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Tax Planning for Foreign Expansion by U.S. Petroleum Companies

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TAX PLANNING FOR FOREIGN EXPANSION BY U.S. PETROLEUM COMPANIES

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I. INTRODUCTION

The purpose of this article is to provide a basic overview of the tax planning considerations for expansion in foreign petroleum exploration and production operations by U.S. oil companies, with two typical examples of reorganizing foreign branches of U.S. corporations into foreign corporations. U.S. companies have many options in deciding how to begin and expand foreign operations--from the debt capitalization and financing of a foreign entity to the contribution of property to a foreign entity. Domestic companies may begin foreign operations through a foreign branch to allow a flow-through treatment of expenses and losses and subsequently may incorporate the branch into a foreign corporation after the start-up stage to defer U.S. taxable income until repatriation of earnings and profits through dividends to the U.S. shareholder.

Although prior branch losses are recaptured, either through foreign tax credit resourcing or upon a taxable foreign incorporation, a U.S. taxpayer has the advantage of current cash flow and the benefit of the time value of money in U.S. tax savings derived from immediate deductions. Contribution of property can result in taxable income, depending upon the entity classification of the parties and whether the stock or the active trade or business exception applies to exempt gain recognition. The sale or exchange of foreign corporation stock can result in a deemed dividend treatment of any gain recognition.

II. FOREIGN ENTITY CLASSIFICATION

Although the foreign laws of a host country treat a U.S.-owned entity in the country as a corporation, the U.S. tax treatment for the U.S.

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parent corporation of the foreign entity depends upon the foreign enterprise's classification under U.S. tax principles as either a partnership, corporation, trust, or a foreign branch. Under U.S. Treasury Regulations (the "regulations"),[1] the Internal Revenue Service (the "Service") simplified entity classification by allowing a taxpayer an elective "check-the-box" method for treating a foreign entity as a corporation, a partnership, or a foreign branch for U.S. tax purposes.[2]

The new regulations allow the freedom to select the appropriate foreign entity without imposing the prior business constraints on the foreign parties to achieve or fail the majority of the traditional corporation characteristics under the old regulations. A taxpayer may require a classification change for an existing entity to achieve a certain tax treatment, or for particular business reasons. However, the conversions by election from partnership to corporation or from corporation to partnership may result in a taxable event.[3]

The regulations under this elective regime make an exception to the optional status of foreign entities with a *per se* corporation rule for specific foreign entities.[4] The regulations classify a list of 80 foreign business entities, subject to certain exceptions, as corporations for U.S. tax purposes. A foreign entity, not classified as a *per se* corporation, is referred to as an "eligible entity" and is considered an "unincorporated entity."

Only an eligible entity can elect its federal tax classification under the new regulations. An eligible entity, having at least two members, can elect to be classified as an association (a corporation under Section 301.7701-2(b)(2)) or a partnership.[5] An eligible entity with a single member can be classified as an association or disregarded as a separate entity separate from its owner (i.e., treated as a foreign branch).[6]

Eligible entities elect only if they do not want their "default classification," or they want to change their classification.[7] A foreign

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[1] Except as noted, all statutory and section references are to the Internal Revenue Code of 1986 (26 U.S.C.), as amended, and all regulation references are to the U.S. Treasury Regulations.

[2] T.D. 8697 (1996), 1997-2 I.R.B. 11.

[3] *See* B. Davis, *International Tax Planning Under the Final Check-the-Box Regulations*, TAX MANAGEMENT INTERNATIONAL JOURNAL, Vol. 26, No. 1, 3 (Jan. 10, 1997).

[4] Treas. Reg. § 301.7701-2(b)(8) (1997).

[5] Treas. Reg. § 301.7701-3(a) (1997); *see* Treas. Reg. § 301.7701-3(c)(1)(i) (1997) (foreign business entity election). The term partnership means a partnership as determined under §§ 301.7701-1, 301.7701-2 and 301.7701-3. Treas. Reg. § 1.761-1(a) (1997).

[6] Treas. Reg. §§ 301.7701-1(a)(4), -2(c)(2), -3(a) (1997).

[7] Treas. Reg. § 301.7701-3(a) (1997).

entity, failing to make an election, is subject to the default classification.[8] Under the default classification rules, a foreign entity is (1) classified as a partnership if it has two or more members and any member has unlimited liability, (2) classified as an association if no member has unlimited liability, or (3) a foreign branch if it has a single owner with unlimited liability.[9]

Classification, as a taxable entity in one country and a flow-through entity under the laws of another country, creates an inconsistent entity. A hybrid entity is a foreign entity classified as a partnership for U.S. tax purposes and a taxable entity in the foreign country. A reverse hybrid entity is a foreign entity classified as an association taxable as a corporation for U.S. tax purposes and a partnership for foreign tax purposes. The differences in the U.S. tax treatment are significant between a foreign corporation classification and a foreign partnership classification. Although the regulations do not contain any restrictions on hybrid entities, the *per se* foreign corporation list would limit some hybrid situations in particular countries.

In Notice 98-5, the Service indicates that future regulations may address hybrid entity structures and transactions intended to create a significant mismatching between the time foreign taxes are paid or accrued and the time the foreign-source income giving rise to the foreign tax liability is recognized for U.S. tax purposes.[10] The future regulations could either defer the tax credits until the taxpayer recognizes the income, or accelerate the income recognition to the time of credit allowance.[11] The Service is not interested in the mismatching that occurs with hybrid entities involved in legitimate business transactions, but with abusive mismatching that occurs without any business purpose for the structure or transaction.

Corporate shareholders, owning at least ten percent but less than fifty percent of a foreign corporation, are subject to a foreign tax credit limitation, requiring income to be placed in a separate noncontrolled section 902 statutory category.[12] The foreign tax credits from each noncontrolled corporation are computed separately.[13]

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[8] Treas. Reg. § 301.7701-3(b)(2) (1997).

[9] *Id.*

[10] Notice 98-5, 1998-3 I.R.B. 49, 52.

[11] *Id.*

[12] I.R.C. § 904(d)(2)(E) (1997) (defining "noncontrolled section 902 corporation").

[13] I.R.C. § 904(d)(1)(E) (1997). For taxable years after 2002, the separate 10/50 baskets for dividends from all noncontrolled § 902 corporations that are not passive foreign investment companies ("PFIC") as defined in § 1296 are merged into a single 10/50 basket. I.R.C. § 904(d)(2)(E) (1997).

However, there is no limitation on cross-crediting if the foreign corporation is treated as a partnership for U.S. tax purposes.

Section 902 credits incurred by a first-tier foreign corporation are claimed only by U.S. shareholders, holding at least ten percent of the voting power.[14] If the foreign entity is treated as a partnership for U.S. purposes, all U.S. interest owners can claim tax credits as a partner.[15] Indirect stock ownership flows up through the chain of foreign entities, ending with the first U.S. person in the chain. Indirect tax credits are claimed only for taxes incurred down to the sixth-tier foreign corporation. A foreign entity treated as a partnership for U.S. tax purposes is not counted under the sixth-tier limitation for indirect tax credits.

Since the foreign tax credit is limited to the U.S. tax on foreign source income of the taxpayer, any excess credits may be carried back two years and forward five years. The carryback/carryforward period begins for a partnership or a branch operation in the year in which the tax is paid or accrued. The period does not begin to run for a foreign corporation until the year in which the earnings and profits with the prorated taxes are repatriated to the U.S. shareholder as dividends.

The timing flexibility of the indirect foreign tax credit under Section 902 applies only to foreign taxes paid by a foreign corporation.[16] By contrast, a U.S. corporation, holding an interest in a foreign partnership, claims direct section 901 foreign tax credits for the taxes in the year paid by the partnership.

The rules under subpart F,[17] pertaining to U.S. persons with

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[14] I.R.C. § 951(b) (1997) (stating that a U.S. shareholder is a U.S. person who owns, directly or indirectly, at least 10% of the total combined voting power of all classes of stock in the foreign corporation). The constructive ownership rules of § 318(a), as modified by § 958(b), apply.

[15] I.R.C. § 702(a)(6) (1997). *See* Rev. Rul. 71-141, 1971-1 C.B. 211 (the § 902 credit with respect to foreign stock held by a partnership flowed through to a domestic corporation - two 50% domestic corporate general partners of a domestic general partnership allowed to claim foreign tax credits under § 902 for foreign taxes paid by a foreign corporation in which the partnership owned 40% of the voting stock).

[16] I.R.C. § 902 (1997) (stating that the deemed paid tax credit applies pro rata upon the distribution of dividends).

[17] I.R.C. §§ 951-964 (1997). Subpart F income is easily shifted among different tax jurisdictions and subject to tax haven manipulation. The subpart F provisions restrict the ability to defer U.S. taxation on certain income of a CFC, functioning only as a middleman for another corporation in another country, and the income is not repatriated to the U.S. shareholders. A U.S. shareholder of a CFC includes in U.S. taxable income as a deemed dividend its pro rata share of the subpart F income earned by the CFC.

interests in a controlled foreign corporation ("CFC"),[18] may deem dividend payments to the U.S. shareholder for subpart F income. If the CFC is a partner in a foreign partnership, the character of the income included in the CFC's distributive share of partnership income is determined as if the CFC received the income directly.[19]

Members of a U.S. consolidated group may transfer assets among the members under the nonrecognition of gain treatment rules for incorporations or reorganizations[20] or by the deferred intercompany gain rules of the consolidated return regulations.[21] For outbound transfers of assets, transfers under Section 367 exceptions to gain recognition may apply to transactions involving entities classified as corporations. If the transferring entities are not given corporate status under a Section 367 exception, the transfer is taxable. For entities with corporate status, gain recognition agreements may be required to maintain nontaxable transfers.

If the foreign entity, transferring assets, is treated as a partnership for U.S. tax purposes, the partnership rules under Sections 701 through 761 apply. If the interest transferred represents more than fifty percent of the total capital or profits interest in the partnership, the transaction results in a deemed liquidation of the partnership.[22] If partners transfer partnership assets to another domestic partnership entity, the contribution is usually nontaxable under Section 721. However, gain recognition under Section 721(c) may be imposed on the property transferred to foreign transferees.

Both a U.S. shareholder of a foreign corporation and a U.S. partner in a foreign partnership are subject to the reporting requirements under Section 6038. Both a U.S. shareholder of a CFC and a U.S.

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[18] A CFC is defined as a corporation, in which more than 50% of either the voting power or value of the stock of the corporation is owned by U.S. shareholders on any day during the tax year of the foreign corporation. I.R.C. § 957(a) (1997). A U.S. shareholder is defined as a U.S. citizen or resident, a domestic corporation, or a partnership, estate or trust that owns 10% or more of the voting stock of the foreign corporation. I.R.C. §§ 951(b) and 958 (1997). The constructive ownership rules of § 318(a), as modified by § 958(b), are used to determine whether U.S. persons are U.S. shareholders for CFC status. I.R.C. § 958(b) (1997).

[19] Treas. Reg. §§ 1.904-5(h)-(i) (1997) (defining look-through rules for partnerships and related entities). *See* Rev. Rul. 89-72, 1989-1 C.B. 257 (stating that a CFC's distributive share of partnership income from the sale of machines by the partnership is treated as foreign base company sales income).

[20] *See* I.R.C. §§ 332 (regulating liquidations of subsidiaries), 351 (regulating property transfers to a controlled corporation), 354 (regulating exchanges of stock and securities), 356 (regulating receipt of additional consideration) and 361(regulating nonrecognition to corporations) (1997).

[21] Treas. Reg. § 1.1502-13 (1997).

[22] I.R.C. § 708(b)(1)(B) (1997).

partner that controls a foreign partnership by holding more than a fifty percent interest in the capital or profits of the partnership, or the partnership's losses are required to file an annual information return.[23] Reporting by a U.S. person of an acquisition or disposition of an interest in a foreign partnership, or a change in the person's proportionate interest in the partnership, is required with acquisitions, dispositions, or changes of at least a ten percent interest.[24]

Although the sale of the stock of one foreign subsidiary to another may result in some or all of the gain to be treated as a deemed dividend in the U.S.,[25] the sale provides the benefits of the 904 general basket income under the look-through rules, deemed-paid foreign tax credits and profit repatriations without the imposition of foreign withholding taxes on actual dividends. If the foreign entity being sold is treated as a foreign partnership for U.S. tax purposes, the selling partners would recognize capital gain on the sale. If the seller of a partnership interest is a U.S. person, the gain is U.S. source income.[26] If the seller is a CFC, the gain is foreign source passive income and subpart F income.[27]

To defer U.S. tax on foreign source income, U.S. companies typically will form an offshore holding corporation, using transparent entities for U.S. tax purposes down the ownership chain. Under the "check-the-box" regulations, transparent foreign entities with two or more owners are treated as partnerships and entities with only one owner can be disregarded or treated as a branch. The Service is concerned by the use of hybrid branches to reduce foreign source income and taxes and concurrently to defer U.S. taxes.

Under Notice 98-11, the Service announced plans to issue regulations, concerning the use of "hybrid branch" arrangements to reduce foreign tax and avoid subpart F income.[28] Recently, the Service issued temporary regulations under section 1.954-9T on hybrid branches.[29] The regulations re-characterize certain hybrid branch payments as subpart F income.[30]

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[23] I.R.C. §§ 6038(a) and 6038(e)(3) (1997).

[24] I.R.C. § 6046A(a) (1997).

[25] I.R.C. § 304 (1997). Dividends paid by one CFC to a CFC in a different country are treated as subpart F income. I.R.C. § 954(c)(1)(A) (1997).

[26] I.R.C. § 865(a)(1) (1997) (stating capital gains from the disposition of a partnership interest sourced based upon the seller's residence).

[27] I.R.C. §§ 904(d)(2)(A), 954(c)(1)(B)(ii) (1997).

[28] Notice 98-11, 1998-6 I.R.B. 18.

[29] T.D. 8767, 98 TNI 34 (effective March 23, 1998).

[30] Temp. Treas. Reg. § 1.954-9T(a)(1).

A hybrid branch is one that is treated under U.S. tax principles as fiscally transparent and a part of a CFC, but under the laws of the CFC's country of incorporation as an entity separate from the CFC.[31] A U.S. shareholder of a CFC includes in gross income its pro rata share of subpart F income earned by the CFC.[32] Subpart F limits the deferral of U.S. taxation of a CFC's subpart F income.

Multinational taxpayers can use hybrid branches to circumvent the purposes of subpart F.[33] The arrangements usually involve deductions which reduce the CFC's subpart F income under foreign law and the CFC's foreign tax credit and shift the subpart F income to a separate entity under foreign law.[34] These arrangements create in another entity low-taxed, passive income of the type to which subpart F was intended to apply.[35] The "subpart F income" under the hybrid branch arrangement is not treated as subpart F income and thus is not subject to U.S. taxation.[36]

The subpart F provisions define specific categories of income subject to current taxation.[37] The primary category for potentially abusive foreign operations is the foreign base company income ("FBCI").[38] FBCI includes the following types of income: (1) foreign

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[31] Temp. Treas. Reg. § 1.954-9T(a)(6).

[32] A U.S. shareholder that is required to include undistributed earnings and profits of a CFC in income under the subpart F provisions is also deemed to have paid a pro rata share of the foreign taxes paid by the CFC. I.R.C. § 960; Treas. Reg. § 1.960-1(foreign tax credit from a CFC).

[33] T.D. 8767; Notice 98-11 at 18. Transactions of CFCs that involve related parties frequently give rise to subpart F income unless an exception, such as a CFC engaged in an active business in the same country, applies. Related party transactions are easily manipulated to reduce both U.S. and foreign taxes. One of the purposes of Subpart F is to prevent CFCs from structuring transactions designed to manipulate the inconsistencies between foreign tax systems to inappropriately generate low- or non-taxed income on which U.S. tax might be permanently deferred. *Id.*

[34] T.D. 8767; Notice 98-11 at 18.

[35] T.D. 8767; Notice 98-11 at 18.

[36] T.D. 8767; Notice 98-11 at 18. As illustrated by examples in the temporary regulations and in Notice 98-11, a CFC in Country A has a fiscally transparent branch in Country B under U.S. tax law, but both the CFC and its branch are classified as separate, non-fiscally transparent entities under the laws of Countries A and B. The branch makes a loan to the CFC, which creates an interest deduction against taxable income for the CFC under the laws of Country A with little or no tax being paid by the branch to Country B on the interest income. The loan arrangement (known as an "earnings stripping" arrangement) shifts a tax base equal to the interest payment from a high-tax country to a tax haven country. As a branch under U.S. tax law, the interest payments are not recognized as subpart F income under section 954(c) and the CFC has lowered its foreign tax on deferred income.

[37] The basic categories of income are (1) insurance income, (2) foreign base company income, (3) international boycott income, (4) income resulting from illegal bribes and kickbacks and (5) activities carried on in certain foreign countries not recognized by the U.S. government. I.R.C. § 952(a).

[38] I.R.C. §§ 952(a)(2) and 954 (foreign base company income); Treas. Reg. § 1.954-1.

personal holding company income ("FPHCI"), (2) foreign base company sales income ("FBCSI"), (3) foreign base company services income ("FBCSEI"), (4) foreign base company shipping income ("FBCSHI"), and (5) foreign base company oil related income ("FBCORI").[39] However, the oil and gas working interest income (i.e., the foreign oil and gas extraction income ("FOGEI")) and the gain from the sale of a working interest of a CFC are not subpart F income.[40]

The subpart F income re-characterization would apply only to hybrid branch payments if: (1) a hybrid branch payment is made between a CFC and its hybrid branch; (2) the payment reduces foreign tax; (3) the payment is categorized as FPHCI; and (4) the hybrid is located in a low-tax or no-tax jurisdiction (i.e., a tax haven country).[41] Also, the potential re-characterization can apply to hybrid branch payments involving partnerships in which a CFC is a partner, either directly or through one or more branches or other partnerships.[42]

Previously, a branch rule under Section 954(d)(2) was enacted to prevent a similar situation for FBCSI.[43] The branch rule pertains to the avoidance of subpart F taxation through the use of a branch of the CFC outside the country in which the CFC is organized, and the foreign tax treatment of the use of such branch has substantially the same effect as if the branch were a separately incorporated subsidiary.[44] Section 954(d)(1) is concerned with the sales income of a selling subsidiary, which is separated from the manufacturing activities of a related corporation to achieve a lower tax rate on the sales income.[45] Sales income[46] derived in certain situations by a foreign branch of a CFC that

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[39] I.R.C. §§ 954(a) and 951(a)(1)(A)(i).

[40] I.R.C. § 954(g)(1).

[41] Temp. Treas. Reg. § 1.954-9T(a)(1) and -9T(a)(5)(iv)(tax disparity rule); Notice 98-11 at 18. The amount of recharacterized income will equal the gross amount of the hybrid branch payment limited by the amount of the CFC's earnings and profits attributable to nonsubpart F income. There is no carryover or carryback of any excess recharacterized income. Temp. Tres. Reg. § 1.954-9T(a)(5).

[42] Temp. Treas. Reg. § 1.954-9T(a)(2)(i)(C), (D) and -9T(a) (2)(ii).

[43] S. REP. NO. 87-1881 (1962), 1962-3 C.B. 790.

[44] *Id.*

[45] H.R. REP. NO. 87-1447 (1962), 1962-3 C.B. 405, 466.

[46] Foreign base company sales income ("FBCSI") is income derived from the purchase or sale of personal property from or to, or on behalf of, a related person if such property (1) is manufactured, produced, grown or extracted outside the country of incorporation of the CFC and (2) is sold or purchased for use, consumption or disposition outside the country of incorporation of the CFC. Personal property sold to an unrelated person outside of the CFC's country is presumed to be sold for use in the country of distribution. I.R.C. § 954(d)(3) (1997) (defining "related person" as more than 50% ownership under the attribution rules). Section 954(d)(3) defines related person to include a corporation controlled by a CFC. A partnership, in which a CFC is a controlling partner, is a related person within the meaning of Section 954(d). I.R.C.

is treated as a separately incorporated foreign subsidiary of the CFC gives rise to FBCSI of the CFC.[47]

III. DEBT CAPITALIZATION AND FINANCING OF FOREIGN ACTIVITIES

The selection of the appropriate methods to finance operations, purchase assets, reinvest liquid assets and meet working capital requirements may necessitate the use of debt, the use of hybrid and risk-covering instruments, or the use of financial arrangements through a "foreign treasury center" subsidiary. To reduce the risk in crude oil pricing and currency fluctuations, companies may enter into hedging transactions. In the use of debt in the capital structure of foreign operations, U.S. companies must be careful to avoid debt-equity re-determinations and must consider under the regulations the interest capitalization rules and the allocation and apportionment rules for interest expense deductions.

The double taxation of dividend income creates an incentive for using debt capital rather than equity capital to finance a foreign entity. Also, a dividend received by a domestic corporation from at least a ten percent owned foreign corporation is allowed the Section 243 deduction only on the U.S.-source portion of such dividend and then any foreign tax credits on the U.S.-source portion are disallowed.[48]

The use of debt in the capital structure of a foreign company can be advantageous, with a return of capital through principal payments being nontaxable and interest being deductible for foreign income tax purposes by the foreign corporation. Under many tax

§ 954(d)(1) (1997); Treas. Reg. § 1.954-3(a) (1997) (regulating foreign base company sales income). FBCSI is not limited to income from the purchase and sale of personal property, but includes commissions, fees and any other income related to the purchase and sale activity. I.R.C. § 954(d)(1) (1997); Treas. Reg. § 1.954-3(a)(1)(i) (1997). Treas. Reg. § 1.954-3(a)(3)(ii) (1997) (outlining rules for determining country of use, consumption or disposition).

[47] I.R.C. § 954(d)(2) (1997); Treas. Reg. § 1.954-3(b) (1997) (stipulating that the branches of a CFC are treated as separate corporations). The courts applied the "normal and customary" meaning to the term "branch" and held that the term means "a division, office or other unit of business located at a different location from the main offices or headquarters." Ashland Oil Inc. v. Commissioner, 95 T.C. 348 (1990) (The Tax Court was defining "branch or similar establishment" under I.R.C. § 954(d)(2). *Id.* In *Ashland Oil*, an unrelated manufacturing corporation in Belgium was held not to be a branch or similar establishment of a CFC organized in Liberia within the meaning of Section 954(d)(2). *See* Vetco, Inc. v. Commissioner, 95 T.C. 579 (1990) (involving the sale of equipment used in exploring and drilling for oil and the court's consideration of the branch rule for purposes of Section 954(d)(1)).

[48] I.R.C. § 245(a) (1997) For example, the "U.S.-source portion" may represent the earnings and profits effectively connected with a trade or business within the U.S. and subject to U.S. tax. *Id.*

treaties, interest income is exempt from withholding tax or greatly reduced, unless the interest income is effectively connected with a permanent establishment maintained by the creditor in the source country.

Also, interest income received by a U.S. corporation from a CFC can be included in the numerator of the Section 904(d)(1)(I) overall foreign tax credit limitation fraction, which increases the allowable foreign tax credit for foreign taxes that otherwise would not be creditable.[49] A potential problem is that the Service may treat a loan from a U.S. shareholder to its CFC for U.S. tax purposes as a contribution of equity.[50] An equity re-characterization could change principal and interest payments into a stock redemption, resulting in a nondeductible "dividend" for the payor.[51] Additionally, the payor would be required to withhold taxes at the rate applicable to dividends under any existing treaty.

However, capitalizing a foreign subsidiary with equity may result in greater dividend distributions, which may generate much needed overall deemed paid foreign tax credits to reduce overall foreign source taxable income. Also, the withholding tax on dividend payments to foreign shareholders is greatly reduced under many tax treaties.

The U.S. tax characterization of an instrument as either debt or equity is based upon considering the economic substance of the instrument rather than its legal form in determining whether there is a certainty of principal and interest payment.[52] The debt-equity determination of "thin capitalization" under federal tax law is dependent on the specific facts and circumstances involved with the advance at the time of the transaction.[53] Many foreign tax jurisdictions have "thin capitalization" rules, which could result in debt re-

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[49] I.R.C. § 904(d)(3) (1997) (discussing look-through for CFC).

[50] I.R.C. § 385 (1997) (treating certain interests in corporations as stock or indebtedness).

[51] I.R.C. § 302 (1997) (distributions in redemption of stock).

[52] Section 385(b) lists possible factors to consider in determining whether a debtor-creditor relationship exists or a corporation-shareholder exists. The factors may include, among others: (1) whether there is a written unconditional promise to pay on demand or on a specific date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed interest rate; (2) whether there is subordination to or preference over any indebtedness of the corporation; (3) the ratio of debt to equity of the corporation; (4) whether there is convertibility into the corporate stock; and (5) the relationship between holdings of the corporation stock and holdings of the interest in question. I.R.C. § 385(b) (1997).

[53] I.R.C. § 385(b) (1997); Fin Hay Realty Co. v. United States, 398 F.2d 694, 698 (3rd Cir. 1968).

characterization and interest expense disallowance or deferral.[54] However, some U.S. income tax treaties override these rules.

Since some foreign jurisdictions consider the legal form of an instrument in characterizing it as debt or equity for local tax purposes, foreign subsidiaries may be capitalized by a hybrid instrument[55] that is treated as equity for U.S. tax purposes[56] and debt in the particular foreign tax jurisdiction. Along with structuring cross-border hybrids between a U.S. corporation and a related foreign corporation, cross-border hybrids between two foreign subsidiaries in different countries may be structured. For U.S. tax purposes, the earnings and profits and subpart F income of the U.S. multinational's foreign subsidiaries would need to be determined under U.S. tax principles.

The regulations determine the method of allocation and apportionment of interest expense deductions.[57] The method of allocation and apportionment for interest expense in the regulations is based on the principle that money is fungible.[58] Thus, interest expense deductions are attributable to all of a taxpayer's activities and property regardless of whether there was any specific purpose for incurring the obligation on which interest is paid.[59] The aggregate of deductions for interest is considered related to all income producing activities and assets of the taxpayer and allocable to all the gross income which the assets of the taxpayer generate, have generated, or could reasonably have been expected to generate.[60]

The interest expense of members of an affiliated group is considered to be allocable to all the gross income of the members of the group as if all members were a single corporation.[61] All allocations and apportionments of interest expense are to be made on the basis of assets rather than gross income.[62] The interest expense is apportioned on the basis of either the tax book value of the assets or their fair market

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[54] *See* "International Aspects of Thin Capitalization," *Cahiers de Droit Fiscal International, International Fiscal Association*, Vol. LXXXIb, Subject II, 1996 Geneva Congress.

[55] A hybrid instrument has characteristics of both debt and equity and may be treated as debt in a particular tax jurisdiction and equity in another jurisdiction.

[56] The Service may challenge the U.S. tax treatment of such instruments.

[57] Treas. Reg. § 1.861-8(e) (1997), Temp. Treas. Reg. § 1.861-8T(e) (1997) (outlining the allocation and apportionment of deductions).

[58] Temp. Treas. Reg. § 1.861-9T(a) (1997).

[59] *Id.*

[60] *Id.*

[61] I.R.C. § 864(e)(1) (1997) (the "one-taxpayer rule"); Temp. Treas. Reg. §§ 1.861-9T(a)-11T. I.R.C. § 864(f)(4)(D) (1997) provides regulatory authority for allocations with affiliated groups.

[62] I.R.C. § 864(e)(2) (1997).

value.[63]

In allocating a group's interest expense, a company with foreign source income may deconsolidate to increase the ratio of U.S. to foreign assets, which would increase the interest expense allocated to U.S. source income, reducing U.S. taxable income and raising the foreign tax credit limitation ceiling for foreign tax credits.[64] The Service, under the authority of Section 864(e)(7), can prevent the manipulation to obtain an increase in foreign tax credits of interest expense between U.S. and foreign source income.

For interest expense to be allocated and apportioned, it must be determined that the interest expense is deductible.[65] Section 263A requires the capitalization of interest expense that is allocable to designated types of property.[66] Any interest expense that is capitalized under Section 263A does not constitute deductible interest expense for purposes of allocation and apportionment under Section 1.861-9T.[67] However, capitalized interest expense is effectively allocated and apportioned as part of, and in the same manner as, the cost of goods sold, or the amortization or depreciation of a capital asset.[68]

Derivative financial instruments or risk-hedging financial instruments may be needed based upon the nature of the transactions, the taxpayer, the aspects of taxation, the timing of income or loss recognition and the amount of profit or loss to be reported in a particular tax jurisdiction. For example, U.S. companies to hedge foreign currency exposures may enter into positions in foreign currency derivative financial instruments.

If any transaction is part of a Section 988 hedging transaction, all transactions which are part of the hedging transaction will be integrated and treated as a single transaction.[69] Foreign currency gain or loss from a Section 988 transaction is treated as ordinary income or loss.[70] A Section 988 hedging transaction occurs when a taxpayer enters into a transaction primarily (1) to reduce the risk of currency fluctuations for property such as crude oil held or to be held by the

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[63] Temp. Treas. Reg. § 1.861-8T(b)(2) (1997) (stating that apportionment is based on assets).

[64] *See* Temp. Treas. Reg. § 1.861-11T(g) (1997) (providing examples of allocation and apportionment of interest expense among an affiliated group of corporations).

[65] Treas. Reg. § 1.861-9T(c) (1997).

[66] Treas. Reg. § 1.861-9T(c)(2) (1997).

[67] *Id.*

[68] *Id.*

[69] I.R.C. § 988(d)(1) (1997) (describing the treatment of § 988 hedging transactions).

[70] I.R.C. § 988(a)(1)(A) (1997).

taxpayer, or (2) to reduce the risk of currency fluctuations for loan transactions as a borrower or as a lender, and (3) identified by the Service or the taxpayer as a Section 988 hedging transaction.[71]

Special sourcing rules apply to the Section 988 transaction, overriding the general source rules in Section 865.[72] Under the special source rule, foreign exchange gain or loss subject to Section 988(a)(1) is sourced by reference to the "residence" of the taxpayer.[73] If the corporation or partnership is a U.S. resident, the exchange gain or loss is U.S. source.[74] If the corporation or partnership is a foreign resident, the exchange gain or loss is foreign source.[75] Gain or loss attributable to a foreign branch of a U.S. corporation, or a U.S. branch of a foreign corporation, is sourced to the location of the branch.[76]

A U.S. company may establish a "foreign treasury center" subsidiary to manage its funds and financial risks more efficiently, to finance operations of foreign related companies through intercompany loans and to raise capital from third parties for the related group. Typical locations for foreign treasury centers are the Netherlands, Switzerland, Ireland, Singapore and Belgium. For example, a Belgian Coordination Center ("BCC") is exempt from the (1) Belgian income tax, (2) the withholding tax on payment of dividends and interest, (3) the Belgium "Situation Tax" on receipt of capital infusions, and (4) work permit requirements on hiring of foreign personnel. The BCC is taxed only on costs. However, any BCC earnings from interest income are reported as foreign source subpart F income for a CFC.

The interest income of a foreign treasury center, usually a CFC, is subpart F income and taxable to the U.S. shareholder corporation.[77] Foreign personal holding company ("FPHC") income is a category of subpart F income, which includes interest income, dividends, the net gains from the sale of securities and certain net foreign currency gains.[78] FPHC income is passive income for purposes of determining the

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[71] I.R.C. § 988(d)(2) (1997); *see* ENERGY FUTURES: TRADING OPPORTUNITIES FOR THE 1990S (J. Treat, ed., 1st ed. 1990) 213-241 (discussing risk management in the energy industry).

[72] I.R.C. §§ 988(a)(3), 865(k) (1997) (Section 988 for sourcing income from certain currency transactions); Treas. Reg. § 1.988-4(a) (1997) (overriding § 865). Section 865 applies to gain or loss from foreign currency transactions not treated as ordinary income or loss under § 988(a)(1)(A).

[73] I.R.C. § 988(a)(3) (1997).

[74] I.R.C. § 988(a)(3)(B)(i)(residence) (1997).

[75] *Id.*

[76] I.R.C. § 988(a)(3) (1997).

[77] I.R.C. § 951(a)(1) (1997). I.R.C. § 952(a)(2) (1997) (stating that foreign base company income includes foreign personal holding company income).

[78] I.R.C. §§ 954(a)(1), 954(c)(1) (1997) (discussing interest, dividends, etc.).

passive income foreign tax credit limitation of Section 904(d)(1)(A).[79] Also, it is passive income for purposes of determining whether a foreign corporation is a passive foreign investment company.[80]

If the earnings of a CFC are from interest income of loans made to U.S. related corporations, the Service may question whether interest income should be allocated and sourced under Section 482 to the U.S., or the income should be allocated and sourced under Section 904(g)[81] to the U.S. where it is earned. U.S. and foreign related taxpayers must be careful to structure financing arrangements on an arm's length basis to avoid Section 482 reallocation. The Service may impute interest[82] on intercompany loans, which pay below-market interest, between a U.S. corporation and a foreign corporation that are members of the same controlled group of corporations.[83] A functional analysis may be requested by the Service to determine the applicability of Sections 482, 904(g) and possibly 882.[84]

In Notice 98-5, the Service announced that regulations will be issued, disallowing foreign tax credits for taxes generated in abusive transactions from which the reasonably expected economic profit is insubstantial compared to the value of the credits expected to be obtained.[85] The Service has targeted various abusive tax-motivated arrangements, which acquire or generate foreign tax credits for the only purpose of sheltering low-taxed, foreign-source income from residual U.S. tax.[86] The provisions of Section 904(d) permit cross-crediting of foreign taxes imposed on the same categories of income, in which credits from higher-taxed countries offset income from lower-taxed countries before applying the foreign tax limitation.[87] The foreign tax credit limitation is applied separately to each statutory category.[88]

Section 904(d) limits the averaging of various foreign tax rates

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[79] I.R.C. § 904(d)(2)(A)(i) (1997).

[80] I.R.C. § 1296(b)(1) (1997).

[81] I.R.C. § 904(g) (1997) (outlining the source rules for U.S.-owned foreign corporations).

[82] The Service could impute interest on loans under Section 482, utilizing the Federal short-term interest rate as specified in I.R.C. § 1274(d) (1997). Treas. Reg. §§ 1.482-2(a)(1)(i), 1.482-2(a)(2)(i), 1.482-2(a)(2)(iii)(B) (1997).

[83] *See* I.R.C. § 267(f) (1997) (defining members of the same controlled group of corporations).

[84] I.R.C. § 882 (1997) (tax on income of foreign corporations connected with U.S. business).

[85] 1998-3 I.R.B. 49.

[86] *Id.*

[87] *Id.*

[88] I.R.C. § 904(d) (1997). FTC limitation = [Taxable income from foreign sources/Taxable income from all sources] x (U.S. income tax). I.R.C. § 904(a) (1997).

on different categories of income. Section 904(d)(1) requires that the limitation of foreign source taxable income be applied separately to nine categories of income.[89] The statutory categories are (1) passive income,[90] (2) high withholding tax interest,[91] (3) financial services income,[92] (4) shipping income,[93] (5) dividends from each noncontrolled corporations,[94] (6) certain dividends from an IC-DISC or former DISC[95], (7) foreign trade income,[96] (8) certain distributions from a FSC or former FSC,[97] and (9) all other income.[98] For each tax year, the foreign tax credit is the lesser of the foreign tax, paid or accrued, or the total amount of each of the computed statutory categories. Any unused foreign tax credit, arising from one category, cannot offset the foreign income arising from any other category.[99]

U.S. taxpayers, who enter into foreign tax credit-generating schemes, abuse the cross-crediting Section 904(d) provisions. An abusive transaction results in credits from high-taxed income in excess of the applicable U.S. rate limitation, sheltering low-taxed income from residual U.S. tax.[100] The typical abusive transaction would generate no or a minimal economic profit relative to the projected U.S. tax credits and involve either the acquisition of an asset, generating an income stream subject to foreign withholding tax, or the effective duplication of tax benefits through the use of certain structures designed to exploit

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[89] Treas. Reg. § 1.904-4 (1997) (separate application of Section 904 with respect to certain categories of income).

[90] I.R.C. § 904(d)(1)(A) (1997). The passive income category includes interest, dividends, rents and royalty income. Passive income does not include certain high-taxed income. I.R.C. §§ 904(d)(2) (A)(iii)(III), 904(d)(2)(F) (1997) (outlining the high-tax, kick-out rule). The purpose of the high-tax, kick-out rule is to prevent taxpayers from manipulating foreign source income categories to average high-taxed foreign source income with lightly taxed passive income and increase the use of foreign tax credits. Income subject to the high-tax, kick-out rule is treated as general limitation income. Treas. Reg. § 1.904-4(c)(1) (1997).

[91] I.R.C. § 904(d)(1)(B) (1997). The high withholding tax interest category is subject to a withholding tax of a foreign country of at least 5%. Treas. Reg. § 1.904-4(d) (1997).

[92] I.R.C. § 904(d)(1)(C) (1997) (financial services income).

[93] I.R.C. § 904(d)(1)(D) (1997) (shipping income).

[94] I.R.C. § 904(d)(2)(E) (1997) (noncontrolled Section 902 corporation).

[95] I.R.C. § 904(d)(1)(F) (1997). A Domestic International Sales Corporation ("DISC") provided income tax deferral to encourage exports, but was challenged by other countries as an illegal subsidy in violation of GATT. The DISC survives in a limited form as an interest charge DISC ("IC-DISC").

[96] I.R.C. § 904(d)(1)(G) (1997) (foreign trade income).

[97] I.R.C. § 904(d)(1)(H) (1997) (FSC).

[98] I.R.C. § 904(d)(1)(I) (1997). The general limitation category is for income that is not placed in the other statutory categories.

[99] The excess foreign tax credit from a statutory category can be carried back two years and forward five years. I.R.C. § 904(c) (1997).

[100] Notice 98-5 at 49.

inconsistencies between U.S. and foreign tax laws.[101] The Service has identified the purchase of tax credits from transactions with insubstantial economic profit and cross-border tax-arbitrage transactions as the two types of arrangements that may create foreign tax credit abuse.[102]

The transfers of tax credits through the acquisition of an asset, generating an income stream subject to foreign withholding taxes, can be an abusive transaction if the expected economic profit from the arrangement is insubstantial compared to the received foreign tax credits.[103] The income-stream assets can represent securities, loans, or other similar arrangements and acquisitions in combination with total return swaps.[104]

Also, the Service is concerned about credits claimed through abusive arrangements in which the assets or income streams are hedged under portfolio hedging strategies without any risk of loss, such as a creditor's risk, for a significant time period.[105] Although the Service does not object to hedges that reduce a taxpayer's risk of interest rate or currency fluctuations, the taxpayer must have an economic risk of ownership of the foreign-taxed income stream, or the asset itself, to be entitled to a foreign tax credit.

A cross-border tax-arbitrage transaction occurs when U.S. tax laws grant benefits and, in addition, the tax laws of a foreign country grant benefits which effectively are duplicated to separate persons with respect to the same taxes or income.[106] However, the arbitrage transaction becomes an abusive arrangements when the U.S. taxpayer exploits these inconsistencies with arrangements in which the "expected economic profit" is insubstantial compared to the received foreign tax credit.[107] Cross-border tax-arbitrage transactions only become a concern to the Service when an abusive arrangement is created.

An objective approach will be used to determine the expected economic profit based upon the likelihood of realizing both potential

[101] *Id.* at 50.
[102] *Id.* at 50.
[103] *Id.*
[104] *Id.* Under an example in Notice 98-5, a U.S. corporation purchases for $75 a right to a foreign copyright, expiring shortly and paying a $100 royalty subject to a 30 percent withholding tax in the foreign country. The U.S. corporation receives the $100 payment less the $30 withholding tax. The U.S. corporation incurs a $5 economic loss to acquire a $30 foreign tax credit. *Id.*
[105] *Id.* at 51.
[106] *Id.*
[107] *Id.*

gain and loss over the term of the arrangement discounted to present value.[108] The reasonably expected economic profit will be determined by taking into account foreign tax consequences, but not U.S. tax consequences.[109] Under this "reasonably expected economic profit" determination, an objective test is applied based upon the facts and circumstances at the time of the transaction. The objective determination is not based upon the final outcome of the transaction, since legitimate business transactions can result in little or no economic profit through business miscalculations or misfortunes in the marketplace.

A transaction aimed only at generating tax credits and without any business purpose would fail this objective test, since the transaction itself would not be profit driven. Because an objective determination is easier to establish than a subjective determination, the proof of a "reasonably expected economic profit" would be easier to establish than proof that the transaction had a business purpose. However, the business purpose would be implied from the proof of a "reasonably expected economic profit." A business purpose would be defined as a legitimate business transaction based upon a rational business decision concerning true economic profit.

When comparing economic profit to the foreign tax credits, it is very important to delineate the extent of the arrangement. A series of related transactions or investments may be treated as a single arrangement, or portions of a single transaction or investment may be treated as separate arrangements.[110] The proper grouping of transactions and investments into an arrangement will depend upon all of the relevant facts and circumstances.[111]

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[108] *Id.* at 51.

[109] *Id.* The calculation of the expected economic profit does not include expected foreign tax savings attributable to a tax credit or similar benefit allowed by a foreign country with respect to a tax paid to another foreign country. The expected economic profit is determined by taking into account expenses associated with the arrangement without regard to whether such expenses are deductible in determining taxable income. Foreign taxes, interest expense, borrowing fees, "in lieu of" payments, forward contract payments, notional principal contract payments and similar types of payments are treated as expenses in determining economic profit. Also, the expected economic profit will be determined without considering executory financial contracts, such as notional principal contracts, forward contracts, or other similar instruments, that do not represent a real economic investment or potential for profit or that are not properly treated as part of the arrangement. *Id.*

[110] *Id.*

[111] *Id.* A purchase and resale might be treated as a single arrangement. An investment with the related financing transaction (the borrowing) and hedging transaction (an asset swap designed to limit economic exposure to the investment) might be treated as a single arrangement. However, if a CFC enters into a buy-sell transaction involving a debt instrument as part of its

IV. CONTRIBUTION OF STOCK OR ASSETS TO A FOREIGN ENTITY

The domestic transfers of stock or assets in connection with certain incorporations, or reorganizations, may satisfy nonrecognition of gain treatment to a transferor under particular provisions of the Code and the underlying regulations, however, the outbound transfers may deny corporate status to the foreign transferee and thus deny the nonrecognition treatment.[112] With the transfer of property by a U.S. person[113] to a foreign corporation, Section 367(a) gain (not loss) is recognized as though the property is sold at its fair market value.[114] For outbound transfers of property not covered by Section 367(a) such as contributions to a foreign corporation as paid-in capital and contributions to a partnership, trust, or estate, Sections 367(f), 721(c) and 684 apply gain recognition. U.S. shareholders, transferring stock or assets to a foreign corporation, do not recognize gain if the percentage stock exception or the active trade or business exception is satisfied.[115] However, branch loss recapture occurs and overrides the trade or business exception when there is a transfer of assets from a foreign branch of a U.S. person with previously deducted losses to a foreign corporation.

A. Transfers of Property from the U.S.

The purpose of Sections 367, 721(c) and 684 is to discourage the removal of appreciated property from the U.S. taxing jurisdiction prior to a sale or exchange. Section 367(a) applies to direct, indirect and constructive transfers.[116] Section 367(a) can apply to unexpected transfers, such as a reclassification for any U.S. partners of a foreign partnership to a foreign corporation.[117] This classification change is

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business, the buy-sell transaction may be treated as a separate arrangement. *Id.*

[112] I.R.C. § 367(a) (1997) (describing the outbound transfer of appreciated property or a stream of income to a foreign corporation by a United States person under either §§ 332, 351, 354, 356 or 361). However, outbound § 322 liquidations to a foreign parent are "subject to" § 367(e)(2) and treated as an exchange of property for stock of the foreign corporation equal in value to the fair market value of the property transferred. Temp. Treas. Reg. § 1.367(e)-2T(a)(2) (1997).

[113] A "United States person" is defined under § 7701(a)(30) as a citizen or resident of the U.S., a domestic partnership or corporation, any non-foreign estate and any trust subject to U.S. jurisdiction and U.S. fiduciaries control all substantial trust decisions.

[114] I.R.C. § 367(a)(1) (1997); Temp. Treas. Reg. § 1.367(a)-1T(b)(1) (1997).

[115] I.R.C. § 367(a) (1997) (exceptions to gain recognition).

[116] Temp. Treas. Reg. § 1.367(a)-1T(c) (1997).

[117] Temp. Treas. Reg. § 1.367(a)-1T(c)(6) (1997).

treated as a transfer of property under a Section 351 exchange.[118]

Section 367 regulations apply an aggregate treatment to partnerships, in which a transfer of property by a partnership to a foreign corporation is treated as a transfer by each partner of its pro rata share of the transferred property.[119] A transfer by a U.S. person of a partnership interest to a foreign corporation is treated as a transfer of a pro rata share of the underlying assets of the partnership.[120] Under the aggregate treatment, a transfer by a domestic partnership can be outside Section 367(a) to the extent that the transferor partnership has foreign partners and a transfer by a foreign partnership can be within Section 367(a) to the extent that the transferor partnership has U.S. partners.[121] If a domestic or foreign partnership owns stock or securities in the U.S. transferor corporation (the "U.S. target company") or the transferee foreign corporation and transfers stock or securities in a Section 367(a) exchange, each partner is treated as transferring and owning a proportionate share of the stock or securities of the U.S. target company.[122]

A transfer of property by a domestic estate or trust is treated as a Section 367(a)(1) transfer by the entity itself, regardless of whether the beneficiaries are foreign persons.[123] A transfer of property by a foreign trust or estate is not subject to Section 367(a)(1), regardless of whether the beneficiaries are U.S. persons.[124] However, a transfer of some or all of the assets of a foreign or domestic trust to a foreign corporation is a Section 367(a)(1) exchange and is considered a transfer by any U.S. person who is treated as the owner of any of the assets under the grantor trust provisions of Sections 671 through 679.[125]

If a U.S. person transfers property to a foreign corporation as paid-in surplus or as a contribution to capital in a transaction not otherwise described in Section 367(a), the transfer is treated as a sale or exchange under Section 367(f) for an amount equal to the fair market value of the property transferred. The transferor recognizes as gain the

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[118] *Id.*

[119] Temp. Treas. Reg. § 1.367(a)-1T(c)(3)(i)(A) (1997).

[120] I.R.C. § 367(a)(4) (1997) (looking through partnership interest to underlying assets of the partnership).

[121] Temp. Treas. Reg. § 1.367(a)-1T(c)(3)(i)(A) (1997).

[122] Treas. Reg. § 1.367(a)-3(c)(4)(i) (1997) (outlining the aggregate treatment of partnerships).

[123] Temp. Treas. Reg. § 1.367(a)-1T(c)(4)(i) (1997) (entity treatment for estates and non-grantor trusts).

[124] *Id.*

[125] Temp. Treas. Reg. § 1.367(a)-1T(4)(ii) (1997) (aggregate treatment for grantor trusts).

excess of the fair market value of the transferred property over the transferor's adjusted basis.[126]

The nonrecognition under Section 721(a) of gain or loss on a contribution of property to a partnership does not apply, if the gain when recognized could be included in the gross income of a person other than a U.S. person.[127] The denial of nonrecognition applies to transfers to foreign partnerships and domestic partnerships with foreign partners. Denying nonrecognition treatment under Section 721 on partnership contributions by a U.S. partner will require a "looking through the partnership" to determine whether the gain will be allocated to a foreign partner as a result of a property sale by the partnership or a subsequent in-kind distribution of the property to a foreign partner.

If a U.S. person transfers property to a foreign estate or trust, the transfer is treated under Section 684(a) as a sale or exchange for an amount equal to the fair market value of the transferred property.[128] The transferor recognizes as gain the excess of the fair market value of the transferred property over the transferor's adjusted basis.[129] If a domestic trust becomes a foreign trust, the trust is treated as transferring, immediately before becoming a foreign trust, all of its assets to the foreign trust.[130] Appreciated property owned by the trust is deemed to be sold and gain recognized on the conversion date of the trust from domestic to foreign status.[131]

Gain recognized under Section 367(a) is characterized as capital or ordinary according to the character that the gain would have had if the U.S. transferor had sold or exchanged the property in a taxable transaction.[132] An exception to the general characterization occurs under the branch loss recapture rule, that characterizes the gain according to the character of the recaptured loss.[133] Gain that is recognized pursuant to the recapture of foreign branch ordinary losses is treated as ordinary income of the transferor.[134] Gain that is recognized pursuant to the recapture of capital losses is treated as

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[126] I.R.C. § 367(f) (1997).

[127] I.R.C. § 721(c) (1997).

[128] I.R.C. § 684(a) (1997) (recognition of gain on certain transfers to certain foreign trusts and estates). Section 684(a) does not apply to a transfer to a trust by a U.S. person who is treated as the owner of the trust under Section 671. I.R.C. § 684(b) (1997).

[129] *Id.*

[130] I.R.C. § 684(c) (1997).

[131] *Id.*

[132] Temp. Treas. Reg. § 1.367(a)-1T(b)(4)(i)(A) (1997).

[133] I.R.C. § 367(a)(3)(C) (1997); Temp. Treas. Reg. § 1.367(a)-6T(c)(1) (1997).

[134] Temp. Treas. Reg. § 1.367(a)-6T(b)(1) (1997).

capital gain.[135]

The source of the Section 367(a) gain is determined as if the property had been disposed of in a taxable exchange with the transferee foreign corporation[136] and the normal sourcing rules of Sections 861, 862 and 863 apply. For example, if a U.S. corporation transfers inventory (that is not produced by the transferor but is produced within the U.S.) to a foreign corporation in an exchange for stock of the foreign corporation under Section 351(a) with title passing in the U.S., any gain is treated as ordinary income from sources within the U.S. based upon the sourcing rule of Section 861.[137]

Under branch loss recapture, any gain is treated as income from sources outside the U.S.[138] The gain recognized and treated as foreign source income under the branch loss recapture rule is allocated to particular Section 904 foreign tax credit limitation categories, based upon the limitation category to which the recaptured losses related.

A U.S. person is required to report transfers of property under Section 367(a) or (d) (for intangible property) on Form 926 and to attach such information as is required under Section 6038B. The transferor corporation is responsible for filing the notice and reporting the transaction no later than the transfer date.[139] Failure to file the required notice can result in a penalty of ten percent of the fair market value of the transferred or contributed property.[140] Also, failure to file results in the property transferred as not considered to be transferred for use in the active conduct of a trade or business outside of the United States for purposes of the Section 367(a)(3) exemption from gain recognition.[141] Until the transferor complies with the applicable reporting requirements, the time for assessment of tax is extended indefinitely.[142]

When ten percent or more of the total voting power or the total value of the stock of the U.S. target company is transferred by U.S.

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[135] *Id.*

[136] Temp. Treas. Reg. § 1.367(a)-1T(b)(4)(i)(A) (1997).

[137] Temp. Treas. Reg. § 1.367(a)-1T(b)(4)(ii) (1997).

[138] I.R.C. § 367(a)(3)(C) (1997); Temp. Treas. Reg. § 1.367(a)-6T(c)(1) (1997) (character and source of gain).

[139] Temp. Treas. Reg. § 1.6038B-1T(b) (1997).

[140] I.R.C. § 6038B(c)(2) (1997) (allowing a reasonable cause exception if "such failure is due to reasonable cause and not to willful neglect").

[141] Temp. Treas. Reg. § 1.6038B-1T(f)(1) (1997) (outlining the consequences of failing to report).

[142] I.R.C. § 6501(c)(8) (1997). The time for assessment of any tax with respect to any event or period, relating to information required to be reported under Section 6038B, does not expire until 3 years after the date the required information is furnished. *Id.*

persons, the U.S. target company must comply with the reporting requirements in Section 1.367(a)-3(c)(6) to qualify for the exceptions to the general rule under Section 367(a)(1). The U.S. target company must attach to its timely filed U.S. income tax return for the taxable year of the transfer a form entitled "Section 367(a) Reporting of Cross-Border Transfer Under Reg. § 1.367(a)-3(c)(6)." Also, the transferor must comply with the reporting requirements of Section 6038B and file a binding agreement to recognize gain upon the transferee corporation's subsequent disposition of the transferred stock or securities.[143]

A U.S. person must report any contribution of property to a foreign partnership similar to transfers to foreign corporations.[144] However, the reporting requirement only applies if (1) the U.S. person holds immediately after the transfer directly or indirectly at least a ten percent interest in the partnership, or (2) the value of the property transferred by the U.S. person or any related person to the partnership or a related partnership over a twelve-month period exceeds $100,000.[145]

The gain recognition agreement rules apply to a transfer of stock in a foreign corporation to a foreign partnership.[146] In a subsequent disposition of the transferred stock, any gain realized from the disposition is allocated under Section 704(c) to each contributing partner's precontribution gain in such stock.[147] Each partner is required to pay interest on the amount of tax due as a result of such allocation between the date that was prescribed for filing the return for the initial transfer year and the date on which the tax is paid.[148] The transferors must amend their tax returns for the taxable year of the initial transfer and recognize income equal to the income realized but not recognized on the original transfer, if the partnership disposes of the stock received in a nonrecognition transaction, or if the transferors dispose of their interests in the partnership.[149]

If a U.S. person transfers to a foreign corporation the stock or securities of another foreign corporation that is a party to the reorganization, Section 367(a) does not apply to the transfer under

[143] Temp. Treas. Reg. § 1.367(a)-3T(g) (1997).
[144] I.R.C. § 6038B(a)(1) (1997).
[145] I.R.C. § 6038B(b)(1) (1997).
[146] Priv. Ltr. Rul. 91-030-33 (Jan. 18, 1991).
[147] *Id.*
[148] *Id.*
[149] *Id.*

Section 367(a)(2).[150] Section 367(a)(1) does not apply to a transfer of stock of a foreign corporation by a U.S. person to another foreign corporation pursuant to a Section 368(a)(1)(B) reorganization,[151] since the foreign corporation whose stock is transferred is a party to the reorganization.[152] However, the transfer by a domestic corporation of all the stock of a foreign corporation to a CFC of the domestic corporation's parent in a Section 351 exchange under Section 367(c)(2) is subject to Section 367(a).[153] Also, the distribution of stock and securities of a domestic or foreign corporation, qualifying for Section 355 nonrecognition by a domestic corporation to a person who is not a U.S. person, is taxable under Section 367(e)(1).[154] Section 367(a)(6) provides that the Secretary may exempt certain transactions by regulation from application of Section 367(a)(1). A U.S. person, transferring property to a foreign entity, does not recognize gain if the stock exception for stocks and securities, or the active trade or business exception for assets is satisfied.[155]

1. Percentage Stock Exception

A transfer of stock or securities of the U.S. target company by a U.S. person to a foreign corporation is not subject to Section 367(a)(1), if the U.S. target company satisfies four stock ownership[156] conditions and complies with the reporting requirements in Section 1.367(a)-3(c)(6).[157] The four stock ownership conditions are that (1) the amount of stock received from the foreign corporation by U.S. persons does not exceed the fifty-percent ownership threshold,[158] (2) there is no

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[150] Temp. Treas. Reg. § 1.367(a)-3T(b)(1) (1997); Temp. Treas. Reg. § 1.367(a)-1T(b)(2)(i) (1997).

[151] A "B" reorganization occurs when the acquiring corporation exchanges stock only with the target corporation. I.R.C. § 368(a) (1)(B) (1997).

[152] Temp. Treas. Reg. § 1.367(a)-3T(b)(1) (1997); Temp. Treas. Reg. § 1.367(a)-1T(b)(2)(i) (1997).

[153] Rev. Rul. 92-86, 1992-2 C.B. 199.

[154] I.R.C. § 367(e)(1) (1997); Temp. Treas. Reg. § 1.367(e)-1T (1997) (treating Section 355 distributions under § 367(e)).

[155] I.R.C. §§ 367(a)(2)-(3) (1997) (exceptions to gain recognition).

[156] Ownership attributions under I.R.C. § 958 apply.

[157] Treas. Reg. § 1.367(a)-3(c)(1) (1997) (transfers by U.S. persons of stock or securities of domestic corporations to foreign corporations).

[158] Treas. Reg. § 1.367(a)-3(c)(1)(i) (1997) (50% or less of both the total voting power and the total value of the stock of the "transferee foreign corporation" is received in the transaction, in the aggregate, by U.S. transferors). A "transferee foreign corporation" is the foreign corporation whose stock is received in the exchange by U.S. persons. Treas. Reg. § 1.367(a)-3(c)(5)(vi) (1997).

control group of U.S. persons,[159] (3) the active trade or business test is satisfied,[160] and (4) either the U.S. person is not a five-percent transferee shareholder or, if so, the U.S. person enters into a five-year agreement to recognize gain in the U.S. target company stock or securities it exchanged.[161]

Under the stock ownership conditions, the active trade or business test is satisfied if (1) the transferee foreign corporation, or any qualified subsidiary,[162] or qualified partnership[163] is engaged in an active trade or business outside the U.S. for the entire 36-month period immediately before the transfer; (2) neither the transferors nor the transferee foreign corporation or qualified subsidiary or qualified partnership have an intention to substantially dispose of or discontinue such trade or business at the time of the transfer; and (3) the substantiality test is satisfied.[164] A transferee foreign corporation will be deemed to satisfy the substantiality test if, at the time of the transfer, the fair market value of the corporation is at least equal to the fair market value of the U.S. target company.[165]

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[159] Treas. Reg. § 1.367(a)-3(c)(1)(ii) (1997) (50% or less of each of the total voting power and the total value of the stock of the transferee foreign corporation is owned, in the aggregate, immediately after the transfer by U.S. persons that are either officers or directors of the U.S. target company or that are 5% target shareholders).

[160] Treas. Reg. § 1.367(a)-3(c)(1)(iv) (1997).

[161] Treas. Reg. § 1.367(a)-3(c)(1)(iii) (1997).

[162] A "qualified subsidiary" is a foreign corporation whose stock is at least 80% owned (by total voting power and total value), directly or indirectly, by the transferee foreign corporation. Also, it was not affiliated with the U.S. target company during the 36-month period prior to the transfer, nor acquired by the transferee foreign corporation during such period for the principal purpose of satisfying the active trade or business test or the substantiality test. Treas. Reg. § 1.367(a)-3(c)(5)(vii) (1997).

[163] A "qualified partnership" is a partnership in which the transferee foreign corporation has active and substantial management functions as a partner in the partnership business, or has an interest in 25% or greater of the partnership's capital and profits. Also, it is not a qualified partnership if the U.S. target company or any affiliate of the U.S. target company held a 5% or greater interest in the partnership's capital and profits during the 36-month period prior to the transfer, nor if the transferee foreign corporation's interest was acquired by that corporation during such period for the principal purpose of satisfying the active trade or business test or the substantiality test. Treas. Reg. § 1.367(a)-3(c)(5)(viii) (1997).

[164] Treas. Reg. § 1.367(a)-3(c)(3)(i) (1997) (active trade or business test for the stock exception).

[165] Treas. Reg. § 1.367(a)-3(c)(3)(iii)(A) (1997).

2. Active Conduct of a Trade or Business Exception for Assets

Under the active trade or business exception[166] of Section 367(a)(3), gain is not recognized under Section 367(a)(1) if certain assets are transferred to a foreign corporation for use[167] by the foreign corporation in the active conduct[168] of a trade or business[169] outside the U.S.[170] The active trade or business exception does not apply for inventory items, accounts receivable, foreign currency, Section 936(h)(3)(B) intangible property and installment obligations.[171] Also, the active trade or business exception does not apply to gain realized on the transfer of the assets of a foreign branch of a U.S. person to a foreign corporation to the extent of previously deducted losses.[172] Any gain recognized is treated as foreign source income with the same character as the previous losses.[173]

The Section 367(a)(3) exception for property used in an active foreign business does not apply unless the domestic corporation is controlled by five or less domestic corporations.[174] Section 367(a)(5)

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[166] I.R.C. § 367(a)(3)(A) (1997) (active trade or business exception for assets); Temp. Treas. Reg. § 1.367(a)-2T (1997) (active trade or business exception and reporting requirements).

[167] Whether property is "used or held for use" in a trade or business must be determined under all the facts and circumstances. Generally, property is used or held for use in a foreign corporation's trade or business, if it is (1) held for the principal purpose of promoting the present conduct of the trade or business, (2) acquired and held in the ordinary course of the trade or business, or (3) otherwise held in a direct relationship to the trade or business. The property is held to meet the present needs of that trade or business and not the anticipated future needs. Temp. Treas. Reg. § 1.367(a)-2T(b)(5) (1997).

[168] Whether a trade or business is "actively conducted" must be determined under all the facts and circumstances. Generally, a corporation actively conducts a trade or business only, if the officers and employees of the corporation perform substantial managerial and operational activities. Temp. Treas. Reg. § 1.367(a)-2T(b)(3) (1997).

[169] Whether the activities of a foreign corporation constitute a "trade or business" must be determined under all the facts and circumstances. In general, a trade or business is a specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit. Temp. Treas. Reg. § 1.367(a)-2T(b)(2) (1997).

[170] Whether a foreign corporation conducts a trade or business "outside of the United States" must be determined under all the facts and circumstances. Generally, the primary managerial and operational activities of the trade or business must be conducted outside the U.S. and the transferred assets must be located outside the U.S. after the transfer. Temp. Treas. Reg. § 1.367(a)-2T(b)(4) (1997).

[171] I.R.C. § 367(a)(3)(B) (1997) (dealing tainted assets); Temp. Treas. Reg. § 1.367(a)-5T (1997) (dealing tainted assets).

[172] *See* I.R.C. § 367(a)(3)(B) (1997) (analyzing the transfer of foreign branch with previously deducted losses). The branch loss recapture provisions are intended to recapture the pre-incorporation losses of the branch. *See* Temp. Treas. Reg. § 1.367(a)-6T(b) (1997).

[173] *See id.*

[174] I.R.C. § 367(a)(5) (1997).

can prevent Section 367(a)(3) from applying the active trade or business exception. If the transferor corporation is eighty percent controlled by five or less domestic corporations, Section 367(a)(5) does not prevent Section 367(a)(3)(A) from providing an exception to Section 367(a)(1) gain recognition. All members of the same affiliated group within the meaning of Section 1504 are treated as one corporation.[175]

Special rules are provided for determining whether oil and gas working interests are considered to be used in an active trade or business.[176] The working interest qualifies for the active trade or business exception, if the following conditions are satisfied:

> (1) At the time of the transfer, the transferee has no intention to farm out or transfer any part of the transferred working interest;
>
> (2) during the first 3 years after the transfer, there are no farmouts or other transfers of any part of the transferred working interest in which the transferee retains less than fifty percent of the transferred working interest; and
>
> (3) active use test is met:
>
> > (a) The transferor is regularly and substantially engaged in exploration for and production of oil and gas, either directly or through interests in joint ventures (exclusive of the working interest transferred);
> >
> > (b) the terms of the working interest were actively negotiated among the joint ventures;
> >
> > (c) the working interest transferred constitutes at least a 5 percent working interest; and
> >
> > (d) prior to the transfer, at the time of the

[175] *Id.*

[176] Temp. Treas. Reg. § 1.367(a)-4T(e) (1997) (dealing with oil and gas working interests); *see* Priv. Ltr. Rul. 91-27-053 (Apr. 11, 1991) (relating to outbound transfer of working interest with closing agreement).

> transfer and for the foreseeable future, through its own employees or officers, the transferor was regularly and actively involved in decision making with respect to the operations of the venture, including discussions with respect to exploration, development, production and marketing.[177]

Special rules apply to the transfer of working interests to foreign corporations in start-up operations, in which the transferor does not have an oil and gas exploration and production history to satisfy the above active use requirement.[178] Start-up operations satisfy the active conduct of a trade or business if:

> (1) The working interest was acquired by the transferor immediately prior to the transfer and for the specific purpose of transferring it to the transferee foreign corporation;
>
> (2) the terms of the working interest transferred were actively negotiated among the joint venturers;
>
> (3) the working interest transferred constitutes at least a 5 percent working interest; and
>
> (4) the transferee foreign corporation will for the foreseeable future:
>
> > (a) Through its own employees or officers be regularly and actively engaged in operating the working interest, or analyzing technical data relating to the activities of the venture; and
> >
> > (b) through its own employees or officers be regularly and actively involved in decision making with respect to the operations of the venture, including decisions relating to

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[177] Temp. Treas. Reg. §§ 1.367(a)-4T(e)(1)(ii)-1.367(a)-4T(e)(2) (1997).

[178] *See* Temp. Treas. Reg. § 1.367(a)-4T(e)(3) (1997) (relating to start-up operations).

> exploration, development, production and marketing.[179]

Further, the regulations provide that the transfer of working interests, not otherwise satisfying the above safe harbor requirements or start-up rules, may qualify for the active trade or business exception based upon the facts and circumstances.[180] The transfer of a non-operating working interest to a foreign corporation qualifies for the active trade or business exception, if the transferor otherwise satisfies the requirements of the regulations.[181] A transfer of less than five percent working interests, as part of a multiple working interests property transfer, may qualify for the exception provided the transferor can demonstrate by clear and convincing evidence that the criteria identified above, excluding the five percent working interest requirement, have been satisfied.[182] A compulsory transfer of property previously used in the country of the transferee foreign corporation is presumed to be transferred for use in the active conduct of a trade or business outside the U.S.[183] The transfer is either legally required by the foreign government as a necessary condition of doing business in the country, or compelled by a genuine threat of immediate expropriation by the foreign government.[184]

3. Intangible Property

The transfer of geological and geophysical data, relating to the transferred working interest, is considered as part of the underlying working interest for purposes of the exception.[185] However, a royalty interest in oil and gas properties is not treated as transferred for use in the active conduct of a trade or business outside the United States.[186] A royalty, or similar interest constituting intangible property, is subject to the rules for intangible property under Section 1.367(d)-IT.[187]

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[179] *Id.*

[180] *See* Temp. Treas. Reg. § 1.367(a)-4T(e)(4) (1997).

[181] Rev. Rul. 89-27, 1989-1 C.B. 106.

[182] *See* Priv. Ltr. Rul. 89-110-39 (Dec. 19, 1988) (stating that transferring shut-in or undeveloped properties would not qualify those properties for the exception, unless the properties are put into production within three years after the transfer).

[183] Temp. Treas. Reg. § 1.367(a)-4T(f) (1997) (discussing compulsory transfers).

[184] *Id.*

[185] Priv. Ltr. Rul. 87-360-69 (June 12, 1987).

[186] Temp. Treas. Reg. § 1.367(a)-4T(e)(4) (1997).

[187] *Id.*

Intangible property within the meaning of Section 936(h)(3)(B) is not property for purposes of the active conduct of a trade or business exception. The intangible property rules of Section 367(d) apply to the transfers of rights to contracts, surveys, designs, processes and licenses from a U.S. person to a foreign corporation.[188] The transfer of intangibles to a partnership by a U.S. person is treated as a sale of contingent payments.[189] The transfer generates deemed annual payments from the partnership to the U.S. transferor, and any deemed income included in gross income under Section 367(d) is treated as ordinary income.[190] Intangible property payments from an outbound transfer of intangibles to a foreign corporation is treated as foreign-source income to the extent the use of the intangible will be outside of the U.S. The payments are established on an arm's-length basis that is commensurate with the annual income attributable to the intangible.

Section 936(h)(3)(B) defines intangible property to include any patent, invention, formula, design, pattern, know-how, method, program, system, procedure, survey, study, forecast, estimate, technical data, or any similar item, which has substantial value independent of the services of any individual. For purposes of Section 367 and the underlying regulations, the term "intangible property" means knowledge, rights, documents and any other intangible item within the meaning of Section 936(h)(3)(B) that constitutes property for purposes of Section 332, 351, 354, 355, 356, or 361, as applicable.[191]

When a transferor contributes tangible property to a transferee under a Section 367 transaction, associated know-how and other technical intangibles that are ancillary and subsidiary to the tangible property usually are included. The transaction should be considered solely as a tangible property transfer, if the intangible property does not have substantial value independent of the tangible property. The same principle applies under the Section 482 regulations, which use the same Section 936(h)(3)(B) definition for intangible property.[192]

The transfer of tangible property with an embedded intangible is not considered a transfer of intangible property, if the transferee does not acquire any rights to exploit the intangible property other than rights relating to the resale of the tangible property under normal commercial

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[188] *See* I.R.C. §§ 367(d)(1)-(2)(A) (1997).
[189] *See* I.R.C. §§ 367(d)(3), 721(d) (1997).
[190] *See* I.R.C. § 367(d)(2) (1997).
[191] Temp. Treas. Reg. § 1.367(a)-1T(d)(5)(I) (1997).
[192] Treas. Reg. § 1.482-4(b) (1997).

circumstances.[193] Thus, if tangible property with an embedded intangible is transferred by a U.S. person to a foreign corporation in a Section 351 or 361 exchange and the intangible property does not have substantial value independent of the tangible property, the transfer is not treated as a Section 367(d) intangible transfer, but solely as a tangible property transfer under Section 367(a).

According to Treasury regulations, if a U.S. person transfers intangible property to a domestic corporation with the "principal purpose" of avoiding compliance with Section 367(d) and afterward that person transfers the stock of that domestic corporation to a related foreign corporation, he will be treated as if he had transferred the intangible property *directly* to the foreign corporation.[194] There is a presumption of a principal purpose of avoidance, "if the property is transferred to the domestic corporation less than two years prior to the transfer of the stock of the domestic corporation to a foreign corporation."[195]

B. Branch Loss Recapture Rule

A U.S. company may begin foreign operations through an overseas branch and use any branch losses to offset taxable income. The subsequent incorporation of a foreign branch results in the recapture of prior losses incurred by the branch.[196] If a foreign branch of a U.S. corporation transfers its assets to a foreign corporation, gain is recognized by the transferor to the extent that the branch incurred and deducted losses in an amount that exceeds the sum of (1) the taxable income of the branch incurred after the year in which the loss was incurred, and (2) the amount of income recognized under the overall foreign loss ("OFL") recapture provisions.[197]

Branch loss recapture occurs when there is a transfer of assets from a foreign branch[198] of a U.S. person with previously deducted

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[193] Treas. Reg. § 1.482-3(f) (1997).

[194] Temp. Treas. Reg. § 1.367(d)-1T(g)(6) (1997) (stating an anti-abuse rule).

[195] *Id.*

[196] I.R.C. § 367(a)(3)(C) (1997).

[197] I.R.C. § 904(f)(3) (1997) (dispositions); *see* Rev. Rul. 81-82, 1981-1 C.B. 127 (amplifies Rev. Rul. 78-201, 1978-1 C.B. 91) (transferring a foreign branch into a CFC with recapture under § 367(a)); *see also* Rev. Rul. 81-89, 1981-1 C.B. 129 (recapturing of losses of affiliated corporations' foreign branches in the same country transferred to a new foreign corporation).

[198] The term "foreign branch" is defined as an integral business operation carried on by a U.S. person outside the United States. Temp. Treas. Reg. § 1.367(a)-6T(g)(1) (1997) (definition of foreign branch for purposes of Section 367).

losses to a foreign corporation. The branch loss recapture rule takes precedence over the active trade or business exception.[199] The active trade or business exception does not apply to transfers of a foreign branch to the extent of "previously deducted losses" of the foreign branch.[200] The "previously deducted losses" of the foreign branch are the total ordinary loss and the total capital loss that were realized by the foreign branch in the "branch loss year" prior to the transfer and that were or will be reflected on a U.S. income tax return of the transferor.[201]

Any gain recognized by reason of Section 367(a)(3)(C) is treated as income from sources outside the U.S. having the same character as such losses had.[202] Thus, the character of the gain recapture is the same as the character of the prior losses. Any gain recognition under the branch loss recapture rule gives rise to a corresponding basis adjustment.[203]

The recapture rule requires that the excess of losses, which gave rise to deductions over taxable income from the branch and adjusted for any recapture of OFL,[204] be included as income on the transfer. An OFL arises when gross foreign-sourced income for the tax year is exceeded by the sum of the expenses, losses and other deductions properly allocated and apportioned to foreign income.[205]

Prior dispositions of OFL assets (other than the current transferred branch assets) reduce on a pro rata basis the branch losses for purposes of the branch loss recapture computations.[206] The recapture of OFL is accelerated to the extent property used outside the U.S. is disposed of during the tax year.[207] A sale, exchange or distribution of property constitutes a disposition under the recapture

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[199] I.R.C. § 367(a)(3)(C) (1997) (branch loss recapture rule). *See* I.R.C. § 987 (explaining that foreign currency gains of the branch are taxed at the time of the transfer of branch assets to a foreign corporation); *see also* Rev. Rul. 78-201, 1978-1 C.B. 91 (historical branch loss recapture).

[200] I.R.C. § 367(a)(3)(C) (1997) (previously deducted losses); Temp. Treas. Reg. § 1.367(a)-6T(b)(2) (1997) (branch loss recapture rule).

[201] Temp. Treas. Reg. § 1.367(a)-6T(d)(1) (1997) (previously deducted losses).

[202] I.R.C. § 367(a)(3)(C) (1997); Temp. Treas. Reg. § 1.367(a)-6T(c)(1) (1997) (character and source of gain).

[203] Temp. Treas. Reg. § 1.367(a)-1T(b)(4)(i) (1997) (character, source and adjustments) and -6T(i)(basis adjustments).

[204] I.R.C. § 904(f)(3) (1997).

[205] I.R.C. § 904(f)(2) (1997) (overall foreign loss defined).

[206] Temp. Treas. Reg. § 1.367(a)-6T(e)(5) (1997) (amounts previously recaptured under § 904(f)(3)).

[207] I.R.C. § 904(f)(3) (1997) . An amount, equal to the lesser of the fair market value of the property over its basis or the unrecovered OFL, is recognized as taxable income. *Id.*

rule, whether or not gain or loss is recognized.[208]

The gain recognized by the branch loss recapture cannot exceed the realized gain attributable to the transferred assets, calculated on an asset-by-asset basis without offsetting loss assets against gain assets.[209] Also, an adjustment is permitted for the losses incurred by the branch, which effectively did not result in a U.S. tax benefit because of the expiration of net operating losses, investment tax credits or foreign tax credits.[210] Branch recapture is reduced by any gain recognized under Section 367(a) from the transfer of tainted assets.[211]

A foreign branch means an "integral business operation" carried on by a U.S. person outside the U.S.[212] Whether the activities of a U.S. person outside the U.S. constitute a foreign branch operation is determined under all of the facts and circumstances.[213] Evidence that shows the existence of a foreign branch can include the existence of a separate set of books and records, and the existence of a fixed place of business used by employees or officers of the U.S. person in carrying out business activities outside the U.S.[214] If the activities constitute a permanent establishment under the terms of a U.S. income tax treaty, the foreign activities are deemed to constitute a foreign branch.[215]

The rules of Section 367 recapture apply separately to each foreign branch that is transferred to a foreign corporation even within the same country.[216] Previously deducted losses of one transferring branch cannot be offset by the income of another branch that is also transferred to a foreign corporation for purposes of determining the amount of gain to be recaptured.[217] Also, the losses of one branch cannot be recaptured with the transfer of the assets of another separate branch.[218]

Whether the foreign activities of a U.S. person are carried out by more than one branch is determined under all of the facts and circumstances. A separate branch exists if a particular group of activities is "sufficiently integrated to constitute a single business that

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[208] *Id.; see* Temp. Treas. Reg. § 1.367(a)-6T(e)(3) (1997).

[209] Temp. Treas. Reg. § 1.367(a)-1T(b)(3) (1997) (limiting gain required to be recognized) and -6T(c)(2)(transferring foreign branch with previously deducted losses).

[210] Temp. Treas. Reg. § 1.367(a)-6T(d)(2) to (4) (1997).

[211] Temp. Treas. Reg. § 1.367(a)-6T(e)(4) (1997) (gain recognized under § 367(a)).

[212] Temp. Treas. Reg. § 1.367(a)-6T(g)(1) (1997).

[213] *Id.*

[214] *Id.*

[215] *Id.*

[216] Temp. Treas. Reg. § 1.367(a)-6T(g)(2) (1997).

[217] *Id.*

[218] *Id.*

could be operated as an independent enterprise."[219] Business operations even if nominally separate do not constitute separate businesses for purposes of recapture if there is a substantial identity of products, customers, operational facilities, operational processes, accounting and record-keeping functions, management, employees, distribution channels, or sales and purchasing forces.[220]

Also, the foreign activities of two U.S. corporations of the same consolidated group can constitute a single foreign branch.[221] The foreign activities of each of two U.S. corporations are considered to constitute a single foreign branch if the two corporations are members of the same consolidated group and the foreign activities of the two corporations in the aggregate constitute a single foreign branch if conducted by a single corporation.[222]

In Rev. Rul. 81-89,[223] two foreign branches in the same country were functionally integrated, although each branch was owned separately by two affiliated U.S. corporations. The two branches had "common purchasing, accounting, personnel, and record keeping departments; a common sales force, headquarter staff, and management team; and, a substantial identity of customers, employees, distribution channels and operation facilities and processes."[224]

Also, losses that must be recaptured at the time of the incorporation of a foreign branch include expenses directly related to branch property not transferred but abandoned as worthless.[225] In Rev. Rul. 80-247,[226] the mineral properties that had no commercial value were abandoned and not transferred at the time of incorporating the foreign branch. Since it was the branch business that incurred the losses and not the specific parcels of property, the expenses attributable to the abandoned properties were included in determining the previously deducted losses subject to recapture.[227]

The regulations provide an anti-abuse rule to prevent a U.S. person from transferring foreign branch property of a domestic

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[219] *Id.*

[220] *Id.* The regulations refer to Rev. Rul. 81-82, 1981-1 C.B. 127 as an application of these principles for determining the existence of more than one branch.

[221] Temp. Treas. Reg. § 1.367(a)-6T(g)(3) (1997).

[222] *Id.* The regulations refer to Rev. Rul. 81-89, 1981-1 C.B. 129 as an application of these principles.

[223] 1981-1 C.B. 129.

[224] *Id.*

[225] Temp. Treas. Reg. § 1.367(a)-6T(g)(4) (1997).

[226] 1980-2 C.B. 127.

[227] *Id.*

corporation to a second U.S. corporation with a subsequent transfer by the second corporation of the same property to a foreign corporation for the principal purpose of avoiding Section 367 recapture.[228] Under this rule, the U.S. person is treated as having transferred the branch property directly to the foreign corporation.[229]

If the property is transferred to the second U.S. corporation less than two years prior to the second corporation's transfer to a foreign corporation, there is a presumption that the principal purpose of the transfer was to avoid the effect of the Section 367 recapture.[230] The presumption can be rebutted by clear evidence that the subsequent transfer of the property was not contemplated at the time of the initial transfer to the second corporation and that avoidance of the effect of the recapture Section was not a principal purpose for the transaction.[231]

V. SALE OR EXCHANGE OF FOREIGN CORPORATION STOCK

A U.S. shareholder of a CFC, who exchanges its stock pursuant to a reorganization for stock in another CFC of which he is a U.S. shareholder, generally qualifies for nonrecognition treatment under Sections 354 and 356.[232] However, the stock received in the transaction is subject to Sections 367(b) and 1248 gain recharacterization.[233] Section 367(b) prevents U.S. shareholders from avoiding Section 1248(a) by using the nonrecognition provisions. Section 1248(a) applies only if gain is recognized.[234]

A U.S. person, exchanging CFC stock under the nonrecognition rules of Sections 332, 351, 354, 355, or 361, generally will not trigger Section 1248(a). However, Section 1248(f) can override the nonrecognition rules. Section 1248(f)(1) requires recognition of gain on distributions by U.S. corporations of CFC stock to conform with the repeal of the *General Utilities* doctrine.[235] The Section 1248 dividend is described in Section 907(c)(3)(A).[236]

A U.S. shareholder recognizes gain on a reorganization

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[228] Temp. Treas. Reg. § 1.367(a)-6T(h) (1997).
[229] *Id.*
[230] *Id.*
[231] *Id.* A transfer may have more than one principal purpose. *Id.*
[232] Treas. Reg. § 7.367(b)-7(b) (1997).
[233] Treas. Reg. § 7.367(b)-9 (1997).
[234] Treas. Reg. § 1.1248-1(c) (1997); I.R.C. § 964(e)(1) (1997).
[235] I.R.C. § 1248(f)(1) (1997) applies only to distributions that remain nonrecognition events (certain liquidating corporate distributions to 80% distributee under Section 337).
[236] Treas. Reg. § 1.367(b)-2(d) (1997) defines the "Section 1248 amount."

exchange, if he receives stock in a U.S. corporation, a non-CFC foreign corporation, or a CFC in which he is not a U.S. shareholder.[237] The gain recognized equals the lesser of the "Section 1248 amount" or the actual gain realized.[238] If the actual gain realized exceeds the 1248 amount, the excess can qualify for nonrecognition treatment under Sections 354 and 356.[239] If the U.S. shareholder is a corporation, who receives stock and assets of another U.S. corporation in the exchange under Sections 368(a)(1)(C), (D), or (F), the U.S. shareholder recognizes as a dividend the earnings and profits attributable to the stock exchanged.[240]

Section 367(b) changes the Section 351 rules for transfers by foreign corporations. Stock, received by a foreign transferor corporation in a Section 351 exchange and immediately after the exchange the transferee corporation is a CFC and all U.S. shareholders of the foreign transferor corporation are also U.S. shareholders of the transferee, is subject to Sections 367(b) and 1248. If the transferee corporation is a domestic corporation, a non-CFC foreign corporation, or a CFC whose U.S. shareholders do not include all of the transferor's U.S. shareholders, gain is triggered to the transferor corporation.[241] Section 367(b) does not apply to a transfer, if the transferor foreign corporation is not and has not been a CFC at any time during the preceding five years.

If a foreign corporation receives a distribution in complete liquidation of its foreign subsidiary, the normal rules of Section 332 apply.[242] If a U.S. corporation receives a distribution in complete liquidation of a foreign subsidiary, the U.S. corporation recognizes the realized gain on the transaction unless the U.S. corporation includes in income as a dividend the earnings and profits attributable to the stock exchanged.[243] When the assets of a foreign corporation are acquired by a U.S. corporation in a Section 332 liquidation or Section 368(a) reorganization, the U.S. shareholders of the foreign corporation recognize a deemed dividend equal to their ratable share of the foreign corporation's earnings and profits.[244]

If a CFC sells or exchanges stock in any other foreign

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[237] Treas. Reg. § 1.367(b)-7(c)(1) (1997).
[238] *Id.*
[239] *Id.*
[240] Treas. Reg. § 7.367(b)-7(c)(2) (1997).
[241] Treas. Reg. § 1.367(b)-8(c)(2) (1997).
[242] Treas. Reg. § 7.367(b)-5(c) (1997).
[243] Treas. Reg. § 7.367(b)-5(b) (1997).
[244] Prop. Treas. Reg. § 1.367(b)-3(b) (1997).

corporation, the recognized gain is included in the gross income of the CFC as a dividend to the extent that it would have been included under Section 1248(a) if the CFC were a U.S. person.[245] For example, if a U.S. corporation owns 100 percent of the stock of a foreign corporation, which owns 100 percent of the stock of a second foreign corporation, any gain on the sale of the first corporation is treated as a dividend for purposes of subpart F income inclusions to the U.S. stockholders to the extent of earnings and profits of the second corporation attributable to periods in which the first corporation owned the stock of the second corporation while the latter was a CFC with respect to the U.S. shareholder.[246] The dividend treatment would include deemed sales under the Code.[247] For example, if a CFC distributes to its shareholder stock in a foreign corporation and the distribution results in gain being recognized by the CFC under Section 311(b) (a distribution of appreciated property) as if the stock were sold to the shareholder for fair market value, the CFC is treated as having sold or exchanged the stock.[248]

Capital gains treatment is denied on the sale of CFC stock to the extent the gain represents the shareholder's interest in undistributed earnings and profits not previously taxed under subpart F.[249] If a U.S. person sells or exchanges stock of a foreign corporation and owns ten percent or more of the combined voting power of all classes of stock of the foreign corporation at any time during the five year period ending on the sale or exchange date, then any gain on the sale or exchange of the stock is treated as a dividend to the extent of the earnings and profits attributable to the shares disposed of that were accumulated during periods in which the shareholder owned the shares and the foreign corporation was a CFC.[250]

Also, certain U.S. persons who own, acquire or dispose of stock in a foreign corporation are required to file reporting information.[251]

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[245] I.R.C. § 964(e)(1) (1997).

[246] H.R. 2014, Taxpayer Relief Act of 1997 (P.L. 105-34), Act. Sec. 1111 (1997).

[247] I.R.C. § 964(e)(3) (1997).

[248] H.R. 2014, Taxpayer Relief Act of 1997 (P.L. 105-34), Act. Sec. 1111 (1997).

[249] I.R.C. § 1248 (1997).

[250] I.R.C. § 1248(a) (1997); Treas. Reg. § 1.1248-1(a) (1997). The earnings and profits of lower-tier foreign subsidiaries are included in the dividend recharacterization to the extent the U.S. person indirectly owns 10% or more of the total combined voting power of any lower-tier foreign corporation. I.R.C. § 1248(c)(2) (1997); Treas. Reg. §§ 1.1248-2 and 1.1248-3 (1997) (determination of earnings and profits of foreign subsidiaries).

[251] I.R.C. §§ 6038 (1997) (information with respect to certain foreign corporations) and 6046 (returns as to incorporation or reorganization of foreign corporations and as to acquisitions of their stock).

U.S. citizens or residents, who are officers or directors of a foreign corporation, are subject to information reporting rules.[252]

To the extent earnings and profits were included previously under the subpart F or "PFIC" provisions,[253] they are not included in the deemed dividend calculation in which the foreign shares are sold or exchanged.[254] To the extent gain from the sale or exchange of stock in a foreign corporation is recharacterized as a dividend, the deemed dividend gives rise to a deemed paid foreign tax credit under principles similar to the provisions, covering actual distributions.[255]

VI. CONCLUSION

As the U.S. petroleum industry expands into more foreign jurisdictions and undertakes more foreign activities, U.S. companies must carefully review any stock or asset transactions with foreign entities for possible tax exposure. Although a domestic transfer of stock or assets in an incorporation or reorganization may be nontaxable, a similar transaction with foreign parties may be subject to Section 367 taxation and reporting requirements. The change of a foreign branch or partnership to a foreign corporation may result in a taxable event with a recapture of prior foreign losses. Failure to follow the various procedures can result in unexpected tax liabilities, substantial penalties and the tolling of the statute of limitations.

In limited circumstances, a taxpayer may request a private letter ruling for a determination of whether the taxpayer qualifies for an exception to the general rule under Section 367(a)(1).[256] A letter ruling is permitted if a taxpayer is unable to satisfy all of the active trade or business requirements, but is substantially in compliance and meets all of the percentage ownership requirements under Section 1.367(a)-3(c)(1), or is unable to satisfy any requirements due to the application of the Section 1.367(a)-3(c)(4)(iv) attribution rule with respect to determining the ownership of stock, securities or other property.[257] The Service will not rule on whether the principal purpose of an acquisition

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[252] I.R.C. §§ 558, 6035, 6046 (1997). Penalties and a reduction of foreign tax credits may result for failure to file Form 5471. I.R.C. §§ 6038(b)-(c) (1997).

[253] Although a CFC could also be a PFIC, the CFC is not treated as a PFIC with respect to U.S. shareholders who own at least 10% of the voting stock in the CFC and are subject to the subpart F rules. I.R.C. § 1297(e) (1997).

[254] I.R.C. §§ 1248(d)(1), (7) (1997) (exclusions from earnings and profits).

[255] Treas. Reg. § 1.1248-1(d) (1997) (credit for foreign taxes).

[256] Treas. Reg. § 1.367(a)-3(c)(9) (1997) (private letter ruling option).

[257] *Id.*

was to satisfy the active trade or business test or the substantiality test.[258]

The recent Notices 98-5 and 98-11 indicate the direction of the Service in reviewing international tax planning situations. As stated in Notice 98-11, "U.S. international tax policy seeks to balance the objective of neutrality of taxation as between domestic and foreign business enterprises . . . with the need to keep U.S. business competitive." Abusive arrangements disturb this balance. In the areas of hybrid arrangements and cross-crediting of foreign tax credits between high-taxed and low-taxed countries, the Service realizes that mismatching and cross-crediting occurs. In fact, appropriate cross-crediting between countries supports the purpose of the foreign tax credit by making the U.S. impact from different foreign income taxes of various countries a neutral factor in the investment decision of location. However, the concern is over abusive hybrid structures to avoid subpart F taxation or create tax-arbitrage situations and abusive transactions to purchase foreign tax credits without a reasonably expected economic profit, which implies no business purpose.

Through proper tax planning, a U.S. petroleum company can significantly minimize U.S. tax on foreign source income. The U.S. government through its Code and regulations provides to the U.S. petroleum industry a competitive tax advantage in the world energy market. The control of world oil resources and the maintenance of a secure supply of crude oil through U.S. oil companies will be always a major security concern of the U.S. government.

A trade off has been made through the U.S. Tax Code and regulations between taxing foreign source income versus providing tax advantages to U.S. multinationals to compete effectively in foreign markets against foreign companies. The fiscal benefits of this trade off have contributed indirectly to the extraordinary and competitive U.S. economy, which is generating substantial tax revenues and creating the first budget surplus for the U.S. Treasury since 1969.

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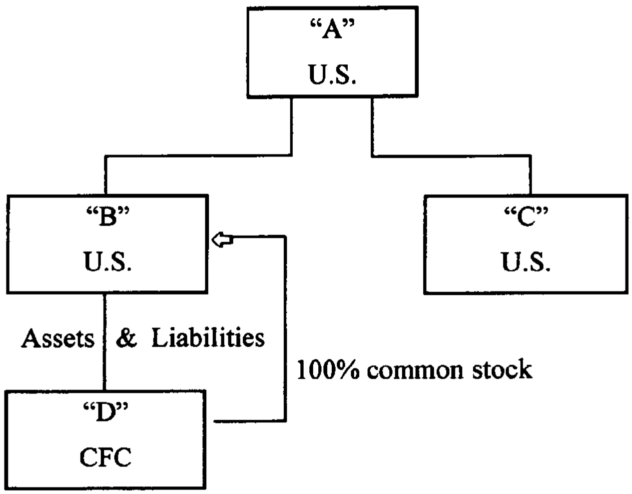
[258] Treas. Reg. § 1.367(a)-3(c)(9)(ii) (1997).

APPENDIX

Examples

Section 351(a) Asset Transfer

Company *A*, the U.S. parent corporation, owns 100% of Company *B*, a domestic corporation, and 100% of domestic Company *C*. Company *B* and Company *C* held oil and gas working interests and operated foreign branches. Company *B* transferred its branch business, consisting of a working interest in a foreign offshore oil and gas lease and related field and office equipment, to Company *D*, a newly formed CFC of Company *B*. All employees of the foreign branch were transferred to Company *D*.



The transfer was treated by Company *B* as an I.R.C. Section 351(a) asset transfer of the branch's oil and gas business with 100% of the common stock of Company *D* transferred to Company *B*. At the time of the transfer, Company *B* had incurred substantial leasehold and exploration expenditures, but there was not any production income.

Under Section 351(a), no gain or loss is recognized if property is transferred to a domestic corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in Section

368(c)) of the corporations.[259] If a U.S. person transfers property under a Section 351(a) exchange to a foreign corporation, the transfer may be treated as a taxable exchange under I.R.C. 367(a)(1). If Section 367(a)(1) treats the foreign corporation as not a corporation, Section 351(a) cannot prevent gain recognition. The taxable exchange of property for stock results in gain recognition.[260]

Company B transferred the branch's assets of an active trade or business to a new Company *D* in exchange for 100% of Company *D*'s common stock. Company *B* treated the transfer as a nontaxable exception under Section 367(a)(3) and Treas. Reg. Section 1.367(a)-2T and computed branch losses recapture under Section 367(a)(3)(C) and Treas. Reg. Section 1.367(a)-6T.

All branch losses were recaptured up to the amount of the gain realized on the assets transferred. Company *B*'s basis in Company *D*'s common stock is the same as Company *B*'s basis in the property transferred increased by the amount of any gain to Company *B* which is recognized on such exchange.[261]

"F" Re-incorporation and "D" Reorganization

Company *C* ("Oldco") was reincorporated in a foreign country based upon state law procedures in the U.S., enabling corporations to simultaneously de-register in the state and register as a corporation in another state or a foreign country. The transaction was treated by the U.S. parent company (*A*) in its consolidated return as an "F" reorganization described in Section 368(a)(1)(F) and was treated under Temp. Treas. Reg. Section 1.367(a)-1T(f) as a transfer of assets from the domestic corporation, Oldco, to a new foreign corporation ("Newco"), in exchange for the stock of Newco followed by a distribution of the Newco stock by Oldco to Oldco's shareholder (*A*).

Oldco held assets which were used in the active conduct of the oil and gas business. Oldco treated the transfer as a transfer described in Section 367(a)(3) and Temp. Treas. Reg. Section 1.367(a)-2T. Oldco claimed that it followed the application of branch loss recapture as

[259] Section 368(c) requires 80% ownership control of the voting power of all classes of stock entitled to vote and 80% of the total number of all other shares. The regulations combine the ownership of all members of the affiliated corporations filing a consolidated return. Treas. Reg. § 1.1502-34 (1997); Rev. Rul. 70-141, 1970-1 C.B. 76.

[260] I.R.C. § 1001 (1997).

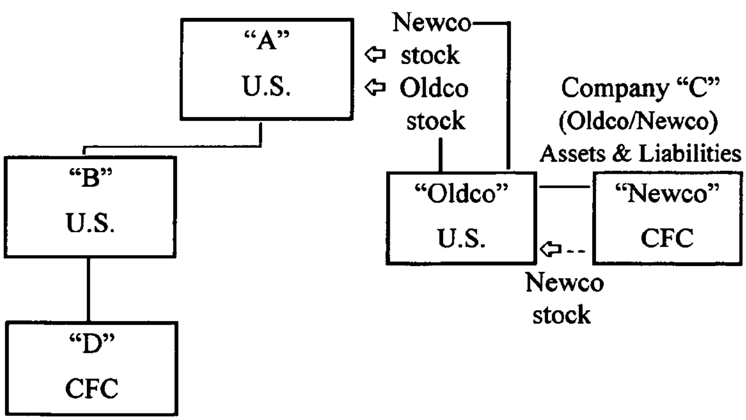
[261] I.R.C. § 358(a) (1997).

required under Section 367(a)(3)(C) and Treas. Reg. Section 1.367(a)-6T.

An "F" reorganization is "a mere change in identity, form, or place of organization of one corporation, however [sic], effected."[262] When a foreign corporation is a party, the reorganization can be both a "D" and "F" reorganization.[263]

In an acquisitive "D," the target corporation ("Oldco") transfers "substantially all of its assets"[264] to the acquiring corporation ("Newco"), which is controlled[265] by Oldco or one or more of Oldco's shareholders (*A*). Pursuant to a plan of reorganization, Newco issues its stock to Oldco's shareholders in exchange for the assets and liabilities of Oldco. Upon Oldco's shareholders (*A*) receiving the Newco stock, Oldco dissolves.

"F" Re-incorporation



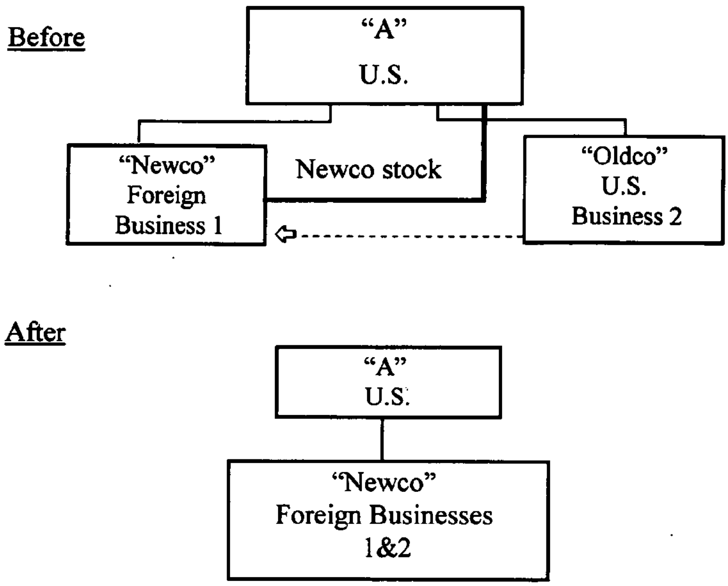
[262] I.R.C. § 368(a)(1)(f) (1997).

[263] Rev. Rul. 87-27, 1987-1 C.B. 134 (an "F" reorganization that was also a "D" reorganization).

[264] I.R.C. § 354(b) (1997).

[265] I.R.C. § 368(a)(2)(H) (1997) (acquisitive "D" control uses Section 304(c) definition of control of 50% of the vote or value with attribution).

Acquisitive "D"



An "F" reorganization can apply to either a domestic or foreign corporation. Since the "F" reorganization requires a change involving one corporation, the entity involved must be a corporation for U.S. tax purposes under Section 7701(a)(3) for an "outbound F" reorganization to occur.[266]

An "outbound F" reorganization occurs when a domestic corporation becomes a foreign corporation under the following steps:

1. The transfer of assets by the domestic corporation under Section 361(a) in exchange for stock of the foreign corporation and its assumption of liabilities;[267]

2. the distribution by the domestic corporation of the stock of the foreign corporation to the shareholders of the domestic corporation;[268] and

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[266] *See* Ltr. Rul. 88-480-42 (September 2, 1988).
[267] Temp. Treas. Reg. § 1.367(a)-1T(f)(1) (1997).
[268] Temp. Treas. Reg. § 1.367(a)-1T(f)(2) (1997).

3. the exchange by the domestic corporation's shareholders of the stock of the domestic corporation for the stock of the foreign corporation under Section 354(a).[269]

Also, the regulations provide that it is immaterial if the applicable foreign or domestic state law treats the acquiring corporation as a continuance of the transferor corporation.[270]

As mentioned, a transaction may qualify as both an "F" and a "D" reorganization. If the liabilities of the transferor domestic corporation exceed the basis of its assets, treatment as a "D" reorganization would result in the recognition of gain.[271] However, the Service has stated that the "F" treatment prevails over the "D" and the domestic corporation does not recognize gain.[272] All of the assets and liabilities of the domestic corporation are transferred to a new corporation without a change in shareholder or shareholder proprietary interest in the corporation.[273] The reorganization of a single entity does not recognize Section 357(c) gain.[274]

The transfer of the assets and liabilities of Oldco to Newco in exchange for Newco stock, followed by a distribution of the Newco stock to Oldco's shareholders in exchange for the Oldco stock results in no change in shareholder or shareholder proprietary interest. The recharacterization constitutes a reorganization under Section 368(a)(1)(F), because the effect of the transaction is a mere change in the place of organization of Oldco. Oldco and Newco are both parties to the reorganization within the meaning of Section 368(b)(2).[275]

The basis of the assets of Oldco will have a carryover basis to Newco increased by any gain required to be recognized by Oldco.[276] The holding period of the assets held by Newco after the transaction will include the Oldco's holding period prior to the transfer.[277] The basis of the Newco shares received by "A" will be a substitute basis of the Oldco shares surrendered in the exchange.[278] The holding period of

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[269] Temp. Treas. Reg. § 1.367(a)-1T(f)(3) (1997). *See* Notice 88-50, 1988-1 C.B. 535; Notice 87-29, 1987-1 C.B. 474.

[270] Temp. Treas. Reg. § 1.367(a)-lT(f) (1997).

[271] I.R.C. § 357(c)(1)(B) (1997).

[272] Rev. Rul. 87-27, 1987-1 C.B. 134.

[273] *Id.*; *see* Rev. Rul. 79-289, 1979-2 C.D. 145.

[274] *Id.*

[275] Ltr. Rul. 88-480-42 (September 2, 1988).

[276] I.R.C. § 362(b) (1997).

[277] I.R.C. § 1223(2) (1997).

[278] I.R.C. § 358(a) (1997).

the Newco stock received by "A" after the transfer will include the Oldco stock holding period provided the Oldco stock was held as a capital asset on the exchange date.[279] No gain or loss will be recognized by Newco upon the receipt of Oldco's assets in exchange for the Newco stock.[280]

When a domestic corporation transfers assets to a foreign corporation in an "F" reorganization, the taxable year of the domestic corporation ends with the close of the transfer date.[281] The taxable year of the acquiring foreign corporation ends on the date the domestic corporation's taxable year would have ended if not for the reorganization.[282] The domestic corporation that transfers assets to a foreign corporation in an "F" reorganization must comply with the reporting rules under Section 6038B.[283]

Generally, Section 361(a) prevents the domestic corporation that transfers the assets from recognizing gain or loss with an "F" reorganization and Section 354 prevents the corporate shareholders from recognizing gain or loss. If a foreign corporation is involved, Section 367(a)(1) generally requires that gain (but not loss) be recognized on the transfer of property. If Section 367(a)(1) treats the foreign corporation as not being a corporation for tax purposes, the transaction would not qualify as a reorganization under Section 368 and the transferor ("Oldco") would be denied nonrecognition treatment under Section 361(a).[284] However, Oldco claims the exception to the general rule of gain recognition under Section 367(a)(3) for property used in an active foreign business.[285]

Section 367(a)(1) by its terms applies only when a U.S. person transfers property to a foreign corporation. In an "F" reorganization, the shareholders of the domestic corporation that becomes a foreign corporation do not transfer any property to the foreign corporation. The shareholders surrender all the stock of the domestic corporation to the domestic corporation in exchange for the stock of the foreign corporation.[286] Thus, Section 367(a)(1) does not prevent the general

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[279] I.R.C. § 1223(l) (1997).

[280] I.R.C. § 1032(a) (1997).

[281] Temp. Treas. Reg. § 1.367(a)-lT(e) (1997).

[282] *Id.*

[283] Ltr. Rul. 88-480-42 (September 2, 1988).

[284] Rev. Rul. 87-27, 1987-1 C.B. 134.

[285] *See* Ltr. Rul. 88-480-42 (September 2, 1988) (foreign corporation used assets in active conduct of foreign business within the meaning of Temp. Treas. Reg. § 1.367(a)-2T(b) (1997)).

[286] Temp. Treas. Reg. § 1.367(a)-lT(f)(3) (1997).

rules of Section 354 from applying to shareholder "A" of the domestic corporation.[287]

The U.S. consolidated group, which included Company C ("Oldco"), was in the process of funding and expanding foreign operations, while gradually selling domestic assets. The foreign branch of Oldco, prior to Oldco's re-incorporation as a foreign corporation ("Newco"), incurred interest expense deductions from intercompany loans, resulting in foreign branch losses. Also, the U.S. consolidated group incurred an OFL during these years as a result of the interest expenses on all foreign activities. A portion of the interest expenses was allocated U.S. source under Treas. Reg. Sections 1.861-8 and -8T through -14T, based upon the fair market value of the assets.

The portion of the interest expense deductions incurred as a result of activities of the foreign branch but allocated U.S. source was not included in the computation of the foreign losses. Thus, interest expense, which is allocated U.S. source, is not subject to recapture under the OFL Section 904(f)(3) and branch loss Section 367(a)(3)(C).

If a fair market value rather than a book value method is used to allocate interest expense based upon assets, there may be a question of whether the foreign assets were given a high value and the U.S. assets were given a low value to shift a maximum amount of interest expense deduction to U.S. source from foreign source. Along with minimizing future branch loss recapture, any shifting of interest expense deductions to U.S. source would increase foreign source income and foreign tax credits.

[287] Rev. Rul. 87-27, 1987-1 C.B. 134.