) that automatically treated the deemed payments as U.S.-source income. Thus, the payments could be treated as foreign-source income under generally applicable sourcing rules.

The TRA, however, did not provide guidance as to the appropriate foreign tax credit limitation category for the deemed payments. Although section 367(d) treats the transfer as a sale in exchange for contingent payments, it did not serve to allocate the payments to a particular limitation category under section 904(d). Taxpayers thus were required to make this determination separately.

The Act now specifies that royalty treatment applies to all amounts taxable under section 367(d). Royalty treatment applies to deemed payments received on or after August 5, 1997. This retroactive effective date may provide opportunities for certain taxpayers. A U.S. taxpayer who transferred intangible property subject to section 367(d) may have concluded after the TRA that the resulting deemed payments fell into the passive limitation category. The taxpayer now may be able to file an amended return or other claim to treat the deemed payment as general limitation income, according to the look-through rules for related-person royalty income.

More importantly, for future transactions, the new provision may actually encourage taxpayers to rely affirmatively on section 367(d). Before the Act, taxpayers that wanted general limitation income from the transfer of an intangible would have been required to transfer less than substantially all rights in the intangible to the transferee.[6] New section 367(d)(2)(C) allows

---

[6] If a taxpayer transferred substantially all rights in the intangible to the foreign corporation in consideration for contingent payments, the transfer likely would have been viewed as an outright sale. Under section 904(d)(2)(A), income from the sale of property that produces royalty income generally falls within the passive limitation category. By contrast, if the taxpayer transferred less than substantially all rights in the intangible, the transfer would have been viewed as a royalty-bearing license. The resulting royalty income in certain cases could qualify as general limitation income under the look-through rules of section 904(d)(3).

the taxpayer to transfer all rights in the intangible without jeopardizing general limitation characterization, provided the transfer qualifies under section 351 or 361.

Taxpayers may continue to find it more advantageous to transfer the intangible in consideration for actual royalties, as the royalty payments generally would be deductible in computing the foreign tax base. The taxpayer also needs to examine whether the royalty payment would be subject to source-basis withholding taxes and whether those taxes would be creditable. Since a section 367(d) payment is a notional payment solely for U.S. tax purposes, there would be no source-basis withholding taxes on the notional payment.

B. Look-through Rules to Apply to Dividends from Noncontrolled Section 902 Corporations (Act § 403, I.R.C. § 904)

Special foreign tax credit limitation rules apply to dividends from so-called "10/50 companies." A 10/50 company is a foreign corporation in which a U.S. corporation owns at least 10 percent of the stock by vote and which is not a CFC. Before the TRA, section 904(d)(1)(E) required the U.S. corporation to compute a separate foreign tax credit limitation for dividends received from each of its 10/50 companies. This requirement restricted the ability of U.S. multinationals to cross-credit foreign taxes, particularly those incurred by 50-50 joint ventures structured in corporate form.

The TRA eliminated the requirement of separate baskets. Dividends paid by a 10/50 company out of post-2002 earnings became entitled to look-through treatment, in a manner similar to the treatment of dividends paid by a CFC. Due to revenue concerns, however, the TRA did not implement the look-through approach for all earnings. It applied only to post-2002 earnings. This arbitrary effective date in many cases caused taxpayers' credits in their 10/50 baskets to expire unused.

For example, the TRA assigned credits associated with pre-2003 earnings of all 10/50 companies to a single 10/50 basket. Excess credits in a pre-2003 separate 10/50 basket could be carried forward to post-2002 years only to the extent of excess limitation in the single 10/50 basket. Because look-through treatment applied to all post-2002 earnings, however, taxpayers typically could not generate any 10/50 basket income in post-2002 years—the type of income necessary to absorb these excess credits. Thus, they typically expired unused, unless, for example, the creation of the single 10/50 basket itself allowed the taxpayer to offset them against existing limitation in other 10/50 baskets.

The TRA also created the need for complex transition rules. For instance, taxpayers were permitted to elect whether to consolidate OFL accounts and separate limitation loss ("SLL") accounts from each of their 10/50 baskets into one OFL and SLL account for their single 10/50 basket. If they did not choose to consolidate, however, they were not permitted to carry over excess credits arising in separate 10/50 baskets to the single 10/50 basket. Taxpayers unfortunately were required to weigh the relative benefits of consolidation or separation without the benefit of regulatory guidance.

The Act completes the reform started in the TRA. Under the Act, dividends from 10/50 companies now are entitled to look-through treatment regardless of the year in which the underlying earnings were generated. The regime for 10/50 companies therefore resembles much more closely the look-through regime for dividends from CFCs. In fact, the Act envisions that both look-through regimes can apply simultaneously. If a U.S. corporation receives a distribution from its CFC, look-through rules apply to the extent any of the CFC's earnings are attributable to dividends from a 10/50 company. This regime appears to apply to deemed distributions under subpart F as well.

The legislative changes take effect for taxable years beginning after December 31, 2002. This retroactive effective date frees the credits previously combined in the single 10/50 basket for use on a look-through basis. The Act also specifically applies the look-through approach to credit carryforwards from pre-2003 years. Thus, the Act eliminates the problems described above regarding credits "trapped" within the single 10/50 basket.

Because of the provision's retroactive effective date, U.S. corporations with 10/50 companies should review their returns for 2003 to determine to what degree they benefit from the new law. In conducting this review, they also should begin to gather whatever documentation they can from their 10/50 companies to support the allocation of dividends to the various limitation categories. The new law requires this type of substantiation, and the failure to provide it may result in passive limitation treatment for the dividend.

While the Act provides some forms of immediate relief, it continues to leave open issues for the IRS and Treasury to resolve through guidance. The legislation gives regulatory authority to deal with two specific issues.

First, it authorizes regulations regarding the application of look-through treatment to earnings accumulated by the 10/50 company before the taxpayer acquired its stock in the company. If the IRS and Treasury follow the approach previously announced in Notice 2003-5, 2003-3 C.B. 294, look-through treatment would apply to any earnings accumulated by the 10/50 company while it was a 10/50 company or a CFC, regardless of when the taxpayer acquired its stock. It is less clear how other 10/50 earnings will be treated. Because the single 10/50 basket no longer exists, IRS and Treasury presumably would assign all other earnings to the passive basket, subject to any applicable exceptions under section 904(d).

Second, the Act authorizes regulations regarding the carryback of the post-2002 credits of a 10/50 company to pre-2003 years. If the IRS and Treasury again adhere to the approach announced in Notice 2003-5, excess credits carried back from post-2002 years to pre-2003 years would be carried back within the same look-through basket in which they are generated. They would not be carried back to separate 10/50 baskets.

Coordination rules also will be required for OFLs and SLLs previously associated with 10/50 baskets. An approach consistent with Notice 2003-5 would allow taxpayers to elect whether to allocate such OFL and SLL accounts to various limitation categories on a look-through basis.

C. Equal Treatment of Interest Paid by Foreign Partnerships and Foreign Corporations (Act § 410, I.R.C. § 861)

Section 861(a)(1) treats interest paid by a U.S. person as U.S. source income, potentially subject to a 30 percent U.S. withholding tax. A foreign partnership engaged in a U.S. trade or business is considered to be a U.S. person for this purpose. Thus, interest paid by a foreign partnership engaged in a U.S. trade or business is U.S. source income and potentially subject to U.S. withholding tax. This rule creates a potential trap for the unwary, particularly in situations where even limited U.S. activities of a partner inadvertently may cause the foreign partnership to be engaged in a U.S. trade or business.

The Act now provides some relief in this situation. Under new section 861(a)(1)(C), interest paid by a foreign partnership will be foreign source income unless (1) the interest is paid by the actual U.S. trade or business, (2) the interest expense is allocable to effectively connected income, or (3) the partnership is not predominantly engaged in the active conduct of a *foreign* trade or business. Foreign partnerships with substantial foreign activities now have additional flexibility to engage in U.S. activities without risking significant U.S. withholding tax liabilities.[7]

One issue raised by the statutory language is the method for allocating interest expense to effectively connected income. As noted above, this type of interest will continue to be treated as U.S. source income, potentially subject to withholding. Proposed regulations under section 1446, governing partnership withholding for effectively connected income, generally endorse an allocation based upon the proportion of the partnership's assets that produce effectively connected income.[8] The allocation rules for foreign corporate partners are complex, however, and it remains to be seen whether this approach will be extended to the new section.

Another issue presented by the statute is the amount of effectively connected income taken into account. The statute simply refers to interest "allocable to income which is effectively connected (or treated as effectively connected)." The income in question is not explicitly limited to income *of the partnership*. Treasury and IRS should confirm that the effectively connected income of the partner is not taken into account for allocation purposes.

New section 861(a)(1)(C) is effective for tax years beginning on or after January 1, 2004. It therefore may provide retroactive relief for taxpayers currently caught in this trap.

---

[7] Note that U.S. partnerships with foreign operations are not afforded this same flexibility.

[8] Prop. Reg. § 1.1446-2(b)(3)(iv) refers to Reg. § 1.861-9T(e)(7), which governs the interest expense allocation for partners who are nonresident alien individuals, and to Reg. § 1.882-5, which provides corresponding rules for foreign corporations.

D. Prevention of Mismatching of Original Issue Discount ("OID") and Income Inclusions in Transactions with Related Foreign Persons (Act § 841, I.R.C. §§ 163, 267)

Section 163(e)(1) allows the issuer of a debt instrument to deduct OID on the instrument in the year in which it accrues. Sections 163(e)(3) and 267(a)(3) generally defer this deduction until the year of payment where a related foreign person holds the instrument. Regulations under those sections nevertheless permit the current deduction of accrued but unpaid OID if (1) the related holder is an FPHC, a CFC or a PFIC, and (2) the OID is "includible" in its income.

The regulations match the timing of the deduction to coincide with the inclusion of OID by the foreign corporation—not its U.S. owners. Some taxpayers therefore had devised related-party lending arrangements that produced a current U.S. tax deduction with no matching inclusion anywhere and no current cash flow consequence.

After several years of consideration (for example, in the Clinton Administration's FY2000 Budget Proposals), Congress included a provision in the Act which tightens the regulatory exception, at least with respect to related-party CFCs and PFICs. Regardless of when the CFC or PFIC includes the OID in income, the issuer now can deduct accrued but unpaid OID only to the extent it is included in the income of a U.S. person owning stock in the CFC or PFIC.

The scope of deferral is broad and may impact a variety of planning situations involving CFCs. For example, the new law defers the deduction until payment to the extent of any foreign ownership of the CFC or PFIC. The deduction also may be deferred because some exception to subpart F applies. For example, the CFC's U.S. shareholders may have no current inclusion because the section 954(b) *de minimis* rule applies or because the section 954(c)(3) same-country exception applies.

The new statute, however, does not defer the deduction where the U.S. shareholders of a CFC avoid a current inclusion because the CFC's allocable deductions or qualified deficits offset its subpart F income. The new provision also gives regulatory authority for the IRS and Treasury to exempt transactions "entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged." It remains to be seen how and when IRS and Treasury will exercise this authority.

The Act appears to accentuate still further the severely negative consequences of PFIC status. The statute on its face defers the issuer's OID deduction unless there is a current-year PFIC inclusion, even though the excess distribution regime for PFICs may not tax the U.S. shareholders of the PFIC for several years. Nevertheless, when the U.S. shareholder ultimately does receive an excess distribution from the PFIC, the shareholder's deferred tax amount includes an interest charge that effectively treats the shareholder as having received the OID when accrued. Thus, the issuer's deduction is deferred, but the U.S. shareholder, in economic terms, receives a current income inclusion.

The existing regulations permit a current deduction only if the issuer has elected QEF treatment with respect to the PFIC. This rule would not suffice under the amended statute to

indicate how much accrued unpaid interest the issuer can deduct currently. Under the Act, the timing of the issuer's deduction would depend upon the timing of inclusion by *other* U.S. shareholders. The QEF election is made shareholder by shareholder, and the issuer is unlikely to have access to information about whether other shareholders have made a QEF election. As noted above, the deduction also is deferred to the extent of foreign ownership in the PFIC. If the IRS and Treasury condition a current deduction upon QEF status, therefore, the practical effect will be to defer the issuer's deduction until payment in most cases.

The new provision is effective for payments accrued on or after October 22, 2004. Therefore, taxpayers should review all related-party instruments bearing OID to determine whether modifications will be required to avoid the deferral of current-year interest deductions. Moreover, unless the issuer owns sufficient stock in the related foreign corporation to ensure CFC status, taxpayers should strengthen PFIC representations and warranties to avoid the potential deferral of the interest charge.

E. Effectively Connected Income to Include Certain Foreign Source Income (Act § 894, I.R.C. § 864)

A foreign person engaged in a U.S. trade or business is subject to net-basis U.S. taxation on income effectively connected with the conduct of that trade or business (provided, of course, that a true and accurate federal income tax return is filed on a timely basis). Foreign-source income generally is not considered to be effectively connected with the conduct of a U.S. trade or business and therefore generally is not subject to U.S. tax. However, section 864(c)(4)(B) lists three categories of income which, if earned by the foreign person through an office or fixed place of business in the United States (an "OFPB"), are effectively connected income.

Section 864(c)(4)(B)(ii) describes the most significant of the three categories (for purposes of the present discussion): dividends and interest, either derived in the active conduct of a banking, financing or similar business, or earned by a foreign corporation from trading in stock or securities for its own account. This category, even though foreign source, is treated as effectively connected and subject to U.S. net-basis taxation if earned through an OFPB. The Act now extends the same treatment to "income or gain which is equivalent" to this category of income, as well as the other two types of income encompassed by section 864(c)(4)(B) (discussed below).

Based upon the legislative history of the Act and past similar proposals, the new provision appears to target income from the issuance of guarantees and notional principal contracts, as well as in-lieu-of payments made in connection with securities lending arrangements. Taking guarantee fees as an example, no explicit sourcing rule exists at present. Based upon informal IRS guidance, guarantee fees and commissions from the issuance of letters of credit generally are regarded as equivalent to interest because they compensate the recipient for credit risk and credit administration in a manner similar to how interest compensates for such items. Thus, guarantee fees, like interest, are thought to be sourced according to the residence of the payor of the fees.

Before the Act, a foreign corporation engaged in an active financing business in the United States arguably could issue a guarantee to a foreign person through its OFPB without paying any U.S. tax on the resulting fees. Section 864(c)(4)(B)(ii) would not have applied because the income, although foreign source and associated with the OFPB, would not have been treated as "interest." The Act expands the attribution rule to reach this type of income "equivalent" to interest. Thus, the foreign corporation would be subject to U.S. net-basis taxation on the guarantee fees.

While the primary effects of the Act amendments appear to relate to the U.S. branch activities of foreign financial institutions, the scope of the new rules is broader. They also apply to the "equivalents" of (1) rents and royalties for the use of certain intangible property derived in the active conduct of a trade or business, and (2) gain from the foreign sale or exchange of personal property for use or consumption within the United States. The scope of the Act with respect to these categories is unclear. For example, it is unclear whether a long-term lease of property through a U.S. agent would be considered "equivalent" to a sale or exchange. The new law also gives the IRS the ability to impose U.S. net-basis taxation on future innovative financial products that replicate economically any traditional type of return.

The new language in section 864(c)(4)(B) takes effect in taxable years beginning after October 22, 2004. Because of the immediate effective date of this provision, foreign corporations and nonresident alien individuals with an OFPB should review their U.S. activities to determine whether additional categories of income now may be considered effectively connected and therefore subject to U.S. tax.

F. Recapture of Overall Foreign Losses on Sale of Controlled Foreign Corporation (Act § 895, I.R.C. § 904)

When a taxpayer's deductions, allocated and apportioned to foreign source income, exceed its foreign source income for the year, the excess reduces the taxpayer's U.S. source income and its U.S. taxes on such income. The cumulative amount of this reduction represents the taxpayer's OFL account. The taxpayer later must recapture the tax benefit of using the foreign losses in its U.S. return. Section 904(f) recaptures the benefit by treating some or all of the taxpayer's foreign source income as U.S. source income, to the extent of the balance in its OFL account. Similar rules apply to recapture a loss within one foreign tax credit limitation basket that have been used to offset income in another basket. The loss transfer between baskets creates an SLL account.

When a taxpayer disposes of property that generates foreign source income in a foreign tax credit limitation basket with an OFL account, section 904(f)(3) re-sources any realized gain from the transaction to the United States. Section 904(f)(5)(F) similarly re-sources income in a basket with an SLL account back to the basket that generated the SLL. These recapture rules override the nonrecognition provisions of Chapter 1 of the Code, subject to limited exceptions. Thus, a U.S. taxpayer with an OFL or SLL account generally must recapture that account to the extent of any gain *realized* on a transfer of foreign branch assets used or held for use in a trade or business to a separate domestic or foreign entity—even if the transaction otherwise qualifies for nonrecognition treatment.

Until the Act, these recapture rules generally did not apply to gain realized on the transfer of corporate stock. They applied only to the disposition of active foreign business assets. New section 904(f)(3)(D), however, now imposes these recapture regimes on certain dispositions of CFC stock. In general, a stock disposition triggers the new recapture rule if the taxpayer owned more than 50 percent by vote or value of the stock of the CFC before the disposition. There are two exceptions.

First, the recapture rule generally does not apply to section 351 or section 721 contributions, or to other exchange-basis transactions. This exception, however, only applies if the transferor owns the same percentage (by vote or value) in the CFC after the transaction as before the transaction, applying the section 958(a) and (b) ownership attribution rules. Taxpayers will have to carefully analyze the facts of each transaction, but the use of these indirect and constructive ownership rules should allow many intra-group reorganizations to qualify for relief.

Second, the recapture rule does not apply to a certain intra-group, tax-free exchanges of a CFC's stock for its assets. This exception covers section 332 liquidations and asset acquisitions described in section 368(a) (*e.g.*, intra-group Type-C reorganizations). However, in the case of both this exception and the one described above, the new recapture rules continue to apply to any gain *recognized* in the transaction—for example, gain from the receipt of taxable boot.

New section 904(f)(3)(D) adds yet another layer of complexity to the already opaque section 904(f) recapture rules. For example, an OFL or SLL account generally is recaptured only as the taxpayer earns foreign source income in the basket in which the OFL or SLL arose. If new section 904(f)(3)(D) overrides a nonrecognition provision, the question arises into what basket the resulting gain would fall.

If section 1248 does not apply to the transaction, then the resulting gain generally would be U.S. source income, in the case of a U.S. transferor, or foreign-source passive income (subject to the various exceptions for that basket).[9] The taxpayer thus may not have an OFL or SLL account in the same limitation category as the gain from the deemed stock sale.

The same issue arises if section 1248 does apply to the stock transfer, but the resulting categorization of the gain could be quite different. Gain from the stock transfer would be recharacterized as a dividend to the extent of the CFC's earnings and profits attributable to the shareholder's period of ownership. The portion of the stock gain that is considered to be a dividend is generally foreign source income, and the separate limitation category for the deemed dividend is determined pro rata, based upon the CFC's earnings and profits in each category. Thus, if section 1248 applies, the question of whether an OFL is recaptured may depend upon the limitation category of the CFC's earnings—hardly an intuitive result.

[9] If the gain is U.S. source, based upon the residence of the transferor, the taxpayer still could argue that the income clears its OFL account. The IRS agreed with a similar result in F.S.A. 200041004 (Oct. 13, 2000). The taxpayer also could make this argument if section 1248 *does* apply and all or part of the deemed dividend is re-sourced to the United States under section 904(g).

New section 904(f)(3)(D) applies to stock dispositions after October 22, 2004. Taxpayers with OFL or SLL accounts therefore must examine carefully any proposed CFC stock dispositions, even in a nonrecognition transfer, with an eye towards the new rules.

G. Attribution of Stock Ownership through Partnerships in Determining Section 902 and 960 Credits (Act § 405, I.R.C. §§ 901, 902)

Before the Act, section 902(a) failed to specify whether a domestic corporation owning 10 percent or more of the voting stock of a foreign corporation through a partnership was entitled to deemed-paid foreign tax credits.

Most taxpayers relied upon Rev. Rul. 71-141, 1971-1 C.B. 211, to claim these credits. In the ruling, two unrelated domestic corporations formed a partnership, which, in turn, acquired 40 percent of the stock of a foreign corporation. The ruling held that the partners were entitled to section 902 credits, based upon their distributive shares of the local taxes incurred by the foreign corporation. The ruling appeared to adopt an aggregate approach to ownership: the ruling reasoned that each partner was a 50 percent owner of the assets of the partnership, which included 40 percent of the stock of the foreign corporation. Thus, each of the partners was treated as owning 20 percent of the stock of the foreign corporation, which allowed them to meet the required 10 percent ownership threshold for claiming credits.

The IRS and Treasury, however, cast doubt about how far taxpayers could extend the implications of the ruling. In the preamble to 1995 proposed regulations under section 902, the IRS asked whether or not it should "expand" the holding of Rev. Rul. 71-141 to allow deemed paid credits to be claimed by "domestic corporations that are partners in domestic limited partnerships or foreign partnerships, shareholders in limited liability companies, and beneficiaries of domestic or foreign trusts and estates or interest holders in other pass-through entities." The IRS received numerous comments to the effect that Rev. Rul. 71-141 already covered these situations. Nevertheless, in the preamble to the 1997 final regulations, the IRS and Treasury continued to caution that "[t]he final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity. . . . The IRS is still considering under what other circumstances [Rev. Rul. 71-141] should apply."

One issue of apparent concern to the IRS was the possible extension of the ruling by taxpayers to situations involving special partnership allocations. In Rev. Rul. 71-141, the two partners shared equally in profits and losses, but the IRS did not condition its holding upon a 50-50 allocation of partnership items. In fact, the ruling did not specify the theoretical predicate for its conclusion that each partner indirectly owned 50 percent of the partnership's assets. Thus, taxpayers could have taken the position that indirect stock ownership for 902 purposes was determined on some basis different than profit and loss allocation (*e.g.*, capital accounts, local law, etc.). In the preamble to the 1997 final regulations, the IRS and Treasury promised another regulatory project on the question of indirect ownership, which presumably would consider this and other issues.

The Act resolves the basic question of entitlement to the credit. New section 902(c)(7) provides that stock owned directly or indirectly by or for a partnership will be considered to be owned proportionately by its partners, reaffirming the basic holding of Rev. Rul. 71-141. The statute also specifically attributes stock through tiers of partnerships, resolving one of the issues raised in the 1995 preamble.

The new provision, however, does not resolve the question of special allocations. It gives Treasury the authority to issue regulations accounting for "special partnership allocations of dividends, credits, and other incidents of ownership of stock in determining proportionate ownership." It remains to be seen whether this grant of authority will accelerate the issuance of regulations promised in 1997.

The Act contains one additional clarification. Prior to amendment, section 901(b)(5) allowed "individual" partners to claim direct foreign tax credits for their proportionate share of the foreign taxes paid by the partnership. This reference to individuals in section 901(b)(5) technically precluded corporations from claiming direct credits in this situation. Taxpayers had relied upon section 702(a)(6), which allows each "partner" to take into account his distributive share of the partnership's foreign taxes, to claim credits for corporate partners. The Act amends section 901(b)(5) to replace the word "individual" with the word "person," which confirms the entitlement of corporations to this type of credit.

New sections 902(c)(7) and 901(b)(5) are effective for taxable years of foreign corporations beginning after October 22, 2004. Therefore, these sections most likely will provide comfort for future tax planning.

H. Minimum Holding Period for Foreign Tax Credit for Withholding Taxes on Income other than Dividends (Act § 832, I.R.C. § 901)

Section 901(k), enacted in the TRA, limits the ability of taxpayers to claim foreign tax credits for dividend withholding taxes if the recipient of the dividend does not meet certain holding period requirements or is under an obligation to make related payments with respect to substantially similar or related property. The purpose of section 901(k) is to prevent tax-indifferent parties from "selling" their foreign tax credits through the transfer of an asset generating an income tax stream subject to foreign withholding taxes. Under pre-1997 law, taxpayers successfully claimed foreign tax credits in these types of transactions.[10]

Soon after the enactment of section 901(k), however, Treasury and IRS expressed renewed concern about taxpayers trafficking in foreign tax credits. In Notice 98-5, 1998-1 C.B. 334, the IRS and Treasury targeted an expanded class of such transactions, including "acquisitions of income streams through securities loans and similar arrangements and acquisitions in combination with total return swaps."

---

[10] *See Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001); *IES Indus. Inc. v. Commissioner*, 253 F.3d 350 (8th Cir. 2001).

Notice 98-5 promised regulations that would deny foreign tax credits if the reasonably expected economic profit from the transaction was insubstantial compared to the expected value of the credit. This approach was widely criticized, and IRS and Treasury ultimately withdrew Notice 98-5 in Notice 2004-19, 2004-11 I.R.B. 606. In the Administration's Budget, however, Treasury continued to propose measures for combating credit-trafficking transactions, one of which found its way into the Act.[11]

The Act effectively extends section 901(k) to foreign withholding taxes imposed on income or gain *other than* dividends (such as interest, rents, and royalties). New section 901(l)(1) denies a foreign tax credit for any withholding tax imposed "on any item of income or gain with respect to any property" if the recipient holds the property for 15 days or less during the 31-day period surrounding the date on which the entitlement to the income or gain arises. Credits also are denied to the extent that the recipient is under an obligation to make related payments with respect to positions in substantially similar or related property. The new provision directly addresses the first class of transactions described in Notice 98-5.

> *Example*. On Day 1, a domestic corporation purchases all rights to a copyright for $75. The copyright will expire shortly, and the only income expected to be received with respect to the copyright is a royalty payable on Day 2. The gross amount of the royalty is expected to be $100. The royalty payment is subject to a 30-percent foreign withholding tax. On Day 2, the domestic corporation receives the $100 royalty payment, less the $30 withholding tax. The corporation incurs an economic loss of $5 because it paid $75 for a $70 royalty payment. However, it also has purchased $30 of creditable foreign taxes.

While section 901(l) was being considered by Congress, at least one commentator[12] suggested that it might apply too broadly, particularly in the case of debt instruments. Under the plain language of the statute, for example, no foreign tax credit is allowed for withholding taxes imposed on interest from a 10-day loan. In addition, section 901(l)(4) applies by cross-reference the holding period requirements for the dividends-received deduction under section 246(c)(4). These requirements could have the effect of denying credits with respect to even long-term debt instruments subject to a guarantee.

Section 901(l)(3) grants general regulatory authority to provide exceptions, and section 901(l)(2) provides a specific exception for withholding taxes imposed on securities dealers. The latter exception also applies to other types of "dealers" as well. For example, the statutory language appears to allow a U.S. parent corporation to claim deemed-paid credits with respect to certain withholding taxes imposed upon CFCs that sell inventory on credit in third countries. Apart from these specific exceptions, however, taxpayers must wait to see what types of transactions IRS and Treasury will exempt in the regulations.

---

[11] The other proposal, for broad regulatory authority to address transactions that involve inappropriate separation of foreign taxes from the related foreign income, was offered by the Senate but rejected in Conference.

[12] Letter from James M. Peaslee, Cleary, Gottlieb, Steen & Hamilton, to Greg Nickerson, House Ways and Means Committee, and Barbara Angus, International Tax Counsel (Aug. 25, 2003).

While we wait, the legislative history of the new provision provides stopgap guidance: "It is anticipated that such regulations will provide that credits are not disallowed merely because a taxpayer eliminates its risk of loss from interest rate or currency fluctuations. In addition, it is intended that such regulations might permit other hedging activities, such as hedging of credit risk, provided that the taxpayer does not hedge most of its risk of loss with respect to the property unless there has been a meaningful and unanticipated change in circumstances." Thus, certain types of hedging—to some limited degree—should not result in the denial of foreign tax credits. While generally helpful, this statement unfortunately does not delineate with sufficient clarity what transactions will be exempted by the regulations.

New section 901(l)(3) is effective for amounts paid or accrued after November 21, 2004 (*i.e.*, more than 30 days after the date of enactment of the Act). Taxpayers should review their current lending practices (*e.g.*, short-term intercompany loans) to ensure that they do not run afoul of the new provision.

I. Election Not to Use Average Exchange Rate for Foreign Tax Paid Other Than in Functional Currency (Act § 408, I.R.C. § 986)

From 1986 until 1997, foreign taxes were translated into U.S. dollars at the spot rate on the date of payment to the foreign taxing authority. For accrual basis taxpayers, foreign taxes accrued during the year were translated at the year-end rate. When the foreign taxes were subsequently paid, they were translated at the spot rate on the payment date, which typically resulted in the need for an adjustment under section 905(c). Taxpayers complained about the frequent need for redeterminations and the difficulty of tracking the rates applicable to the various foreign tax payments.

In the TRA, Congress responded to these complaints by amending section 986(a) to require generally the use of average exchange rates for accrual basis taxpayers. Under the TRA, an accrual-basis taxpayer accrues foreign taxes at the average rate. So long as the foreign taxes are paid within two years, no section 905(c) adjustment is required. If the taxes are paid after two years, the original accrual is reversed and the payment is translated at the spot rate on the date of payment.

Use of the average rate, however, creates problems in the case of taxpayers and qualified business units ("QBUs") that use the U.S. dollar as their functional currency. For example, when a U.S. corporation receives a dividend subject to foreign withholding taxes, sections 986(b)(2) and 989(b) require the taxpayer to translate the dividend at the spot rate on the distribution date. The associated withholding taxes, by contrast, are translated at the average rate for the year under section 986(a). This disconnect may raise or lower the effective rate of foreign tax in U.S.-dollar terms.

The Act attempts to address this issue. New section 986(a)(1)(D) allows a taxpayer to elect to use spot rates to translate the payment of taxes denominated in nonfunctional currency. If it makes this election, a U.S. parent corporation that receives a dividend subject to foreign withholding taxes would translate both the income and the associated taxes at the spot rate on the date of payment. The rates used to translate the income and the taxes thus would match.

The Act authorizes the election to be made by the "taxpayer." Presumably, the foreign subsidiaries of a U.S. corporation would be considered separate "taxpayers" for this purpose. If not, an election under this new section of the Act could create unintended mismatches. For section 902 pooling purposes, the nonfunctional-currency tax liabilities of the foreign subsidiary would be translated at the spot rate, pursuant to the election, while its functional-currency tax liabilities would continue to be translated at the average rate for the year.

> *Example*. First-tier French CFC receives a dividend from second-tier Japanese CFC. The dividend is subject to withholding taxes. If the U.S. parent's election under section 986(a)(1)(D) applies to the French CFC as well, then it would translate the Japanese withholding taxes into U.S. dollars at the spot rate on the date the dividend was paid. The potential subpart F inclusion with respect to the Japanese dividend, however, would depend upon the French CFC's dollar tax pool, which is maintained using average exchange rates. This could create a mismatch.

On the one hand, a CFC and its U.S. parent are different "persons" under section 7701(a)(1). Thus, they should be different "taxpayers" under section 7701(a)(14). On the other hand, the IRS might reasonably conclude that the U.S. parent's election determines the parameters of its subpart F inclusions. The better answer is that separate elections would be required for the foreign subsidiaries of the U.S. parent, but additional guidance would be helpful. The IRS and Treasury could provide this guidance in the context of a short revenue procedure explaining the method for making the election.

The Act grants regulatory authority to apply the election to QBUs of the taxpayer. Although the legislative history so far provides no particular guidance on the subject, the regulations could possibly limit the election to QBUs with a U.S. dollar functional currency. These are the only QBUs for which a spot-rate election would match income inclusion to taxes. An election for other QBUs potentially could create mismatches where the QBU pays some functional-currency taxes and some non-functional-currency taxes. Significant distortions could arise, for example, if a CFC has multiple QBUs with different functional currencies. An election for some but not others could create administrative problems of potentially greater magnitude than the simplification benefits offered by the new law.

Finally, the Act includes a special provision, added in Conference, for regulated investment companies ("RICs") using an accrual method of accounting. New section 986(a)(1)(E) specifies that such RICs in all cases must translate foreign taxes using the exchange rate as of the date the income accrues.

New sections 986(a)(1)(D) and (E) are effective for tax years beginning on or after January 1, 2005. U.S. taxpayers that receive significant inflows subject to foreign withholding taxes should consider making the election. Because the election is largely irrevocable, however, taxpayers may be reluctant to base their decision on the current currency environment of their foreign operations (*e.g.*, depreciating currency relative to the dollar) or even their current foreign tax credit position. The main benefits of the election likely will be administrative, if the

taxpayer's internal recordkeeping systems can track accurately the various spot rates on each date of payment.

VI. Tax Shelter Provisions

The Act contains a large number of provisions aimed at combating tax shelters. These provisions are considered revenue raisers and were included in the Act to offset the cost of other provisions. Many of these provisions were motivated by recent tax scandals such as the Enron scandal. Some of these provisions deal with the administrative process of identifying tax shelter transactions and the taxpayers involved with them, while other provisions deal with closing some specific "loopholes" that current tax shelters exploit.

A. Administrative Provisions

The administrative tax shelter provisions build upon and reinforce the changes begun by the IRS and Treasury over the last couple of years. The prior scheme of tax shelter registration by promoters under section 6111 has been eliminated, and the system (or "web") of disclosure from multiple sources begun in the regulations has been broadened.

1. Information Reporting by Material Advisors (Act § 815, I.R.C. § 6111)

Under the pre-Act section 6011 regulations, taxpayers are required to file disclosure statements with their tax returns for "reportable transactions." There are six categories of reportable transactions. The most critical category is that of "listed transactions," *i.e.*, transactions which are the "same as or substantially similar to" transactions identified as listed transactions by the IRS in published guidance.[13] This list is not static; the IRS periodically adds and removes transactions.

Regulations under section 6112 also require that "material advisors" maintain lists identifying the participants in reportable transactions. Under the pre-Act regulations, a material advisor is defined as someone who (1) makes a "tax statement" to a taxpayer regarding a reportable transaction, and (2) receives at least a minimum fee related to the transaction (equal to $250,000 for corporate taxpayers).

The Act takes this process one step further by amending section 6111 to eliminate tax shelter registration by promoters and replace it with annual information reporting by material advisors.

The Act provides a broader definition of "material advisor": any person who (1) "provides material aid, assistance or advice with respect to organizing, managing, promoting,

[13] Listed transactions include lease-in-lease-out transactions, lease stripping transactions and contingent liability tax shelters. The other five categories of reportable transactions are: (1) confidential transactions, (2) transactions with contractual protection, (3) loss transactions, (4) transactions with a significant book-tax difference and (5) transactions involving a brief asset holding period.

selling, implementing, insuring, or carrying out any reportable transaction" and (2) receives a minimum fee. In other words, no "tax statement" is necessary. Without further clarification, this definition is broad enough to encompass law firms providing corporate or securities-law advice with respect to a transaction, regardless of whether they also provide tax advice.

The Act leaves to the IRS the task of designing the information return and determining the specific information to be reported by the material advisor.[14] Generally, these returns must contain at least two items: (1) information identifying and describing the transaction, and (2) information describing any potential tax benefits expected to result from the transaction. The identity of the taxpayer is not a required item enumerated in the Act. The Senate version of the Act stated that, for purposes of the material advisors' list maintenance requirements, a person's identity is not subject to the attorney-client privilege (or the section 7525 tax practitioner-client privilege). While this provision did not survive in the final version of the Act, court cases such as *U.S. v. BDO Seidman*, 337 F.3d 802 (7th Cir. 2003), have not supported assertions of the privilege with respect to client identity.

2. Penalty for Non-Reporting by Material Advisors (Act § 816, I.R.C. § 6707)

If the information reporting form designed by the IRS requires the name of the taxpayer—and it likely will—the penalties for non-compliance with reporting requirements may force practitioners to fill in this information, particularly in the case of listed transactions. Filing incomplete information on the form results in a $50,000 penalty on the material advisor for reportable transactions generally, and a penalty equal to the greater of $200,000 or half of the material advisor's fees (three-quarters in the case of an intentional violation) in the case of listed transactions. Penalties related to listed transactions cannot be rescinded by the IRS. These penalties are effective for returns, the due date for which is after October 22, 2004. (The Act does not specify whether the due date includes extensions, but the better answer appears to be that it does not.)

The harshness of these penalties, especially in the case of listed transactions, may result in other conservative behavior by practitioners. They likely will interpret the minimum fee threshold for becoming a material advisor broadly and will treat the phrase "same as or substantially similar to" broadly as well. The Act permits Treasury to prescribe regulations requiring only one information return when there are two or more material advisors. However, unless these regulations shield advisors who have not been designated as information return filers from penalties due to the non-compliance of the designated advisors, duplicate reporting may become the norm.

[14] This is one of a number of areas where the tax shelter provisions in the Act give the IRS and Treasury substantial discretion. Other examples include the definitions of the terms "reportable transaction" and "same as or substantially similar," and the adjustment of the minimum fee in the definition of "material advisor."

3. Penalties Related to Other Failures to Disclose (Act §§ 811, 812, 817, I.R.C. §§ 6662A, 6707A, 6708(a))

The Act strengthens the other strands of the government's web of disclosure with additional penalties.

The penalty for failure by a material advisor to satisfy its section 6112 list maintenance requirements by furnishing the list to the IRS within 20 days of demand has increased from $50 *per violation* to $10,000 *per day*. The penalty related to section 6011 disclosure is effective for returns, the due date for which is after October 22, 2004.

Corporate taxpayers failing to disclose their reportable transactions under section 6011 now face a $50,000 penalty. In the case of listed transactions, the penalty increases to $200,000 and cannot be rescinded. Penalties for the failure to disclose reportable transactions that are not listed transactions can be rescinded by the IRS in whole or in part, but only if "rescinding the penalty would promote compliance with the requirements of [the Code] and effective tax administration." In addition, the IRS must file a statement with the Office of the Commissioner every time the penalty is rescinded. The penalty related to section 6112 list maintenance is effective for requests made after October 22, 2004.

These penalties are in addition to the new accuracy-related penalty on understatements with respect to reportable transactions. This penalty applies to listed transactions and to other reportable transactions for which the avoidance of Federal income tax is a significant purpose. Unlike the standard substantial understatement penalty, this penalty is levied on a transaction-by-transaction basis, and so can apply even if the taxpayer has an overall loss. The amount of the penalty is based on the difference between the proper treatment of an item and the taxpayer's treatment of the item "as shown on the taxpayer's return of tax." If an item is first raised by the taxpayer on an amended return or as a claim for refund, the IRS may attempt to impose the penalty by characterizing the amended return or refund claim as a "return of tax." The phrase "return of tax," when used elsewhere in the Code and regulations, does not support this characterization, but there is no guarantee that the IRS cannot convince a court to interpret "return of tax" more broadly for purposes of applying the penalty.

This new accuracy-related penalty is increased from 20 percent to 30 percent if the transaction was not disclosed as required under section 6011. Furthermore, the failure to disclose a reportable transaction significantly increases the likelihood that the accuracy-related penalty will be imposed. No matter how strong a taxpayer's position, if the failure-to-disclose penalty is imposed with respect to a transaction, the 30 percent accuracy-related penalty also will be imposed, unless the taxpayer prevails on the merits with respect to the transaction. If the taxpayer fails to disclose the transaction, but the IRS rescinds the failure-to-disclose penalty, then the 30 percent accuracy-related penalty can be avoided under the reasonable cause and good faith exception (which also is available with respect to all disclosed transactions).[15]

[15] Because non-disclosure penalties for listed transactions can never be rescinded, the reasonable cause and good faith exception never is available with respect to an undisclosed listed transaction.

The reasonable cause and good faith exception for reportable transactions, however, is more stringent than the exception under the substantial understatement penalty for non-reportable transactions. In addition to disclosure, there must be substantial authority for the taxpayer's position, and the taxpayer must reasonably believe that its position is more likely than not proper. A taxpayer can make a showing of reasonable belief by relying upon an opinion, provided that the opinion was not made by a disqualified tax advisor and the opinion is not a disqualified opinion.

A disqualified opinion is an opinion that is not properly based on the facts, because (1) unreasonable factual (or legal) assumptions are made; (2) representations are unreasonably relied upon; or (3) less than all the facts are considered. Disqualified tax advisors include material advisors who participate in the organization, management, promotion or sale of the transaction and people related to such material advisors. The legislative history to the Act makes clear that merely providing a tax opinion does not constitute participation in organizing a transaction. It remains unclear, however, what level of input a tax advisor can have regarding the structure of a transaction before his or her opinion becomes a disqualified opinion.

The new accuracy-related penalty for reportable transactions is effective for taxable years ending after October 22, 2004.

4. Other Consequences (Act §§ 811, 814, 838, I.R.C. §§ 163(m), 6501(c), 6707A)

If the taxpayer's group must file periodic reports with the SEC, those reports must disclose to the SEC any penalties imposed for the failure to disclose a listed transaction, as well as accuracy-related penalties associated with non-disclosure of any reportable transaction.

Interest on underpayments attributable to undisclosed reportable transactions is no longer deductible under section 163. This provision is effective for transactions in taxable years beginning after October 22, 2004.

The non-disclosure of a listed transaction carries with it one further consequence: the statute of limitations remains open until one year after the earlier of the actual date of disclosure or discovery by the IRS of the transaction through a list maintained under section 6112. This provision is effective for taxable years which have not expired as of the date of enactment.

Under the section 6011 regulations, a transaction can become a listed transaction after the fact, if the IRS adds it to the list while the statute of limitations is still open. Therefore, it is particularly important for taxpayers and their advisors to monitor the list of listed transactions periodically. For example, if a transaction becomes a listed transaction after the fact, but while the statute of limitations remains open, then the statute of limitations for the year the transaction occurred will remain open indefinitely until that transaction is disclosed.

B. Substantive Provisions

The Act contains several substantive anti-tax-shelter provisions. For example, (1) the Act authorizes Treasury to promulgate regulations extending the rules for stripped bonds and stripped preferred stock to funds whose assets substantially consist of such investments; (2) the Act disallows interest deductions with respect to debt that is convertible into the equity of an entity unrelated to the issuer; (3) the Act expands the rules on leases to tax-exempt entities to reach leases of computer software and section 197 intangibles; and (4) the Act generally limits a taxpayer's deduction for charitable contributions of intangibles to the taxpayer's basis plus a fraction of the income earned by the donee from the intangible. Finally, as discussed in more detail below, the Act limits the importation or duplication of losses to reduce U.S. taxes on other income.

1. Anti-Loss Importation (Act § 836, I.R.C. §§ 334(b), 362(e)(1))

Loss importation occurs when a foreign person, a tax-exempt organization, or another person not subject to U.S. income tax transfers to a U.S. taxpayer property with a tax basis higher than its fair market value, in a carryover-basis transaction, such as a section 351 exchange. After the transfer, the U.S. transferee would depreciate or sell the property and shelter gain or income from other sources.

Before the Act, section 482 had been interpreted to prevent built-in losses from being imported, but only in limited situations. The Act makes anti-loss importation the general rule, without regard to section 482. The new rule applies if a person not subject to U.S. tax (*e.g.*, a foreign person or a tax-exempt organization)[16] transfers property with an aggregate net built-in loss to a U.S. corporation in a reorganization, a section 351 exchange or (for foreign corporate transferors only) a section 332 liquidation. Generally, in such a transaction the transferor's basis in the transferred property would carry over to the transferee, and so the built-in loss would be available to the transferee. Under the Act, however, the basis of all the transferred property (both gain and loss property) in the transferee's hands is adjusted to fair market value. The effect is to eliminate some basis and to shift other basis among transferred properties.

Example. F, a foreign person, and D, a domestic taxpayer, own property as follows:

Owner	Property	Basis	FMV	Built-in Gain (Loss)
F	1	$90	$100	$10
	2	115	100	(15)
D	3	10	100	90
Total	--	$215	$300	$85

In a section 351 exchange, F transfers Property 1 and Property 2, and D transfers Property 3, to X, a domestic corporation. F receives 200 shares of X stock, and D receives 100 shares of X stock, which is all the X stock. Even though there is $85 net built-in gain in all the properties, Properties 1 and 2 (transferred by F) have $5 net built-

[16] If the transferor is a partnership, the rule is applied at the partner level. The treatment of other pass-through or modified pass-through entities, such as S corporations, RICs, REITs and trusts, is not specified.

in loss. Thus, X's basis in Properties 1 and 2 will equal their fair market value. The effect is to eliminate $5 of Property 2 basis altogether and to shift $10 of basis from Property 2 to Property 1, all without any gain or loss being recognized. X's basis in Property 3 is a carryover basis of $10.

The anti-loss importation rule applies only if there is a net built-in loss in all the property transferred by a person not subject to U.S. tax. Thus, if F's basis in Property A were $85, instead of $90, there would be no net built-in loss, and all the property would take a carryover basis in X's hands. Similarly, if the transfers took place in more than one transaction (each qualifying under section 351), the basis of property would be affected by the rule only in transactions with net built-in loss.

It is not clear whether the anti-loss importation rule applies on a transferor-by-transferor basis or if transfers by all persons not subject to U.S. tax are aggregated in determining whether there is a net built-in loss in the property transferred in the same section 351 exchange.

The anti-loss importation rule applies to transactions after October 22, 2004, the date of enactment of the Act.

2. Anti-Loss Duplication (Act § 836, I.R.C. § 362(e)(2))

The IRS and Treasury have been concerned for many years with situations in which one economic loss can give rise to more than one tax deduction. In 1990, Treasury adopted the controversial "loss disallowance rule" of Reg. § 1.1502-20, which, among other things, disallowed any loss on a sale of stock of a consolidated subsidiary, to the extent the loss was duplicated by a built-in loss inside the subsidiary. After that regulation was declared invalid in *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), Treasury adopted Reg. § 1.1502-35T to prevent a single consolidated group from benefiting from duplicated losses on sales of subsidiary stock and deductions inside the subsidiary.

Another type of loss duplication also has been blocked. Generally, in a reorganization or a section 351 exchange, the basis of the transferee corporation stock that the transferors receive is reduced by the liabilities the transferee assumes. Because of the narrow definition of "liability," a transferee can assume a contingent liability which reduces the value of the stock but not its basis.[17] The result can be a duplicated loss. In 1997, Congress adopted section 358(h), which reduces the basis of the transferee stock after a reorganization or a section 351 exchange, if the stock has a built-in loss and there are "liabilities" (now defined more broadly) that do not otherwise reduce stock basis.

These rules still left open the possibility of loss duplication arising from transfers of built-in loss property to corporations in section 351 exchanges, an issue of concern to the Joint Committee on Taxation in the Enron Report. The Act blocks this type of loss duplication. The following example illustrates the new rule:

[17] Examples of this type of loss duplication appear in two recent cases, *Black & Decker Corp. v. United States*, 2004 U.S. Dist. Lexis 21201 (D.Md. Oct. 20, 2004); and *Coltec Industries, Inc. v. United States*, No. 01-072T (Fed. Cl. Ct. Oct. 29, 2004).

Example. Domestic individual Y owns the following properties:

Property	Basis	FMV	Built-in Gain (Loss)
1	$90	$100	$10
2	110	100	(10)
3	120	100	(20)
Total	$320	$300	$(20)

In a section 351 exchange, Y transfers Property 1, Property 2 and Property 3 to X, a domestic corporation, and receives all the X stock.

Under pre-Act law, X would take a carryover basis in all the properties, and Y's basis in the X stock would be $320. Y could sell the X stock and deduct a $20 capital loss, and X could sell or depreciate Property 2 and Property 3 and deduct its $30 loss against other income (including the $10 built-in gain on Property 1).

Under the Act, however, X's basis in Property 2 and Property 3 is reduced by $20, the net built-in loss of the properties transferred. This basis reduction is apportioned between Property 2 and Property 3 in proportion to their relative built-in losses (1/3 to Property 2 and 2/3 to Property 3). X keeps its carryover basis in Property 1, and Y's basis in his X stock reflects the full basis in the transferred properties, $320. As an alternative, if X and Y so elect, X's basis in its properties will be a carryover basis, and Y's basis in his X stock is reduced by the net built-in loss of $20, to $300.

As with the anti-loss importation rule, the anti-loss duplication rule applies only if there is a net built-in loss. Thus, if the basis of Property 3 were $100, instead of $120, the rule would not apply. Similarly, if Y transferred Property 2 and Property 3 in separate transactions, the amount of built-in loss would be $30, and the property basis would be reduced by that full amount.

The anti-loss-duplication rule applies only to the extent the anti-loss-importation rule does not apply. Thus, the anti-loss-importation rule takes precedence where both could apply, but the interaction between the two rules may require further guidance. The anti-loss-duplication rule is also restricted to section 351 exchanges. It does not apply to reorganizations or section 332 liquidations.

The interaction between the anti-loss duplication rule and section 358(h) (discussed above) also requires clarification. Specifically, if built-in-loss properties are transferred and contingent liabilities are assumed in the same transaction, the same built-in loss could result in both property-basis reduction under the anti-loss-duplication rule and stock-basis reduction under section 358(h). We expect Treasury to coordinate these rules to prevent such a double hit.

The anti-loss-duplication rule applies to transactions after October 22, 2004, the date of enactment of the Act.

3. Partnership Anti-Loss Provisions (Act §§ 833, 834, I.R.C. §§ 704(c), 743, 743, 755(c))

The Act includes partnership provisions which also are aimed at preventing loss duplication.

The Act requires adjustments to a partnership's basis in its property under section 734 (when partnership property is transferred to a partner) and section 743 (when partnership interests are transferred), regardless of whether a section 754 election is in place, if such adjustments would result in a "substantial basis reduction," *i.e.*, a reduction of more than $250,000 in the aggregate basis of the partnership's property. Special rules apply for electing investment partnerships.

Under another new provision, the "mandatory" section 734 adjustment described above cannot result in basis reduction to partnership property consisting of the stock of a partner or of any entity related to a partner. Instead, either (1) other partnership property's basis is reduced, or (2) gain is recognized. The reason for this provision is the concern that a corporate partner has techniques at its disposal to avoid recognizing built-in gain in its own stock or the stock of an affiliate. This same concern drove IRS and Treasury to issue proposed regulations under section 337(d) (the "May Company" regulation), which may be finalized in the near future.

Finally, when built-in-loss property is transferred to a partnership, the Act provides that the property is treated as having a reduced, fair market value basis for purposes of partnership allocations to the *non-contributing* partners. For purposes of partnership allocations to contributing partners of items like depreciation, the property is treated as having a carryover basis.

C. Provisions Not in the Final Version of the Act

The Senate version of the Act contained a number of provisions that did not survive in the final version of the Act, but are nevertheless worth noting because they may re-emerge in future legislation:

(1) Codification of the economic substance doctrine;

(2) The expansion of section 269 to cover situations where the acquirer obtains property from a corporation not controlled by the taxpayer;

(3) The requirement that the CEO of a corporation sign a declaration attached to the corporate income tax return; and

(4) An increase in the maximum criminal fraud penalty imposed on corporations under section 7206 from $500,000 to $1 million.

Recently, the Court of Federal Claims held that "where a taxpayer has satisfied all statutory requirements established by Congress, … the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the [doctrine of] separation of

powers."[18] This language provides some encouragement for taxpayers, but it also may cause Congress to reconsider its decision not to codify the economic substance doctrine.

---

[18] *Coltec Industries, Inc. v. United States*, No. 01-072T (Fed. Cl. Ct. Oct. 29, 2004).