

U.S. INTERNATIONAL TAX DEVELOPMENTS



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I. Outbound Developments

A. CFCs

1. Limits to Subpart F

a. Section 954(c)(6) Exception for Related CFC Payments

New § 954(c)(6) of the Internal Revenue Code of 1986, as amended (the "Code")¹ applies a look-through exception to the payment of dividends, interest, rents and royalties between related controlled foreign corporations ("CFCs") such that those items of income are not foreign personal holding company income to the extent that such income is allocable to income of the related person that is not subpart F income nor effectively connected income. For these purposes, interest includes factoring income that is treated as income. The look-through rule, however, does not apply to items which create or increase deficits in earnings and profits. This provision is effective for the tax year of foreign corporations beginning on or after December 31, 2005 and before January 1, 2009. The special rules of § 954(c)(3) would not appear to have any application during this period.

The service is authorized to issue regulations necessary or appropriate to carry out the purposes of § 954(c)(6).

b. Extension of Active Financing Exception

The exception to Subpart F income contained in § 954 for active financing, which was subject to a sunset provision, was extended for two years through tax years beginning before January 1, 2009.

c. Shipping Exemption

Notice 2006-48 informs taxpayers that Treasury intends to issue regulations addressing the treatment of rents derived from leasing an aircraft or vessel in foreign commerce in order to clarify the treatment of such rents since the repeal of the foreign base shipping income inclusion in subpart F. These regulations will provide that aircraft and vessel leasing which satisfies the active rent exception will also satisfy the requirements for avoiding income inclusions under § 956 and § 367(a). Further, the new regulations will also clarify that an aircraft or vessel will be considered leased in foreign commerce for purposes of determining which rents derived from leasing an aircraft or vessel in foreign commerce will be treated as derived in the active conduct of a trade or business pursuant to § 954(c). An aircraft or vessel used in the transportation of persons or property in foreign commerce will be excluded from U.S. property, if rents derived from the leasing of an aircraft or vessel are excluded from Subpart F under the active rent exception and

¹ All section references are to the Code or the Treasury Regulations promulgated thereunder, unless otherwise indicated.

the property is considered to be used predominately outside of the United States. The regulations will also provide that the principles of § 954(c) active rent rules will be used in determining whether a trade or business that produces rents and royalties is actively conducted. For these purposes, the primary managerial and operational activities of the business must be outside of the United States and the aircraft or vessel must be used predominately outside of the United States.

2. Guidance Under § 964

The IRS issued temporary regulations that deal with CFCs and 10/50 corporations.

First, the temporary regulations allow, in the first tax year of a foreign corporation following the publication of the temporary regulations, the adoption of any method of accounting or tax year otherwise available and any election otherwise allowable by the foreign corporation notwithstanding that election or adoption would have been required in a prior year or that the books of the corporation were kept in a different manner. Any allowable methods adopted or elections made will be reflected in the computation of earnings and profits ("earnings and profits") of the corporation in current, future, and prior years. The regulations also add "tax year" to the provision that an election, adoption or change in accounting method or tax year may be made under the § 964 rules, but must satisfy other Code requirements including consent. Elections and adoptions must be made by the controlling domestic shareholders. A statement must be filed and notice may have to be given to other shareholders. Each controlling domestic shareholder must file the statement with its return. The 180-day filing requirement for § 964 elections and adoptions has been eliminated

Elections to adopt an accounting method or tax year are not required until the due date of the return for a controlling domestic shareholder's first tax year within which ends the foreign corporation's tax year in which computation of earnings and profits is significant with respect to the controlling domestic shareholders. Six significant events are specifically listed: (1) a distribution from a foreign corporation to its shareholders; (2) an amount is includible in gross income with respect to the corporation under § 951(a); (3) an amount is excluded from subpart F income of the foreign corporation or another foreign corporation by reason of § 952(c); (4) any event making the foreign corporation subject to tax under § 882; (5) use by the foreign corporation's controlling domestic shareholders of the tax book value method of allocating interest expense under § 864(e)(4); or (6) a sale or exchange of the foreign corporation's stock by the controlling domestic shareholders that results in recharacterization of gain under § 1248. The regulations allow a reasonable cause exception to take any action after the period provided, upon a showing to the IRS.

3. Guidance Under § 959

The IRS issued proposed regulations pursuant to § 959. The proposed regulations are based primarily on maintaining shareholder-level accounts for previously taxed income ("PTI"). Earnings and profits will still be maintained at the foreign corporation level on

an aggregate basis. The proposed regulations also modify the current regulations to reflect changes in law.

First, the proposed regulations require that each covered shareholder of a foreign corporation maintain a PTI account for each share of stock in the foreign corporation held directly or indirectly. A covered shareholder is (i) a U.S. person who owns stock in a foreign corporation and has a § 951(a) inclusion; (ii) a successor in interest; or (iii) a corporation not described in (i) or (ii) that owns stock in foreign corporation in which another corporation is a covered shareholder if they are members of the same consolidated group. The PTI accounts must be reflected in the functional currency of the foreign corporation and show the annual dollar basis of each category of the PTI in the account. The proposed regulations provide detailed rules regarding the maintenance of the PTI accounts.

Second, the proposed regulations implement the rule that if earnings and profits of a lower-tier CFC are attributable to amounts that have been included in the gross income of a U.S. shareholder, the amounts will not be included in the income the upper-tier CFC when distributed.

The proposed regulations also clarify that a selling CFC is deemed to have received distributions through a chain of ownership described in § 958(a) in a § 304 transaction in which earnings and profits of an acquiring foreign corporation or an acquired foreign corporation or both is deemed distributed to the selling CFC.

4. Substantial Assistance Limitation

On January 24, 2007, the IRS issued long-awaited Notice 2007-13, which announces that the IRS will amend Treasury Regulation § 1.954-4(b)(1)(iv) and (b)(2)(ii), as amended in 1968, to limit the definition of what activities constitute substantial assistance by a related person to a CFC. The current regulations provided that subpart F includes services income if the CFC receives substantial assistance from a related person, presumably to address the situation where a CFC is not inherently capable of performing the services independently from a related person. In those cases, a related person is using a CFC to perform services, which the related person could perform, because the CFC is subject to a lower rate of tax (or no tax) in its country of origin, and the related person can defer U.S. tax until the income is repatriated. Thus, a U.S. person would otherwise be motivated to earn services income through a CFC located in a low tax jurisdiction, rather than perform those services directly.

The notice anticipates that the future regulations will change the definition of substantial assistance to include only assistance received from related persons who are U.S. persons. Thus, assistance provided by related CFCs would not constitute substantial assistance. Future regulations will also provide that substantial assistance would include only assistance furnished, directly or indirectly, by a related U.S. person where the assistance meets the new objective cost test described below. Thus, assistance in the form of financial assistance (other than contributions to capital), equipment, material, and supplies would now be subject to the new cost test rather than the separate rules.

Assistance furnished by a related U.S. person in the form of direction, supervision, services, or know-how that assists a CFC indirectly in the performance of services would also be taken into account in the determination of substantial assistance, whereas, under the current regulations, only assistance that assists the CFC directly in the performance of services performed by the CFC is included in the substantial assistance determination.

In addition, future regulations will increase the cost threshold from 50% to 80%. Thus, the cost test would only be met if the cost to the CFC of the assistance furnished by a related U.S. person was at least 80% of the total cost to the CFC of performing the services. The increase in the threshold of assistance that a related person would have to provide in order for the assistance to be substantial, and the exclusion of assistance from related CFCs, from assistance would eliminate many situations in which a related person is providing assistance but the CFC is providing the service, and only capture those cases in which a related U.S. person is by far the predominant actor in the performance of the services. In addition, the future regulations will provide guidance on how the CFC could establish that the cost test was not met including allowing a CFC to either demonstrate that the cost of the services provided by the related U.S. person was less than 80%, or by demonstrating that the cost of the services performed by the CFC and related CFCs was more than 20%.

The future regulations will also eliminate the principal element test entirely. Accordingly, the future regulations would greatly reduce the uncertainty in the tax impact of multinational operations, something practitioners have strongly sought.

The future regulations will be effective for any tax year of a CFC beginning on or after January 1, 2007 and to taxable years of U.S. shareholders in which or with which such taxable years of the foreign corporations end. Taxpayers may, however, rely on the notice until the future regulations are issued.

5. Guidance Under § 1248 Measure of Earnings and Profits

The IRS issued proposed regulations regarding the determination of earning and profits of controlled foreign corporations that were involved in certain nonrecognition provisions. Generally, under § 1248, the ownership period of a U.S. person for purposes of attributing earnings and profits to the stock held by that person includes the period the stock was held by another person to the extent the U.S. person received the stock with a carryover basis and includes the period during which the U.S. person held other property if the U.S. person received the stock with a substitute basis referencing the other property. The proposed regulations provide that when an exchanging shareholder receives stock in a foreign corporation and the shareholder is either a § 1248 shareholder or a foreign corporate shareholder immediately after a restructuring transaction, earnings and profits are determined based on the type of property exchanged. If the property exchanged is not stock of a foreign acquired corporation with respect to which the exchanging shareholder is a § 1248 shareholder, the earnings and profits attributable to foreign corporation stock received by the exchanging shareholder is determined in accordance with § 1248 rules without regard to any portion of the § 1223(a) holding period in that stock that reflects periods prior to the transaction. If the property is stock

of the foreign acquired corporation, the earnings and profits attributable to the stock received by the exchanging shareholder will be the sum of the earnings and profits attributable to (i) the stock of the foreign corporation accumulated prior to the transaction and (ii) the stock of the foreign corporation that the exchanging shareholder receives in the transaction but without regard to any portion of the § 1223(a) holding period prior to the restructuring transaction. The earnings and profits attributable to any portion of the § 1223(1) holding period of the foreign acquiring corporation prior to the restructuring remains attributable through the operation of the § 1248 regulations to foreign acquiring corporation stock held by non-exchanging shareholders.

In the case of a triangular reorganization involving a foreign issuing corporation that controls a domestic acquiring corporation, the earnings and profits attributable to the foreign parent stock received by a U.S. person owning stock in a target consists solely of earnings and profits attributable to the foreign parent stock received without regard to any portion of the U.S. persons § 1223(1) holding period in the target stock. The earnings and profits attributable to the target stock is generally attributable to the target stock owned by the acquiring subsidiary after the transaction.

The proposed regulations also address the situation in which a foreign corporation contributes stock of a wholly owned foreign subsidiary to a domestic corporation it also owns in a § 351 transaction. The proposed regulations provide that when an acquiring corporation receives stock in a foreign acquired corporation, the holding period of which is determined under § 1223(2) and the acquiring corporation is either a § 1248 shareholder or a foreign corporate shareholder immediately after the restructuring transaction, the amount of earnings and profits that will be attributable to the stock of the foreign acquired corporation will depend upon whether the acquiring corporation becomes a § 1248 shareholder or a foreign corporate shareholder immediately after the restructuring transaction. If it is not, the earnings and profits attributable to the stock of the contributed foreign corporation will be determined without reference to the § 1223(2) holding period. Otherwise it will be determined by taking into account the portion of the § 1223(2) holding period in that stock that the exchanging shareholder took into account.

Non-exchanging shareholders generally do not pick up any earnings and profits attribution that accumulated prior to the restructuring transaction. An exception exists if the non-exchanging shareholder holds stock in foreign corporation that is both an acquiring corporation and an exchanging shareholder in the same transaction, i.e., an upstream merger.

The proposed regulations also allow for a reduction in earnings and profits on the sale by a CFC of stock in another foreign corporation to which earnings and profits has been attributed under these rules in order to prevent earnings and profits from being taken into account more than once. Another rule to prevent double counting relates to the operation of § 381(a) in a restructuring transaction. The proposed regulations attribute the pre-acquisition earnings and profits of the transferor to the stock received by the exchanging shareholder, except in the upstream merger case. The earnings and profits of another corporation to which the foreign corporation succeeded will not be attributed to its stock.

The proposed regulations also clarify that the hovering deficit rule will not apply to § 332 liquidations. The earnings and profits of the distributing foreign corporation to which the foreign distributee succeeds through operation of § 381 will not be taken into account by the foreign distributee for purposes of § 1248.

Finally, the proposed regulations address the treatment of foreign partnerships by clarifying that a foreign partnership is treated as an aggregate of its partners for these purposes.

B. Section 367(b)

The IRS finalized the majority of the proposed regulations regarding carryover tax attributes in nonrecognition transactions involving foreign corporations.

The final regulations contain a new provision, Treasury Regulation § 1.367(b)-2(j), which provides that if a qualified business unit ("QBU") has a different functional currency determined under § 985 from what it used prior to the transaction, the QBU will be deemed to have changed its functional currency immediately prior to the transaction and must make the adjustments contained in Treasury Regulation § 1.985-5.

Treasury Regulation § 1.367(b)-3, dealing with repatriation of foreign corporate assets in certain non-recognition transactions, contains a new subsection providing that a net operating loss or capital loss carryover of the foreign acquired corporation is described in § 381 and thus eligible to carry over from the foreign acquired corporation to the domestic corporation only to the extent that the underlying deductions and losses were allowable under the Code. Thus, only a net operating loss or capital loss carryover that is effectively connected with a U.S. trade or business (or attributable to a permanent establishment) is eligible to be carried over under § 381. Similarly, earnings and profits of the foreign acquired corporation that are not included in income as a deemed dividend under the § 367(b) regulations is eligible to be carried over from the foreign acquired corporation to the domestic acquiring corporation only to the extent the earnings and profits are effectively connected with the conduct of a U.S. trade or business.

The new regulations also add important new provisions regarding an acquisition by a foreign corporation of the assets of another foreign corporation in a transaction described in § 381. First, Treasury Regulation § 1.367(b)-7(c) states that dividend distribution out of a foreign surviving corporation's earnings and profits will be ordered in accordance with rules depending upon whether it is a pooling or non-pooling corporation.

Pooling corporation distributions will be made first out of post-1986 pool and second out of its pre-pooling annual layers under a LIFO approach. The regulations provide detailed and specific examples concerning a situation in which either foreign corporation has a deficit in one or more separate categories of post-1986 undistributed earnings or an aggregate deficit in pre-1987 accumulated profits or in earnings and profits of a pre-pooling year.

If the foreign corporation is a non-pooling corporation, the pre-pooling annual layers will consist of pre-1987 accumulated profits and pre-1987 foreign income taxes of both

corporations. There are similar detailed rules and examples for hovering deficits in the non-pooling case.

The regulations provide, however, that the hovering deficit and side-by-side account deficits will not be taken into account in determining current or accumulated earnings and profits of a foreign surviving corporation other than to offset post-transaction accumulated earnings, including for purposes of calculating the earnings and profits limitation under § 952(c)(1)(A) and the amount of the foreign surviving corporation's subpart F income. The rule, however, will not apply for purposes of calculating earnings and profits under §§ 952(c)(B) and (C).

The regulations are effective with respect to transactions that occur after February 7, 2007.

C. Gain Recognition Agreements

The IRS issued temporary regulations under § 367(a) which address problems created under Notice 2005-74. Notice 2005-74 provided that certain asset reorganizations would not be triggering events under a gain recognition agreement ("GRA") if (1) the U.S. transferor was a member of a consolidated group at the time of the initial transfer and the common parent of that group entered into a GRA; (2) immediately after the asset reorganization, the successor U.S. transferor is a member of the consolidated group; and (3) the original common parent enters into a new GRA. The temporary regulations address concerns raised by practitioners that the consolidation continuity requirement was unduly restrictive and that if there were no consolidation continuity requirement, actions of the successor corporation could inappropriately affect the liability of the original consolidated group under the GRA. The temporary regulations provide that when a U.S. transferor transfers stock of the transferee corporation to an acquiring corporation in an asset reorganization, the exchange made pursuant to the reorganization will not constitute a triggering event and the GRA will terminate without further effect if certain requirements are met. First, the acquiring corporation must be a U.S. corporation and the successor corporation, or a common parent of the consolidated group of which the successor U.S. transferor is a member, must enter into a new GRA to recognize gain with respect to the initial transfer during the term of the initial GRA. Second, with its next certification, the U.S. transferor must provide to the IRS the new GRA, notice of the transaction, and an extension of the period of assessment on the initial transfer. Third, unless the successor U.S. transferor is a member of the consolidated group of which the U.S. transferor was a member immediately before the reorganization, the person entering into the GRA must elect that if the new GRA is triggered in whole or part, the person will include the required amount in the year of the triggering event.

The temporary regulations depart from the notice and current regulations in other respects as well. First, in the case of a nontaxable liquidation, the consolidation continuity requirement is removed and the GRA will not be triggered if requirements similar to those above are met.

The temporary regulations retain the rule under the notice that when a transferee corporation transfers stock or securities of a transferred corporation to a foreign corporation in an asset reorganization, a triggering event will result unless the U.S. transferor, common parent, or new common parent, as applicable, enters into a new GRA and the U.S. transferor provides the new GRA and notice of the asset reorganization with its next annual certification. Under the temporary regulations, if these conditions are met, the original GRA will terminate without further effect.

If a transferred corporation transfers substantially all of its assets in an asset reorganization and the U.S. transferor, U.S. parent corporation, or new U.S. parent corporation enter into a new GRA, the original GRA will terminate without further effect under the temporary regulations. The temporary regulations, however, provide specific GRA rules if the transferred corporation transferred substantially all of its assets in an asset reorganization and the transferee corporation recognized gain under § 356(a)(1).

Additionally, a nonrecognition transaction will not constitute a triggering event but the receipt of boot in the exchange at the transferee foreign corporation level or the transferred corporation level are triggering events. The temporary regulations, however, provide that the receipt of some boot will not trigger the entire GRA, but will only trigger the GRA to the extent gain would be recognized in the transaction by the transferee corporation or a transferred corporation (before taking into account basis increases that may apply to the stock or securities disposed of as a result of the GRA). If a U.S. transferor has not recognized all the gain realized on the initial transfer, its new GRA will reflect any remaining gain. If a new GRA is not filed with the nonrecognition transaction, the entire original GRA will be recognized.

The temporary regulations also address the effect of GRAs on transactions involving consolidated groups. A U.S. transferor becoming a member of a consolidated group is a triggering event unless the U.S. parent of the consolidated group the U.S. transferor files a new GRA for the remaining term of the original GRA and elects to recognize gain in the tax year of any subsequent triggering event as opposed to in the year of the original transfer. A U.S. transferor leaving a consolidated group would also be a triggering event unless the U.S. transferor enters into a new GRA for the remaining term of the original GRA and elects to recognize gain in the year of the triggering event.

The temporary regulations provide that when a U.S. transferor goes out of existence in a transaction giving rise to a GRA, the gain may qualify for nonrecognition treatment if five or fewer domestic corporations control the U.S. transferor and basis adjustments are made; if the transferred corporation is domestic, the requirements of Treas. Reg. § 1.367(a)-3(c)(1) are satisfied; all domestic shareholders that hold at least 5% of the vote or value of the transferee corporation immediately after the transaction enter into pro rata GRAs; and all domestic corporate shareholders that enter into the GRAs elect to recognize any gain upon a subsequent trigger event of the GRA in the year of the triggering event. Private letter rulings are no longer available.

The temporary regulations also clarify that the determination of whether there has been a disposition of "substantially all of the assets" of a transferred corporation, will be

determined under a facts and circumstances analysis and may be found under less than the safe harbor amount for a C reorganization.

The temporary regulations retain the rule that a GRA will terminate upon a taxable disposition of the transferee foreign corporation's stock by the U.S. transferor, but only to the transferee corporation stock that is received in the initial transfer and the basis of the transferee corporation's stock received in the initial transfer properly reflects the sum of the aggregate basis of the transferred stock immediately before the initial transfer plus any increase in the basis of that stock or securities as a result of recognizing gain on the transfer. If the basis exceeds the basis of the transferred stock or securities, the U.S. transferor may elect to reduce the basis and may offset the decrease by increasing the basis in other stock it holds of the transferee corporation but only to the amount of its fair market value. The temporary regulations also allow this basis reduction in the case of a § 355 or § 332 and § 337 transactions.

Also, if the transferee foreign corporation or transferred corporation is acquired in a triangular asset reorganization, the exchange made pursuant to the reorganization will not be a triggering event if the acquiring subsidiary is foreign, the U.S. transferor or common parent enters into a new GRA, the U.S. transfer provides notice of the transaction with its next annual certification, and certain other designations are made depending upon whether the parent corporation of the foreign acquiring subsidiary is domestic or foreign and the type of reorganization.

Finally, the temporary regulations clarify that all references to stock in the current regulations now include stock and securities. They also provide a reasonable cause exception when a person required to file a GRA fails to do so timely.

The temporary regulations are effective to transfers after March 7, 2007 with the exception of the boot rules which are effective with respect to transfers occurring on after 180 days after February 7, 2007.

D. FTC

1. Guidance on § 902

The IRS issued temporary and proposed regulations dealing with dividends from noncontrolled § 902 corporations. Pursuant to the Tax Payer Relief Act and the Jobs Act, dividends from 10/50 corporations became eligible for look-through treatment for tax years beginning after December 31, 2002, without regard to when the distributed earnings were accumulated. Taxpayers can elect not to apply the new rules for years beginning before January 1, 2005.

Temporary Treasury Regulation § 1.861-9T(f)(4) applies the CFC apportionment rules for purposes of apportioning interest expense of a 10/50 corporation in order to apply the dividend look-through rule. The interest expense may be apportioned using either the asset method or the modified gross income method. The method may be elected by the corporation itself or the majority domestic corporate shareholders. A 10/50 corporation will not be required to use the asset method, however, even though the majority corporate

shareholder elect the fair market value method of apportionment. Under Temporary Treasury Regulation § 1.861-12T(c)(4), stock in a 10/50 corporation is characterized as an asset in the various separate categories on the basis of the method used by the corporation to apportion its interest expense.

For purposes of § 904, the temporary regulations provide that to the extent that a taxpayer has excess taxes in a separate category for dividends from a 10/50 corporation paid in pre-2003 tax year, the excess taxes are assigned to the separate category as if the associated dividends had been eligible for look-through treatment when paid, based on a reconstruction of the corporation's pre-2003 earnings. Foreign taxes attributable to dividends paid from a 10/50 corporation with respect to which the taxpayer is no longer a qualified shareholder are assigned pro rata to separate categories of to which the foreign corporation's pre-2003 earning would have been assigned if distributed in the last year the shareholder was a qualified shareholder. Excess taxes allocable to dividends paid in post-2002 tax years that are attributable to separate categories are carried back to the prior tax year in the same categories to which the dividends were assigned.

The temporary regulations also apply these same grouping rules to determinations of whether otherwise passive income is high-taxed income. Further, dividends paid in a post-2002 tax year to a domestic corporation that meets the ownership requirements of § 902(a) by a 10/50 corporation are treated as income in a separate category in proportion to the ratio of earning and profits attributable to income in that category to the total earnings and profits of the corporation. If the domestic corporation does not meet the ownership requirements or if the look-through characterization is not substantiated, the dividend is passive income.

Expenses are apportioned in the same manner as a CFC without the special allocation rule for related party interest.

Temporary Regulation § 1.904-5T(m) provides that the resourcing rules of § 904(g) apply to 10/50 corporations. These resourcing rules require that certain inclusions, including dividends and interest, paid or accrued by a U.S.-owned foreign corporations to a U.S. shareholder or related person that would be treated as foreign-source income are treated as U.S.-source income.

Temporary Treasury Regulation § 1.904-7T(f)(2) provides that earnings accumulated and foreign income taxes paid after a 10/50 corporation had a domestic corporate shareholder that met the ownership requirements of § 902(a) but before any shareholder was eligible for look-through treatment with respect to dividends that exist as of the end of the 10/50 corporation's last pre-2003 tax year are treated as if they were accumulated and paid during a period in which the distribution would have been eligible for look-through treatment. The earnings and taxes are treated as the opening balance of the post-1986 undistributed earnings and taxes pools in the 10/50 corporation's other separate categories on the first day of the 10/50's corporation's first post-2002 tax year. Dividends that were paid in pre-2003 tax years out of earnings accumulated in a non-look-through pool are not eligible for look-through treatment.

To substantiate the look-through characterization of earnings and taxes in the non-look-through pools, the taxpayer must reconstruct the non-look-through pools of earnings and taxes for each year in the non-look-through period, beginning with the first year in which the earnings were accumulated in the non-look-through pools.

The regulations provide a safe harbor in reconstructing the non-look-through pools. Under the safe harbor, the taxpayer may allocate the earnings and taxes in the non-look-through pools ratably to the look-through pools on the first day of the 10/50 corporation's first post-2002 tax year in the same percentages as the taxpayer properly characterizes the stock of the 10/50 corporation in the separate categories for purposes of apportioning the taxpayer's interest expense in its first tax year ending after the first day of the 10/50 corporation's first post-2002 tax year. If the taxpayer does not elect the safe harbor method and the IRS determines that the taxpayer has not met the substantiation requirements, then the earnings and associated taxes will be assigned to the passive category.

Temporary Treasury Regulation § 1.904-7T(f)(5) provides that if there is an accumulated deficit in a non-look-through pool as of the end of the 10/50 corporation's last pre-2003 tax year, the deficit and associated taxes are treated in the same manner as earnings and taxes in a positive non-look-through pool. They are assigned to the look through pools based on where the 10/50 corporation's income and expense or losses would have been assigned or based on the safe-harbor provisions.

The temporary regulations also provide for look-through treatment for pre-acquisition earnings and profits. Distributions out of earnings and profits from 10/50 corporations and CFCs in post-2002 tax years are generally eligible for look-through treatment regardless of whether the distributing corporation was a look-through entity when the earnings were accumulated and regardless of when the taxpayer acquired its stock.

Temporary Treasury Regulation § 1.904-7T(f)(7) provides that a CFC's look-through pool of earnings and taxes will be adjusted to account for accumulated earnings and taxes attributable to dividends from lower-tier 10/50 corporations as if the earnings and taxes were accumulated and deemed paid during a look-through period. The safe harbor provisions are available.

2. Guidance on § 901, Technical Taxpayer Regulations

The IRS issued proposed regulations that modify the "technical taxpayer rule" set forth in Treasury Regulation § 1.901-2(f). First, the proposed regulations retain the general principle that tax is considered paid by the person who has the legal liability under foreign law for the tax and clarify the application of this rule when foreign law imposes the liability on one person but requires another to remit the tax. The foreign law is considered, in such case, to impose legal liability for the income tax on the person who is required to take such income into account even if another person has the sole obligation to remit the tax. Also, when tax is paid on the combined income of two or more corporations, the tax must be apportioned among all the members pro rata based on the relative amounts of net income of each member as computed under foreign law.

Second, the regulations provide that a reverse hybrid is considered to have legal liability under foreign law for foreign taxes imposed on an owner of the reverse hybrid in respect of the owner's share of income of the reverse hybrid.

Third, the proposed regulations provide that a hybrid entity that is treated as a partnership for U.S. income tax purposes is legally liable under foreign law for foreign income tax imposed on the income of the entity, and that the owner of an entity that is disregarded for U.S. purpose is considered to have legal liability for such tax.

The regulations also provide rules for apportioning tax to the extent required (except with respect to income attributable to related hybrid payments or accrued amounts described in a "reserved" section of the proposed regulations). The tax must be apportioned based on each person's portion of the combined income as shown on any return, schedule or other document that must be filed or maintained with respect to a person showing that person's income for foreign tax purposes. If there is no such document, the tax is determined with respect to the person's income as shown in the books of account regularly maintained by or on behalf of the person for purposes of computing its taxable income under foreign law.

If tax is considered to be imposed on the combined income of three or more persons and one or more of those persons has a net loss for the year, special rules apply. If foreign law provides mandatory rules for allocating the net loss among the other persons, the rules that apply for foreign tax purposes will apply for purposes of these rules. Otherwise, the net loss will be allocated among all other persons pro rata based on the amount of each person's income. Foreign law will not be considered to provide mandatory rules for allocating a loss solely because the loss is attributed from one person to the second person for purposes of computing combined income.

3. Guardian Industries. Case Affirmed on Appeal

The Court of Appeals for the Federal Circuit affirmed the district court decision in Guardian Industries. Guardian Industries is a parent of a consolidated group of subsidiaries in the United States. One of the subsidiaries is the sole shareholder of GIE, a Luxembourg company. GIE is the parent of a number of Luxembourg subsidiaries. Guardian claimed a credit for certain foreign taxes paid by GIE.

The district court held that GIE could claim a credit for taxes paid on behalf of the Luxembourg affiliated group and that Luxembourg law did not make GIE and its subsidiaries jointly and severally liable for the tax. The government challenged the holding, arguing that under Treasury Regulation § 1.901-2(f)(1), the subsidiaries and not GIE had legal liability for the tax. The Court of Appeals, however, found in favor of the taxpayer. The court found that the government's argument that Treasury Regulation § 1.901-2(f)(1) created a regime under which the party liable for the tax is the party that earns the income Luxembourg law was erroneous. Rather, the court held that the IRS could have written such a regulation if it wanted but did not. The court did not consider whether the outcome would be different under the then recently proposed Treasury Regulation § 1.901-2(f)(1).

4. Partnership Regulations

The IRS finalized the temporary regulations issued under § 704, which address foreign tax credits in the partnership context.

First, the regulations provide that in determining whether an allocation of a partnership item is in accordance with the partners' interest in the partnership, the allocation of creditable foreign tax expenditures ("CFTE") is disregarded, except to the extent the partner to whom the taxes are allocated reasonably expects to claim a deduction for those taxes in determining his or her U.S. tax liabilities. Further, allocations of creditable foreign taxes do not have substantial economic effect under the § 704(b) regulations.

An allocation of CFTE is deemed to be in accordance with the partners' interest in the partnership if (i) the CFTE is allocated and reported on the partnership return in proportion to the distributive shares of income to which the CFTE relates; and (ii) allocations of all other partnership items that, in the aggregate, have a material effect on the amount of the CFTE's allocated to a partner pursuant to the § 704(b) regulations are valid.

A CFTE is defined as a foreign tax paid or accrued by a partnership that is eligible for credit under § 901 or a treaty without regard to whether a partner elects to claim a credit for the tax. CFTEs are related to net income in the partnership's CFTE category or categories to which the CFTE is allocated and apportioned. The CFTE category is a category of net income (or loss) attributable to one or more activities of the partnership. The net income in a CFTE category is the net income for U.S. federal income tax purposes, determined by taking into account all partnership items attributable to the relevant activity or group of activities, including items of gross income, gain, loss, deduction, and expense and items allocated pursuant to § 704(c).

Income attributable to an activity includes the amount included in the partner's income as a guaranteed payment from the partnership to the extent that the guaranteed payment is not deductible by the partnership under foreign law. Similarly, income attributable to an activity does not include net income that foreign law would exclude from the foreign tax base as a result of the status of a partner.

Distributive share of income means the net income from each CFTE category that is allocated to a partner. If more than one partner receives positive income from a CFTE category, which in the aggregate exceeds the total net income in the CFTE category, then the partner's distributive share of income from the CFTE category will equal the partner's positive income allocation divided by the aggregate positive income allocations from the CFTE category multiplied by the net income in the CFTE category.

If a CFTE is allocated or apportioned to a CFTE category that does not have net income for the year in which the foreign tax is paid or accrued, the CFTE will be deemed to relate to the aggregate of the net income recognized by the partnership in that CFTE category for the three preceding years. If there is no income in that CFTE category for the three preceding years, the allocation must be made in the same proportion that the

partnership expects to allocate net income in that CFTE category for the succeeding three tax years. Otherwise, if the partnership has net income in one or more other CFTE categories for the year, the CFTE will be deemed to relate to that net income and must be allocated in proportion to the allocations of that other net income. If none of these apply, the CFTE must be allocated in proportion to outstanding capital contributions.

The regulations provide many examples illustrating these principles.

5. Antiabuse guidance on Structured Passive Investment Structures

a. Proposed Regulations

Proposed regulation § 1.901-2(e)(5) denies the foreign tax credit for foreign income taxes incurred in connection with certain structured passive investment arrangements. The IRS issued these regulations in response to its concern that U.S. taxpayers are engaging in highly structured transactions with foreign counterparties in order to generate foreign tax credits. The transactions are intentionally structured to create a foreign tax liability when, removed from the elaborately engineered structure, the basic underlying business transaction generally would result in significantly less, or even no, foreign taxes. The transaction, the IRS claims, are deliberately structured to create income in a special purpose vehicle ("SPV") for foreign tax purposes, which income is purportedly subject to foreign tax.

The proposed regulations address the application of § 1.901-2(e)(5) in cases where a U.S. person directly or indirectly owns one or more foreign entities and in cases in which a U.S. person is a party to a highly structured passive investment arrangement described in the preamble. The proposed regulations treat as a single taxpayer for purposes of § 1.901-2(e)(5) all foreign entities with respect to which a U.S. person has a direct or indirect interest of 80% or more. The proposed regulations treat foreign payments attributable to highly structured passive investment arrangements as noncompulsory payments under § 1.901-2(e)(5) and, thus, would disallow credits for such amounts.

The proposed regulations focus on highly complex international tax arbitrage transactions that allow U.S. participants to attain foreign tax credits by intentionally paying foreign income tax. The following three broad classes of transactions are identified in the proposed regulations: (i) U.S. borrower transactions, (ii) U.S. lender transactions, and (iii) asset holding transactions.

A "U.S. borrower transaction" is a transaction in which a U.S. person indirectly borrows funds from an unrelated foreign counterparty. If a U.S. person were to borrow funds directly from a foreign person, the U.S. person generally would make nondeductible principal payments and deductible interest payments. The U.S. person would not incur foreign tax. The foreign lender generally would owe foreign tax on its interest income. In a structured financing arrangement, the U.S. borrower attempts to convert all or a portion of its deductible interest payments and, in certain cases, its nondeductible principal payments into creditable foreign tax payments. The U.S. borrower's foreign tax credit benefit is shared by the parties through the pricing of the arrangement. For example, a

U.S. person is seeking to borrow \$1.5 billion from a foreign person, but instead of simply borrowing the money, the U.S. person contributes \$1.5 billion to a special purpose entity (“SPV”) in exchange for 100% of the SPV’s equity. SPV then loans \$1.5 billion to a wholly owned subsidiary of the U.S. person. the U.S. person “sells” all its SPV stock to foreign counterparty for \$1.5 billion, but it is obligated to repurchase the shares in five years and is required to pay interest to the foreign counterparty. This is a repo transaction and for U.S. income tax purposes, the U.S. person is considered the owner of the SPV shares because the repo is treated as a secured loan. For foreign income tax purposes, however, the foreign counterparty is treated as the owner of the SPV shares.

Each year the SPV earns \$120 million of interest from the U.S. person’s subsidiary, pays \$36 million of foreign income tax on that interest and distributes the remaining \$84 million to the U.S. person, which in turn transfers the \$84 million to the foreign counterparty pursuant to the repo transaction. For U.S. income tax purposes, the U.S. person recognizes a dividend on the distribution from SPV because it is treated as the owner of the SPV shares. The dividend carries § 902 indirect foreign tax credits (and is increased by the § 78 gross up). the U.S. person is also entitled to an interest deduction for the \$84 million of interest paid to the foreign counterparty and the U.S. person’s subsidiary is entitled to a deduction for the \$120 million it paid to SPV. For foreign income tax purposes, the foreign counterparty is treated as the owner of the SPV shares subject to the repo transaction and the \$84 million it receives from the U.S. person is treated as a dividend from SPV, which is exempt from foreign income tax under a participation exemption. At the end of the day, the foreign jurisdiction receives income tax payments from the SPV on the interest income equal to the payments it would have received on a direct loan from the foreign counterparty. The U.S. borrower obtains lower after-tax borrowing costs because it has in effect transformed interest deductions into foreign tax credits. The foreign counterparty is compensated by receiving a higher interest rate than it would have received in a straightforward loan.

A “U.S. lender transaction” consists of transactions in which a U.S. person indirectly loans funds to an unrelated foreign counterparty. If a U.S. person were to loan the funds directly to the foreign person, the U.S. person generally would be subject to U.S. tax on its interest income and the borrower would receive a corresponding deduction for the interest expense. The U.S. person generally would not be subject to foreign tax other than, in certain circumstances, a gross basis withholding tax. In a typical structured financing arrangement, the U.S. person advances funds to a foreign borrower indirectly through an SPV. The U.S. person asserts that its interest in the SPV is equity for U.S. tax purposes. Income of the foreign borrower (or another foreign counterparty) is effectively shifted into the SPV. The U.S. person receives cash payments from the SPV and claims a credit for foreign taxes imposed on the income recognized by the SPV for foreign tax purposes. The foreign tax credits eliminate all or substantially all of the U.S. tax the U.S. person would otherwise owe on its return and, in many cases, U.S. tax the U.S. person would otherwise owe on unrelated foreign source income. The economic cost of the foreign taxes is shared through the pricing of the arrangement.

An “asset holding transaction consists of transactions in which a U.S. person that owns an income-producing asset moves the asset into a foreign taxing jurisdiction. For example,

assume a U.S. person owns passive-type assets (such as debt obligations) generating an income stream that is subject to U.S. tax. In an asset holding transaction, the U.S. person transfers the assets to an SPV that is subject to tax in a foreign jurisdiction on the income stream. Ordinarily, such a transfer would not affect the U.S. person's after-tax position since the U.S. person could claim a credit for the foreign tax paid and, thereby, obtain a corresponding reduction in the amount of U.S. tax it would otherwise owe. In the structured transactions, however, the cost of the foreign tax is shared by a foreign person who obtains a foreign tax benefit by participating in the arrangement. Thus, the U.S. person is better off paying the foreign tax instead of U.S. tax because it does not bear the full economic burden of the foreign tax.

The proposed regulations provide that a foreign income tax payment or accrual that is attributable to a structured passive investment arrangement is not a compulsory payment and is not eligible for foreign tax credit benefits.

A structured passive investment arrangement is an arrangement that satisfies six conditions representing features that are common to international tax arbitrage transactions. The first condition is that the arrangement uses an SPV that meets the following two requirements: (i) substantially all of its gross income is passive income and substantially all of its assets generate passive income, and (ii) it makes a purported foreign income tax payment with respect to its income (either at the entity level or at the owner level in the case of a pass through entity). The second condition is that a U.S. person is eligible to claim a foreign tax credit for all or a portion of the foreign income tax paid or incurred by SPV. The third condition is that the foreign tax credit claimed by the U.S. person is substantially greater than the foreign tax credit the U.S. person would be entitled to if it owned a pro rata share of the assets owned by SPV through an arrangement that was not subject to full tax of the foreign country. The fourth condition is that the arrangement generates some foreign tax benefit (including a credit, deduction, loss or payment) to a counterparty that is not related to the U.S. person. The fifth condition is that the counterparty not related to the U.S. person is considered under foreign income tax law to own at least 10% of SPV's equity, or to have acquired at least 20% of the SPV's assets. The sixth condition is that the U.S. and a foreign country in which a counterparty (or a related person) is subject to net basis income tax treat at least one of a number of aspects of the arrangement inconsistently under their respective income tax systems. The aspects of the arrangement subject to this requirement include: (i) classification of an entity as a corporation or as a fiscally transparent entity; (ii) characterization of an instrument as debt or equity or something that is disregarded for tax purposes; (iii) the proportion of the equity of the SPV that is considered owned by the U.S. person and the foreign counterparty; or (iv) the amount of taxable income of the SPV for one or more taxable years during the life of the arrangement.

b. Rulings

In ILM 2006-20022, the IRS concluded that a taxpayer's acquisition of certain disregarded entities should be disregarded under the economic substance doctrine and the step transaction doctrine and the foreign tax credits that the taxpayer claimed should be disallowed. In this ruling, the seller acquired interests in a publicly traded foreign

corporation and held legal title to several special purpose disregarded entities. Seller sold the entities to the taxpayer. The entities held the shares of the issuer. The taxpayer then acquired a put and the seller a call option which put the parties into the same economic situation as if the shares of the issuer were sold back to the seller. A third party then purchased the shares from the taxpayer. The disregarded entities paid foreign tax and the taxpayer planned to liquidate the disregarded entities after repatriation of the net proceeds. The taxpayer claimed a credit for the foreign taxes paid. The IRS held that this transaction was not consistent with the purposes of the foreign tax credit, which was never intended to motivate taxpayers to engage in transactions that are expected to result in an economic loss. This transaction is a listed transaction.

In ILM 2006-22044, the taxpayer was a U.S. corporation with a U.K. subsidiary. The subsidiary acquired and borrowed shares of companies resident in various foreign countries other than the United Kingdom. The subsidiary did not hold the interests for long, but was generally the legal owner on the dividend date. During the years at issue, the subsidiary paid noncreditable taxes imposed by the United Kingdom and used a substantial portion of the foreign dividend withholding tax that it paid as a credit against its liability for tax rather than against its U.K. net income tax. The taxpayer claimed foreign tax credits for the dividend withholding tax and for the subsidiary's U.K. net income tax. The IRS held that the portion of the U.K. net income tax that could have been reduced by the dividend withholding tax was noncreditable.

E. Inversions (§ 7874)

The IRS issued a second set of temporary regulations dealing with inversion transactions. The most notable aspect of these new temporary regulations is guidance on how to determine when an expanded affiliated group has a substantial presence in a particular country and the treatment of publicly traded foreign partnerships as surrogate foreign corporations. First, Temporary Treasury Regulation § 1.7874-2T(b) provides that an acquisition by a foreign corporation is considered to be an indirect acquisition of a proportionate amount of the property held by the domestic corporation and that an acquisition of a partnership that holds stock in a domestic corporation is considered an indirect acquisition of the properties held by the domestic corporation. A foreign corporation's acquisition of stock in another foreign corporation is not considered an indirect acquisition of any domestic corporation or partnership owned by the second foreign corporation.

Second, the new regulations now provide both a facts and circumstances test and a safe harbor for determining if an expanded affiliate group has substantial business activities in the acquiring entity's country of incorporation. The regulations provide a nonexclusive list of factors (including payroll, property, and sales) to consider in comparing the activities in the relevant foreign country to the total activities of the expanded affiliated group. Activities transferred to the foreign country with a principle purpose of avoiding § 7874 will be disregarded. Under the safe harbor test, the expanded affiliated group must meet three requirements relating to employees, assets, and sales during a 12 month testing period ending on the last day of the accounting period during which the acquisition occurs. Each of the employees, assets, and sales in the foreign country are

compared to and must be at least 10% of the total of all group employees, assets, and sales.

Third, Temporary Regulations § 1.7874-2T(e) provides that a publicly traded foreign partnership will be treated as a foreign corporation for purposes of applying § 7874(a)(2)(B) to determine if the entity is a surrogate foreign corporation.

Finally, the new regulations provide that options and similar interests held by a former shareholder or former partner of the expatriated entity by reason of holding stock or a partnership interest in the expatriated entity will be treated for purposes of the § 7874(a)(2)(B)(ii) ownership test as exercised to the extent that effect is to treat the foreign corporation as a surrogate foreign corporation.

Pursuant to Notice 2006-70, the effective date of these regulations will be amended when finalized so that they will not apply to any transaction completed on or after June 6, 2006 for which there was a binding agreement on or before December 28, 2005. A binding agreement includes entering into options and similar interests.

F. Section 911 Exclusion

Notice 2006-87 increased the housing cost exclusion limitation for most U.S. citizens and residents living abroad. The notice provides the housing cost limits for workers in more than 150 cities in 52 countries. The IRS also clarified in Notice 2006-84 that workers at the U.S. naval base in Guantanamo Bay would qualify for the exclusion even though Cuba is a country to which travel is proscribed for U.S. citizens.

G. Guidance Under § 1503(d)

The IRS finalized the regulations on dual consolidated losses. The final regulations represent several changes to the current regulations. First, along with S corporations, Regulated Investment Companies ("RICs") and Real Estate Investment Trusts ("REITs") will also not be treated as dual resident corporations. Also, the separate unit combination rules will apply to same-country separate units of multiple domestic corporations that members of the same consolidated group.

The final regulations clarify that a foreign branch is defined, in part, by reference to § 1.367(a)-6T(g)(1) rather than by reference to § 1.367(a)-6T(g). A foreign branch, thus, means an integral business operation carried on by a U.S. person outside of the United States determined under all of the facts and circumstances. Certain business operations that, under an applicable income tax treaty, would not be considered a permanent establishment, are excluded from the definition of foreign branch separate unit.

The consistency rule was removed from the final regulations.

In response to comments received, the IRS incorporated into the new regulations four rules addressing transparent entities. First, a transparent entity is defined as an entity that (i) is not taxable as an association for U.S. purposes; (ii) not subject to income tax in a foreign country as a corporation; and (iii) is not a passthrough entity under the laws of the

foreign country in which the relevant foreign branch separate unit is located or the foreign country that subjects the relevant hybrid entity or dual resident corporation to an income tax. Second, the regulations contain rules for attributing income, gain, deduction, and loss to interests in transparent entities that are consistent with the hybrid entity separate unit attribution rules. Third, the regulations provide that attributed items are not considered when calculating whether a dual resident company that holds an interest in such an entity has income or a dual consolidated loss. Finally, interest in a transparent entity will be treated as a domestic affiliate for purposes of determining whether there is a domestic use of a dual consolidated loss.

The final regulations adopt a reasonable cause standard for late filings. Therefore, untimely filings under § 1503(d) will no longer be eligible for 9100 relief.

The final regulations also adopt the exceptions to the domestic use limitation rule. Exceptions apply if (i) there is an elective agreement in place between the U.S. and a foreign country; (ii) there is no possibility of foreign use; or (iii) the taxpayer certifies there has not been, and will not be, a foreign use of any portion of the dual consolidated loss. A foreign use is deemed to occur if (i) any portion of a deduction or loss taken into account in computing the dual consolidated loss is made available under the law of the foreign country to offset or reduce, directly or indirectly, any item that is recognized as income or gain under the laws of that country regardless of whether there is an actual offset or how they are treated under U.S. principles; and (ii) the offset items are considered items of a foreign corporation or a direct or indirect interest in a hybrid entity, provided the interest is not a separate unit. The final regulations do contain certain safe harbors under which foreign use will be deemed not to occur, including a de minimis rule and a rules that apply to certain transactions involving the carryover of asset basis and the assumption of liabilities. Another exception applies in a multi-party event so long as at least 90% of the acquired entity is held by an acquiring unaffiliated domestic owner or consolidated group.

The regulations provide that losses are to be used in an order that would not result in recapture of a dual consolidated loss. The final regulations also contain a stand-alone exception to the mirror rule that would apply when filing a domestic use election that would not violate the public policy of § 1503(d), and an exception to the elimination of the dual consolidated loss in certain § 381(a) transactions. The limitations of § 1503(d)(1) will not prevent the use of a dual consolidate loss, even when the dual resident company ceases to be subject to tax in the foreign country.

The tainted income rule of the proposed regulations remains in the same form in the final regulations. The basis adjustment rules, however, were eliminated retroactively. The general rule that a triggering event (other than a foreign use) can be rebutted only if no portion of the dual consolidated loss can be used by another person under foreign law is kept in the final regulations.

The final regulations allow a taxpayer to reduce the recapture amount by showing that the dual consolidate loss would have offset other income for any tax year up to and including the year of the triggering event if the loss had been subject to the separate return

limitation year limitation. The taxpayer must however pay a deductible interest charge on any recapture.

The certification period for a (g)(2) election is reduced by the final regulations to five years.

The regulations apply to any dual consolidated loss incurred in tax years beginning on or after April 18, 2007. Taxpayers may elect to have them apply for any dual consolidated loss incurred in a tax year beginning on or after January 1, 2007.

H. Foreign Currency Rules

a. New Proposed § 987 Regulations

The IRS proposed new § 987 regulations that were very different from the § 987 regulations proposed in 1991. The check-the-box regime has made branch treatment far more common than in 1991 requiring these changes. The statutory language of § 987 refers to remittance of earnings and the Congressional report refers to triggering exchange gain or loss inherent in accumulated earnings or branch capital, but the regulations do not use either approach. Rather, the regulations introduce the "Foreign Exchange Exposure Pool Method." First the income of a qualified business unit (a "QBU") is determined by reference to the items of income, gain, deduction, and loss booked to the QBU in its functional currency (generally, translated at the average exchange rate for the year), adjusted to reflect U.S. tax principles. The basis of historic assets and deductions for depreciation, depletion, and amortization of those assets is translated at the historic exchange rate.

Then, the foreign exchange exposure pool method uses a balance sheet approach to determine exchange gain or loss. The gain or loss is recognized when a remittance is made. Only items whose value fluctuates with respect to changes in the functional currency of the owner will enter into this determination. Exchange gain or loss with respect to marked items (generally an asset or liability that would generate § 988 gain or loss if held directly by the owner of the § 987 QBU) is identified annually and is pooled and deferred until a remittance is made. When a § 987 QBU makes a remittance, a portion of the pooled and deferred exchange gain or loss is recognized in an amount equal to the product of the owner's portion of the § 987 QBU's net unrecognized exchange gain or loss, multiplied by the owner's remittance proportion.

b. Proposed Regulations on Dollar Approximate Separate Transactions Method ("DASTM")

Under the DASTM method of accounting, a QBU's income or loss is computed in U.S. dollars and adjusted to account for its DASTM gain or loss. The DASTM gain or loss is determined by first computing the QBU's change in net worth from the prior year and then making specified adjustments. The change in net worth is determined by comparing year end balance sheet items. Items are classified as historic if the value of the item does not fluctuate with changes in exchange rates and as current if it does. The QBU's net worth is adjusted to reflect transactions that increase or decrease the QBU's net worth

without affecting the QBU's income or loss. Under the DASTM method of accounting, the adjustments are translated into dollars at the exchange rate on the date the amount is paid.

The proposed regulation provide that if the items giving rise to the adjustment is a current asset that would be translated at the exchange rate for the last translation period if it were on the QBU's year-end balance sheet, the item would be translated at the exchange rate on the date the item is transferred. If the item giving rise to the adjustment is a historical asset that would be translated at the exchange rate for the translation period in which the cost of the item was incurred if it were on the QBU's year-end balance sheet, the item will be translated at the same historical rate.

I. Miscellaneous

1. Kohler Case Affirmed

The Court of Appeals for the Seventh Circuit affirmed the district court opinion in the Kohler case. Kohler involved a taxpayer who built a plant in Mexico. As part of the financing, the taxpayer engaged in a debt-equity swap whereby the Mexican government would swap \$19.5 million worth of pesos of government debt for debt Kohler purchased from Bankers Trust for \$11.1 million. The pesos were required to be spent in Mexico on projects approved by the government and could not be freely converted to dollars or other foreign currencies until 1998. The taxpayer treated the purchase of the debt and sale to the Mexican government as a wash. The IRS disagreed and increased the taxpayer's taxable income by the \$8.4 million difference in the purchase and sale prices.

In its opinion, the court of appeals considered several alternative characterizations of the transaction, including capitalizing the cost and taking depreciation or treating the Mexican government as making a contribution to capital. At the end of the day, however, the court determined that the characterization by the taxpayer as a sale should prevail. The question then remained whether the taxpayer's view that the \$19.5 million in pesos paid by the Mexican government had a value of \$19.5 million. The court analyzed who had the burden of proof. The court found that the taxpayer would ordinarily bear the burden of proof after the IRS made an assessment. In this case, however, the IRS's assessment was clearly erroneous as the IRS failed to make a showing that the pesos were worth \$19.5 million. The court stated that the IRS could have justified a more modest showing but stubbornly held to the untenable value.

2. Rev. Proc. 2006-42

Revenue Procedure 2006-42 allows taxpayers to change their elections for allocating and apportioning interest and research and development expense to qualified production activity as required by § 199. (Pursuant to Treasury Regulations § 1.861-8(f)(2), taxpayers are required to use the same method of allocating and apportionment for all operative sections.) In the revenue procedure, taxpayers are granted permission to change from the fair market value method or alternate book value method. With respect to research and development expenses, taxpayers are granted permission to change to the

sales method or the optional gross income methods. One commentator suggested that a better approach would be to sever the connection between § 199 allocations and apportionments and those under §§ 861 and 904 as they have no reason to be connected.

3. Penalty and Form 5471

The IRS issued two rulings regarding the penalty for failure to file IRS Form 5471. In the first, FSA 2006-4602F, the IRS held that a parent company was not liable for the penalty for the short tax year ending the date it was acquired. IRS Form 5471 is required for CFCs with tax years that end with or within the taxpayer's tax year. Since the taxpayer had no CFCs that ended with or within its short tax year, the taxpayer was not legally required to file the form. In ILM 2006-45023, however, the IRS found that the taxpayer was liable for the penalty. The IRS held that the taxpayer did not have reasonable cause for failing to file complete IRS Forms 5471 for its subsidiaries. The taxpayer with another party created a subsidiary that formed another subsidiary which in turn acquired a corporation with various U.S. and foreign operations. After the transaction, the entities were to be liquidated with the taxpayer receiving the U.S. operations of the target and its co-acquiror receiving the non-U.S. operations. The liquidations did not occur for four months. The taxpayer asserted that under the step transaction doctrine, it never held the foreign operations and was not required to file the IRS Form 5471, but filed the forms nonetheless. The IRS assessed the penalty on the basis that the forms were required for the four month period and were incomplete.

4. NOL Successfully Moved Offshore

In Private Letter Ruling 2006-52036, a life insurance company resident in a foreign country, which provided insurance, asset management, and investment advisory services outside of the United States, was a partner in several domestic partnerships and had been indirectly engaged in a U.S. trade or business through these partnerships. The company also had a wholly owned subsidiary that invested in U.S. real property through partnerships. The company liquidated a U.S. subsidiary which had a net operating loss carryforward. Then, a second subsidiary, with no earnings and profits and which is a U.S. real property holding company, made a distribution to the company. The company intended to report the § 301(c)(3) gain as U.S. effectively connected income. The IRS ruled that the company's net operating loss carryforward inherited under § 381 could be deducted against its effectively connected income as a result of the distribution from the second subsidiary.

5. Killer "B" Notice

Notice 2006-85 announced the intent of the IRS to issue regulations that would end so called "Killer B reorganizations." Killer B reorganizations are triangular reorganizations that involve one or more foreign corporations and generally involve a subsidiary purchasing its parent's stock for cash or a note and then transferring that stock in exchange for stock or assets of a corporation in a triangular reorganization. The transactions avoid U.S. tax on the repatriation of the subsidiary's earnings. Typically, taxpayers take the position that sale of the parent's stock to the foreign subsidiary for cash

or a note results in no gain recognition and the subsidiary takes a cost basis in the stock. The transfer of the parent shares immediately after the purchase results in no gain because the basis is equal to the fair market value.

To combat these reorganizations, the IRS states that it will issue regulations under § 367(b) that will apply to triangular reorganizations in which either the parent or the subsidiary is foreign and pursuant to which the subsidiary, in exchange for property, acquires stock of the parent that was used to acquire the target subsidiary. The regulations will treat the property transferred from the subsidiary to the parent as a distribution separate from the receipt of the stock under § 301.

The regulations will generally be applicable to transactions after September 22, 2006.

6. PLRs

a. Settlement Generated Foreign Source Income

Private Letter Ruling 2006-20016 held that payments received by a nonresident alien under a bankruptcy settlement agreement constitute foreign-source income pursuant to § 862(a)(6). In this ruling, a nonresident alien operated a sole proprietorship in a foreign country. The sole proprietorship imported sporting goods for sale and use solely in that country. All of its employees were residents of that country and it had never been engaged in a U.S. trade or business. A U.S. corporation entered into a contract with the sole proprietorship under which the sole proprietorship became the exclusive distributor of the corporation's sporting equipment in the foreign country. The corporation was acquired by another corporation which suddenly stopped supplying the sporting equipment. The sole proprietorship brought suit against the corporation and the acquiror. The acquiror filed a petition for bankruptcy. The nonresident alien filed a claim in the bankruptcy action on the same basis and reached a settlement whereby he received a cash payment from the former owners of the acquiror and the bankruptcy trustee. The amounts were paid to the trust account of the nonresident alien's attorney. The IRS found that the nature of the claim should have been determined in accordance with the origin of the claim test and that the purchase of the sporting good equipment would be foreign-source income. Accordingly, the principle payments in settlement of the claim should have been foreign-source income and not subject to withholding when paid out of the trust account.

b. Acquisition of Domestic Target

In Private Letter Ruling 2007-09054, the IRS ruled that a transaction would substantially comply with the active trade or business test notwithstanding that the market capitalization of the foreign corporation involved in the transaction would be less than taxpayer's on the date of the transfer. In this ruling, a foreign corporation was traded on a foreign stock exchange. It acquired a foreign subsidiary to expand its business. The taxpayer issued shares to raise money and repay credit facilities used by the foreign corporation in the acquisition. The foreign corporation also issued shares on the exercise of stock options and in exchange for convertible notes. The foreign corporation

established two subsidiaries. Pursuant to a merger agreement with the taxpayer, the first subsidiary merged into the taxpayer and the taxpayer merged into the second subsidiary. The U.S. shareholders of the domestic corporation were treated as having made an indirect transfer of stock in the corporation to the foreign corporation in exchange for that stock pursuant to § 367(a). In order for the transaction to be exempt under Treasury Regulation § 1.367(a)-3(c)(1), the U.S. transferors must (i) receive 50% or less of the total voting power and total value of the stock of the transferee corporation; and (ii) not be a 5% transferee shareholder or enter into a gain recognition agreement.

Additionally, the transaction must meet three requirements to satisfy the active trade or business test: (i) the foreign corporation must be engaged in an active trade or business outside of the United States for the entire 36-month period preceding the transfer; (ii) the transferors and transferee corporation must not intend to dispose of or discontinue the business in a substantial way; and (iii) a substantiality test must be met. The substantiality test is met if the fair market value of the transferee corporation (less certain prohibited assets) equals or exceeds the fair market value of the U.S. target corporation at the time of the transfer. One of the prohibited assets is any asset acquired within 36 months other than in the ordinary course of business.

The IRS, invoking its authority to issue an exception under Treasury Regulation § 1.367(a)-3(c)(9), nonetheless issued this ruling finding that the taxpayer was in substantial compliance.

c. Foreign Restructuring in Bankruptcy Proceeding as a D Reorganization

In Private Letter Ruling 2007-09018, a public limited liability company organized under the laws of two foreign countries underwent a voluntary bankruptcy under the laws of a third foreign country. The company agreed with creditors to reorganize by forming a new corporation to which it transferred all of its assets in exchange for stock of the new corporation. The stock of the new corporation was transferred to the bank lenders in exchange for outstanding obligations. The IRS held that the acquisition of substantially all of the assets of the company by the new corporation and distribution of stock to creditors qualified as a D reorganization.

7. LMSB Directive on Foreign Going Concern Value

The LMSB Industry Director, Retailers, Food, Pharmaceuticals, and Healthcare issued a directive on February 2, 2007 dealing with determining an arm's-length royalty price for services, marketing, and distribution activities conducted by a U.S. parent company of a CFC operating in Puerto Rico as a result of the § 936 phase out. The directive asserts that taxpayers may improperly classify foreign workforce in place as foreign goodwill and going concern value or take the position that the foreign workforce can be transferred tax-free, stating that workforce in place is an intangible under § 936(h)(3)(B). One commentator disagrees. He argues that workforce in place is not an intangible under § 936(h)(3)(B) and therefore not subject to § 367(d). Temporary Regulations § 1.367(a)-1T(d)(5) defines foreign goodwill and going concern value as the residual value of a

business conducted outside of the United States after all other tangible and intangible assets have been identified and valued. The commentator argues that workforce in place is properly characterized under this temporary regulation as going concern value. Further, under the statute, even if it is going concern value, the result is the same since workforce in place is not described in § 936(h)(3)(B).

The commentator also notes that if foreign workforce in place is a separate asset subject to § 367(a) and/or § 367(d), every taxpayer that ever incorporated a foreign branch will have failed to describe this asset as is required under the § 6038B regulations. The commentator also points out that § 367(d) requires a continuing royalty commensurate with income when property described under § 936(h)(3)(B) is transferred. Accordingly, the period of limitations for taxpayers that incorporate foreign branches could be open for many years and it would be difficult to apply such a royalty stream to workforce in place.

II. Inbound Developments

A. FDAPI

1. Portfolio Interest Exemption

The portfolio interest exception from withholding contained in § 871(h) (for individuals) and § 881(c) (for corporations) does not apply to interest paid to a 10% shareholder of the payor. Until the recently issued regulations, it had been unclear whether this exclusion applies at the partner or partnership level when a nonresident alien or a foreign corporation is a partner in a partnership to which the interest is paid. The regulations make clear that the determination is at the partner level and that when interest is paid to a partnership, it is the partner who "receives" the interest. In the case of a simple trust or grantor trust, if the interest is distributed to or included in the gross income of a beneficiary, the 10% test will be applied at the beneficiary or owner level. The regulations also explain that this determination is made at the time that a withholding agent, absent any exception, would otherwise be required to withhold tax with respect to that interest.

Regarding the registered form requirements for the portfolio interest exception, the IRS issued Notice 2006-99. This notice provides guidance on withholding and information reporting on foreign persons and includes guidance on certain book-entry systems in foreign countries. It concludes that a dematerialized bond that can be held and transferred only through a book entry system is in registered form when a holder may only obtain a physical certificate in bearer form if the clearing organization that maintains the book entry system goes out of business without a successor. Obligations that are outstanding prior to January 1, 2007, and that were issued in compliance Treasury Regulation § 1.163-5(c)(2)(i)(D) ("TEFRA D") may continue to be treated as obligations in bearer form until the obligations mature.

Notice 2006-99 also announced that the IRS intends to issue regulations dealing with foreign targeted registered obligations. Generally, the rules in Code § 1.871-14(e) relating to foreign targeted obligations will not apply to obligations issued after

December 31, 2006, except in limited circumstances. The regulations will provide that the rules will apply to obligations issued after December 31, 2006, and before January 1, 2009, but only if those obligations have a stated maturity of no more than 10 years from the date of issuance.

2. DRH

In ILM 2006-45018, the IRS held that Treasury Regulation § 1.894-1(d)(2)(ii)(B) could be used to recharacterize deemed interest payments by a U.S. company to a foreign company as dividend distributions and disallow the interest deduction taken by the U.S. company and subjecting the payment to withholding. In this ruling, the parent company was a public company formed in a foreign country and traded on that country's exchange. It also had a subsidiary formed in that country. The subsidiary owned two foreign subsidiaries which formed a general partnership in the United States which elected to be taxed as a corporation for U.S. tax purposes but will be treated as a partnership in the foreign corporation. This U.S. company holds a U.S. subsidiary which is included in the U.S. company's consolidated federal income tax return.

The first-tier foreign subsidiary, the U.S. company and the U.S. subsidiary entered into a series of transactions which it intended to be treated as a secured financing. The parties intended that the U.S. company would be treated as holding preferred shares and that payments made by the U.S. subsidiary to the first-tier foreign subsidiary would be treated as a dividend from the U.S. subsidiary to the U.S. company followed by deductible interest payments from the U.S. company to the first tier foreign subsidiary.

The ILM analyzed this transaction under Treasury Regulation § 1.894-1(d)(2) applicable to domestic reverse hybrids. Under those rules, when a domestic entity makes a payment to a domestic reverse hybrid that is treated as a dividend under either U.S. law or the laws of the foreign country jurisdiction, and the domestic reverse hybrid makes a payment of a type that is deductible for U.S. tax purposes to a related foreign interest holder or certain other related person for which a reduction in U.S. withholding tax would be allowed under the applicable treaty, then to the extent that the payment by the domestic reverse hybrid entity does not exceed the sum of the portion of the payment made to the entity treated as derived by the related foreign interest holder, the payment by the domestic reverse hybrid entity will be treated as a dividend for all purposes of the Code and any applicable treaty. Accordingly, the ILM found that this transaction was covered by those rules and that the deduction in the United States without corresponding tax in the foreign jurisdiction was inconsistent with the purpose of the treaty. Thus, it found that the payment was within the scope of these rules and deemed a dividend.

B. ECI

1. FIRPTA Notice

In Notice 2006-46, the IRS announced that it will issue final regulations revising temporary Treasury Regulations §§ 1.897-5T and 1.897-6T and Notice 89-85. First, the regulations will revise the rules relating to statutory mergers and consolidations to take

into account foreign-to-foreign statutory mergers and consolidations and will create two additional exceptions that provide a foreign corporation with nonrecognition treatment on its transfer of its U.S. real property interest ("USRPI") in certain foreign-to-foreign asset reorganizations. The regulations will also eliminate the conditions for nonrecognition contained in temporary Treasury Regulation § 1.897-6T(b)(1). Prior to this amendment, a reorganization had to satisfy one of five requirements contained in this section.

Additionally, under the current rules, nonrecognition treatment is provided if the foreign person exchanges stock in a U.S. real property holding company ("USRPHC") under § 351(a) or in a B reorganization, and, immediately after the exchange, all of the outstanding stock of the transferee corporation (or the stock of the transferee corporation's parent in the case of a parenthetical B reorganization) is owned in the same proportions by the same nonresident alien individuals and foreign corporations that immediately before the exchange owned the stock of the USRPHC. However, if any of the stock in the foreign corporation received by the individual or corporate transferor in a nonrecognition exchange is disposed of within three years from the date of its receipt, then the transferor must recognize that portion of the realized gain with respect to the stock of the USRPHC for which the foreign stock disposed of was received. This rule has been amended by replacing "all of the stock of the transferee corporation" with "substantially all of the outstanding stock of the transferee corporation." The three year period was revised to one year.

2. FIRPTA Amendment, REITs

a. Withholding

Public Law 109-22, the tax bill signed into law by President Bush in May 2006 provides that distributions made to a foreign shareholder of a RIC or a REIT attributable to sales of USRPI are treated as dividends subject to withholding. In the event the distribution is made to another RIC or REIT, this rule does not apply but the character of the distribution as FIRPTA gain is retained and must be tracked to the recipient RIC or REIT.

A foreign person that disposes of stock of a RIC or REIT during a 61-day period beginning with 30 days before a distribution on that stock that would have been treated as a distribution from the disposition of a U.S. real property interest, who does not actually receive the distribution, and who acquires a substantially identical interest or enters into a contract or option to acquire such interest is required to pay FIRPTA tax on the amount of the distribution that was not taxed under FIRPTA because of the disposition.

b. Notice 2007-55

The IRS announced that it will issue regulations to prevent foreign government investors and other foreign investors from avoiding the application of the Foreign Investors in Real Property Tax Act of 1980 ("FIRPTA") through the use of certain U.S. REIT structures that have become popular in recent years. The announcement, contained in Notice 2007-55, addresses taxpayers who take the position that certain distributions by U.S. REITs of proceeds realized by the REIT from the disposition of U.S. real property are not taxable

to the foreign investors under § 897(h)(1) either because the investors are exempt from the application of § 897(h)(1) by virtue of the "governmental exemption" contained in § 892 or because the distributions are made in the context of a complete liquidation of the REIT under § 331 of the Code. The notice indicates that the IRS intends to issue regulations to "clarify" the interpretation of these statutory provisions dealing with distributions by U.S. REITs of the proceeds realized by the REIT from the sale of U.S. real property. The notice states that the regulations will apply to any distribution occurring on or after June 13, 2007. In addition to announcing its intention to issue the regulations, the notice also states that the IRS intends to challenge the position taken under current law by any taxpayer that § 897(h)(1) does not apply to these distribution by virtue of either § 892 or § 331.

3. Earnings Stripping

PL 109-22 codified the approach taken in Proposed Treasury Regulation § 1.163(j)-3(b)(3), which provided that a partner's proportionate share of partnership liabilities is treated as liabilities incurred directly by the partner for purposes of applying the earnings stripping limitation to interest payments by a corporate partner of a partnership. One change is made from the proposed regulations and the tax bill. The proposed regulations provided that in the case of a corporation that owns, directly or indirectly, an interest in a partnership, the corporation's share of partnership liabilities is treated as liabilities of the corporation for purposes of applying the earnings stripping rules to the corporation. The IRS has regulatory authority to reallocate shares of partnership debt, or distributive shares of the partnership's interest income as may be appropriate to carry out the purposes of the provision.

4. Available Deductions

The IRS issued TAM 200615034 which considered the research and development expense deductible by a partner. In that ruling, a foreign corporation was engaged in research, manufacturing, and marketing and sold its products in many countries. The foreign corporation was a partner in a partnership that performed manufacturing, marketing, and wholesaling activities in the United States. The partnership owned a manufacturing facility in the United States and licensed intellectual property from the partner. The partnership purchased products from entities to whom the partner licensed and produced the product. The partner allocated its research and development expense to its income by aggregating its product categories with product categories determined to be applicable to the partnership's income. The IRS held that the partner's distributive share of income could be reduced by its allocation of research and development expense and further held that the partnership's manufacturing and wholesaling activities with respect to a single industry are aggregated for purposes of allocating and apportioning research and development expense.

5. Interest Deductions for Banks

The IRS issued temporary and proposed regulations as announced in Notice 2005-53, to update the current rules for determining interest expense deductions for foreign

corporations that operate branches in the United States. The temporary regulations update the prior regulations to take account of changes in the international banking sector. They make effective one part of the 1996 proposed regulations, make miscellaneous clarifications with respect to the 1996 final regulations and modify the branch profits tax liability reduction regulations under Treasury Regulation § 1.884-1(e)(3).

Notice 2007-1 provides that Temporary Treasury Regulations § 1.885-5T, regarding the determination of interest expense allocable to effectively connected income of foreign corporations engaged, or treated as engaged, in the trade or business in the United States, are effective for the first tax year-end for which a foreign corporate taxpayer's original tax return due date is after August 17, 2006. A foreign corporation whose tax year-end is on or after September 30, 2005 and whose original tax return due date was on or after June 15, 2006 and on or before August 17, 2006, may elect these provisions for the earlier filing period and may adopt the rules in their entirety for amended returns filed within 180 days of December 18, 2006.

6. Shipping Exemption

a. Notice 2006-42

The Jobs Act eliminated foreign base company shipping income from subpart F income. This change caused concern among commentators regarding how Treasury Regulation § 1.883-3(b) would apply and that foreign corporations would no longer satisfy the income inclusion test under § 883 regulations if they did not derive foreign base company shipping income from international operations. In response to these concerns, the IRS issued Notice 2006-42. In the notice, the IRS stated that residents of countries that do not provide a reciprocal exemption to U.S. corporations on income from operation of their ships or aircrafts might attempt to use the CFC exception to circumvent the rules of § 883(c)(1) by owning more than 50% of the value of the foreign corporation through a U.S. fiscally transparent entity. The IRS believes this is contrary to the congressional intent to insure that the exclusion is provided only to foreign corporations that are owned by residents of foreign countries that provide a reciprocal exemption to U.S. corporations. The IRS stated, however, that the income inclusion test is overly complex and unnecessary, and, thus, the IRS intends to replace it with a new ownership based test. A foreign corporation will satisfy this stock ownership test if it meets a "qualified U.S. person ownership test" and satisfies certain substantiation and reporting requirements. The qualified U.S. person test is met if, for more than half of the days in the year: (i) the foreign corporation is a CFC and (ii) more than 50% of the total value of all of the outstanding stock of the CFC is owned by one or more "qualified U.S. persons." A "qualified U.S. person" is a U.S. person that is a U.S. citizen, resident alien, or domestic corporation.

b. Tonnage Tax

U.S.-flagged vessels that participate in commercial foreign trade and that weigh 6,000 dead-weight tons may now elect to use the tonnage tax as an alternative tax regime. The former weight threshold was 10,000 dead-weight tons.

7. Royalties Capitalized into COGS

TAM 2006-30019 involved a foreign parent with a U.S. subsidiary. The foreign parent and its subsidiaries developed, manufactured, distributed, and provided financing for the sale of the foreign parent's products. The foreign parent granted the subsidiary exclusive right to distribute its product in the United States and exclusive rights and license to its trademark. The subsidiary paid royalties to the parent. These royalties were calculated using the number of units of products sold by the subsidiary. The royalty expense deductions claimed were deferred under § 267(a)(3) until payment.

8. Branch Tax

The IRS issued two private letter rulings addressing branch profits tax. In the first, Private Letter Ruling 2006-49017, a parent corporation owned two foreign corporations, A and Purchaser. A owned a Transferor, from the same jurisdiction, which owned a U.S. subsidiary. Transferor contributed its interests in certain partnerships and U.S. limited liability companies that own real property to the U.S. subsidiary and filed a statement saying that upon its disposition of stock in the U.S. subsidiary, it would increase its dividend equivalent amount for the tax year by an amount equal to the lesser of the amount realized upon disposition of the total amount of effectively connected earnings and profits. Parent, A, Transferor and Purchaser entered into a series of transactions whereby Purchaser purchased all of the outstanding stock of Transferor from A and Transferor merged with and into Purchaser. Purchaser then attempted to file the required statement. The IRS held that the merger of Transferor into Purchaser did not constitute a disposition by Transferor of its stock in the U.S. subsidiary.

In the second, Private Letter Ruling 2006-51021, a foreign parent owned a chain of companies. One foreign subsidiary, FS-1, formerly operated as a branch in the U.S. but terminated its business in the U.S. and no longer conducted any business in the U.S. except through subsidiaries. Two other subsidiaries were domestic limited liability companies that elected to be treated as a corporation. FS-1 engaged in a series of transactions that qualified under § 351. The transactions would have resulted in a branch profits tax liability because a U.S. corporation received certain assets from FS-1. As a condition to the ruling, FS-1 agreed to include amounts in income for U.S. federal tax purposes on a disposition of the subsidiary.

FS-1 engaged in another series of transactions that qualified under § 351 but would have resulted in branch profits tax liability absent a subsequent ruling obtained by FS-1. The parent wanted to consolidate the two chains of corporations created by the FS-1 transactions. The IRS ruled that the merger would not be treated as a disposition and would not result in a branch profits tax. The foreign subsidiary ultimately acquiring the

chains was required to file a statement that it would recognize gain on the disposition of the second resulting chain of corporations.

C. Other

1. REMIC Residuals

The IRS issued temporary and proposed regulations relating to income that is associated with residual interest in a Real Estate Mortgage Investment Conduit ("REMIC") and that is allocated through certain entities to foreign persons who invested in those entities. The regulations accelerate the time when income is recognized for withholding tax purposes to conform to the timing of income recognition for general income tax purposes. The foreign persons covered by these regulations include partners in domestic partnerships, shareholders of REITS and RICs, participants in common trust funds, and patrons of subchapter T cooperatives. The regulations also clarify the timing of income under § 860G for purposes of determining a domestic partnership's withholding tax responsibility with respect to a foreign partner's share of REMIC net income as a result of indirectly holding a residual interest. Excess inclusion is treated as income from U.S. sources.

2. Guidance on § 362(e)(2)

The IRS issued proposed regulations under § 362(e)(2). If assets are transferred in a transaction that is potentially subject to § 362(e)(2), which requires a reduction in basis when property is transferred and its adjusted basis is greater than its fair market value, and the transaction occurs more than two years before entering the U.S. tax system, then the regulations presume the assets aggregate fair market is equal to its aggregate adjusted basis. The presumption applies only if the earlier transaction and the entry into the United States does not have reducing U.S. tax liability or duplicating loss as a purpose. If the entry into the United States occurs within two years of the transaction, the regulations provide a method for the relevant parties to elect to have § 362(e)(2)(C) apply.

III. Other Developments

A. Transfer Pricing

1. Section 482 Service Regulations

The IRS issued temporary and proposed regulations regarding services under § 482. The regulations are effective for tax years beginning after December 31, 2006.

The regulations eliminated the simplified cost based method replacing it with the services cost method. The services cost method, which applies to two categories of covered services, allows related-party services to be charged at cost. The first category to which the service cost method applies is to specified covered services, i.e., those services listed in a revenue procedure as covered. The most recent revenue procedure to contain this list is discussed below.

The second category of covered services are certain low margin covered services. To fall within this category, the median comparable arm's-length markup on total services costs must be less than or equal to 7%. Arm's-length markups must be identified from the marketplace, interquartile ranges must be established and a median comparable arm's-length markup must be determined.

Regardless of which category the services fall under, the services will only qualify for the service cost method if the taxpayer reasonably concludes in its business judgment that the services do not contribute significantly to key competitive advantages, core capabilities, or fundamental chances of success or failure in one or more trades or businesses of the renderer, the recipient, or both. The preamble explains that this business judgment test involves the business judgment preeminently within the businessperson's own expertise and that, in most cases, the taxpayer's judgment will be accepted. Only in the most unusual cases will the IRS need to challenge the taxpayer's reasonable business judgment in concluding that such typical back office services do not contribute significantly to fundamental risks of success or failure.

The taxpayer is required to maintain documentation with respect to the covered services including a statement evidencing the taxpayer's intent to apply the service cost method.

Certain categories of controlled transactions are specifically excluded from the service cost method including manufacturing, extraction, construction, reselling, research and development, engineering or scientific, financial transactions including guarantees, and insurance and re-insurance.

The regulations also contain a new concept of "shared services arrangements." If covered services are the subject of a shared services arrangement, the arm's-length amount charged to each participant is the portion of the total costs of the services otherwise determined under the service cost method that is properly allocable to the participant pursuant to the arrangement. The allocation must be applied consistently for all participants and services. The allocation to each participant must reasonably reflect that participant's respective share of reasonably anticipated benefits for that tax year and participants must reasonably anticipate benefits from the covered services subject to the shared services arrangement. The taxpayer must maintain documentation concerning the arrangement, including a statement that it intends to apply the service cost method and information on the participants, allocation basis, and the grouping of services for purposes of the shared services arrangement.

The other methods for services transfer pricing include (i) the comparable uncontrolled services price method; (ii) the gross services margin method; and (iii) cost of services plus method.

The first method, Comparable Uncontrolled Price ("CUP"), is practically the same as the CUP method for sales of tangible property. This method compares the controlled services to uncontrolled services, making adjustments for difference between the two. The CUP method provides the most direct and reliable measure of an arm's-length result

if there are no differences or only minor differences between controlled and uncontrolled services.

The resale method is used in cases in which a controlled taxpayer performs services or functions in connection with an uncontrolled transaction between a member of the controlled group and an uncontrolled taxpayer. If the controlled taxpayer that performs an agent service or an intermediary function is comparable to a distributor who takes title to goods and resells them, the gross profit margin earned by the distributor on uncontrolled sales, stated as a percentage of the price for the goods, may be used as the comparable gross services profit margin.

The cost plus method ordinarily would apply when the renderer of the controlled services provides the same or similar services to both controlled and uncontrolled parties. Only in those circumstances would the taxpayer have the information necessary to apply this method. This method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to objective measures of profitability similar to the general cost plus transfer pricing method. This method is applied only when the renderer of controlled services is the tested party. The temporary regulations state that a new profit level indicator of the ratio of operating profit to total services cost may be a reliable basis.

The new regulations eliminate any reference to "interrelated transactions," "high-value services," and "highly integrated transactions," because commentators objected that the terms were too vague and subjective and that the profit-split method would constitute a default best method in far too many situations. The new regulations instead say that the profit-split method should be used in controlled services transactions involving a combination of nonroutine contributions by multiple controlled taxpayers. A nonroutine contribution is a "contribution that is not accounted for as a routine contribution." Example 2 of the proposed regulations, which involved the profit-split analysis, was also eliminated.

The temporary treasury regulations also deal with contingent-payment contractual terms for services. For the arrangement to be contingent it must meet the following requirements. It must be in writing prior to or contemporaneously with the start of the activity constituting the controlled services transaction. The contract must state that the payment is contingent on the occurrence of a future benefit to the recipient directly related to the controlled services transaction and must provide for payment on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer. The IRS may impute contractual terms if the economic substance of the transaction is consistent with the existence of such a term. Emphasizing the importance of the economic substance, the temporary regulations eliminate any reference to a factor of whether an uncontrolled taxpayer would have paid a contingent fee.

The temporary regulations also define service costs as all costs directly identified with provision of controlled services as well as all other costs reasonably allocated to such services. Further, all contributions in cash or in kind, including stock-based

compensation, are included in total services costs. The new regulations do, however, allow the certain third-party costs to be evaluated on a disaggregated basis.

The temporary regulations also discuss whether services are a "benefit." An activity provides a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position or that may be reasonably anticipated to do so. An activity is generally considered a benefit if the recipient would be willing to pay an uncontrolled party to perform the same or similar activity of either a fixed or contingent payment basis.

Financial transactions, including guarantees, are explicitly excluded from eligibility for service cost method.

The temporary regulations also address coordination of service transfer pricing rules with other transfer pricing rules. The regulations provide that a transaction that is structured as a controlled services transaction may contain other elements for which a separate category of methods is provided, but whether the integrated transaction is evaluated as a controlled services transaction or the other elements are evaluated separately will depend on which approach will provide the best result in terms of an arm's length measure. If, however, the controlled services transaction contains an element involving intangible property and that element is material, the arm's length result must be corroborated or determined by an analysis under the intangibles rules.

The temporary regulations also contain three new examples illustrating the best method rule. In example 10, a foreign parent designs and manufactures consumer electronic devices that incorporate advance technology. In year 1, it introduces an entertainment device product aimed at the youth market. The parent's U.S. subsidiary is the exclusive U.S. distributor. The subsidiary hires an independent marketing firm to promote the product. The firm receives a markup of 25% on all costs of promoting the produce with the exception of media buys which are reimbursed at cost.

In year 3, the parent introduces a new entertainment device intended for the youth market. This time, the subsidiary performs the functions itself using staff hired from the agency and methods similar to the agency. The best method for allocating service income is cost plus on all services except media buys which are reimbursed at cost.

In example 11, a foreign parent sells its products to retailers in Europe under the trademark "Moda." It owns the worldwide (including U.S.) rights to this trademark. Its U.S. subsidiary is the exclusive distributor of its merchandise in the United States. Although the European and U.S. products are identical, the U.S. customers generally resell the product as non-branded merchandise. An independent firm hired by the parent determines that the parent could generate a substantial profit by using its trademark in the U.S. wholesale and retail markets. The parent enters into a new agreement with the subsidiary whereby the subsidiary will develop this market for the parent. The activities of the subsidiary in this phase of development are similar to those performed by

uncontrolled advertising and media relations companies. Accordingly, using the profit level indicator of operating profit to total service costs is utilized.

In example 12, a U.S. company is a manufacturer of athletic apparel sold under a trademark to which a foreign parent owns the worldwide (including U.S.) rights. The U.S. company sells the trademarked apparel in countries throughout the world, but prior to year 1, did not sell in Country X. In year 1, the U.S. company acquires an uncontrolled company in Country X and enters into an exclusive distribution agreement with that company. The acquired company continues to distribute merchandise from uncontrolled suppliers. Prior to year 1, the U.S. company executed long-term endorsement contracts with professional athletes allowing the U.S. company to use their names and licenses on the apparel. Before being acquired, the acquired company renewed a long-term contract with a nationwide chain of retailers of which it has been the primary supplier since the retailers operations began. Under this agreement, the retailer will provide preferred shelfspace and will feature the merchandise in its print ads and seasonal promotions at no charge. The U.S. company and acquired company grant the retailer advance access to new products and the right to use the professional athletes in advertising featuring the foreign parent's product. This example assumes it is possible to segregate the various transactions and that arm's length compensation for functions other than promoting the apparel in Country X can be reliably determined. Because both the U.S. company and the acquired company made valuable nonroutine contributions to the marketing and promotional activities in Country X, neither CUP, cost plus method for services, nor the general cost plus method will provide a reliable arm's length measure. The most reliable method, therefore is a the residual profit-split method.

2. Services Charged at Cost

Notice 2007-5 modified these temporary regulations under § 482 regarding rules for specified services that can be charged at cost, including modification of the effective date. The temporary regulations will apply to tax years after December 31, 2007 to the extent the service cost method is concerned, except for the business judgment rule which is effective after December 31, 2006. Thus, for the 2007 calendar year, taxpayers may apply the existing regulations for purposes of identifying controlled services that are eligible to be priced on a cost basis. Services priced on a cost basis must be non-integral and must satisfy the business judgment test. Taxpayers can elect to have all of the service cost method apply after December 31, 2006.

The service cost method is elective and no statement is required to be attached to the taxpayer's return.

Despite comments to the contrary, the IRS declined to adopt a departmental approach to specified covered services eligible for the services cost method, stating that the services cost method is intended to provide a practical and administrable means of identifying low-margin services that may be evaluated by reference to total services cost without a markup. More categories were added though, as discussed below.

The temporary regulations provide that the business judgment rule should be applied by reference to "one or more trades or businesses of the renderer, recipient, or both." The notice, however, changes the focus and provides that taxpayers are to apply the business judgment rule by reference to "one or more trades or businesses of the controlled group," as defined in Treas. Reg. § 1.482-1(i)(6). The notice states that the business judgment rule should take into account whether a particular activity contributes to the operating profit of one or more controlled parties. The evidence necessary to establish the business judgment will be determined under all of the facts and circumstances.

The notice also confirms that taxpayers may make allocations of arm's-length charges for services ineligible for the service cost method that yield a benefit to multiple members of the same controlled group. In such a case, however, the flexible rules under the service cost method for establishing a joint benefit are inapplicable. Instead, the more robust analysis under the general transfer pricing rules applies.

For tax years beginning after December 31, 2007, the written contract required by the temporary regulations may be prepared prior to or contemporaneously with the filing of the income tax return.

3. Specified Covered Services

Revenue Procedure 2007-13 identifies 48 activities that constitute specified services that can be charged at cost, assuming they otherwise qualify under the temporary regulations. This list is a significant broadening of the prior list in that it contains the inclusion "other similar activities" at the end of each category of activities. These activities are described as support services common among taxpayers in a variety of industry sectors that generally do not involve a significant arm's length markup on total services costs.

4. Temporary Regulations on Intangibles

The IRS issued temporary and proposed regulations for allocation of income from intangibles. These regulations are effective for tax years after December 31, 2006 unless a taxpayer elects to apply them to earlier years.

First, the regulations create a single owner of the intangible. The legal owner of an intangible pursuant to the intellectual property law of the relevant jurisdiction or the holders of the rights constituting an intangible pursuant to a contractual term or other legal provision will be considered the sole owner of the intangible unless the ownership is inconsistent with the economic substance of the underlying transaction. If there is no clear legal owner under these rules, then the controlled taxpayer who has control of the intangible based on the all the facts and circumstances, will be considered the sole owner. The regulations provide two examples to this ownership rule. In the first example, a foreign parent company is the registered holder of a trademark it licenses to its U.S. subsidiary. The parent is the owner of the trademark pursuant to intellectual property law. The U.S. subsidiary is the owner of the license but not the owner of the trademark. In the second example, a U.S. subsidiary develops a list of creditworthy customers that purchase the trademarked products. Neither the intellectual property law nor the contract

between the subsidiary and parent specify who owns the list. Because the subsidiary has practical control over the list, it is considered the sole owner.

Next, the preamble to the proposed and temporary regulations address the arm's-length consideration that must be allocated to a controlled taxpayer that develops or enhances (or is reasonably anticipated to develop or enhance) the value of an intangible owned by another. Generally, the consideration must be determined in accordance with the rules under § 482. The preamble, however, makes clear that no compensation is due if the controlled party's activities are reasonably anticipated to enhance only the value of its own rights under a license or exclusive distribution agreement.

The preamble also addresses the use of the term "incremental marketing activities" as used in several examples in the regulations. In example 2, a foreign producer of wristwatches is the registered owner of a trademark in the United States and other countries. The foreign producer enters into an exclusive five-year renewable agreement with its newly organized U.S. subsidiary which gives the subsidiary the rights to resale the trademarked watches in the United States and obligates the subsidiary to pay a fixed price for the watches. The consideration for the foreign producer and subsidiary's incremental marketing activities is embedded in the transfer price paid for the watches. A comparability analysis would include consideration of all relevant facts, including the nature of the intangible embedded in the wrist-watches and in the nature of the incremental marketing activities under the agreement.

In example 3, the facts are the same except that the foreign producer manufactures athletic gear and the subsidiary manufactures and sales the athletic gear pursuant to a license agreement. The subsidiary pays the foreign producer a royalty. The consideration for the respective incremental marketing activities is embedded in the contractual terms of the license.

Example 4 has the same facts as example 3. In year 2, the subsidiary undertakes incremental marketing activities in addition to those required by the license. To the extent that it is reasonable to anticipate the incremental marketing activities will only increase the value of the license and not the value of the trademark held by the producer, the subsidiary's incremental marketing activities to not constitute a contribution for which an allocation is warranted.

In example 5, the same foreign producer and subsidiary enter into an agreement that requires the subsidiary to perform incremental marketing activities beyond that required by the license. Whether an allocation is warranted is evaluated under § 482 service regulations. Whether an allocation is warranted with respect to the royalty under the license agreement is also determined under the § 482 regulations. The comparability analysis would take into account that the compensation for the incremental marketing activities by the subsidiary is provided for in the separate agreement rather than embedded in the royalty paid for use of the trademark.

The term "incremental marketing activities" refers to activities by a controlled party that are quantitatively greater than the activities taken by comparable uncontrolled parties in

the transactions used to analyze the controlled transactions. The activities must be taken into account by either evaluating a separate transaction that accounts for such incremental activities or analyzing the underlying transaction and making necessary adjustments to uncontrolled transactions to incorporate such activities into the comparability analysis.

The preamble also states that the IRS may invoke its authority to provide contractual terms in only two situations: (i) when the controlled taxpayers fail to specify contractual terms for the transaction; or (ii) when the controlled taxpayers specify contractual terms that are not in accordance with economic substance. The IRS must impute an arrangement that best conforms to the economic substance of the transaction. The IRS may consider evidence from the taxpayer in determining what arrangement to impute. Also, the examples make clear that in certain circumstances, the IRS may have its choice of arrangements to impute.

Commentators were concerned that the IRS's authority in this regard was broader than necessary and could allow the IRS to apply commensurate with income principles to transactions that have no significant intangible property component. The preamble explains that the commensurate with income principle is consistent with the arm's-length principle and fundamentally relates to the underlying economic substance and true risk allocations inherent in the relevant controlled transactions. Further, the preamble claims, the IRS's authority to impute contingent-payment contractual terms is tailored to result in application of economic substance principles in those situations in which it is warranted.

Finally, the temporary regulations also modify the current regulations to conform to, and be consistent with, the revised language relating to controlled services transactions, picks up the concept of "shareholder activities," and cross-references the definition set forth in Temp. Treas. Reg. § 1.482-9T(1)(3)(iv).

5. Glaxo Settlement

The IRS announced that it successfully solved its transfer pricing dispute with GlaxoSmithKline, with GlaxoSmithKline remitting \$3.4 billion to the United States.

6. Glaxo Advanced Pricing Agreement

Documents filed in the GlaxoSmithKline Tax Court proceeding included the SmithKline Beecham advanced pricing agreement ("APA"), which the IRS is not otherwise authorized to disclose. In the APA, SmithKline Beecham agreed to price Tagamet using the resale price method under the § 936 cost-sharing rules. The resale price was to be calculated reducing the net trade sales for a 28% marketing commission and another 8% for Tagamet's trademark and company name, resulting in a transfer price for Tagamet sold to SmithKline Beecham by its manufacturing subsidiary of 64% of net sales. Net trade sales is defined as sales less returned items, allowances, and any cash discounts that do not exceed 2% of sales.

7. 8th Annual APA Report

The IRS issued its 8th Annual Advance Pricing Agreement Report. The IRS and taxpayers executed 82 APAs (42 unilateral, 39 bilateral, and 1 multilateral) and amended 3 APAs. Of pending requests for APAs, however, 203 are bilateral while only 46 are unilateral; 167 are requests for new APAs and 82 are pending requests for renewal APAs.

The IRS streamlined the APA process and added 8 staff members reducing the average amount of time to complete an APA from 34 months to 31 months.

The categories with the most 2006 APAs were "Electronic Equipment, Appliance and Component Manufacturing" and "Computer and Electronic Product Manufacturing." These categories accounted for 21 APAs. The "Wholesale Trade, Durable Goods" accounted for 12 APAs and the rest were divided among 20 categories. Inbound APAs accounted for 42 of the total with 36 being outbound APAs. Half of the inbound APAs were bilateral with somewhat more than half of the outbound APAs being bilateral.

The sale of tangible property into the United States was the subject of 41 APAs. The use of intangible property by a non-U.S. entity accounted for 25 APAs and the sale of tangible property from the United States accounted for 18 APAs.

The functions performed by the tested party were 64 distribution functions, 44 marketing functions, 30 transportation and warehousing functions. Manufacturing functions were performed by the tested party in 41 APAs and product assembly and/or packaging in 25 APAs. 17 APAs involved research and development functions performed by the tested party.

Comparable price method was the primary transfer pricing method used for transfers of tangible and intangible property. The primary source of comparables was Compustat, used in 73 APAs. Five years was the most common APA term with 46 APAs having such term. Only 15 APAs had rollbacks to prior years.

B. Patent Cross Licensing

The IRS issued Revenue Procedure 2007-23, which provides rules allowing taxpayers to change to, or continue to use, the Net Consideration Method with respect to qualified patent cross-licensing agreements ("QPCLA"). As defined in the Revenue Procedure, a QPCLA is a nonexclusive, nontransferable patent cross-licensing arrangement among uncontrolled parties, the subject matter of which is limited to the parties' present or future patent rights, as specified in the arrangement. If the parties to an arrangement also engage in more than de minimis licensing or other transfer of other intangible property (including copyrights, trademarks, and know how) pursuant to the arrangement, the arrangement is not a QPCLA. The determination of whether the licensing or other transfer of other intangible property is de minimis is determined under all the facts and circumstances.

Under the Net Consideration Method, only the net consideration transferred between the parties to a QPCLA during a taxable year will be taken into account for withholding purposes. "Net consideration" is defined as the amount of consideration other than license

rights and de minimis other intangible property received in the taxable year by a party pursuant to the arrangement, reduced by the amount of consideration other than license rights and de minimis other intangible property paid in the taxable year by the party pursuant to the arrangement.

A change to the Net Consideration Method is a change in accounting method for which a taxpayer must obtain IRS consent.

These procedures apply to QPCLAs entered into on or after February 14, 2007. Use of the Net Consideration Method for a QPCLA entered into prior to February 14, 2007 will not be raised as an issue by the IRS, and, if the taxpayer's use of that method is an issue under consideration in examination, in appeals, or before the U.S. Tax Court, that issue will not be further pursued by the IRS.

The Net Consideration Method applies whether the QPCLA is entered into in advance of, during, or after a patent dispute. The taxpayer, however, must take into account only net consideration for the QPCLA on its audited financial statements for years ending after February 14, 2007.

C. Binding Arbitration Procedures on International Issues

The IRS issued Revenue Procedure 2006-44, which formally establishes an arbitration program for matters before Appeals. The arbitration procedures, however, are not available for issues for which a request for competent authority assistance has been filed under the provisions of Rev. Proc. 2002-52, including issues in cases submitted to the competent authority under the simultaneous appeals procedure. If the competent authority declines assistance, the competent authorities fail to agree, or if the taxpayer does not accept the mutual agreement reached by the competent authorities, the taxpayer is permitted to refer the unresolved issues to Appeals for further consideration and may submit a request to arbitrate unresolved factual issues under this revenue procedure.

D. Space, Ocean and Communication Income

The IRS issued final regs under § 863(d) governing sourcing of income from space and ocean activities and § 863(e) governing source of income derived from international communications activities. The final regulations basically adopt the proposed regulations issued in 2005 and generally provide the standard sourcing rules that income from stated activities derived by U.S. persons is U.S. source, and income derived by foreign persons is foreign source. Exceptions apply in the case of CFCs, foreign persons engaged in U.S. trade or business, and U.S. person income attributable to functions performed, resources employed, or risks assumed in foreign country. Some modifications to the proposed regulations were also made.

A commentator to the proposed regulations noted that, in some situations, the allocation of income derived from a transaction to determine space and ocean income based on functions performed, resources employed, or risks assumed presumably would remove the subsequent need to further analyze functions performed, resources employed, or risks assumed within a country to determine the source of the space and ocean income. Thus,

the extent to which the character rules overlap with the source rules is particular to the type of transaction involved. The IRS did not follow this comment as a general matter because it felt the overlap was necessary to produce workable rules. The IRS, however, made a conforming amendment to Example 1 in § 1.863-8(f) to more clearly illustrate how the rules work. That example illustrates that the transaction involved is first classified in its entirety as a space or ocean activity, and then the resulting space and ocean income is subjected to the source rules. The space and ocean income is sourced as foreign source income to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

Additionally, § 1.863-8(a) of the proposed regulations provided that a taxpayer will not be considered to derive income from space or ocean activity if such activity is performed by another person. The approach under § 1.863-8(a) of the proposed regulations, providing that a taxpayer derives income from a space or ocean activity only if it conducts such activity directly, is consistent with the approach adopted in the § 1.863-3 regulations governing the source of income from certain sales of inventory. Accordingly, the IRS clarified its agreement with commentators that this provision assured that a content provider that retains a satellite operator to transmit programming abroad would not derive space and ocean income based on attribution of the satellite operator's activity, and modified examples to make clear that the taxpayers were directly engaged in the activities.

Commentators noted that there was little guidance as to the mechanics of allocations other than that allocations must be made under § 482 principles. While the final regulations were not changed in response to these comments, the IRS clarified that it intends for taxpayers to adopt a reasonable approach to the allocations required in this area, stating that taxpayers know their businesses and will generally be in the best position to fashion a reasonable method that most reliably reflects the relative value of functions performed, resources employed, and risks assumed in different locations. The IRS also indicated that allocations of gross income based on functions performed, resources employed, and risks assumed are appropriate in these circumstances.

Section 1.863-9(h)(3) of the proposed regulations provided that the type of communications activity (and thus the applicable source rule) is determined by identifying the two points between which the taxpayer is paid to transmit the communication. For U.S. and foreign persons, U.S. communications income is entirely U.S. source income. A taxpayer derives U.S. communications income when the taxpayer is paid to transmit between two points in the United States or between the United States and a point in space or international water. Foreign communications income is entirely foreign source income for U.S. and foreign persons. A taxpayer derives foreign communications income when the taxpayer is paid to transmit between two points in a foreign country or countries (or a possession or possessions of the United States), between a foreign country and a possession of the United States, or between a foreign country (or a possession of the United States) and a point in space or international water. Finally, the proposed regulations provided different source rules for international communications income of United States and foreign persons. A taxpayer derives

international communications income when the taxpayer is paid to transmit between a point in the United States and a point in a foreign country (or a possession of the United States). When a taxpayer cannot establish the two points between which the taxpayer is paid to transmit the communication, § 1.863-9(f) of the proposed regulation provided a default source rule under which all the income derived by the taxpayer from such communications activity is U.S. source income.

In light of the potential complexity in identifying the endpoints and, thus, the type of communications activity, the final regulations provide that a taxpayer may satisfy the requirement that the taxpayer establish the two points between which the taxpayer is paid to transmit, and bears the risk of transmitting, the communication by using any consistently applied reasonable method to establish one or both endpoints. In doing so, the taxpayer carries the burden of proof and must establish that the method used is reasonable (taking into account all of the facts and circumstances) and is consistently applied. In satisfying its burden of proof, a taxpayer will need to maintain reasonable records of communications activities.

Under the proposed regulations, a taxpayer derives income from a certain type of communications activity (for example, foreign communications or international communications) only if the taxpayer is paid to transmit, and bears the risk of transmitting (the paid-to-do rule), the communications of such type. The IRS agreed that the paid-to-do rule may be over-inclusive in certain cases. Accordingly, the final regulations provide that international communications income also includes income derived from communications activity when the taxpayer is paid to transmit foreign-originating communications (communications with a beginning point in a foreign country or a possession of the United States) from a point in space or international water to a point in the United States. Also, a new example was added to § 1.863-9(j) of the final regulations to illustrate the changes made in the final regulations with respect to foreign-originating communications.

The regulations are generally effective for tax years beginning on or after December 27, 2006.

E. Possessions

1. Residence Test

Following issuance of final regulations § 1.937-1, which provide alternatives to the 183-day rule for satisfying presence in a U.S. territory (and thereby being a bona fide resident of the territory), the IRS received comments requesting the IRS revisit the presence test. Under the amended final regulations, an individual can meet the presence test if the individual is present in the relevant territory for a simple nonweighted three-year average of 183 days per year, provided that a minimum of 60 days presence is met in each of those years. This test is in addition to the three alternatives provided by the regulations. Those three alternatives include: (1) the individual spend no more than 90 days in the U.S. during the year; (2) the individual has no more than \$3000 of earned income from U.S. sources and is present for more days in the territory than in the U.S. during the year;

or (3) the individual has no significant connection to the U.S. during the tax year. The presence test under the Code, which will still apply, requires the person be present in the territory for at least 183 days during the tax year.

2. Source Rules

The IRS issued Notice 2006-76, which provides additional examples to illustrate and confirm the application of § 937(b) and Temp. Treas. Reg. §§ 1.937-2T and -3T in determining whether income is derived from sources within a U.S. possession or territory or whether income is effectively connected with the conduct of a trade or business within a U.S. territory.

In example 1, a corporation organized in a U.S. territory is engaged in the development and sale of computer software. Its sole place of business is within the territory and it is not engaged in a U.S. trade or business. The corporation receives orders to ship its software around the world, including to the United States by disc or by download. Each transaction is classified as a sale of a copyrighted article. Under principles of § 863(a), because the corporation possessed the rights, title and interest to the copyrighted articles in the territory, its sales income is sourced to the territory and its sales income is effectively connected with a trade or business in the territory, not within the United States.

In example 2, a corporation is organized in a territory and has its sole place of business within the territory. The corporation is not engaged in a trade or business in the United States. The corporation employs a software business model generally referred to as an "application service provider." Employees of the corporation develop software and maintain it on the server in the territory. The corporation's customers around the world, including in the United States, transmit data about their customers to the server and electronic storage facility in the territory. They pay a monthly fee to use the software. Under the principles of § 861(a)(3), because the corporation performs personal services only with the territory, the compensation that it receives is sourced to the territory and is effectively connected with the territory and not the United States.

IV. Treaty Developments

A. New Treaties/Protocols

1. Denmark

A protocol was signed between the United States and Denmark providing for a zero rate of withholding on certain intercompany dividends and on dividends paid to pension funds. The protocol also revised the article on the limitations on benefits.

2. Finland

The United States and Finland signed a protocol which eliminates withholding tax on dividends arising from certain direct investments, dividends paid to pension funds, and

cross-border royalty payments. The protocol also revises the limitations on benefits article.

3. Germany

A new protocol was signed by Germany and the United States which eliminates withholding on dividends from direct investment and dividends paid to pension funds. The protocol also provides for mandatory arbitration of certain cases involving the application of residence, permanent establishment, business profits, associated enterprises, or royalties provisions that cannot be resolved by the competent authorities within two years after the start of competent authority proceedings. The competent authorities may also agree to arbitrate other subjects. The protocol also provides for a new limitations on benefits provision.

4. Iceland

The United States and Iceland entered into a new treaty which, unlike the existing treaty, contains a limitations on benefits provision.

5. Belgium

A new income tax treaty and protocol was signed by the United States and Belgium which eliminates withholding on dividends from direct investments and dividends paid to pension funds. Similarly to the new treaty with Germany, the United States -- Belgium treaty and protocol also provide for mandatory arbitration in certain cases that cannot be resolved by competent authorities within a certain period of time. The limitations on benefits provision was also modified.

6. Bulgaria

An income tax treaty was entered into between the United States and Bulgaria that reduces withholding on cross-border dividends, interest, and royalty payments. Withholding is eliminated on dividends to pension funds and interest paid to the government of the non-source country or a financial institution resident of the non-source country.

7. Canada

The United States and Canada are expected to enter into new treaty by the end of this year which would likely be effective as of January 1, 2008. The treaty would eliminate withholding on interest payments and would also allow treaty benefits for limited liability companies.

B. New U.S. Model Treaty and Treasury Explanation

Treasury released a new model treaty and explanation. Unlike many recent treaties to which the United States is a party, the new model treaty does not provide a zero rate of

withholding on dividends for direct investment nor does it contain an arbitration provision.

The definition of "permanent establishment" was changed in the model treaty. The previous model treaty stated that maintenance of a fixed place of business solely for any combination of activities exempt from permanent establishment status will not constitute a permanent establishment. The Treasury position was that if each activity was exempt, the combination of activities would also be exempt. The new treaty limits this exemption by stating that the overall activity of the fixed place of business resulting from the combination must be preparatory or auxiliary in character. The definition of business profits, under Article 7, attributable to a permanent establishment was also modified to include profits derived from "risks assumed" by the permanent establishment as well as assets used and activities performed by the permanent establishment in the previous model treaty.

The dividends article addresses pension funds and dividends paid by a RIC or a REIT.

The term "computer software" was removed from the royalties article. The Technical Explanation gives as the reason for this change that whether computer software will be treated as royalties or business profits will depend upon the nature of the rights transferred.

A new article entitled "Income from Employment" was added to the new model treaty. Also, the term "artistes" was replaced by "entertainers and sportsmen."

The limitations on benefits provision was substantially rewritten with the relative size safe harbor being removed from the determination of whether an entity is engaged in the active conduct of a trade or business. This determination would be made based on all of the facts and circumstances and the relative size of the economies in the two countries at issue must be considered.

Article 23, "Relief from Double Taxation", now contains a re-sourcing rule for gross income to ensure that a U.S. resident can obtain appropriate amounts of U.S. foreign tax credit for income taxes paid to the other contracting state. If the treaty allows the other contracting state to tax an item of gross income, the United States will treat that item of gross income as gross income from foreign sources.

The exchange of information provisions were also modified in the new model treaty.

The Technical Explanation contains a lengthy discussion of fiscally transparent entities, and defines "pension fund."

The Technical Explanation also addresses dual resident companies. If a company is incorporated under the laws of any state in the United States and is also a resident of the other country party to the treaty because of its place of effective management, then the entity will only be a resident of the United States. Otherwise, the competent authorities are directed to try to determine a single state of residency. If they cannot agree, the company will only be entitled to the benefits of the treaty that are not limited to residents.

The company may also be treated as a resident of either contracting state for purposes other than obtaining benefits under the treaty.

The Technical Explanation also modified the rules for deductions in computing business profits of a permanent establishment. It applies an arm's-length principle to the amount of an expense that can be deducted. The permanent establishment may deduct payments to its head office or other branch as compensation for services performed for the benefit of the permanent establishment.

The Technical Explanation also discusses the concept of beneficial owner at length, though it provides that the term is defined in accordance with the internal law of the country imposing the tax. The Technical Explanation also addresses hybrid entities in which the person deriving the income is not synonymous with the beneficial owner.

Interesting, the Technical Explanation does not contain an arbitration provision although the recent treaties between the United States and Germany and the United States and Belgium do.

C. Competent Authority

1. New Procedures

The IRS issued Revenue Procedure 2006-54 updating procedures for competent authority requests. Section 7, "Coordination with Other Administrative or Judicial Proceedings" was modified in several respects. First, the Revenue Procedure now provides that taxpayers requesting unilateral withdrawal of a U.S. adjustment without consultation with the treaty country must address the request to IRS appeals rather than to the U.S. competent authority. Second, if a taxpayer is not using the Simultaneous Appeals procedure and enters into a settlement with IRS Appeals before making a competent authority request, the competent authority may consider, but would not be bound by IRS Appeals views of the case. Third, if the taxpayer enters into the arbitration program with IRS Appeals, the taxpayer may not request competent authority assistance until the arbitration is complete, unless the taxpayer can demonstrate that the period of limitations is approaching expiration.

Section 7.05 "Effect of Agreements or Judicial Determinations on Competent Authority Proceedings" was also modified to include a parenthetical extending to settlements through arbitration the rule that if a taxpayer executes a closing agreement or reaches a settlement with respect to an issue, the competent authority will seek only to obtain a correlative adjustment from the treaty country but will not otherwise change the agreement. Section 7.06 now states that the accelerated competent authority procedure is now implicitly invoked if a taxpayer requests a rollback of its requested bilateral accelerated competent authority procedure to years already filed.

Section 9.03(3) changes from six months to twelve months the frequency with which a taxpayer filing a protective claim had to inform the competent authority of its intent to request assistance prior to doing so.

Section 12.02(8) adds to the list of situations under which the competent authority assistance will cease or be denied. Now assistance will also be denied or ceased if the transaction giving rise to the request for assistance is a listed transaction.

A \$15,000 user fee will apply to all requests for determination on limitations of benefits regardless of whether the request is for an initial determination, a renewal of a previously issued determination, or a supplemental determination. This change was already announced in Revenue Procedure 2006-26, which also provided that no refunds would be issued if requests were withdrawn except in the discretion of the competent authority.

The Revenue Procedure requires that requests now also be submitted in electronic form.

2. Limitation on Benefits Active Business Requirement

In Private Letter Ruling 200620017, the IRS ruled on the active trade or business requirement in the limitations on benefits provision of a U.S. treaty. In this case, the taxpayer, a country A entity, is a wholly-owned subsidiary of a publicly traded parent in country B. The parent is engaged in a service business and related businesses through various subsidiaries and would be entitled to the benefits of the U.S. treaty with country B. The taxpayer's business is to finance the parent's and affiliates' world-wide activities, including those activities of a U.S. subsidiary. The taxpayer has loans outstanding to the U.S. group which represent less than 15% of its total assets. Taxpayer also provided funds to the acquisition of a country A subsidiary. Both the U.S. subsidiary and the country A subsidiary are engaged in the service business of the parent and are among the largest providers of that service in their respective countries.

The IRS ruled that (i) the parent could be the indirect common owner for purposes of determining whether the taxpayer and members of the country A group were connected for purposes of the U.S. treaty with country A; (ii) the taxpayer would be viewed as engaged in the active conduct of a trade or business of the country A resident corporations; and (iii) the taxpayer should determine whether its country A trade or business is substantial in relation to its U.S. trade or business by comparing the size and nature of the trade or business conducted in country A with the size and nature of the trade or business in the U.S. that give rise to the items of income, e.g., comparing relative asset values, income, and payroll expense of the members in each country.

3. Agreement with the United Kingdom on Dual Consolidated Losses

The United States and the United Kingdom reached an agreement to overcome the mirror legislation rule which barred a taxpayer from taking a loss in the United States that was not allowed as a loss in the United Kingdom pursuant to U.K. § 403D(6) of the U.K. Income and Corporation Taxes Act of 1988, preventing the taxpayer from claiming a loss in either country.

The agreement allows a consolidated group of which a domestic owner is a member (or an unaffiliated domestic owner) that has a permanent establishment in the United States to elect annually for accounting periods after April 1, 2005 whether to take the loss in the United States or the United Kingdom if the taxpayer is otherwise subject to the mirror

rule and the U.K. bar on the loss. Elections may not be made for prior years unless the period for claiming such loss remains open in both the United States and the United Kingdom. The agreement does not apply when the losses are incurred by a dual-resident corporation, other than to the extent a U.K. permanent establishment is treated as a dual-resident corporation, by a hybrid entity separate unit, or by a separate unit within the meaning of the dual consolidated loss regulations.

D. List of "Qualified Foreign Corporations" for Purposes of § 1(h)(11) (15% Dividend Rate)

Notice 2006-101 lists the U.S. tax treaties that meet the requirements of § 1(h)(11) of the Code. Treaties with Bermuda, the Netherlands Antilles, and the Soviet Union (which applies to former Soviet Union republics) do not qualify. The treaty with Barbados has been added to the list of treaties that qualify. Also added to the list are treaties with Sri Lanka and Bangladesh, which have entered into force since the time of the last list in Notice 2003-69.

V. Proposed Legislation

A. Codification of Economic Substance

The chairperson of the Joint Committee on Taxation issued a proposal in July 2006 to modify the Telephone Excise Tax Repeal Act of 2005 and the Taxpayer Protection and Assistance Act of 2005 to include a codification of the economic substance doctrine. The Senate again was expected to take up this issue in May or June of 2007. The proposal would include penalties on taxpayers whose transactions did not meet these requirements. The proposal comes on the wake of the Supreme Court's decision not to hear appeals in the Dow Chemical and Coltex cases. These cases turned on the judicial interpretation of the economic substance doctrine. In both cases, the IRS rulings on economic substance were upheld. Some commentators argue that the Supreme Court's decision is an indication that the Court believes that the court system is correctly applying the doctrine on a case-by-case basis and no codification is necessary.

B. International Bills

The Administration's Revenue Proposal for 2008 contains a proposed changes to § 163(j). These changes would eliminate the current safe harbor provision that applies when the taxpayer's debt to equity ratio is no more than 1.5 to 1. The adjusted taxable income threshold would also be reduced from the current 50% to 25%. Interest on guaranteed debt, however, would continue to be subject to the 50% threshold. The indefinite carryforward for disallowed interest under the adjusted taxable income limitations of current law would be limited to ten years and the three-year carryforward of excess limitations would be eliminated.

The Stop Tax Haven Abuse Act introduced in Congress earlier this year sets forth a list of thirty-four "offshore secrecy jurisdictions." If a U.S. person directly or indirectly formed, transferred assets to, was a beneficiary of, or received distributions from, an offshore secrecy jurisdiction entity, such person will be presumed to have exercised control over

the entity. Any amount transferred to a U.S. person directly or indirectly from an account or entity in an offshore secrecy jurisdiction, or transferred from such a U.S. person directly or indirectly to an account or entity in an offshore secrecy jurisdiction, will be presumed to represent previously unreported income to the U.S. person in the year of transfer. These presumptions are rebuttable by clear and convincing evidence. The bill would also prevent charging a fee for tax services based on tax savings. The bill would contain additional disclosures and fees for failure to disclose.

C. Carried Interest to Generate Ordinary Income

As reported in the press, members of the Senate Finance Committee and House Ways and Means Committee may be considering legislation that would effectively treat amounts paid to managers or sponsors of investment funds as compensation income taxable at ordinary rates (up to 35%), rather than as partnership income (taxable at 15% if capital gain). As a result, managers and fund sponsors who currently are entitled to pay tax on their carried interest at the capital gains tax rate would see their tax burden increased. Additionally, a bill was introduced in the Senate that would tax as corporations all publicly traded partnerships that derive most of their income by managing other people's assets.

VI. IRS/Treasury Top International Projects

In August, 2006, the IRS and Treasury released their 2006-2007 priority guidance plan for the 2006 through 2007 year. The plan includes issuing guidance regarding subpart F issues including those resulting from the Jobs Act and the TIPRA. The IRS also stated that guidance under § 959 is a priority, and in August issued proposed regulations pursuant to § 959. The IRS indicated that it expected to issue guidance on the tax treatment of cross-licensing arrangements, international restructurings, and expense apportionment (including issues relating to partnership structures). In February, 2007, the IRS issued Revenue Procedure 2007-23, which addresses patent cross-licensing. Additionally, the IRS expects to issue regulations under § 367(d) and § 482 (dealing with services and cost sharing). No new regulations have been proposed under those sections, however, since the temporary regulations under § 482 in July 2006. The IRS also indicated that it expected to issue guidance under § 987 and § 1503(d). As described above, new final regulations on the dual consolidated loss rules of § 1503(d) were issued in December 2006 and regulations were proposed under § 987 in September 2006.

VII. Joint Committee Tax Policy Report

The Joint Committee issued a report on the impact of a shift to a territorial tax system. Under such a system, income from foreign sources would be exempt from tax. Accordingly, corresponding deductions for foreign income, e.g., interest deductions that are attributable to earnings from foreign source, would no longer be available. The Joint Committee Report concluded that one significant result of such a shift would be that the impact of transfer pricing decisions would also become more important. Under the current transfer pricing regime, the income is either currently taxed or deferred; a move to a territorial tax system would require that the income either be currently taxed (if U.S.

source) or permanently exempt (if foreign source). The report also noted that a territorial tax system would not effect all taxpayers equally but would be beneficial to some taxpayers, detrimental to others, and irrelevant to still others. For example, taxpayers who receive income from CFCs located in low tax jurisdictions would benefit as those earnings would be subject only to the low tax rate. Taxpayers who receive income from CFCs in high jurisdictions would suffer if they are no longer able to apply the foreign tax credit for those taxes paid in the higher jurisdiction. Still other taxpayers, such as a taxpayer whose sole activity is exportation, may be unaffected by the change.