Foreign Activities of U.S. Taxpayers

Submitted by the Committee on Foreign Activities of U.S. Taxpayers:
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Legislation

Source Rules

Section 1162 of the Taxpayer Relief Act of 1997 (TRA '97), Pub. L. No. 105-34, 111 Stat. 788 amended Code section 864 to repeal the requirement that the principal office of a nonresident alien be outside the United States in order to qualify for section 864(b)(2)(A)'s rule that trading in securities for one's own account would not amount to the conduct of a trade or business in the United States effective for tax years beginning after December 31, 1997.

Foreign Tax Credit

TRA '97 section 1102 amended section 986 to simplify the rules relating to an accrual basis taxpayer's translation of foreign taxes paid in a foreign currency into U.S. dollars for foreign tax credit purposes effective for taxes paid or accrued in tax years beginning after December 31, 1997. The new rules generally allow accrual method taxpayers paying foreign taxes in a noninflationary currency to translate accrued foreign taxes at the average exchange rate for the tax year to which the taxes relate. TRA '97 section 1102 also simplified the redetermination rules for foreign taxes that are paid within two years after the close of the tax year to which the taxes relate. The redetermination rules provide that no redetermination is necessary, even though the accrual amount differs from the actual dollar value of the foreign tax paid due to currency fluctuations effective for taxes relating to tax years beginning after December 31, 1997.

TRA '97 section 1103 amended section 59 to permit taxpayers to use regular taxable income from a foreign source in the computation of the alternative minimum tax ("AMT") foreign tax credit limitation, effective for tax years beginning after December 31, 1997. Election of the simplified limitation relieves taxpayers of reallocating and reapportioning deductions for AMT purposes.

TRA '97 section 1105 amended section 904 to generally repeal the separate foreign tax credit limitation for dividends from noncontrolled section 902 corporations ("10/50 companies") and instead applies the look-through rules, but only for dividends derived from post-2002 earnings. Dividends received from 10/50 companies in years beginning after December 31, 2002, but derived out of earnings accumulated before such taxable years will generally be combined into

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a single basket for dividends from 10/50 companies. This rule does not apply if the corporation is also a passive foreign investment company as defined by section 1297; the foreign tax credit limitation is calculated separately for dividends paid from each noncontrolled section 902 corporation.

TRA '97 section 1163 amended section 902 to clarify that for purposes of determining the section 902 deemed-paid foreign tax credit, foreign taxes related to a dividend distributed by a foreign corporation in prior tax years do not remain in the foreign tax pool, even though no credit is ever claimed for them effective August 5, 1997. Each dividend carries with it the same fraction of foreign taxes deemed paid with respect to the dividend under section 902, regardless of whether the taxpayer elects to deduct the foreign taxes under section 164 or credit them under section 901. *See infra* Technical Advice Memorandum 97-27-002 (March 14, 1997).

TRA '97 section 1053 amended sections 901, 902, 960, and 853 to impose a stock holding period requirement similar to section 246(c) to claim a foreign tax credit under the amended sections with respect to dividends from foreign corporations and regulated investment companies on dividends paid or accrued after September 4, 1997. Generally, taxpayers cannot claim direct or indirect foreign tax credits for taxes paid or deemed paid with respect to the dividend if a 16-day holding period (or a 46-day holding period for certain dividends on preferred stock) is not satisfied.

TRA '97 section 1055 codified the result in *Fluor Corp. v. United States*, 126 F.3d 1397 (Fed. Cir. 1997), *reh'g granted*, 132 F.3d 700 (Fed. Cir. 1997), *cert. denied*, 118 S. Ct. 1057 (1998), by amending Code section 6601 to provide that if an underpayment is reduced by a foreign tax credit carryback, interest accrues on the underpayment until the filing date for the year in which the foreign taxes carried back were accrued or paid. This provision is effective for foreign tax credit carrybacks arising in tax years beginning after August 5, 1997.

TRA '97 section 1056 reversed the result in *Ampex Corp. v. United States*, 620 F.2d 853 (1980), and confirmed the result in Revenue Ruling 84-125, 1984-2 C.B. 125, by amending section 6511 to provide that the ten-year limitations period for filing a refund claim resulting from a foreign tax credit carryback begins to run by reference to the year in which the foreign taxes were paid or accrued, not the year to which the foreign tax credits are carried. This provision is effective for taxes paid or accrued in tax years beginning after August 5, 1997.

TRA '97 section 1057 amended section 59 to repeal the special exception provided to certain corporations by the 1989 Tax Act from the AMT limitation that a taxpayer cannot offset more than 90 percent of its pre-credit tentative minimum tax liability by its net operating loss carryovers and foreign tax credits, effective for tax years beginning after August 5, 1997.

Subpart F

TRA '97 section 1111(a) amended section 964 to extend section 1248 dividend treatment to gain from the sales of stock in a lower-tier controlled foreign corporation ("CFC") for foreign tax credit limitation purposes. This change, effective after August 5, 1997, substitutes look-through treatment for passive treatment for the section 1248 portion of the gain.

TRA '97 section 1111(b) amended section 904 to repeal the rule under prior law that denied (except as provided in regulations) foreign tax credit limitation "look-through" treatment of dividends from a controlled foreign corporation out of earnings accumulated prior to the shareholder's ownership of stock in that corporation effective for distributions made after August 5, 1997.

TRA '97 section 1112 provided two provisions to eliminate double taxation. First, TRA '97 section 1112(a) amended section 951 to reduce the subpart F inclusion of the buyer of a CFC by the lesser of (1) the amount treated under section 1248 as a dividend to the seller or (2) the portion of the CFC's subpart F income for the year allocated on a pro rata basis to the period during the year during which the buyer did not own the stock it purchased, effective for dispositions after August 5, 1997. Second, TRA '97 section 1112(b) amended Code section 961 to grant regulatory authority to extend the basis adjustment rules of section 961 to adjust a CFC's basis in a lower-tier CFC from which the U.S. shareholder included subpart F income, effective for determining inclusions for tax years of U.S. shareholders beginning after December 31, 1997.

TRA '97 section 1112(c) amended section 952 to provide that a treaty exemption from or reduction of the branch profits tax that would be imposed under Code section 884 on a deemed remittance of earnings from a foreign corporation's U.S. branch to its home office will not trigger subpart F income effective for tax years beginning after December 31, 1986.

TRA '97 section 1113 amended section 902 to extend the section 902 deemed-paid foreign tax credit to foreign taxes paid by fourth- through sixth-tier CFCs, with certain limitations regarding liquidations, reorganizations, or similar transactions for tax years beginning after August 5, 1997.

TRA '97 section 1051 expanded section 954's definition of foreign personal holding company income ("FPHCI") by adding two new categories of FPHCI: (1) net income from a notional principal contract (with exceptions for hedging transactions); and (2) payments in lieu of dividends from a Code section 1058 equity securities lending transaction for tax years beginning after August 5, 1997.

TRA '97 section 1173, added two exceptions to the definition of "U.S. property" in section 956 for dealers in securities or commodities: (1) the deposit of cash or securities made or received as collateral or margin, and (2) obligations of U.S. persons under repurchase and reverse repurchase agreement transactions to the extent that such obligations do not exceed the fair market value of readily marketable securities transferred or otherwise posted as collateral for tax years of foreign corporations beginning after December 31, 1997, and to tax years of U.S. tax shareholders with or within which such tax years of foreign corporations end.

Passive Foreign Investment Companies

TRA '97 sections 1121-1124 modified section 1296 and 1297's passive foreign investment company ("PFIC") rules to eliminate overlap with subpart F, allowed mark-to-market elections for certain stock, and modified the asset valuation test.

TRA '97 section 1121 amended section 1296 to eliminate the PFIC regime overlap for 10 percent shareholders for their post-1997 holding periods for tax years beginning after December 31, 1997. This provision does not apply to a shareholder of a nonqualified electing fund PFIC unless the shareholder makes an election under Code section 1298(b)(1) to pay tax and an interest charge with respect to the unrealized appreciation in the stock or the accumulated earnings of the corporation.

TRA '97 section 1122 amended sections 1296 and 1297 to permit shareholders that own nonqualified electing fund PFIC stock to avoid the interest-charge PFIC regime by making a mark-to-market election for "marketable" stock for tax years beginning after December 31, 1997 and tax years of foreign corporations ending with or within such tax years of U.S. persons.

TRA '97 section 1123 amended section 1297 to modify the asset valuation rules for determining the PFIC status of publicly traded corporations for tax years beginning after December 31, 1997 and tax years of foreign corporations ending with or within such tax years of U.S. persons. Publicly traded PFICs are now required to test their status using a fair market value computation. The Act did not change the rules applicable to non-publicly-traded foreign corporations.

Foreign Sales Corporations

TRA '97 section 1171 amended section 927 to expand the scope of eligible foreign sales corporation ("FSC") export property to include computer software that is licensed for reproduction abroad (whether or not patented), effective for gross receipts from computer software licenses attributable to post-1997 periods, in tax years ending after such date.

Transfers to Foreign Entities

TRA '97 section 1131 generally replaced the excise tax of section 1491 on certain transfers by U.S. persons to foreign entities with recognition of gain on such transfers, effective on August 5, 1997. Transfers to foreign partnerships will be free of income tax as well as excise tax under TRA '97, except as provided in the regulations. TRA '97 section 1131 also repealed the section 1494(c) penalty for failure to report transfers covered by section 1491.

TRA '97 section 1145 extended the coverage of section 6501(c)(8), extending the normal three year statute of limitations to three years after the required notice of transfers or reporting of information under Code sections 6038, 6038A, 6038B, 6046, 6046A, and 6048. This provision is effective for information returns required to be filed after August 5, 1997.

Partnerships

TRA '97 section 1151 granted the Service the authority under section 7701(a)(4) to issue regulations defining whether a partnership will be considered domestic or foreign.

Like-Kind Exchanges

TRA '97 section 1052 extended section 1031(h)'s limitation on like-kind exchanges of foreign real property to foreign personal property for transfers after June 8, 1997, unless the exchange is pursuant to a binding contract in effect on June 8, 1997. Personal property must now meet the "similar in location of use" condition to be treated as like-kind property.

Section 911

TRA '97 section 1172 increased section 911's earned income exclusion gradually from $70,000 to $80,000 in $2,000 annual increments beginning in 1998, and adjusted the $80,000 exclusion by a cost-of-living adjustment for any tax year beginning after 2007.

Information Reporting

TRA '97 section 1141 clarified and codified in section 6031(e) the conditions under which a foreign partnership must file a United States income tax return and the penalty imposed for non-compliance, effective for tax years beginning after August 5, 1997. Generally, section 6031(e) requires a foreign partnership that has U.S. source income or engages in a U.S. trade or business to file a return.

TRA '97 section 1142 extended section 6038's information reporting requirements, previously applicable to CFCs, to controlled foreign partnerships, effective for annual accounting periods beginning after August 5, 1997. Failure to comply with these reporting requirements will result in a $10,000 penalty for each tax year of noncompliance for both controlled foreign partnerships and CFCs.

TRA '97 section 1143 amended section 6046 to impose the information reporting requirements for changes in foreign partnership interests only on acquisitions, dispositions, or changes in ownership involving at least a ten percent interest. However, it also increased the penalty to $10,000 for failure to file the returns or provide the required information with respect to the change in ownership under sections 6046 and 6046A. This provision is effective for transfers and changes occurring after August 5, 1997.

TRA '97 section 1144, amended section 6038B, extending the reporting requirements to include property transfers to foreign partnerships, as well as foreign corporations, and replaced the reporting requirements under now repealed section 1494(c). This provision is effective for transfers made after August 5, 1997, unless an election is made to apply the provision earlier.

TRA '97 section 1146 increased section 6046's stock ownership requirements in a foreign corporation necessary to trigger the filing of an information return from five percent of the total value of the stock to ten percent of either the total value or the total combined voting power of all classes of stock with voting rights, effective January 1, 1998.

Treaties

TRA '97 section 1054 amended section 894 to deny foreign persons the ability to escape or reduce withholding tax on U.S. source payments made through "hybrid" entities by claiming the benefits under an income tax treaty between the United States and the foreign person's residence jurisdiction, effective on August 5, 1997. Following the passage of the House bill and Senate amendment, proposed and temporary regulations were issued addressing the application of reduced rates of withholding tax provided under a treaty in cases involving a hybrid entity. *See* Temporary Regulation section 1.894-1T. *See also* Treasury Decision 8722, *infra*, discussed below.

Regulations

Entity Characterization

Proposed Regulation section 301.7701-3, 62 Fed. Reg. 55,768 (1997), provides check-the-box regulations relating to the consequences of changes in entity classification. These regulations deal principally with the deemed tax effects of an elective entity conversion under the final check-the-box regulations.

Expatriation

In I.R.S. Notice 97-19, 1997-10 I.R.B. 40, the Service provided guidance under sections 877, 2107, and 2501 on the federal tax consequences for individuals who expatriate to avoid tax and the reporting requirements relating to those individuals under section 6039F. The notice explains how to compute the tax under section 877 and the individual's average tax liability for the 5 years preceding expatriation, as well as how to calculate net worth to determine whether the expatriate is subject to the tax. The notice also provides guidance on requesting a private letter ruling to the effect that the loss of U.S. citizenship did not have avoidance of tax as one of its principal purposes.

Source Rules

Proposed Regulation section 1.863-3, 62 Fed. Reg. 52,953 (1997), determines the source of income derived from the sale of inventory that is produced or purchased in a U.S. possession and sold in the United States or produced in the United States and sold in a U.S. possession. The proposed regulations amend the methods for dividing income between the United States and a U.S. possession to reflect certain changes made to the Regulation section 1.863-3, governing cross-border sales of inventory. For property produced and sold by the taxpayer, half of the taxpayer's gross income from "possession production sales" is allocated to production activity and half to business sales activity. The income is then apportioned based on a property fraction and a business sales activity fraction. For property purchased and sold, the taxpayer's income is apportioned on the basis of a business activity fraction with the remaining income sourced U.S. *See* Possessions Corporations, *infra*, for further rules.

In Treasury Decision 8735, 1997-43 I.R.B. 4, the Service issued final regulations under sections 861, 871, 881, 894, and 1441 regarding source substitute payments in securities lending and sale-repurchase transactions. Under a transparency rule in the regulations, substitute payments are treated for purposes of determining tax liability under sections 871, 881, and 1441, and for treaty purposes, as having the same character as the dividend or interest income for which they substitute. In I.R.S. Notice 97-66, 1997-48 I.R.B. 8, the Service provided guidance on complying with the section 871(h)(5) statement requirement for substitute interests payments made between November 13, 1997 and January 1, 1999 to qualify as portfolio income. The statement requirements are applicable January 1, 1999. The notice provides interim requirements for satisfying the statement requirement.

Possessions Corporations

The Service issued proposed regulations under section 936 in 62 Fed. Reg. 52,593 (1997) that determine the source of income derived from the sale in the United States of property purchased from a section 936 corporation. The regulations clarify that the source of income derived from the sale in the United States of a product purchased from a section 936 corporation is U.S. source, if the taxpayer's income from sales of that product is taken into account to determine benefits under section 936(h)(5)(C)(I) for the section 936 corporation. *See* Source Rules, *supra*, for further explanation.

Section 367

In I.R.S. Notice 97-18, 1997-10 I.R.B. 35, the Service provided guidance on reporting requirements for transfers of property to foreign entities under sections 1491 through 1494 as amended by the Small Business Job Protection Act of 1996. The notice stated that a U.S. transferor is not required to report a section 1491 transfer if the transferor recognized gain and did not have a significant interest in the transferee immediately after the transfer. The notice provided that until further guidance was issued, no reporting was required under section 1494 for corporate distributions under sections 301, 302 or 305, or a partnership distributions under section 731 (the Service is studying the appropriate treatment of such distributions). Although sections 1491 through 1494 were repealed in the Taxpayer Relief Act of 1997, effective August 5, 1997, the notice applies to transfers of property after August 20, 1996 and until the repeal date.

In I.R.S. Notice 97-42, 1997-29 I.R.B. 12, the Service extended the deadline established in Notice 97-18, *supra*, for reporting transfers of property under section 1491 made prior to the general repeal of that provision on August 5, 1997. I.R.S. Notice 97-42 extended the time during which certain section 1491 transfers may be reported under the transition rule without the imposition of the section 1494(c) penalty. With respect to the required reporting for a tax year that includes August 20, 1996, no penalty is imposed if the taxpayer files Form 926 in compliance with I.R.S. Notice 97-18 or files the form with the taxpayer's timely-filed (including extensions) income tax return or information return for the first tax year beginning on or after January 1, 1997, provided that the taxpayer's income tax return or information return for the tax year that includes August 20, 1996, includes the items of gross income required to be taken into account as a result of an election on the form (for example, any gain recognized by the taxpayer as a result of a section 1057 election). I.R.S. Notice 97-42 does not affect the interest that accrues on any excise tax due between the date of the transfer and the date on which the excise tax is actually paid.

In Treasury Decision 8702, 1997-8 I.R.B. 4, the Service finalized the outbound "anti-inversion" regulations. Generally, the regulations provide that a U.S. person who exchanges stock or securities of a U.S. corporation for stock of a foreign corporation in a section 367(a) transaction will qualify for nonrecognition only if certain conditions are satisfied, including, *inter alia*, that U.S. transferors receive no more than fifty percent of the voting power and value of the stock of the foreign transferee corporation in the transfer. In addition, an active trade or business requirement must be satisfied. The regulations apply to transfers occurring after January 29, 1997, but may be applied electively to transfers occurring after April 17, 1994 if the statute of limitations of the affected tax years is still open.

Foreign Tax Credit

In Treasury Decision 8704, 1997-8 I.R.B. 12, the Service provided guidance with respect to the determination of a section 960 foreign tax credit with respect to a foreign corporation's post-1986 foreign income taxes. The regulation clarifies that section 960 credits are determined before Section 902 credits with respect to a dividend distribution that is not previously taxed income. The final regulation also illustrates how a post-1986 accumulated deficit in a separate limitation category is allocated with respect to undistributed earnings in other separate categories and how such deficits are recaptured. The final regulation is effective with respect to CFCs' taxable years beginning after March 3, 1997.

In Treasury Decision 8708, 1997-10 I.R.B. 14, the Service finalized the section 902 regulations with respect to determining indirect foreign tax credits from post-1986 foreign income taxes and earnings. The regulations also set forth final rules regarding foreign tax credits affected by deficit carrybacks and carryovers.

The Service provided guidance in 62 Fed. Reg. 1700 (1997) regarding the substantiation requirements for claiming foreign tax credits, modifying the existing section 905 regulations. Generally, the proposed regulations require that substantiating documentation be provided upon request instead of being attached to the income tax return. The proposed regulations also somewhat tighten the secondary evidence that would be allowed to prove withholding of income taxes. These regulations were finalized in early 1998. *See* Treasury Decision 8759, 63 Fed. Reg. 3812 (Jan. 27, 1998).

Subpart F

In Treasury Decision 8704, 1997-8 I.R.B. 12, the Service issued final regulations governing the allocation of the excess of a CFC's subpart F income over its current year's earnings and profits among categories of subpart F income. The regulations also describe how these reductions in subpart F inclusions are recaptured in subsequent years. The regulation is effective with respect to taxable years of a CFC beginning after March 3, 1997.

Treasury Decision 8704 also rendered obsolete Revenue Ruling 72-527, 1972-2 C.B. 456, by providing that the section 103 exclusion from gross income for state or local bond interest does not apply for purposes of subpart F. Accordingly, foreign personal holding company income includes all interest income without regard to whether it otherwise would be described in section 103. Treasury Decision 8704 also modified Regulation section 1.954-2(g)(2) to provide that income from the trade or business of trading foreign currency is not excluded from foreign personal holding company income under the business needs exception.

PFIC

In Treasury Decision 8701, 1997-7 I.R.B. 23, the Service provided final and temporary regulations regarding how a passive foreign investment company ("PFIC") may make a deemed-sale (or if it is a CFC, a deemed-dividend), purging election to eliminate the PFIC taint in a year for which the foreign corporation is no longer a PFIC or makes a section 1295 qualified electing fund ("QEF") election.

Income Affected by Treaty

In Treasury Decision 8722, 1997-29 I.R.B. 4, the Service issued temporary and proposed regulations under section 894 that deny a treaty-reduced rate of tax on payments of U.S. source income to an entity that is treated as fiscally transparent in the United States but as non-fiscally transparent for purposes of the applicable treaty jurisdiction, unless the entity itself is a resident of the applicable treaty jurisdiction. The rules apply to U.S. source income that is not effectively connected with the conduct of a U.S. trade or business, although the Service has indicated that it may issue additional regulations addressing the availability of treaty benefits in the context of treaties' business profits provisions. The U.K. and Netherlands have issued announcements that adopt somewhat similar mirror-image rules.

In Treasury Decision 8733, 62 Fed. Reg. 53,384 (Oct. 14, 1997), the Service issued final regulations under section 6114 that require dual-resident taxpayers and individuals whose residency is determined under a treaty to attach a completed Form 8833 to their returns.

Cases and Rulings

Source Rules

In *Bowater, Inc. v. Commissioner*, 108 F.3d 12 (2d Cir. 1997), *cert. denied*, 118 S. Ct. 689 (1998), the Second Circuit reversed the Tax Court and held that a corporation cannot net interest income against interest expense in determining the amount of deductible interest to be allocated in computing the "combined taxable income" of an exporting corporation and a DISC. The Second Circuit explicitly disagreed with the Fifth Circuit, which had resolved this issue (albeit under an earlier version of the applicable regulation) in favor of the taxpayer in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d 1128 (5th Cir. 1990), *rev'g* 92 T.C. 1276 (1989).

In *International Multifoods Corp. v. Commissioner*, 108 T.C. 25 (1997), the court agreed with the Service that the taxpayer could not allocate a significant portion of the proceeds from the sale of a business of franchising rights to operate Mr. Donut shops in the Pacific-Asia region, to goodwill and a covenant not to compete. The court held that the goodwill was an integral part of the taxpayer's franchise interest and that the gain on the sale of such an interest and trademarks was U.S. source income under section 865(d)(1). The court concluded that section 865(d)(2), setting forth goodwill, trademarks, and franchises as items of intangible property, implied that the special sourcing rule for goodwill of section 865(d)(3) only applies if the goodwill is separate from the other intangible assets delineated in section 865(d)(2). The court agreed that some amount was allocated to the covenant not to compete, which was a severable item and that any amount allocated to the covenant would constitute foreign-source income.

In *International Multifoods v. Commissioner*, 108 T.C. No. 26, (1997) the court also held that a $3.9 million loss incurred by a domestic corporation and its subsidiary on the sale of non-inventory stock in a controlled foreign corporation is U.S.-sourced for purposes of the foreign tax credit. The court rejected the Service's position that since dividend income from the foreign subsidiaries would have been foreign-sourced under section 862(a), then any loss should be foreign-sourced under section 862(b). The court also rejected the Service's position that section 865 applies only to income, not losses, holding that both gains and losses are sourced at the seller's place of residence.

In *Trinova Corp. v. Commissioner*, 73 T.C.M. (CCH) 2118, 1997 T.C.M (RIA) ¶ 97,100, the court dealt with allocation of interest expense and other expenses (such as swap losses, foreign exchange losses, and a Swiss capital tax) agreed by the parties to be allocated in the same manner as interest using the asset method. The issue before the court was how to classify for interest allocation purposes, assets that generated subpart F interest income and exchange gains that the parties agreed was not subpart F income in 1986. The court decided that loan assets that gave rise to both subpart F income and non-subpart F exchange gains should be considered to produce income partly in the statutory grouping (subpart F income) and partly in the residual grouping (other income). He also determined that exchange losses distributable to the accrual of interest payments should not be allocated under the rules for losses from the sale of property but should be allocated under the interest expense rules.

In Private Letter Ruling 97-34-012 (Aug. 22, 1997), the Service ruled that interest paid by a section 936 company will constitute Puerto Rico source gross income if the company satisfies section 861(c)(1)'s eighty percent foreign business requirement, even though that section does not specifically provide rules for determining whether foreign-source interest is sourced within a particular country or possession.

Possessions Corporations

In *Microsoft Corp. v. Commissioner*, 75 T.C.M. (CCH) 1747, 1998 T.C.M. (RIA) ¶ 98,054, the court denied a summary judgment motion regarding whether Microsoft's section 936 subsidiary, which performed software duplication operations, was "manufacturing" in Puerto Rico such that it qualified under the substantial presence rules. The court stated that the Service deserved the opportunity to develop its case.

In Private Letter Ruling 97-47-014 (Nov. 21, 1997), the Service permitted a corporation to rescind its section 936 election in order to qualify as a domestic corporation for purposes of section 338(h)(10) and then to re-elect section 936 treatment after the transaction.

In Private Letter Ruling 97-27-023 (July 3, 1997), the Service granted taxpayer's request to revoke the profit-split method and elect the cost-sharing method under section 936 even though the request was made only for the taxpayer's products in SIC code X. The taxpayer sold these products for consumption in the United States, but these sales had dropped significantly as a percentage of its total sales.

Section 367

In Private Letter Ruling 97-26-035 (April 2, 1997), the Service ruled that the purchase of a U.S. and foreign corporation whose stock was "stapled" together by a U.K. corporation and the contemporaneous de-stapling and domestication of the foreign target corporation would not give rise to a section 367 transfer. In addition, the transfer of the stock in the stapled corporations by a U.S. transferor group with an overall foreign loss did not constitute a section 904(f)(3) disposition of property used predominately outside the United States.

In Private Letter Ruling 97-41-037 (July 14, 1997), the Service ruled that the domestication of a foreign corporation into a Delaware LLC will not cause the entity to cease being a foreign entity. Furthermore, the merger of a U.S. corporation's Delaware LLC into the foreign corporation's Delaware LLC will not be a transfer of property to a foreign partnership to which section 1491 would apply.

Section 482

In *ASAT, Inc. v. Commissioner*, 108 T.C. 147 (1997), the court upheld a section 482 allocation against a foreign-controlled U.S. corporation where the foreign parent failed to satisfy section 6038A appointment of a U.S. agent on a timely basis. The court required taxpayer to show clear and convincing evidence, without reference to material not in the Service's possession or knowledge at the time of determination, that the Service's determination was either based on an improper motive or was clearly erroneous, considering all reasonably credible assumptions or interpretations of fact.

In *Pikeville Coal Co. v. United States*, 37 Fed. Cl. 304 (1997), *mot. for* *recons. denied*, 37 Fed. Cl. at 312 (1997), the taxpayer filed a refund claim, after a taxpayer-favorable reduction in the price received for coal sold to a Canadian parent company, based on the argument that the reduction did not go far enough. The taxpayer argued that it should be permitted to reduce the price at which it sold coal to its parent, as it mistakenly charged a price in excess of the coal's fair market value. The court denied the Service's summary judgment motion on the ground that there were disputes over material facts including the fair market value of the coal and the reasonableness of the Commissioner's section 482 allocation. The Service subsequently moved for reconsideration of the court's ruling. The court denied the government's motion for reconsideration, maintaining that there was no binding precedent holding that the taxpayer could not challenge the reasonableness of the section 482 reallocation even if it was in the taxpayer's favor. Moreover, the Service was unable to cite authority that would prevent the court from determining the fair market value of the coal and the reasonableness of the Service's reallocation. The clear, albeit unusual, implication of these decisions is that the court would be able to increase as well as decrease the Service's taxpayer-favorable section 482 reallocation.

Foreign Tax Credit

In *Fluor Corp. v. United States*, 126 F.3d 1397 (Fed. Cir. 1997), *cert. denied*, 118 S. Ct. 1057 (1997), the court reversed the Court of Federal Claims and held that although a foreign tax credit carried back to an earlier year eliminates a tax underpayment for the earlier year, taxpayer is still obligated to pay interest on the prior deficiency, which accrues until the end of the taxable year in which the foreign tax credit carryback became available. TRA '97 section 1055, *supra*, resolved this issue by requiring that taxpayers in Fluor's situation, on a prospective basis, to pay interest on the deficiency that is eliminated by a foreign tax credit carryback.

In *International Business Machines Corp. v. United States*, 38 Fed. Cl. 661 (1997), the court, on IBM's summary judgment motion, ruled that the 1982 payment of Italian corporate tax, L'Imposta Locale Sui Redditi ("ILOR"), was a "tax" under applicable Treasury Regulations. The court rejected an argument by the Service to disregard Revenue Ruling 70-290, 1970-1 C.B. 160, and ruled that the foreign tax credit could be claimed for the year in which the tax was paid despite the taxpayer continuing to contest the tax. In granting IBM partial summary judgment for 1982, the court held that IBM's payment of ILOR was a "creditable" tax in 1982 under the applicable temporary section 901 Treasury Regulations. The court found that the tax was imposed on the kind of fixed or determinable income that was granted an exception to the net income requirement by the temporary regulations. As to the final regulations applicable to taxes paid in 1983 and 1984, the court found that IBM failed to establish that ILOR was a tax in lieu of an income tax and remanded the issue for trial.

In Technical Advice Memorandum 97-27-002 (Mar. 14, 1997), the Service held that under the final section 902 regulations, a foreign subsidiary must reduce its post-1986 foreign income taxes pool to account for dividend distributions to shareholders who are eligible to compute deemed paid credits but who elect to deduct, not to credit, foreign taxes for the year in which the dividend was received. TRA '97 section 1163 (discussed above) clarifies this treatment for distributions effective August 5, 1997.

In I.R.S. Notice 98-5, 1998-3 I.R.B. 49, the Service announced that it will use existing law and new regulations to prevent certain foreign tax credit abuses. The Service is concerned that certain taxpayers (principally MNCs) use a variety of tax-motivated transactions with the purpose of acquiring or generating foreign tax credits that can be used to shelter low-taxed foreign-source income from residual U.S. tax. The Notice focuses special scrutiny on two transactions: (1) transactions that involve the transfer of tax liability through the acquisition of an asset that generates an income stream subject to foreign gross basis taxes (such as withholding taxes); and (2) cross-border tax arbitrage transactions that permit effective duplication of tax benefits through the use of certain structures designed to exploit inconsistencies between U.S. and foreign tax laws. Under the notice, a transaction is considered "abusive" if the expected economic profit from the arrangement is insubstantial compared to the foreign tax credits generated. The term "insubstantial" is purposely left undefined.

Subpart F

In *Jacobs Engineering Group, Inc. v. United States*, 97-1 USTC ¶ 50,340, 79 A.F.T.R. 2d 97-1673 (C.D. Cal.), the court found that a series of loans from a controlled foreign corporation to its U.S. parent that were taken out within a few days after repayment of each predecessor loan, over a 2-1/2 year period, should be treated as a single unified transaction for purposes of applying the section 956 rules for investments in U.S. property. Under the facts of the case, the court concluded that the transaction should be stepped together under either the "end result" or the "interdependence" step transaction test.

In *Stanford v. Commissioner*, 108 T.C. 344 (1997), the court rejected the taxpayer's argument that the earnings and profits deficits of brother-sister controlled foreign corporations reduced the subpart F inclusion from a profitable related controlled foreign corporation because the subsidiaries were not "qualified chain members" as required by section 952(c)(1)(c). The parents' earnings and profits deficit was not attributable to the same "qualified activity" that generated the subsidiary's subpart F inclusion.

In Revenue Ruling 97-48, 1997-49 I.R.B. 5, the Service revoked Revenue Ruling 75-7, 1975-1 C.B. 244. In Revenue Ruling 75-7, the IRS stated that the activities of a contract manufacturer are attributed to a CFC for purposes of the manufacturing exception in section 954(d)(1) and also for purposes of the branch rule in section 954(d)(2). The Tax Court rejected the second holding of Revenue Ruling 75-7 in *Ashland Oil v. Commissioner*, 95 T.C. 348 (1990) and *Vetco v. Commissioner*, 95 T.C. 579 (1990), in which it held that a contract manufacturer is not a branch for purposes of the branch rule. To address what it saw as a whipsaw situation, the Service stated in Revenue Ruling 97-48 that it will no longer allow the attribution of the activities of a contract manufacturer to a controlled foreign corporation for purposes of either section 954(d)(1) or section 954(d)(2), effective December 8, 1997, but for tax years beginning before that date a taxpayer may continue to rely on the first holding of Revenue Ruling 75-7 if the taxpayer accepts the second holding of Revenue Ruling 75-7.

In Private Letter Ruling 97-29-011 (July 18, 1997), the Service ruled that the cancellation of indebtedness income recognized by a CFC will not constitute subpart F income under section 952, except to the extent a deduction for accrued but unpaid interest reduced subpart F income.

DISC/FSC

In *General Dynamics Corp. v. Commissioner*, 108 T.C. 107 (1997), the court held that period costs deducted in prior years should be allocated against combined taxable income where the taxpayer used the completed contract method of accounting for long-term contracts to determine its taxable income. In addition, the court held that the gain from the sale of two gas transport vessels could not be taken into account in determining DISC/FISC commissions. The vessels were not "export property" because they were not used outside the United States within one year after their sale.

Foreign Currency

In *Intergraph Corp. v. Commissioner*, 121 F.3d 723 (11th Cir. 1997), the court affirmed the Tax Court's decision, 106 T.C. 312 (1996), denying taxpayer foreign currency and interest deductions with respect to its guarantee and repayment of its foreign subsidiary's bank credit line.

In *Norwest Corp. v. Commissioner*, 108 T.C. 265 (1997), the Tax Court denied a loss to Norwest when it converted blocked cruzado deposits having an original cost basis of $12.5 million into cruzados at the official exchange rate and then acquired stock in a Brazilian entity having a fair market value, according to the taxpayer, of $5.5 million. The court declined to disregard the intermediate exchange of the deposits into cruzados at the official exchange rate and implicitly valued the investment at the same rate.

Section 911

In Revenue Procedure 97-51, 1997-45 I.R.B. 9, the Service provided guidance to individuals who failed to meet the section 911(d)(1) eligibility requirements due to adverse conditions in a foreign country which prevented the individual from meeting such requirements.

Other

In *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189, 1997 T.C.M. (RIA) ¶ 97,115, on appeal to the Third Circuit, the court sustained the Service's determination that the 1989 purchase and nearly immediate resale of $175 million of 5-year Citicorp notes by a partnership formed by Colgate, Merrill Lynch, and a foreign bank should be disregarded because the transaction had no business purpose other than the reduction of federal income tax. The resale was for

$140 million cash and contingent installment notes which contained no maximum price but were worth $35 million. Although there was no economic gain or loss on the resale, for tax purposes, the partnership reported a $110.7 million gain in 1989 under installment sale regulations which required that basis be recovered ratably over the period payments could be received on any contingent installment sale with no maximum price. Of this gain, $91.5 million was allocated to the foreign partner (not subject to U.S. tax), $18.9 million to Colgate and the small balance to Merrill Lynch, the architect of the transaction. This gain was offset by a built-in loss on the contingent installment note, which had a value of $35 million but a basis of $146.3 million. Almost immediately after the sale, a portion of the contingent installment note with a basis of $41.8 million and a value of $9.4 million was distributed to Colgate which sold it and reported a $32.4 million loss. The $13.5 million net loss (the $32.4 million loss net of the $18.9 million gain) was carried back against a $105 million capital gain recognized by Colgate in 1988. In 1991, the interest of the foreign partner was eliminated through the purchase by Colgate of a portion of that interest and a redemption of the balance. Thereafter, the balance of the installment note was sold at a $85 million loss, almost all of which was allocated to Colgate. Colgate also carried back this loss against the 1988 gain. The court concluded that the transaction costs incident to the purchase and resale of the installment note made the transaction uneconomic apart from tax consequences. The court questioned the business reasons for acquiring the contingent installment note and for the intricate choreography of the steps that followed. The Colgate partnership was one of 11 so-called section 453 partnerships arranged by Merrill Lynch.

Taxable Income

In *G.M. Trading Corp. v. Commissioner*, 121 F.3d 977 (5th Cir. 1997), the court held that the receipt by the taxpayer's Mexican subsidiary of a single payment of pesos to be applied to construct a plant in Mexico from the Mexican government in excess of the value of Mexican national debt surrendered by the taxpayer is a nontaxable section 118 contribution to capital by the Mexican government to the taxpayer to the extent intended to induce investment in Mexico. The court did not discuss whether section 367 applied to any transfer from the taxpayer to its Mexican subsidiary.

In Technical Advice Memorandum 97-48-005 (Nov. 28, 1997), the Service held that the taxpayer properly reported its sale of four aircraft to a Japanese corporation and the leaseback of the aircraft as a financing transaction in which the company remained the owner of the aircraft. The aircraft were also treated as owned by the Japanese corporation for Japanese tax purposes.

Section 1504(d) Includable Corporations

In *Kohler Co. v. United States*, 124 F.3d 1451 (Fed. Cir. 1997), the court affirmed the Court of Federal Claims and held that a Canadian subsidiary could not be included in a U.S. corporation's consolidated return under section 1504(d) because Canadian law did not require the subsidiary to incorporate in order to purchase a factory in Canada. Rather, the court found that the subsidiary incorporated in Canada to facilitate the mandatory approval process and to obtain advantageous financing.

Income Affected by Treaty

In I.R.S. Notice 97-40, 1997-28 I.R.B. 1, the Service announced that it will continue to treat the People's Republic of China and Hong Kong as separate countries for purposes of the U.S.-P.R.C. tax treaty, the reciprocal shipping exemption, and the U.S. tax rules in general.

Freedom of Information

In *Gibbs International v. Internal Revenue*, 129 F.3d 116 (4th Cir. 1997), the court held that the Service was not required to disclose to a U.S. company a letter the Service sent to German tax officials suggesting a joint audit of the company, which had a German subsidiary.