Chapter 78

Inbound Transactions: Withholding and Reporting

§ 78:1 Carryovers: Mergers and Acquisitions

The Preamble to the 2006 Final Regulations states that the principal policy consideration of section 367(b) with respect to inbound nonrecognition transactions is the appropriate carryover of attributes from foreign to domestic corporations, which has interrelated shareholder-level and corporate-level components.[1]

Also, regulations issued in 2000 clarify that a domestic acquiring corporation succeeds to those foreign taxes paid or accrued by a foreign target corporation only to the extent those taxes are eligible for credit under section 906. The Preamble to those regulations notes that it would be consistent with the policy considerations of section 367(b) for future regulations to provide additional rules with respect to the extent to which attributes carry over from a foreign corporation to a U.S. corporation. Those Final Regulations adopted rules that had been proposed concerning several attributes—specifically: net operating loss and capital loss carryovers, and earnings and profits that are not included in income as an "all earnings and profits" amount (or a deficit in earnings and profits). The regulations generally provide that these tax attributes carry over from a foreign acquired corporation to a domestic acquiring corporation only to the extent that they are effectively connected with a U.S. trade or business (or attributable to a permanent establishment, in the case of an applicable U.S. income tax treaty).[2]

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1. *See* Preamble to T.D. 9273.
2. *See* Treas. Reg. § 1.367(b)-3(e) and (f), issued as T.D. 9273.

§ 78:1.1 Hovering Deficit Rule

The 2006 Final Regulations mentioned above apply the proposed "hovering deficit" rule on a basket-by-basket basis. The regulations clarify that post-transaction earnings and profits that may be offset by hovering deficits don't include earnings and profits that are distributed in the same tax year that they are earned. The regulations further provide that foreign taxes concerning a hovering deficit enter the post-1986 foreign income tax pool on a pro rata basis as the deficit is used to offset post-transaction accumulated earnings and profits.[3]

The regulations also cover the carryover of attributes in an acquisition where both the acquired and the acquiring corporation are foreign. In such cases, E&P generally can carry over to the surviving corporation; however, under the "hovering deficit rule," a deficit in E&P for either corporation can be used only to offset E&P earned after the date of transfer; the Service says this is intended to limit trafficking in favorable tax attributes.[4]

§ 78:1.2 Section 361 Exchanges

In December 2007, the Service released notice that it will be issuing regulations taking the position that on outbound reorganizations under section 361 where the foreign acquiring corporation retransfers acquired property to a domestic controlled corporation, the basis adjustment under section 367(a)(5) must be made to the stock of the foreign corporation that is received by domestic U.S. transferor's shareholders such that the appropriate amount of unrecognized gain in the U.S. transferor's property is reflected in such stock. Also, the regulations will provide that the exception from the section 367 rules for foreign transfers of property for section 351 exchanges will not apply to section 351 transactions that are also section 361 exchanges.[5]

§ 78:1.3 Section 351 Exchanges

Section 367(d) requires a U.S. person that transfers intangible property to a foreign corporation in an exchange described in section 351 or 361 to take into income annual payments over the useful life of the intangible as though the transferor had sold the intangible for payments contingent upon productivity, use, or dispo-

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3. *See* Treas. Reg. § 1.367(b)-7(d)(2).
4. *See* Treas. Reg. § 1.367(b)-7(d)(2), Preamble to T.D. 9273.
5. *See* I.R.S. Notice 2008-10.

sition of the property.[6] Further, the statute requires that the payments be commensurate with the income attributable to the intangible.[7] Thus, although sections 351 and 361 normally allow a transferor to exchange property for stock of a corporation without any recognition of gain, section 367(d) requires a U.S. person to recognize income when it exchanges intangible property for stock of a foreign corporation. The transferor must recognize such income regardless of whether the transferee corporation actually makes payments to the transferor.[8]

Section 367(d) refers to section 936(h)(3)(B) for the definition of intangible property. That section provides that the term "intangible property" means any:

(i) patent, invention, formula, process, design, pattern, or know-how;

(ii) copyright, literary, musical, or artistic composition;

(iii) trademark, trade name, or brand name;

(iv) franchise, license, or contract;

(v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or

(vi) any similar item, which has substantial value independent of the services of any individual.[9]

Thus, a U.S. person will be required to recognize annual payments under section 367(d) upon the transfer of any of these enumerated intangibles or similar items to a foreign corporation in an exchange described in section 351 or 361. These payments must represent an appropriate arm's-length charge for the use of the property, and the charge is determined in accordance with the provisions of section 482 and the regulations thereunder.[9.1]

According to the Service, Congress enacted section 367(d) because it thought it was inappropriate to allow a foreign corporation to earn deferred income from intangible property that was developed by claiming significant expenses in the United States.[9.2] To prevent this mismatch between expenses that offset taxable income

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6. *See* I.R.C. § 367(d).
7. *See* I.R.C. § 367(d)(2)(A).
8. *See* TAM 200907024.
9. *See* I.R.C. § 936(h)(3)(B).
9.1. *See* Treas. Reg. § 1.367(d)-1T(c)(1).
9.2. *See* TAM 200907024, referring to H.R. REP. NO. 98-342 (1984); S. REP. NO. 98-169, at 361 (1984).

in the United States and deferred income in a foreign country, Congress adopted a regime to ensure that a U.S. transferor of intangible property continues to be taxed on amounts commensurate with the income attributable to the transferred intangible.[9.3]

Notice 2012-39[9.4] addresses certain transfers of intangible property by a domestic corporation to a foreign corporation in a section 361(a) or (b) exchange—outbound section 367(d) transfers. The Service says it will issue regulations incorporating the guidance described in the Notice, and those regulations will apply to transfers occurring on or after July 13, 2012 (the date of the Notice).

[A] Exception for Transfers of Foreign Goodwill or Going Concern Value

The Service notes that section 367(d) does not contain any statutory exceptions or special rules for transfers of particular types of intangibles. Nevertheless, Congress stated in the legislative history to the enactment of section 367(d) that the transfer of goodwill or going concern value developed by a foreign branch did not represent the kind of abuse that it wanted to target by enacting this provision. Although there is no specific direction to exclude these items from section 367(d), Regulation section 1.367(d)-1T(b) provides that section 367(d) and the regulations thereunder do not apply to the transfer of foreign goodwill or going concern value. For this purpose, "foreign goodwill or going concern value" is defined as "the residual value of a business operation conducted outside the U.S. after all other tangible and intangible assets have been identified and valued."[9.5]

§ 78:2 Securities Trading

A "trading safe harbor" for securities was intended to provide certainty that foreign persons who merely trade stocks and securities would not be subject to U.S. income tax. This exception is based on the expectation that ordinary income from U.S. stocks and securities will be subject to U.S. taxation through the withholding tax on fixed and determinable or annual and periodic income (FDAP), and that activities beyond the scope of the safe harbor would remain subject to net tax if the taxpayer was engaged in a U.S. trade or business.

9.3. TAM 200907024, referring to section 1231(e) of Pub. L. No. 99-514, 100 Stat. 2095 (adding the "commensurate with income" requirement to section 367(d)(2)(A)).

9.4. I.R.S. Notice 2012-39, 2012-2 C.B. 95.

9.5. *See* Treas. Reg. § 1.367(a)-1T(d)(5)(iii), cited by TAM 200907024.

Proposed regulations would extend the trading safe harbor to taxpayers who enter into derivative transactions for their own accounts.[10] The term "derivatives" is defined for these purposes as an interest rate, currency, equity or commodity notional principal contract, or an evidence of an interest in, or derivative financial instrument in, any commodity, currency, or any item described in Code section 475(c)(2)(A)–(D).[11] The regulations provide that derivative transactions (including hedging transactions) do not constitute a U.S. trade or business if the taxpayer meets the definition of an "eligible nondealer."[12] An eligible nondealer is a foreign resident who is not a dealer in stocks, securities, commodities, or derivatives at any time during the taxable year.[13] Dealer status is determined on a worldwide basis and disqualifies a person from the safe harbor even if no dealing activities are conducted in the United States.[14]

The former requirement that a corporation, in order to avoid being treated as engaged in a U.S. trade or business for the purposes of the "own account" trading rules under Code section 864, had to have its principal office outside the United States, was eliminated by TRA 1997.[15]

§ 78:3 Withholding Rules

A person who makes a payment of U.S.-source income to a foreign person generally must withhold 30% from the payment.[16] Generally, the amount subject to withholding is the gross amount of income paid to a foreign person, not reduced by any deductions, other than personal exemptions.[17] A lower rate of withholding may apply under the Code, the regulations, or a treaty. Generally, the payor must also report the payments on Form 1042-S.[18]

Many of the withholding principles set out in the Code for payments to foreign persons are fleshed out by the regulations.[19]

Foreign payees may be exempt from withholding. A payor can rely on the payee's foreign status through the certifications of a qualified intermediary (QI).

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10. REG-106031-98, released June 1998.
11. *See* Prop. Treas. Reg. § 1.864(b)-1(b)(2).
12. Prop. Treas. Reg. § 1.864(b)-1(a).
13. Prop. Treas. Reg. § 1.864(b)-1(b)(1).
14. *See id.*
15. *See* I.R.C. § 864(b)(2)(A)(ii).
16. *See* I.R.C. § 1441 *et seq.*
17. Treas. Reg. § 1.1441-3(a).
18. *See* Treas. Reg. § 1.1461-1(c).
19. *See* Treas. Reg. § 1.1441-1.

§ 78:3.1 In Lieu of Filing Return

Filing is not required for nonresident aliens who are not engaged in U.S. business if their tax liability is fully satisfied by withholding at the source.[20]

A similar rule applies to partnerships. A foreign partnership that has no income that is effectively connected to the United States and that would be required to file a partnership return only because it has U.S.-source income does not have to file a partnership return if:

(1) there are no U.S. partners;

(2) the U.S.-source income is either fixed or determinable annual or periodical income under section 1441;

(3) Forms 1042 and 1042-S are filed with respect to all such income; and

(4) the tax liability of the partners with respect to such income has been fully satisfied by withholding.[21]

This exception from filing does not apply if the person claims a refund.[22]

§ 78:3.2 Certification of Foreign Status

A certification of foreign status (beneficial owner withholding certificate, Form W-8) is valid for three years.[23] The certificates of intermediaries and non-withholding foreign partnerships are valid indefinitely.[24] The Form W-8 must be signed under penalty of perjury by the beneficial owner, and claims of treaty benefits may require a certified TIN.[25]

The withholding agent generally is entitled to rely on a foreign entity's certification of status.[26] There are proposed guidelines for the electronic transmission of Form W-8.[27]

§ 78:3.3 Supplemental Wages

"Supplemental wages" are distinguished from regular wages for withholding purposes.[28] Supplemental wages can either be aggregat-

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20. *See* Treas. Reg. § 1.6012-1(b)(2).
21. Prop. Treas. Reg. § 1.6031(a)-1(b)(2).
22. *See* ICI Pension Fund v. Comm'r, 112 T.C. No. 8 (1999), citing Treas. Reg. § 1.6012-1(b)(2).
23. Treas. Reg. § 1.1441-1(e)(4)(ii).
24. Treas. Reg. § 1.1441-1(e)(4)(ii)(B).
25. Treas. Reg. § 1.1441-1(e)(2)(ii).
26. Treas. Reg. § 1.1441-1(e)(4)(viii).
27. *See* Prop. Treas. Reg. § 1.1441-1(e)(4)(iv).
28. *See* Treas. Reg. § 31.3401(a) (Employment Tax Regulations).

ed with regular wages or withheld under a flat rate system. The flat rate system generally requires that the employer withholds on the employee's regular wages and that the supplemental wages are either not paid concurrently with regular wages or are separately stated. Traditionally, supplemental wages have been considered to be: sick pay, reimbursements, stock option income, payments in lieu of fringe benefits (such as for accumulated leave and vacation), overtime pay, and retroactive pay.

The 2004 Jobs Creation Act added a noncodified provision that if an employer elects to treat a payment as supplemental wages, withholding must be at least the third lowest rate of tax for single filers (that is, 25% for 2005); also, for supplemental wage payments exceeding $1 million, withholding must be at the highest income tax rate.[29] For purposes of the $1 million threshold, payments from all businesses under common control are aggregated.[30]

A public ruling by the Service illustrates the calculation of withholding on supplemental wages involving nine different situations: (1) commissions paid at fixed intervals with no regular wages; (2) commissions paid at fixed intervals in addition to regular wages; (3) draws paid in connection with commissions; (4) commissions paid only when an accumulated commission credit reaches a specific numerical threshold; (5) a signing bonus; (6) severance pay; (7) lump sum accumulated leave pay; (8) annual payments of vacation and sick leave; and (9) sick pay paid at a different rate than regular pay.[31]

Regulations issued in July 2006 provide that "supplemental wages" include bonuses, overtime pay, back pay, tips, commissions, reimbursements, payments for fringe benefits, sick pay, and stock option income.[32] Generally, this includes payments that vary from one payroll period to another; however, such payments can be treated as regular wages if they are the only wages paid.[33]

§ 78:3.4 Currency Conversion

The current regulations provide that if an amount subject to tax is paid in a currency other than the U.S. dollar, the amount of withholding is determined by converting the amount withheld into U.S.

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29. *See* Pub. L. No. 108-357, Act § 904.
30. *See* Pub. L. No. 108-357, Act § 904(b)(2).
31. *See* Rev. Rul. 2008-29.
32. *See* Treas. Reg. § 31.3402(g)-1(a)(1)(i), issued as T.D. 9276, finalizing REG-152945-04, which had been released in Jan. 2005.
33. *See* Treas. Reg. § 31.3402(g)-1(a)(1)(ii).

dollars at the spot rate on the date of payment. A withholding agent that makes regular or frequent payments in foreign currency is permitted to use a month-end spot rate or a monthly average spot rate.

Previously, the regulations provided that if an amount subject to tax is paid in a currency other than the U.S. dollar, the amount of withholding is determined by converting the amount withheld into U.S. dollars at the spot rate on the date of payment. A withholding agent that makes regular or frequent payments in foreign currency is permitted to use a month-end spot rate or a monthly average spot rate. Regulations issued in 2006 provide that such a withholding agent can make the conversion at the spot rate on the day the tax is deposited, provided that the deposit is made within seven days of the date of payment.[34]

§ 78:3.5 Nonresident Aliens

Nonresident aliens are not allowed to claim the standard deduction, and generally are limited to only one withholding exemption. Because withholding tables take the standard deduction into account in determining the income threshold at which withholding is to begin, the Service's published guidelines for filling out a Form W-4, "Employee's Withholding Allowance Certificate," require nonresident aliens to request additional withholding.

The Service has determined that the old rules (applicable through 2005) resulted in overwithholding. Accordingly, beginning with 2006, the following rules will apply for nonresident aliens filling out Form W-4:

(1) they cannot claim exemption from withholding;

(2) they must request withholding as single, even if married; and

(3) only one withholding allowance can be claimed.

The requirement that additional withholding must be requested has been eliminated. Also, note that the "one allowance" rule does not apply to residents of Canada, Mexico, and South Korea.[35]

A limited "making work pay" credit was added through section 36A by the 2009 Economic Recovery Act.[35.1]

In order to expeditiously get the money into workers' hands, the credit was implemented by establishing reduced withholding amounts. Since nonresident aliens are not allowed to take the cred-

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34. *See* Treas. Reg. § 1.1441-3(e)(2).
35. *See* I.R.S. Notice 2005-76.
35.1. *See* I.R.C. § 36A, added by Pub. L. No. 111-5.

it, this requires an additional, second, modification to the withholding tables for nonresident aliens, for the years covered by the credit.[35.2]

[A] Interest Payments

An internal legal memorandum of the IRS presents the question whether a withholding agent that failed to withhold under section 1441 on payments of interest to a nonresident alien is barred under Treasury Regulations section 1.871-14(c)(3)(i) from subsequently obtaining the required documentation to qualify the payments as portfolio interest payments when: (1) the nonresident alien individual did not file a U.S. tax return nor pay any tax for the year in which the payments were made; or (2) the nonresident alien did file a U.S. tax return and paid tax unrelated to the interest payments for the year in which the payments were made.

The memo concludes that the withholding agent is not barred under Treasury Regulations section 1.871-14(c)(3)(i) from obtaining the documentation when the nonresident alien individual has not filed a U.S. tax return and has not paid any tax for the year in which the interest payments were made.

But, the withholding agent may be required to provide additional proof of entitlement to a reduced rate of withholding under Treasury Regulations section 1.1441-1(b)(7)(ii) to the extent that the reliability of the documentation is affected by the delay in obtaining it.

The withholding agent may be barred under Treasury Regulations section 1.871-14(c)(3)(i) from obtaining the documentation when the nonresident alien individual has filed a U.S. tax return and paid tax for the year in which the interest payments were made. As the filing of the return and the payment of tax both cause the nonresident alien individual's period of limitations under section 6511(a) to begin, the withholding agent has until the expiration of that period to obtain the required documentation.[35.3]

[B] Nonresident Aliens—Withholding

At the beginning of 2017, the IRS made a series of changes and clarifications to the Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, and the accompanying instructions, in an effort to assist withholding agents to more accurately report

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35.2. *See* I.R.S. Notice 2009-91, 2009-48 I.R.B. 717; I.R.C. § 36A (as enacted, section 36A is to apply only for the years 2009 and 2010). The termination of calculations under Notice 2009-91 after 2010 was confirmed by Notice 2011-12, 2011-1 C.B. 514.

35.3. *See* ILM 201434021.

income and withholding information relating to payments made to nonresident alien recipients.

Withholding agents are required to complete Form 1042-S for payments made to nonresident aliens.

Many of the clarifying changes underscore the need for exact reporting of the recipient's name on all copies of Form 1042-S, and for identical information to be reported on all copies of Form 1042-S.

Withholding agents must complete five copies of the Form 1042-S. Copy A should be filed with the IRS. Copies B, C and D should be furnished to the recipient of the payment. Copy E should be retained by the withholding agent. All information, including the name of the recipient, must match exactly on all copies.[35.4]

§ 78:3.6 Treaty Provisions (Reducing Withholding Rate)

Section 871 generally imposes a tax of 30% on amounts received by a nonresident alien individual from sources within the United States as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income (FDAP)—but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.[35.5]

Section 1441(a) generally requires all persons, acting in whatever capacity and having control, receipt, custody, disposal, or payment of an item of FDAP of any nonresident alien individual (or foreign partnership) to withhold a tax equal to 30% of that item of income. But Regulation § 1.1441-6(a) provides that the withholding rate can be reduced to the extent provided under an income tax treaty.[35.6]

For example, in a private letter ruling regarding the treaty with Canada, the Service notes that the treaty provides that pensions may be taxed in the contracting state in which they arise and according to the laws of that state, but if a resident of the other contracting state is the beneficial owner of a periodic pension payment, the tax so charged is not to exceed 15% of the payment. In this treaty, the term "pensions" includes payments from IRAs in the United States.

Accordingly, the Service concluded that a required minimum distribution amount distributed to the IRA owner constituted a "peri-

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35.4. *See* FS-2017-3.
35.5. *See* I.R.C. § 871.
35.6. *See* Treas. Reg. § 1.1441-6(a).

odic pension payment" under the treaty that was eligible for the 15% reduced withholding tax rate.[35.7]

§ 78:4 Reporting Rules

Under the Form 1099 reporting provisions,[36] payors of interest, dividends, royalties, gross proceeds from the sales of securities, and other fixed or determinable income generally must report payments on Form 1099. If a payment is reportable, the payor generally must obtain a Form W-9 from the payee. If the payor does not receive the Form, it must generally backup withhold at a 31% rate under section 3406 and report the payment on Form 1099. These rules do not apply to payments to a foreign person. A payor can treat a person as foreign if the payor can reliably associate the payment with documentation establishing that the person is a foreign beneficial owner of the income or a foreign payee.[37] A payor would not have to backup withhold on such payments because backup withholding applies only to amounts that must be reported on Form 1099.[38]

§ 78:4.1 Documentary Evidence

The current regulations provide an exception from certain information reporting where a payment is made outside the United States and the payor can rely on appropriate documentation to treat the payment as made to a foreign person. This exception allows a payor to rely on documentary evidence instead of an applicable withholding certificate for payments made to an offshore account. For this purpose, the term offshore account means one maintained at an office or branch of a U.S. or foreign bank at any location outside the United States, including Possessions.

Previously, the regulations provided an exception from certain information reporting where a payment is made outside the United States and the payor can rely on appropriate documentation to treat the payment as made to a foreign person. This exception allows a payor to rely on documentary evidence instead of an applicable withholding certificate for payments made to an offshore account. For this purpose, the term offshore account means one maintained at an office or branch of a U.S. or foreign bank at any location outside the United States, including Possessions. The regulations issued in 2006 extend this exception to accounts in U.S. Possessions.[39]

35.7. *See* Priv. Ltr. Rul. 201009012.
36. *See* I.R.C. §§ 6041, 6042, 6045, 6049, and 6050N.
37. *See, e.g.*, Treas. Reg. § 1.6041-4(a).
38. *See* Rev. Proc. 2000-12, 2000-4 I.R.B. 387.
39. *See* Treas. Reg. § 1.6049-5(c)(1).

§ 78:4.2 Foreign-Source Services Income

A U.S. payor generally must report payments made for services performed outside the United States, unless the payee has provided documentation to establish its status as a foreign beneficial owner or a foreign payee, or is presumed to be foreign under the presumption rules.[40] Under those rules a payor must presume U.S. status if the payee is an individual. Proposed regulations would implement Notice 2001-4's provisions that reporting will not be required if:

(1) the payee is an individual;

(2) the payor does not know that the payee is a U.S. person;

(3) the payor does not know, or have reason to know, that the income is U.S. effectively connected income; and

(4) all of the services were performed outside the United States.[41]

The Tax Court has held that fees paid to a Mexican corporation by its U.S. subsidiary—for guaranteeing the subsidiary's debt to U.S. lenders—were analogous to a fee for services; the court further held that this "service" would be sourced where it was provided, and that was Mexico. Accordingly, the payments were not subject to the 30% withholding under section 881(a).[41.1]

§ 78:4.3 Treaty-Based Return Positions

Previously, the regulations provided that if a taxpayer takes a return position that a tax treaty overrules or modifies any provision of the Code and thereby effects a reduction of tax, the taxpayer must disclose that return position, either on a statement attached to the return or on a return filed for the purpose of making such a disclosure. This reporting is required unless expressly waived; a list of specific exceptions from the general reporting requirements is set out in Regulation § 301.6114-1(a) and (b). Regulations finalized in 2006 added a new exception for taxpayers that are not individuals or states and that receive amounts of income that are properly reported on Form 1042-S and do not exceed $500,000 in the aggregate for the tax year.[42]

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40. *See* Treas. Reg. § 1.6049-5(d)(2), § 1.1441-1(b)(3)(iii).
41. *See* Treas. Reg. § 1.1441-1(b)(3)(iii)(E).
41.1. *See* Container Corp. v. Comm'r, 134 T.C. No. 5 (2010).
42. *See* Treas. Reg. § 301.6114-1(c)(8).

§ 78:4.4 Partnerships

Generic legal advice by the Service concludes that when a section 367(a) transfer is made by a partnership, the partners rather than the partnership must file the Form 926 "Return by a U.S. Transferor of Property to a Foreign Corporation." The Service explains that the partners are treated as having transferred their respective shares of the cash or tangible property that was actually transferred by the partnership. The reporting requirement applies to both general and limited partners, including C and S corporations that are partners, and trusts that are not grantor trusts.[43]

§ 78:4.5 Allocating Interest Expense

Temporary and proposed regulations released in January 2012 provide guidance regarding the allocation and apportionment of interest expense by corporations owning a 10% or greater interest in a partnership, as well as the allocation and apportionment of interest expense using the fair market value method.[43.1]

New Business Interest Deduction Rules—
Following Passage of the 2017 Tax Act

Section 163(j) generally limits the business interest expense deduction to the sum of business interest income, 30% of adjusted taxable income, and floor plan financing interest. "Business interest" is defined as any interest paid or accrued on indebtedness properly allocable to a trade or business. There are exceptions for small businesses, some regulated utilities, and electing real estate and farming trades or businesses that make an irrevocable election not to be subject to the limitations. Adjusted taxable income excludes income, gain, deduction, or loss not properly allocable to a trade or business; business interest or business interest expense; deductions for net operating losses; deductions under section 199A; and deductions for depreciation, amortization, or depletion for tax years beginning before January 1, 2022.[43.2]

§ 78:4.6 Country-by-Country Reporting

Revenue Procedure 2017-23 describes the process for filing Form 8975, Country-by-Country Report, and accompanying Schedules A, Tax Jurisdiction and Constituent Entity Information (collectively,

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43. *See* AM 2008-006.
43.1. *See, e.g.*, Temp. Treas. Reg. § 1.861-9T(e)(2), released as T.D. 9571; REG-113903-10.
43.2. *See* I.R.C. § 163(j).

Form 8975), by ultimate parent entities of U.S. multinational enterprise (MNE) groups for reporting periods beginning on or after January 1, 2016, but before the applicability date of Treasury Regulations section 1.6038-4 (early reporting periods).

The procedure reviews that final regulations issued in June 2016[43.3] require certain U.S. business entities that are the ultimate parent entity of a U.S. MNE group to file Form 8975 annually. Form 8975 requires the ultimate parent entity of a U.S. MNE group to report information, on a country-by-country basis (the "CbC" reporting regulations), related to the group's income and taxes paid (along with certain indicators of the location of the group's economic activity). The CbC reporting regulations apply to reporting periods of ultimate parent entities of U.S. MNE groups that begin on or after the first day of the first taxable year of the ultimate parent entity that begins on or after June 30, 2016.[43.4]

§ 78:5 Withholding Regulations

§ 78:5.1 Beneficial Owners

Final regulations adopted a change that had been proposed earlier, providing that for flow-through entities, the persons who are the beneficial owners are the ones who, under U.S. tax principles, are the owners in their separate or individual capacities. For example, partners, not the partnership, are the beneficial owners of partnership income.[44] Under the final regulations, beneficial ownership generally is determined according to U.S. tax principles. A provision that had been proposed for this determination to be made according to foreign law under treaty was eliminated in the final regulations.[45]

§ 78:5.2 Sourcing Payments

The final regulations attempt to clarify the Service's position that amounts can be treated as U.S.-sourced even if the source is undetermined at the time of payment.[46] The Service says this is meant to overturn a Tax Court ruling that such amounts are sourced outside the United States for withholding purposes.[47]

43.3. T.D. 9773.
43.4. *See* Rev. Proc. 2017-23, 2017-7 I.R.B. 915.
44. Treas. Reg. § 1.1441-1(c)(6).
45. *See* Treas. Reg. § 1.1441-1(c)(6)(B)(ii).
46. Treas. Reg. § 1.1441-2(a).
47. *See* T.D. 8734, referring to Miller v. Comm'r, T.C. Memo 1997-134 (T.C. 1997).

§ 78:5.3 Effective Date

The effective date of these regulations has been delayed—initially, to allow financial institutions to avoid additional confusion while attempting to comply with Y2K problems, then to further extend them so that they would not apply until payments made after 1998. The Service later announced that it was delaying application of the regulations to payments made after 1999.[48] Then, in 1999, the Service announced that it was delaying the effective date again to allow financial institutions to deal with the problems associated with the new millennium. The effective date that was to begin on January 1, 2000, was extended to January 1, 2001.[49] This delay was later confirmed by final regulations issued in December 1999.[50]

In IRS Notice 98-16, the Service also stated that it would treat the 1999 calendar year as a transition period for the administration of the withholding system. In enforcing compliance, the Service said it would take into account the extent to which a withholding agent made a good-faith effort to transform its business practices and information systems to comply with the regulations' requirements. As an example, the Service said it would take into account whether a U.S. withholding agent made reasonable efforts during 1999 to modify its account opening practices to conform to the new documentation requirements, obtain new documentation on existing accounts when new withholding certificates become available, and make appropriate systems changes to comply with the published guidance. For foreign withholding agents, the Service said it would also take into account whether or not the withholding agent made an effort to seek qualified intermediary status. The Service said it would also take into account whether or not any withholding agent implemented the final regulations beginning in 2000.[51]

§ 78:6 Particular Withholding Situations

§ 78:6.1 Interest and Dividend Income

The regulations provide that withholding must be made on the gross amount of stated interest, regardless of whether it constitutes a return of capital.[52]

48. I.R.S. Notice 98-16.
49. *See* I.R.S. Notice 99-25.
50. *See* T.D. 8856.
51. *See* I.R.S. Notice 98-16.
52. Treas. Reg. § 1.1441-3(b)(1).

There is an exception for accrued interest where a sale occurs between two interest payment dates.[53] Note that this exception generally does not apply to sales of original issue discount (OID) obligations.[54] Accordingly, the Service has issued proposed regulations regarding the withholding obligations on the sale of OID obligations between interest payment dates.[55]

Interest on a registered obligation will qualify as portfolio interest if the withholding certificate or documentary evidence that must be provided is furnished before the beneficial owner's period of limitations for claiming a refund of tax with respect to the interest expires.[56]

Dividends that are U.S.-sourced but are not effectively connected U.S. income are subject to withholding (and tax) at a 30% rate.[57] Generally, dividends paid by a foreign corporation will be foreign sourced and so not subject to this withholding for non-U.S. recipients; however, U.S. sourcing is applied if the paying company had 25% U.S.-source income for the three years preceding the dividend declaration.[58] This withholding tax on such dividends was eliminated by the American Jobs Creation Act 2004 as to payments made after 2004.[59]

Regulations issued in 2006 treat cumulative preferred stock with accrued but unpaid dividends the same as stock with discretionary distribution rights. This is subject to the exceptions that: (1) earnings and profits to the extent of dividends paid during the year are first allocated to that class of stock, and (2) a present value rule applies to certain mandatorily redeemable cumulative preferred stock.[60]

[A] Withholding Rate

A person who makes a payment of U.S.-source interest, dividends, royalties, and certain other types of income generally must withhold 30% and report it on a Form 1042-S. The 1042-S should state the name and address of the payment recipient, and amounts paid and withheld.[61]

A lower rate of withholding may apply due to a treaty.

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53. Treas. Reg. § 1.1441-3(b)(2).
54. *See* Treas. Reg. § 1.1441-2(b)(3).
55. *See* Prop. Treas. Reg. § 1.1441-3(b); REG-114000-97.
56. Treas. Reg. § 1.871-14(e)(3).
57. I.R.C. § 871(a).
58. *See* I.R.C. § 861(a)(2)(B).
59. *See* I.R.C. § 871(i)(2)(D).
60. *See* Treas. Reg. § 1.951-1(e)(4)(ii), issued as T.D. 9251 (Feb. 2006), finalizing REG-129771-04.
61. *See* Treas. Reg. § 1.1461-1(c).

Note that the reduction in tax rates made by the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Job Growth and Tax Relief Reconciliation Act of 2003 has led to a corresponding reduction in the backup withholding rate; after amendment, the Code now prescribes that the backup withholding rate is tied to the "fourth lowest tax rate" (the former 31% rate), which is dropping in accordance with the reductions scheduled by the Act (that is, to 28% for 2003).[62]

[B] Tax Avoidance—The Economic Substance Rule

Internal guidance by the IRS describes the use of the economic substance doctrine to attack securities lending transactions that it says are being used to avoid withholding on U.S.-source dividends.

The memo states that the avoidance device typically has a borrower enter into a securities loan to: cover a short sale or failure to deliver; implement an arbitrage, hedging, or derivatives trading strategy; or further loan the securities.

A lender will enter such an agreement to increase the return on an investment by receiving fees without changing its economic exposure.

The memo reviews how sections 871(a) and 881(a) generally impose a 30% tax on U.S.-source income received by a nonresident alien individual or a foreign corporation when that income is not effectively connected to the conduct of a U.S. trade or business. The tax generally is collected via withholding—pursuant to sections 1441 and 1442. To avoid excessive taxation where there are multiple transactions involving the same funds, the 30% limit applies in the aggregate.[62.1]

The memo says that the subject tax-avoidance transactions are structured to entirely eliminate U.S. withholding—typically by transferring the dividend-paying stock to a foreign affiliate in a low-tax jurisdiction as the nominal securities borrower. The foreign affiliate pays substitute dividends to the foreign customer in an amount equal to 70% of any dividend paid on the underlying loaned shares, which is the cash amount of the dividend that the foreign customer would have received if U.S. tax had been withheld. The foreign affiliate takes the position that, because both the foreign affiliate and the foreign customer were subject to the same 30% U.S. withholding tax rate, Notice 97-66 permitted the foreign affiliate to pay the substitute dividend to the foreign customer without with-

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62. *See* I.R.S. Announcement 2003-45.
62.1. *See* AM 2012-009, citing I.R.S. Notice 97-66, 1997-2 C.B. 328.

holding and paying any U.S. tax. The foreign affiliate agrees to pay the foreign customer a fee (sometimes called an "enhancement fee"), typically 20% of the dividends (two-thirds of the avoided withholding tax). This "enhancement fee" is designed to split the tax savings between the foreign affiliate and foreign customer.

To hedge its exposure to the stock loan without retaining record ownership of the loaned shares, the foreign affiliate sells the underlying loaned shares to a swap dealer at fair market value and concurrently enters into a total return swap. Typically, the U.S. financial institution guarantees its foreign affiliate's obligation under the total return swap.

The swap effectively eliminates U.S. withholding tax. The swap dealer has paid the foreign affiliate a swap payment equal to the amount of the dividend, and without withholding tax.[62.2] The foreign affiliate made a substitute dividend payment to the foreign customer equal to 70% of the dividend paid with respect to the underlying loaned shares. The foreign customer then terminated the securities loan, which required the foreign affiliate to return the underlying loaned shares and pay the foreign customer an enhancement fee equal to 20% of the dividend (two-thirds of the avoided withholding tax). The foreign affiliate or U.S. financial institution retains the remaining 10% of the swap payment (one-third of the avoided withholding tax).

The advice concludes that the Service may use the economic substance doctrine to disregard or recharacterize certain securities lending transactions that are structured to avoid U.S. withholding tax. In such cases, taxpayers would not be permitted to rely on Notice 97-66. The foreign customers that loaned stock to the financial institutions or their affiliates in those transactions may be liable for U.S. tax on the dividend payments pursuant to section 871 or 881. As withholding agents with respect to U.S.-source dividend payments, the financial institutions that borrowed stock in these transactions may be liable for U.S. withholding tax. Also, other judicial theories may apply, under which either the foreign customers or the financial institutions' affiliates may be liable for U.S. gross basis tax on the dividend payments.[62.3]

62.2. Referring to Treas. Reg. § 1.863-7(b)(1) (which provides that the source of income from a notional principal contract is generally determined by reference to the residence of the recipient).

62.3. *See* AM 2012-009.

[C] STARS Transactions

The Court of Appeals for the First Circuit reviewed that, in order to take advantage of the foreign tax credit (FTC),[62.4] some banks have engaged in complicated transactions for the purpose of generating FTCs in order to take advantage of the corresponding U.S. tax deduction.

One of these "devices" is the "Structured Trust Advantaged Repackaged Securities" (STARS) transaction.

IRS regulations proposed in 2007 and finalized in 2011 prohibited STARS transactions, but not retroactively. In a case involving transactions that pre-dated the prohibition, the court of appeals reversed a district court issuance of summary judgment that the transaction in question had economic substance and replaced that with summary judgment for the government that the transaction did not have economic substance. The court said "economic substance" is lacking where the transaction, even though technically compliant, is one purely to produce tax gains, and has no prospect for pre-tax profit.[62.5]

§ 78:6.2 Notional Principal Contracts

Notional principal contract payments are exempt from withholding; however, if paid to a foreign person, they are presumed to be effectively connected income, and must be reported on a Form 1042-S.[63]

§ 78:6.3 Partnerships, Trusts, and Estates

For partnerships, the regulations provide that, as a general rule, a payment to a foreign partnership is treated as a payment directly to the partners, whether or not documentation has been provided for the partners.[64] There are two exceptions: where the payment is to a withholding foreign partnership or to a foreign partnership that has certified that the payment is effectively connected income. In such cases, payment is treated as to the partnership and not the partners.[65]

Generally, withholding is not required on payments to exempt organizations, provided the payments are not unrelated business taxable income (UBTI).[66]

62.4. I.R.C. §§ 901–09.

62.5. *See* Santander Holdings USA, Inc. v. United States, No. 16-1282 (1st Cir. Dec. 16, 2016).

63. Treas. Reg. § 1.1441-4(a)(3).

64. *See* Treas. Reg. § 1.1441-5(c)(1).

65. *See* Treas. Reg. § 1.1441-5(c)(ii).

66. *See* Treas. Reg. § 1.1441-9.

The Service has released guidance on withholding by foreign partnerships and foreign trusts. As it notes, neither of these entities can use the Qualified Intermediary (QI) agreement to become withholding agents. This is because the relationship of partnerships to their partners and trusts to their owners and beneficiaries differs significantly from the relationship between financial institutions and their account holders—for which the QI agreement was designed.[67]

As an alternative, the Service has prepared proposed agreements whereby a partnership can qualify as a foreign withholding partnership (WP),[68] and a trust can qualify as a foreign withholding trust (WT).[69] A Revenue Procedure published in 2003 provides updated application procedures plus copies of the final withholding foreign partnership agreement, the withholding foreign trust agreement, and an addition to the QI withholding agreement (new section 4A—rules regarding partnerships and trusts that do not enter into withholding agreements).[70] As so qualified, the WP or WT can act as a withholding agent—thus simplifying the withholding and reporting obligations that apply to payments to foreigners. Generally, non-qualified foreign partnerships and trusts have to provide the appropriate withholding agent with a Form W-81MY, along with documentation and withholding statements. Basically, becoming a WP or WT allows these entities in effect to act as the withholding agent themselves, by receiving payments in gross from the withholding agent and filing Form 1042-S. The Form W-81MY can then be provided to the withholding agent without the normally required additional documentation.[71]

In 2005, the Service amended its requirements regarding withholding partnership, withholding foreign trust, and QI withholding agreements, by dropping the "relatedness requirement." This is accomplished by removing the numbered "(3)" provision in each of those agreements requiring the withholding agent or QI to be a general partner or trustee.[72]

Revenue Procedure 2014-47 provides guidance for entering into a withholding foreign partnership agreement and a withholding foreign trust agreement. The procedure provides background on the withholding and reporting requirements of the Code, and highlights

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67. *See* I.R.S. Notice 2002-41.
68. *See* Treas. Reg. § 1.1441-5(c)(2)(ii).
69. *See* Treas. Reg. § 1.1441-5(e)(5)(v).
70. *See* Rev. Proc. 2003-64.
71. *See* I.R.S. Notice 2002-41. The notice includes the proposed agreements.
72. *See* Rev. Proc. 2005-77.

changes to the existing agreements that were published in Revenue Procedure 2003-64 and Revenue Procedure 2005-77.

Revenue Procedure 2014-47 provides the application procedures for becoming a WP or WT and for renewing a WP agreement or WT agreement. The procedure states that the objective of these agreements is to allow a foreign partnership or foreign trust to become a WP or WT and to assume the withholding and reporting obligations for payments of U.S.-source income (such as interest, dividends, and royalties) made to its partners, beneficiaries, or owners, and in some cases, persons holding interests in the WP or WT through one or more foreign intermediaries or flow-through entities.[72.1]

[A] Reduction for Foreign Partner's Deductions

Final regulations issued in 2008 allow a partnership to consider certain partner-level deductions, resulting in a reduction or elimination of the withholding requirement.[73] The regulations, which require the foreign partner to certify deductions and losses to the partnership, refer to Form 8804-C (Certificate of Partner-Level Items to Reduce Section 1446 Withholding) as a means to facilitate this certification and insure that it includes the thirteen required items and is properly captioned.[74] As finalized, the regulations require that the partner must have timely filed a U.S. income tax return for the prior three years.[75] There are provisions under which the Service can notify the partnership that it cannot rely on a certification by a particular partner.[76]

[B] Grantor Trusts—TIN

Under the regulations, a taxpayer identification number (TIN) must be stated on a withholding certificate from a person representing to be a foreign grantor trust with five or fewer grantors. Final regulations issued in 2006 adopt the proposed rule that the taxpayer's identification number (TIN) is not required for withholding certificates by a foreign grantor trust with five or fewer grantors.[77]

§ 78:6.4 Transparent Entities

A "fiscally transparent" entity is one where the pertinent jurisdiction requires interest holders to take into account separately

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72.1. *See generally* Rev. Proc. 2014-47.
73. T.D. 9394.
74. *See* Treas. Reg. § 1.1446-6(c); Preamble to T.D. 9394.
75. Treas. Reg. § 1.1446-6(b)(1)(ii).
76. Treas. Reg. § 1.1446-6(c)(3).
77. *See* Preamble to T.D. 9253, removing former Treas. Reg. § 1.1441-1(e)(4)(vii)(G).

their respective shares of the various items of income of the entity on a current basis and to determine the character of such items as if they were realized directly from the source.[78]

A Code provision added in 1997 provides that a foreign person will be denied treaty-reduced withholding rates on income derived from pass-through (fiscally transparent) entities if:

(1) the income item is not treated by the foreign country as an item of income of the person;

(2) the treaty does not address income from pass-through entities; and

(3) the foreign country does not impose tax on the distribution from the entity to the person.[79]

§ 78:6.5 Alien Students

The Service has announced a temporary experimental program designed to be effective for approximately one year, beginning February 26, 2001. The Voluntary Compliance on Alien Withholding Program (VCAP) allows certain tax-exempt colleges and universities—and affiliated section 501(c)(3) organizations—to request Service approval of their proposals to comply with the withholding and reporting rules that apply to the payment of grants, scholarships, wages, and other income to alien individuals.[80]

Generally, under section 871 payment of U.S.-source income to aliens is subject to 30% withholding (14% for scholarships); also, payments for services performed can constitute effectively connected income. The Service also notes that a participant with specified nonimmigrant status who participates in certain exchange or training programs is treated as being engaged in a U.S. trade or business regarding income derived in connection with the program.

The organization requests VCAP participation by sending a letter to the Tax Exempt/Government Entities office containing a description of its current withholding and reporting procedures, identifying its defects along with the number of individuals involved and amount of taxes affected, and proposed corrections. In return, the Service says it generally will not impose penalties for identified underpayments and deficiencies, if the liability is due to reasonable cause.[81]

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78. Treas. Reg. § 1.894-1T(d)(4)(ii).
79. I.R.C. § 894(c).
80. *See* Rev. Proc. 2001-20.
81. *See id.*

[A] Cultural Exchange Program Students

In what it said was a case of first impression, the Tax Court considered deductions by three foreign national students who participated in the U.S. State Department's summer cultural exchange program.

Apparently, while in the United States the students earned income working in seasonal jobs. The IRS determined deficiencies (approximately $600 for all three).

The court notes that all three of the persons are foreign nationals and nonresident aliens for federal tax purposes. It reviews that this exchange program is intended to increase mutual understanding between U.S. citizens and other nationals. Those "other nationals" are subject to a number of requirements, including to maintain sickness and accident insurance. They enter the United States on nonimmigrant visas, generally are full-time students, and are in the United States to interact with U.S. citizens, and share their culture.

While in the United States they may work in seasonal or temporary jobs to defray their expenses. Their U.S. presence is limited to four months.

As to the deduction of travel expenses, the court concludes that the deduction of expenses under section 162 is not available, because the participants are not "away from home." The court reviews that, under section 871, aliens present in the country on visas are treated as engaged in a trade or business, regardless of whether they are in fact so engaged. As to "travel away from home," the court notes it has defined "home" for these purposes as being the vicinity of the taxpayer's principal place of business, as opposed to where his principal residence is located. It says the purpose of this rule is to mitigate the expense of maintaining a residence far from the place of work.

The court concludes that the rule that applies here is that if no business exigency dictates the location of the taxpayer's usual residence, then the mere fact of taking temporary employment elsewhere is not a compelling reason to maintain that (usual) residence. Accordingly, in such a case, the additional travel and living expenses related to residence near the temporary work are not deductible.[81.1]

§ 78:6.6 Foreign Athletes

The Service has confirmed its prior position that bonus payments to foreign players who do not perform any services within the United States during the year the bonus is paid are not subject

81.1. Liljeberg v. Comm'r, 148 T.C. No. 6 (2017).

to U.S. tax and so not subject to withholding. The bonuses were paid after the players were under contract, which, as the Service points out, means they should be characterized as payments for future services, and so not sourced within the United States.[82]

§ 78:6.7 U.S. Real Property Interests (FIRPTA Reporting)

The withholding rules covering a sale of foreign-owned U.S. real property are covered in depth in chapter 73.

§ 78:6.8 Effectively Connected Income (ECTI)

Many of the procedures regarding withholding for ECTI (effectively connected taxable income) are set out in Revenue Procedure 89-31 (1989-1 C.B. 895). Final regulations were issued in May 2005.[83] They contain the following provisions.

[A] Foreign Partner Status

Generally, any partnership—domestic or foreign—that has U.S. ECTI (effectively connected taxable income), any portion of which is allocable to a foreign partner, must pay a withholding tax as prescribed by section 1446.

For these purposes, a foreign partner is defined as anyone who is not a U.S. person—this includes nonresident aliens, foreign partnerships, foreign corporations, and foreign trusts and estates.

Generally, partnerships have an obligation to determine all partners' tax classification—by obtaining from the partner either: a Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for U.S. Tax Withholding); a Form 8-IMY (Certificate of Foreign Intermediary, Flow-Through Entity), or Certain U.S. Branches for U.S. Tax Withholding); or a Form W-9 (Request for TIN and Certification). The final regulations include allowing reliance on Form W-8ECI (Certificate of Foreign Person's Claim for Exemption From Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States), and Form W-8EXP (Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding).[84] Partnerships generally can rely on

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82. Priv. Ltr. Rul. 200219011, citing I.R.C. § 862(a)(3), and distinguishing Rev. Rul. 71-108, 1974-1 C.B. 248, and Linseman v. Comm'r, 82 T.C. 514 (1984), where bonuses were paid as an inducement for the person to enter into a contract.
83. T.D. 9200, finalizing REG-108524-00, which had been released in September 2003.
84. *See* Treas. Reg. § 1.1446-1(c)(2)(i).

such forms to determine a partner's tax status—unless the partnership has actual knowledge or reason to know that any information is incorrect; "reason to know" for these purposes is defined as being where a reasonably prudent person in the position of the withholding agent would question the claims made.[85] Generally, if the partnership does not have one of the above forms, foreign status of the partner is presumed; although the presumption can be rebutted if the partnership "relies on other means" to ascertain non-foreign status.[86] The final regulations also allow a partnership or withholding agent to substitute its own form for the official Form W-8 to ascertain the identity of a partner.[87]

A person who has elected under section 953(d) to be treated for tax purposes as a U.S. person is not a "foreign partner"—provided he has given the partnership a valid Form W-9.[88]

[B] Calculating ECTI

A partnership's ECTI is determined by first calculating the ECTI allocable to each foreign partner; all partners' ECTI is then combined to produce partnership ECTI.[89]

[C] Paying Withholding Tax

The withholding tax must be paid in installments—on the fifteenth day of the fourth, sixth, ninth, and twelfth months of the partnership's tax year.[90] Generally, the withholding rate for corporate foreign partners is set at the highest rate of tax in section 11(b)(1), currently 35%; for non-corporate foreign partners it is the highest rate in section 1 (changing year by year due to the reductions prescribed by recent tax acts),[91] but the final regulations allow the withholding agent to consider the type of income involved (that is, capital gains) and withhold at the highest rate that applies to that type of income.[92]

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85. *See* Treas. Reg. § 1.1446-1(c)(2)(iii).
86. Treas. Reg. § 1.1446-1(c)(3).
87. Treas. Reg. § 1.1446-1(c)(5).
88. Treas. Reg. § 1.1446-1(c)(1).
89. *See* Treas. Reg. § 1.1446-2(a), issued as T.D. 9200, finalizing REG-108524-00.
90. *See* Treas. Reg. § 1.1446-3(d)(1)(ii), issued as T.D. 9200, finalizing REG-108524-00.
91. *See* Treas. Reg. § 1.1446-3(a)(2)(i).
92. *See* Treas. Reg. § 1.1446-3(a)(2)(ii).

[D] Publicly Traded Partnerships

Partnerships generally apply the withholding rules according to the partner's allocable portion of partnership income; publicly traded partnerships (PTPs) instead apply the withholding rules to distributions. Although the proposed regulations contemplate allowing PTPs to elect to use the withholding system based on allocable income, in the Preamble to the final regulations the Service states that it concluded that such an election provision would not be administrable. The election is made merely by complying with the paying and reporting requirements on the basis of income allocation.[93]

[E] Tiered Structures

The regulations provide a look-through rule that allow a lower-tier partnership to treat an upper-tier partnership's share of ECTI as being allocable to the upper tier's partners as though they were direct partners in the lower-tier partnership, subject to the condition that the upper-tier partnership provides a valid Form W-8IMY indicating that it is a look-through entity, and the lower-tier partnership can reliably associate the upper tier's ECTI to its partners (such as through the appropriate forms—for example, a Form W-9).[94]

[F] Estate and Trust Provisions

There are special rules for apportioning the credit under section 33 for withheld taxes on partnership income allocated to foreign trusts and estates. Basically, the foreign trust or estate can claim a credit of the portion of total section 1446 taxes paid on its behalf as determined by the ratio of total ECTI allocable to the trust or estate and not distributed (or treated as distributed) to its beneficiaries—and, accordingly not deducted under section 651 or section 661 in calculating the entity's taxable income—to the total ECTI allocable to the entity. The section 1446 tax that a foreign trust or estate is thus not entitled to claim as a credit according to this paragraph may be claimed as a credit by the beneficiary of the entity that includes the partnership ECTI allocated to the trust or estate in gross income under section 652 or section 662. In the case of a foreign trust or estate with multiple beneficiaries, each beneficiary may claim a portion of the 1446 tax that may be claimed by all beneficiaries under the previous sentence as a credit in the same proportion as the amount of ECTI included in that beneficiary's gross income

93. *See* Preamble to T.D. 9200, removing Prop. Treas. Reg. § 1.1446-4(g).
94. *See* Treas. Reg. § 1.1446-5(c), issued as T.D. 9200, finalizing REG-108524-00.

bears to the total amount of ECTI included by all beneficiaries. The trust or estate must provide each beneficiary with a copy of the Form 8805 provided to it by the partnership.[95]

An anti-avoidance rule provides that if a partnership knows or has reason to know that a foreign person holds its interest in the partnership through a domestic trust for the principal purpose of avoiding the section 1446 tax, the partnership is required to pay section 1446 tax as if the domestic trust was a foreign trust.[96]

§ 78:6.9 Built-In Losses

Note that a provision added by the American Jobs Creation Act of 2004 states that if a built-in loss is imported into the United States in a tax-free transfer by persons not subject to U.S. tax, the corporate transferee's basis in the transferred property will be its fair market value.[97]

The 2017 Tax Cuts and Jobs Act ("2017 Tax Act") modified section 743(d) to provide that, in addition to the present-law definition, a "substantial built-in loss" also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.[97.1]

§ 78:6.10 Liquidating Distributions

Note that a provision added by the American Jobs Creation Act of 2004 states that if a built-in loss is imported into the United States in a tax-free transfer by persons not subject to U.S. tax, the corporate transferee's basis in the transferred property will be its fair market value.[98]

§ 78:6.11 Gambling Activities by Non-U.S. Persons

A provision added by the American Jobs Creation Act of 2004 exempts from U.S. tax and withholding a nonresident alien's winnings on horse racing due to bets in a pari-mutuel pool that are "initiated" outside the United States.[99]

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95. Treas. Reg. § 1.1446-3(d)(2)(iii)(A), issued as T.D. 9200, finalizing REG-108524-00.
96. Treas. Reg. § 1.1446-3(d)(2)(iii)(B).
97. I.R.C. § 362(e)(1)(A).
97.1. *See* I.R.C. § 743(d), as amended by Pub. L. No. 115-97.
98. *Id.*
99. I.R.C. § 872(b)(5).

[A] "State of Residence"

A citizen of Ireland won $17 million in a backgammon match that took place in the United States. Approximately $5 million was withheld and paid over to the United States for taxes. The plaintiff claimed status as a resident of Ireland—which, if true, would shield him from U.S. taxes.

On review, the Court of Claims notes that the tax treaty between the United States and Ireland does not directly address the treatment of gambling winnings in either country, however, this would mean that it is covered by Treaty Article 22(1), which states that such "unaddressed" income is taxed "only in the state of residence."

As to whether the plaintiff was a "tax resident" of Ireland (even though living in Switzerland), the court reviewed as follows. The plaintiff had not been registered for income tax in Ireland since 1995, and Ireland authority responded that his payment of "a domicile levy" does not qualify him for treaty protection.

The court reviewed that the Treaty language limits its application to persons who are "under the law" of that State, and "liable to tax therein by reason of domicile."

By contrast, the plaintiff has been living in Switzerland, and has not paid any income tax or capital gains tax in Ireland since 1995. Accordingly, his claim for a refund of the withheld $5 million was denied.[99.1]

§ 78:6.12 Mutual Funds (Regulated Investment Companies)

Generally, if a RIC makes excess distributions under section 852(b)(3)(C) (relating to capital-gain dividends) or section 852(b)(5)(A) (relating to exempt-interest dividends), there will be no penalties for underwithholding if the RIC's designations were based on a reasonable estimate, and adjustments are made to amounts withheld. Generally, if an RIC makes excess distributions under section 852(b)(3)(C) (relating to capital-gains dividends) or section 852(b)(5)(A) (relating to exempt-interest dividends), there will be no penalties for underwithholding if the RIC's designations were based on a reasonable estimate, and adjustments are made to amounts withheld. Regulations issued in 2006 extend the reasonable-estimate rule to cover distributions designated as being subject to new section 871(k)(1)(C) (relating to interest-related dividends) or section 871(k)(2)(C) (relating to short-term capital gains dividends), added by the 2004 Jobs Creation Act.[100]

99.1. McManus v. United States, No. 1:15-cv-00946 (Fed. Cl. Mar. 3, 2017).

100. *See* Treas. Reg. § 1.1441-3(c)(3).

Section 854 provides rules for the amount of distributions that can be designated as qualified dividend income. Also, section 871(k) provides rules for determining what distributions can be treated as interest-related dividends and short-term capital gains dividends. These issues are covered in chapter 34 on investments abroad.

§ 78:6.13 U.S. Possessions Payors

U.S. payors that pay foreign-source income outside the United States to non-exempt recipients generally must report these payments on Form 1099 and, if required, apply backup withholding. The regulations provide that U.S. payors are not required to report income on Form 1099 that is from sources within a U.S. Possession and that is exempt from tax under section 931, section 932, or section 933. This exception applies if the payor can reliably associate the payment of such income with valid documentation that supports a claim that the beneficial owner of the payment is a resident of the U.S. Possession.[101]

Also, the regulations add a new provision defining U.S. Possessions for these purposes as being: Guam; American Samoa; the Northern Mariana Islands; Puerto Rico; and the Virgin Islands.[102]

§ 78:6.14 Cross-Licensing Arrangements

Service guidance defines a cross-licensing arrangement as a contract between parties that own intellectual property where each grants the other a license. The guidance describes the "net consideration method" under which, for withholding purposes, each party to a cross-licensing agreement has to take into account only the cash payment made to the other party. Use of the method is conditioned on it being similarly reflected on audited financial statements.[103]

§ 78:6.15 Corporate Distributions to Foreign Shareholders

Regulation § 1.1441-2(a) provides that "amounts subject to withholding" means amounts that constitute fixed or determinable annual or periodical income (FDAP). But Regulation § 1.1441-2(b)(2)(i) excludes gains from the sale of property. Accordingly, a distribution to a shareholder will be subject to withholding, or not, depending on whether it constitutes a dividend (withholding), or is a payment to purchase the shareholder's stock (no withholding).

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101. Treas. Reg. § 1.6049-5(c)(5)(ii).
102. Treas. Reg. § 1.1441-1(c)(30).
103. *See* Rev. Proc. 2007-23.

Section 302 basically defines this determination on whether the shareholder's proportionate ownership interest has been "reduced." A further refinement of this principle in *United States v. Davis* refers to a "meaningful reduction" in the shareholder's interest.[104] Some public rulings have determined what constitutes a meaningful reduction under this standard.[105]

Along these lines, proposed regulations released in October 2007 would provide the following rules for such a section 302 distribution regarding a publicly traded corporation. The regulations are proposed to begin applying to distributions made after 2008.[106]

A U.S. withholding agent would have to set aside in an escrow account the 30% dividend withholding amount.[107] The agent then would provide the foreign beneficial owner with certain information, including the total number of the distributing corporation's shares outstanding before and after the distribution.[108] The agent would also provide a written statement explaining the conditions under which the payment will be treated as a dividend or as a payment in exchange for stock (including an explanation of the constructive ownership rules under section 318).[109] This explanation would also request the beneficial owner to provide a written certification within sixty days as to whether the distribution is either a dividend or a payment in exchange for stock.[110]

The certification to be provided by the owner must include the owner's name and account number, a certification that the distribution is a payment in exchange for stock or is a dividend, and the number of shares actually and constructively owned before and after the distribution.[111] The certification must be signed under penalties of perjury.[112]

The withholding agent generally may rely on the certification for withholding obligations, unless the agent knows or has reason to know that the certification is unreliable or incorrect.[113] If the certification is not received within sixty days, the escrowed amount is treated as taxes withheld.[114]

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104. *See* United States v. Davis, 397 U.S. 301 (1970).
105. *See* Rev. Rul. 76-385, Rev. Rul. 81-289.
106. *See* Preamble to REG-140206-06.
107. Prop. Treas. Reg. § 1.1441-3(c)(5)(iii)(B)(1).
108. Prop. Treas. Reg. § 1.1441-3(c)(5)(iii)(C)(1).
109. Prop. Treas. Reg. § 1.1441-3(c)(5)(iii)(C)(2).
110. Prop. Treas. Reg. § 1.1441-3(c)(5)(iii)(C)(3).
111. *See* Prop. Treas. Reg. § 1.1441-3(c)(5)(iii)(D).
112. Prop. Treas. Reg. § 1.1441-3(c)(5)(iii)(D)(6).
113. *See* Prop. Treas. Reg. § 1.1441-3(c)(5)(iii)(E).
114. *See* Prop. Treas. Reg. § 1.1441-3(c)(5)(iii)(E)(4).

§ 78:6.16 "Fails" Charges

In Notice 2009-61,[114.1] the Service noted that a new trading practice had developed in the pay-for-delivery market for U.S. Treasury securities regarding failed deliveries. The practice has been voluntarily adopted by many market participants (including the Federal Reserve Bank of New York and most dealers, custodians, and asset managers of U.S. Treasuries).

Under this practice, if one party fails to deliver U.S. Treasuries to another party (on a set date), the failing party pays a "Fails Charge" to the other party. The practice was adopted to preserve the secondary market for U.S. Treasuries by reducing the incidence of delivery failures, especially in low interest rate environments, where the economic incentive to deliver timely is reduced. The trading practice is generally expected to impose a fails charge whenever the interest rate on a repo that can be settled with any of a variety of securities (referred to in the market as the "general collateral rate") falls below a certain level.

Based on a concern of a lack of clarity regarding the treatment of these fails charges for purposes of sections 871, 881, 1441, and 1442—which relate to gross-basis taxation of foreign persons not otherwise subject to U.S. net-basis taxation—the Service said in 2009 that it was considering issuing guidance regarding when such charges would be subject to U.S. gross-basis taxation. As an interim measure the IRS said that—as to fails charges paid by the end of 2010, it would not challenge the position taken by a taxpayer or a withholding agent that the charge is not subject to U.S. gross-basis taxation.[114.2]

As a follow-up to the promise of guidance in Notice 2009-61, temporary and proposed regulations were issued in December 2010, and were finalized in February 2012.[114.3] The temporary and proposed regulations provide that the source of income from a qualified "fails charge" is generally determined by reference to the residence of the taxpayer that is the recipient of charge income—with two exceptions. Qualified fails charge income earned by a qualified business unit (QBU) is sourced to the country in which the QBU is engaged in a trade or business, and qualified fails charge income that arises from a transaction the income from which is effectively connected to a U.S. trade or business is sourced in the United

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114.1. *See* 2009-2 C.B. 181.

114.2. *See id.*

114.3. *See* T.D. 9579, finalizing the temporary regulations of T.D. 9508, and REG-132724-10.

States and treated as effectively connected to the conduct of a U.S. trade or business.[114.4]

The Preamble to the final regulations notes that when the temporary and proposed regulations were released no trading practice existed for fails charges on securities other than U.S. Treasuries, but the Preamble to the temporary regulations stated that if a fails charge trading practice pertaining to other securities was endorsed by the Treasury Market Practices Group (TMPG) or an agency of the U.S. government, the Treasury Department and the IRS would consider whether the source rule in the regulations should be extended to those fails charges. The TMPG has since then endorsed a trading practice for debentures issued by or backed by the federal government housing agencies (that is, Fannie Mae, Freddie Mac, Ginnie Mae, etc.), beginning in February 2012.

Accordingly, the final regulations provide that the same source rule should apply to fails charges incurred with respect to agency debt and agency mortgage-backed securities as to fails charges on U.S. Treasuries. Accordingly, the final regulations expand the scope of a qualified fails charge to fails charges paid with respect to agency debt.[114.5]

§ 78:6.17 Dividend Equivalents—Nonresident Aliens

The 2010 "HIRE" Act (Hiring Incentives to Restore Employment—Pub. L. No. 111-147) added section 871(m), which requires withholding on "dividend equivalents." These include: (1) substitute dividends made pursuant to a securities lending or a sale-repurchase transaction that is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States; (2) payments made pursuant to a specified notional principal contract that is contingent upon, or determined by reference to, the payment of dividends from sources within the United States; and (3) any other payment determined by Treasury to be substantially similar to such payments.[114.6]

The statute defines a "specified" notional principal contract as one where: (1) on entering into such a contract, a long party transfers the underlying security to a short party; (2) in connection with termination, a short party transfers the underlying security to a long party; (3) the underlying security is not readily tradable on an established securities market; (4) on entering into such a contract, the underlying security is posted as collateral by a short party with a

114.4. *See* Preamble to T.D. 9579.
114.5. *See* Treas. Reg. § 1.863-10(d) & (e).
114.6. *See* I.R.C. § 871(m)(2).

long party; or (5) the contract is identified by Treasury as a specified notional principal contract.[114.7]

Beginning two years after the date of enactment (March 18, 2010), these rules apply to all notional principal contracts—*unless* the Treasury determines that the contract is of a type that does not have the potential for tax avoidance.[114.8]

[A] Dividend Equivalents

Proposed regulations released in 2013 provided that a dividend equivalent is treated as a dividend from sources within the United States for purposes of sections 871(a), 881, 892, 894, and 4948(a), and chapters 3 and 4 of subtitle A of the Code. This rule follows section 871(m)(1), but adds a reference to section 894 to clarify that a dividend equivalent is treated as a dividend for purposes of any provision regarding dividends in an income tax treaty.

The regulations were finalized in September 2015, retaining the proposed sourcing provision that a dividend equivalent is treated as a dividend from sources within the United States.[114.9]

The final regulations define "a dividend equivalent" as: (1) any substitute dividend that references a U.S.-source dividend made pursuant to a securities lending or sale-repurchase transaction; (2) any payment that references a U.S.-source dividend made pursuant to a specified notional principal contract; (3) any payment that references a U.S.-source dividend made pursuant to a specified "Equity-Linked Instrument" (ELI); or (4) any other substantially similar payment.

An ELI is a financial transaction that references the value of one or more underlying securities, for example: a futures contract, forward contract, option, debt instrument, or other contractual arrangement that references the value of an underlying security.[114.10]

§ 78:7 Withholding Agents

Absent actual knowledge or reason to know otherwise, a withholding agent can rely on the payee's claim of exemption from withholding if, prior to the payment to the foreign person, the agent can reliably associate the payment with a Form W-8 upon which it can rely to treat the payment as made to a foreign beneficial owner.[115]

114.7. *See* I.R.C. § 871(m)(3)(A).
114.8. *See* I.R.C. § 871(m)(3)(B).
114.9. *See* Treas. Reg. § 1.871-15(b), issued as T.D. 9734.
114.10. *See* Treas. Reg. § 1.871-15(a).
115. Treas. Reg. § 1.1441-4(a)(2).

A similar rule applies to a claim of treaty benefit where, prior to payment, the agent can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a foreign beneficial owner.[116] Generally, documentation must include the beneficial owner's taxpayer identification number (TIN).[117]

A withholding agent will be liable for tax, interest, and penalties for failing to withhold the correct amount where there was actual knowledge or reason to know the correct amount.[118] If a withholding agent has actual knowledge or reason to know that a taxpayer's claim that a reduced rate should apply is incorrect, the agent must withhold at the full 30% rate.[119]

The standard for measuring "reason to know" for these purposes is the due diligence standard—whether a reasonably prudent person in the position of the withholding agent would question the claims made.[120]

A withholding agent is required to withhold and deposit amounts withheld and to make the prescribed returns.[121]

Foreign persons claiming treaty benefit relief from withholding on U.S.-source income must place a Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for U.S. Tax Withholding) or Form 8233 (Exemption from Withholding) with the withholding agent. Generally, these forms must include the payee's TIN.[122]

In 2004, the Service announced a "Section 1441 Voluntary Compliance Program" for certain withholding agents. Under the program, withholding agents can voluntarily disclose withholding deficiencies and reporting errors. Certain agents, such as qualified intermediaries, withholding foreign partnerships, and withholding foreign trusts, cannot participate. Neither can agents who are under examination or who have a case pending before IRS Appeals or in litigation. The submitted request must contain identity information; describe the agent's current procedures and failures; state the number of persons affected; calculate taxes not withheld, paid, or reported; and describe corrective procedures. The Service says penalties will not be imposed if the failures are due to reasonable cause.[123]

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116. Treas. Reg. § 1.1441-6(b).
117. Treas. Reg. § 1.1441-6(b)(1).
118. Treas. Reg. § 1.1441-7(b)(1).
119. Treas. Reg. § 1.1441-7(b).
120. Treas. Reg. § 1.1441-7(b)(2).
121. *See* Treas. Reg. § 1.1441-1(e)(5)(iv).
122. Treas. Reg. § 1.1441-6(b)(2)(ii).
123. *See* Rev. Proc. 2004-59. This voluntary compliance program was scheduled to apply only to submissions by the end of 2005, but the program was extended through March 2006. *See* Rev. Proc. 2005-71.

§ 78:7.1 Taxpayer Identification Number (TIN)

Final regulations on TINs were issued in November 2002.[124] The regulations are effective for payments made after 2001.[125]

As finalized, the regulations dispense with the TIN requirement where: there is an "unexpected payment," the payee does not have a TIN, and there is not enough time to get one before the payment.[126] An unexpected payment is defined as one that could not reasonably have been anticipated by the payor or beneficial owner within time to obtain an individual taxpayer identification number (ITIN).[127]

Making use of the exception requires that all of the following conditions exist:

(1) there is an agreement permitting the withholding agent, who is also an acceptance agent under Regulation § 301.6109-1(d)(3)(iv), to request an ITIN for the payee on an expedited basis;[128]

(2) there was an unexpected payment;[129]

(3) an ITIN cannot be obtained in time;[130]

(4) the payment cannot reasonably be delayed to allow obtaining an ITIN;[131] and

(5) the payor applies for an ITIN for the payee on the first business day after the payment.[132]

§ 78:8 Qualified Intermediaries

When the IRS enters into a withholding agreement with a foreign person, that foreign person becomes a qualified intermediary. The regulations say a QI can be:

(1) a foreign financial institution or a foreign clearing organization;

(2) a foreign branch or office of a U.S. financial institution or a U.S. clearing organization;

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124. T.D. 9023.
125. Treas. Reg. § 1.1441-6(h).
126. *See* Preamble to T.D. 8977.
127. Treas. Reg. § 1.1441-6(g)(4).
128. Treas. Reg. § 1.1441-6(g)(2)(i).
129. Treas. Reg. § 1.1441-6(g)(2)(ii).
130. Treas. Reg. § 1.1441-6(g)(2)(iii).
131. Treas. Reg. § 1.1441-6(g)(2)(iv).
132. Treas. Reg. § 1.1441-6(g)(3).

(3) a foreign corporation for purposes of presenting claims of benefits under an income tax treaty on behalf of its shareholders; or

(4) any other person acceptable to the IRS.[133]

A QI is treated as a withholding agent under the Code and as a payor for reporting purposes for amounts that it pays to its account holders. Unless provided otherwise in the Agreement, a QI's withholding and reporting obligations are set by the Code and the regulations. The QI's responsibilities apply only to those accounts it has with a withholding agent and that it has designated as accounts for which it acts as a QI. A QI is not required to act as a QI for all accounts that it has with a withholding agent, but if it designates an account as one for which it will act as a QI, it must act as a QI for all payments made to that account.[134]

A QI can furnish to a withholding agent certifications on behalf of other persons for the purpose of claiming and verifying reduced rates of withholding. Such certificates are furnished in lieu of withholding certificates or other appropriate documentation for the persons for whom the qualified intermediary receives the payment. Although the QI is required to obtain withholding certificates or other appropriate documentation from beneficial owners, payees, or interest holders pursuant to its agreement with the IRS, it is generally not required to attach such documentation to the intermediary withholding certificate. Nevertheless, a QI must provide a withholding agent with the Forms W-9, or disclose the names, addresses, and taxpayer identifying numbers, if known, of those U.S. nonexempt recipients for whom the QI receives reportable amounts, to the extent required in the QI's agreement. A person who has an application pending may be able to get interim QI status.[135]

§ 78:8.1 Agreement

The Service says the objective of the QI withholding agreement is to simplify withholding and reporting obligations for payments of income (including interest, dividends, royalties, and gross proceeds) made to an account holder through one or more foreign intermediaries.[136]

133. *See* Treas. Reg. § 1.1441-1(e)(5)(ii).
134. *See* Rev. Proc. 2000-12, 2000-4 I.R.B. 387.
135. *See* Treas. Reg. § 1.1441-1(e)(5)(i).
136. *See* Rev. Proc. 2000-12, 2000-4 I.R.B. 387.

Under the withholding agreement entered into with the IRS, a QI is subject to the general withholding and reporting rules that apply to withholding agents and payers.[137]

The agreement specifies the type of certifications and documentation upon which the QI can rely to ascertain the classification (for example, corporation or partnership) and status (that is, U.S. or foreign) of beneficial owners and payees who receive payments collected by the QI and, if necessary, entitlement to the benefits of a reduced rate under an income tax treaty. The agreement will also specify whether the QI can assume primary withholding responsibility, and the extent to which return filing and information reporting requirements are modified so the QI may be able to report payments to the IRS on an aggregated basis, without having to disclose the identity of beneficial owners and payees.[138]

The procedures for entering into a withholding agreement, and the contents and scope of the agreement, are set out in a published procedure.[139] A proposed model qualified intermediary withholding agreement has also been published.[140]

A sample form of agreement is set out in the Revenue Procedure.[141]

Guidance released in 2008 provides an amendment to the agreement set out in Revenue Procedure 2000-12,[142] relating to a QI's requirement to notify the IRS if it becomes aware of a material failure of internal controls relating to its performance under the agreement.[143]

[A] Qualified Withholding Agreement

Revenue Procedure 2017-15 sets out the final qualified intermediary (QI) withholding agreement entered into under Treasury Regulations section 1.1441-1(e)(5).

Generally, the QI agreement allows foreign persons to enter into an agreement with the IRS to simplify their obligations as withholding agents and as payors under chapter 61 and section 3406 for amounts paid to their account holders. The QI agreement also allows certain foreign persons to enter into an agreement with the IRS to act as qualified derivatives dealers (QDDs) and to assume primary withholding and reporting responsibilities on all dividend equivalent payments that they make.

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137. *See* Treas. Reg. § 1.1441-1(e)(5)(iii)(A).
138. *See* Treas. Reg. § 1.1441-1(e)(5)(iii)(B).
139. *See* Rev. Proc. 98-27.
140. *See* I.R.S. Notice 99-8.
141. *See* Rev. Proc. 2000-12, 2000-4 I.R.B. 387.
142. 2000-1 C.B. 744.
143. *See* I.R.S. Announcement 2008-98, 2008-44 I.R.B. 1087.

Revenue Procedure 2017-15 additionally noted the withholding foreign partnership (WP) and withholding foreign trust (WT) agreements that were currently in effect, but were supposed to expire on December 31, 2016. Revenue Procedure 2017-15 announced that because the updated WP and WT agreements would not be published before December 31, 2016, WPs and WTs with agreements currently in effect could continue to treat those agreements as in effect until updated agreements were issued (in January 2017).[143.1]

§ 78:8.2 Qualified Persons

A foreign branch of a U.S. financial institution can be a qualified intermediary, in the same manner as a foreign financial institution; U.S. branches of U.S. or foreign financial institutions, however, cannot be qualified intermediaries.[144]

The Service says this difference in treatment conforms to the distinction between accounts maintained outside the United States and accounts maintained on-shore, reflecting the policy that the Form W-8 (signed under penalties of perjury) is the preferred means of establishing foreign status for transactions in the United States, while documentary evidence is the appropriate evidence of foreign status for transactions outside the United States. This is especially so in those countries where financial institutions must document the identity of customers opening new accounts or for whom they process certain transactions.

To prevent U.S. Possessions financial institutions from being treated as nonqualified intermediaries, they will be treated as a U.S. branch.[145] Accordingly, the financial institution can agree with a withholding agent from which it is receiving payments to be treated as a U.S. person.[146]

§ 78:8.3 Application for QI Status

A person must apply to become a QI. The applicant must satisfy the IRS that it has adequate resources and procedures to comply with the terms of the withholding agreement. The application must include the following information:

1. A statement that the applicant is an eligible person and that it requests to enter into a QI withholding agreement with the IRS.

143.1. *See* Rev. Proc. 2017-15, 2017-3 I.R.B. 437.
144. *See* Treas. Reg. § 1.1441-1(e)(5)(ii).
145. Under Treas. Reg. § 1.1441-1(b)(2)(iv).
146. *See* I.R.S. Notice 2001-11.

2. The applicant's name, address, and employer identification number (EIN), if any.
3. The country in which the applicant was created or organized and a description of the applicant's business.
4. A list of the position titles, names, addresses, and phone numbers of those persons who will be the responsible parties for performance under the agreement.
5. An explanation and sample of the account opening agreements and other documents used to open and maintain the accounts at each location covered by the agreement.
6. A list describing the type of account holders (for example, U.S., foreign, treaty benefit claimant, or intermediary), the approximate number of account holders within each type, and the estimated value of U.S. investments that the QI agreement will cover.
7. A general description of U.S. assets by type (for example, U.S. securities, U.S. real estate), including assets held by U.S. custodians, and approximate aggregate value by type.
8. A completed Form SS-4 (Application for Employer Identification Number) to apply for a QI Employer Identification Number (QI-EIN) to be used solely for QI reporting and filing purposes (even if the QI already has another EIN). Each legal entity governed by the QI withholding agreement must complete a Form SS-4.
9. Completed appendices and attachments that are set out in Revenue Procedure 2000-12 at the end of the model QI agreement.[147]

§ 78:8.4 Primary Withholding Responsibility

A QI can inform a withholding agent from which it receives a payment that it will assume the primary obligation to withhold, deposit, and report amounts. The withholding agent then is relieved from withholding on the payment. The withholding agent does not have to determine that the QI agreement actually allows the assumption of withholding responsibility by the QI.[148]

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147. *See* Rev. Proc. 2000-12, 2000-4 I.R.B. 387.
148. *See* Treas. Reg. § 1.1441-1(e)(5)(iv).

§ 78:8.5 "Know Your Customer" Rules

The IRS says it will not enter into a QI agreement that provides for the use of documentary evidence obtained under a country's "know your customer" (KYC) rules if it has not received the applicable practices and procedures for opening accounts, plus responses to the following eighteen specific items.

1. An English translation of the laws and regulations (the "know your customer" rules) governing the requirements of a QI to obtain documentation confirming the identity of the QI's account holders. The translation must include the name of the law, and the appropriate citations to the law and regulations.

2. The name of the organization (whether a governmental entity or private association) responsible for enforcing the rules, how those rules are enforced (for example, through audit), and the frequency of compliance checks.

3. The penalties that apply for failure to obtain, or evaluate, documentation under the rules.

4. The definition of customer or account holder that is used under the rules, whether the definition includes direct and indirect beneficiaries regarding the receipt or disbursal of funds, and whether it includes a trust beneficiary, a company whose assets are managed by an asset manager, a controlling shareholder of a closely held corporation or the grantor of a trust.

5. A statement as to whether the documentation required under the rules requires a financial institution to determine if its account holder is acting as an intermediary for another person.

6. A statement as to whether the documentation required under the rules requires a financial institution to identify the account holder as a beneficial owner of income credited to an account.

7. A list of the specific documentation required to be used under the rules, or if specific documentation is not required, the documentation that is generally accepted by the responsible enforcing authorities.

8. A statement as to whether the rules require that an account holder provide a permanent residence address.

9. A summary of the rules that apply if an account is not opened in person (for example, by correspondence, telephone, or the Internet).
10. Whether an account holder's identity may be established by introductions or referrals.
11. The circumstances under which new documentation must be obtained, or existing documentation verified.
12. A list of all the exceptions to the documentation requirements.
13. A statement as to whether documentation from the account holder is not required where payment is cleared by another financial institution.
14. How long the documentation remains valid.
15. How long the documentation must be retained and in what manner.
16. Maintenance requirements (and length and form) for wire transfer records, and whether they require information as to both the original source and final destination of the funds.
17. A list of any payments or types of accounts that are not subject to the rules.
18. Whether there are special rules for private banking activities.[149]

In the context of international money laundering, the phrase "know your customer" is related to financial institutions' properly identifying their customers and understanding enough about their customary banking activities to be able to comply with applicable suspicious activity reporting rules and other obligations that apply under anti-money laundering regimes. The Service says in the QI context it interprets this phrase as relating to the capacity of financial institutions to determine whether their customers are U.S. persons or, if non-U.S. persons claiming treaty benefits, whether they are residents of the applicable treaty country.[150]

As an interim rule, the Service granted approval to QI status for a branch of a financial institution to act in a country that did not have acceptable KYC rules, provided the branch was part of an entity that was organized in a country that did have acceptable KYC rules, and the branch agreed to apply those rules.[151]

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149. *See* Rev. Proc. 2000-12, 2000-4 I.R.B. 387.
150. I.R.S. Notice 2001-4.
151. *See* I.R.S. Announcement 2000-48; I.R.S. Notice 2001-43.

Now that it has completed extensive review of countries' KYC rules, the Service says it is terminating this interim accommodation after 2006; persons who already have QI status can continue to operate through 2007.[152]

The IRS points out that initially it contemplated granting QI status only for entities operating in jurisdictions that had tax treaties or tax information exchange agreements with the United States. Subsequently, it decided to expand the program to include entities in countries that have acceptable KYC rules.

Accordingly, it has released a list of countries, including some known tax havens, that it has approved as having acceptable KYC rules for purposes of QI withholding agreements.[153]

§ 78:8.6 Payments to Nonqualified Foreign Intermediary

A payment to a foreign intermediary that has not assumed primary withholding responsibility is treated as being made directly to the person for whom the intermediary collects the payment; that person is presumed to be foreign to the extent the payment consists of amounts subject to withholding.[154] If the amount is not subject to withholding, then it is treated as paid to an exempt recipient and is exempt from reporting and backup withholding under Code section 3406.[155]

[A] Possessions Financial Institutions

Corporations and partnerships organized in U.S. Possessions generally are treated as foreign persons. Accordingly, a Possessions financial institution acting as an intermediary is treated as a nonqualified intermediary that must provide documentation and allocation information for the beneficial owners on whose behalf it acts. In contrast, a U.S. branch of a foreign financial institution may agree with a withholding agent to be treated as a U.S. person. In that case, payments of U.S.-source income made to it will be treated as made to a U.S. payee and therefore will not be subject to withholding under section 1441. Since Possessions financial institutions generally are subject to all of the withholding and reporting obligations of a U.S. withholding agent, these additional requirements may not be appropriate. Notice 2001-11 provided that a Possessions

152. *See* I.R.S. Notice 2006-35.
153. The list is posted on the Service's website, www.irs.gov.
154. Treas. Reg. § 1.1441-1(b)(2)(v)(A).
155. Treas. Reg. § 1.6049-5(d)(3)(ii).

financial institution will be treated as a U.S. branch for these purposes. Regulations issued in 2006 implement this provision.[156]

§ 78:8.7 Independent Audit Requirement

A qualified intermediary is a non-U.S. financial institution that has entered into a contractual agreement with the Service. The QI generally agrees to report annually certain aggregate information concerning the beneficial owners of U.S.-source payments and to make any necessary tax payments to the Service. Additionally, the QI agrees to engage an external auditor to verify that it is in compliance with the QI agreement. In return, QIs avoid many documentation and reporting requirements.

[A] Audit Guidelines

Service guidance sets out a three-phase audit process for substantiating a QI. The three phases are:

(1) basic fact-finding by an external auditor;

(2) follow-up fact-finding by the IRS; and

(3) an audit between the IRS and the QI.

The most recent guidance (which includes changes made in 2002) provides the following rules.[157]

The external audit can be waived if the QI has no more than $1 million in reportable amounts for the audit year (this is an increase from the formerly proposed threshold of $25,000), or has between $1 million and $4 million in reportable amounts and was audited in the preceding year. Variances may be permitted within reasonable limits.[158]

§ 78:9 Gain Recognition Agreements

Section 367(a)(1) generally provides that if property is transferred out of the United States in a section 332, 351, 356, or 361 transaction, the transferee will not be considered to be a corporation.

There are a number of exceptions which also may require the U.S. transferor to file a gain recognition agreement (GRA), basically promising to recognize income on the transfer if within five years a "triggering event" occurs, such as disposition of the stock or assets

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156. *See* Treas. Reg. § 1.1441-1(b)(2)(iv).
157. *See* Rev. Proc. 2002-55.
158. *Id.*

of the transferred corporation or the stock of the foreign transferee corporation.[159]

There are also exceptions to the exceptions, basically providing that under certain conditions a change in the transferor's status will not be considered a triggering event; in such cases the GRA "terminates without further effect."[160]

Final regulations issued in November 2014 address the consequences to U.S. and foreign persons for failing to file GRAs or related documents, or to satisfy other reporting obligations associated with certain transfers of property to foreign corporations in nonrecognition exchanges.

The regulations address the reporting requirements under section 6038B;[160.1] how the regulations apply to previously filed requests;[160.2] relief for failure to file;[160.3] amended returns;[160.4] and relief regarding reporting failures.[160.5]

The Preamble to the regulations also notes that it is withdrawing, effective November 19, 2014, directive LMSB-4-0510-017, which allowed taxpayers to remedy, without having to demonstrate reasonable cause, unfiled or deficient GRA documents associated with a timely filed initial GRA. The Service notes that the Directive explained that it would apply "until further notice"—and so is replaced by these regulations.

The Preamble to the regulations also prescribes that a U.S. transferor seeking relief for a failure to file or failure to comply with the GRA rules must file an original Form 8838 (Consent to Extend the Time to Assess Tax Under Section 367—Gain Recognition Agreement) with an amended return.

Other changes include that an extension of the limitations period should be based on when the taxpayer furnishes the information that should have been provided.[160.6] There are also some changes to the reporting requirements relating to section 361 exchanges and gain recognition under section 367.[160.7]

159. *See* Treas. Reg. § 1.367(a)-3.
160. *See* Treas. Reg. § 1.367(a)-8.
160.1. *See* Treas. Reg. § 1.6038B-1(b)(2)(iv).
160.2. *See* Treas. Reg. § 1.367(a)-8(p).
160.3. *See* Treas. Reg. § 1.367(a)-8(r)(3).
160.4. *See* Treas. Reg. § 1.367(a)-8(p)(2).
160.5. *See* Treas. Reg. § 1.367(a)-2.
160.6. Accordingly modifying Treas. Reg. §§ 1.367(a)-8(j)(8) and 1.367(e)-2(e)(4)(ii)(B).
160.7. *See generally* T.D. 9704.

§ 78:9.1 Regulations

Final regulations on gain recognition agreements (GRAs) were issued in February 2009.[161] The regulations set out the terms and conditions for a GRA entered into by a U.S. person in connection with a transfer of stock or securities to a foreign corporation under an exchange that otherwise would be subject to section 367(a)(1).[162] The regulations set out the terms and content of the agreement,[163] the filing requirements,[164] the list of events that might trigger gain recognition,[164.1] exceptions from those rules,[164.2] and certain events that preclude using those exceptions.[164.3]

§ 78:10 Outbound Transactions

Section 367(a)(1) generally provides that if a U.S. person transfers property to a foreign corporation in connection with an exchange described in section 332, 351, 354, 356, or 361, then the foreign corporation will not be considered a corporation for purposes of determining the extent to which the U.S. person recognizes gain on the transfer. Sections 367(a)(2) and 367(a)(3), respectively, provide exceptions to this general rule for: (1) transfers of stock or securities of a foreign corporation that is a party to the exchange or reorganization; and (2) certain property used in an active foreign trade or business.[165]

Section 367(a)(5) generally provides that the exceptions under section 367(a)(2) and (a)(3) do not apply to a transfer of property by a domestic corporation to a foreign corporation in an exchange described in section 361(a) or (b).[166]

Section 367(b)(1) provides that where there is no transfer of property in one of the above-referenced types of exchanges, a foreign corporation will be treated as a corporation, except as otherwise provided in regulations "necessary or appropriate to prevent the avoidance of Federal income taxes."[167] The Service says a fundamental policy of section 367(b) is to preserve the potential application of

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161. T.D. 9446, finalizing the temporary regulations of T.D. 9311, which had been released in Feb. 2007.
162. *See* Treas. Reg. § 1.367(a)-8(a).
163. *See* Treas. Reg. § 1.367(a)-8(c).
164. *See* Treas. Reg. § 1.367(a)-8(d).
164.1. *See* Treas. Reg. § 1.367(a)-8(j).
164.2. *See* Treas. Reg. § 1.367(a)-8(k).
164.3. *See* Treas. Reg. § 1.367(a)-8(m).
165. *See* I.R.C. § 367(a)(1).
166. *See* I.R.C. § 367(a)(5).
167. *See* I.R.C. § 367(b)(1).

section 1248 following the acquisition of the stock or assets of a foreign corporation by another foreign corporation.[168]

Section 367(c)(1) provides that, under section 367, a distribution described in section 355 is treated as an exchange—whether or not it is an exchange.[169]

§ 78:11 Sale or Distribution of Interest in Foreign Corporations

Section 1248(a) provides that a U.S. person includes in gross income, as a dividend, any gain recognized on the sale or exchange of stock of a foreign corporation that was a controlled foreign corporation (CFC) at any time during the five-year period ending on the date of the sale or exchange—but only if the U.S. person owned 10% or more of the total combined voting power of the foreign corporation at any time during that five-year period (that is, was a "section 1248 shareholder"). The amount of gain recognized as a dividend is generally limited to the foreign corporation's Earnings and Profits (E&P) attributable to the stock sold or exchanged that was accumulated while the stock was held by the U.S. person, and while the foreign corporation was a CFC.[170]

Section 1248(e) generally provides that if a U.S. person sells or exchanges stock of a domestic corporation used principally for holding foreign corporation stock, the transaction will be treated as a sale of the foreign corporation held by the domestic corporation.[171]

Section 1248(f)(1) generally provides that where a domestic corporation distributes stock of a foreign corporation in a distribution to which section 311(a), 337, 355(c)(1), or 361(c)(1) applies, the domestic corporation includes in gross income, as a dividend, the excess of the fair market value of such stock over its adjusted basis—but only to the extent of the E&P of the foreign corporation, accumulated while the stock was held by the domestic corporation and while the foreign corporation was a CFC, attributable to that stock.[172]

§ 78:11.1 Sales or Transfers Involving 10%-Owned Foreign Corporations

Beginning with 2018, on the sale or exchange by a domestic corporation of stock in a foreign corporation held for one year or more,

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168. *See* Preamble to REG-209006-89.
169. *See* I.R.C. § 367(c)(1).
170. *See* I.R.C. § 1248(a).
171. *See* I.R.C. § 1248(e).
172. *See* I.R.C. § 1248(f)(1).

any amount received by the domestic corporation that is treated as a dividend for purposes of section 1248, is also treated as a dividend for purposes of applying section 245A (deduction for foreign-source portion of dividends).[172.1]

For dividends received in tax years that begin after 2017, a domestic corporate shareholder's adjusted basis in the stock of a "specified 10%-owned foreign corporation" is reduced by an amount equal to the portion of any dividend received with respect to such stock from such foreign corporation that was not taxed by reason of a dividends received deduction allowable under section 245A in any tax year of the domestic corporation, but only for the purpose of determining losses on sales and exchanges of the foreign corporation's stock.[172.2]

If, after 2017, a U.S. corporation transfers substantially all of the assets of a foreign branch to a foreign subsidiary corporation, the "transferred loss" amount (the losses incurred by the foreign branch over certain taxable income earned by the branch) must generally be included in the U.S. corporation's gross income.[172.3]

§ 78:12 2008 Proposed Regulations

Proposed regulations released in August 2008 ("2008 Proposed Regulations") would address some of the issues under sections 367 and 1248 related to "outbound transactions."[173]

As noted above, section 367(a)(2) and (3) provides exceptions to the general rule of section 367(a)(1)—section 367(a)(2) for transfer of stock or securities of a foreign corporation that is a party to the exchange or reorganization, and section 367(a)(3) for transfer of property used in an active foreign trade or business.

Section 367(a)(5) in turn provides exceptions to the exceptions of section 367(a)(2) and (3)—for a transfer of property by a domestic corporation to a foreign corporation in a section 361 exchange. Such transfers are subject to the general rule of section 367(a)(1)—that the U.S. transferor recognizes gain with respect to appreciated property.[174]

Section 367(a)(5) further provides that its exceptions do not apply (and therefore the exceptions under section 367(a)(2) and (3) might) if the U.S. transferor is controlled by five or fewer domestic corporations (members of the same affiliated group are treated as a

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172.1. I.R.C. § 1248(j), as amended by Pub. L. No. 115-97, Act § 14102(a).

172.2. *See* I.R.C. § 961(d), as amended by Pub. L. No. 115-97, Act § 14102(b).

172.3. I.R.C. § 91, as added by Pub. L. No. 115-97, Act § 14102(d)(1).

173. REG-209006-89.

174. *See* I.R.C. § 367(a)(1).

single corporation).[175] The Service says this is to assure that built-in gain in the transferred property remains subject to U.S. tax.[176]

The 2008 Proposed Regulations provide an elective exception to the general rule of section 367(a)(5), if certain conditions and requirements are satisfied. The first of these conditions is a control requirement. At the time of the section 361 exchange, the U.S. transferor must be controlled by five or fewer, but at least one, domestic corporations.[177]

§ 78:12.1 Gain Recognition by U.S. Transferor

Even if the elective exception provided by the 2008 Proposed Regulations covered above applies, in two instances the U.S. transferor must recognize gain on the transfer of section 367(a) property in the section 361 exchange. This is the case even if an exception to the general rule of section 367(a)(1) would otherwise apply to such transfer.

First, the U.S. transferor must recognize gain equal to the aggregate amount of inside gain allocable to non-control group members. The inside gain is allocated among control group members and non-control group members based on each shareholder's ownership interest (by value) in the U.S. transferor at the time of the section 361 exchange. The U.S. transferor must recognize gain with respect to non-control group members even if the entire inside gain could be preserved in the stock received by the control group members as a group.[178] Second, the U.S. transferor must recognize gain to the extent any control group member cannot preserve its share of inside gain in the stock received.[179]

§ 78:12.2 Adjustments to Basis of Stock

The 2008 Proposed Regulations provide that each control group member's basis in the stock received in the transaction that is allocable to the section 367(a) property transferred by the U.S. transferor in a section 361 exchange is reduced to the extent necessary to preserve the control group member's share of inside gain.[180]

175. *See* I.R.C. § 367(a)(5).
176. *See* Preamble to REG-209006-89.
177. Prop. Treas. Reg. § 1.367(a)-7(c)(1).
178. *See* Prop. Treas. Reg. § 1.367(a)-7(c)(2)(i).
179. *See* Prop. Treas. Reg. § 1.367(a)-7(c)(2)(ii).
180. *See* Prop. Treas. Reg. § 1.367(a)-7(c)(3).

§ 78:12.3 Agreement to Recognize Gain and File Amended Tax Return

The 2008 Proposed Regulations require the U.S. transferor to include a statement with its income tax return for the year of the section 361 exchange certifying that if the foreign acquiring corporation disposes of a significant amount of the section 367(a) property transferred in the section 361 exchange in a transaction entered into with a principal purpose of avoiding U.S. tax applicable to the section 361 exchange, then the U.S. transferor must file an income tax return for the year of the exchange reporting the amount of gain realized but not recognized.[181]

§ 78:12.4 Election and Reporting Requirements

To elect the exception, the 2008 Proposed Regulations require the U.S. transferor and the control group members to enter into a written agreement to make the election by the due date for the U.S. transferor's timely filed return for the tax year in which the section 361 exchange occurs.[182]

§ 78:13 Section 367(b)

Section 367(b)(1) provides that in the case of an exchange under section 332, 351, 354, 355, 356, or 361, where there is no transfer of property described in section 367(a)(1), a foreign corporation will be considered a corporation, except to the extent provided by regulations to prevent the avoidance of tax.[183]

§ 78:13.1 Outbound Asset Reorganizations

Existing regulations require that a U.S. transferor that is a section 1248 shareholder of a foreign acquired corporation and that transfers the stock of such corporation to a foreign acquiring corporation in a section 361 exchange must include in income the "section 1248 amount" attributable to the stock of the foreign acquired corporation. The U.S. transferor must include the section 1248 amount in income even if the foreign acquiring corporation and the foreign acquired corporation are CFCs in which the U.S. transferor is a section 1248 shareholder immediately after the exchange.[184]

Later regulations provided an exception to the general rule for triangular reorganizations where the exchanging shareholder re-

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181. Prop. Treas. Reg. § 1.367(a)-7(c)(5)(ii)(A).
182. Prop. Treas. Reg. § 1.367(a)-7(c)(5)(iv).
183. *See* I.R.C. § 367(b)(1).
184. *See* Treas. Reg. § 1.367(b)-4(b)(1)(iii), ex. 4.

ceives stock of a domestic corporation that controls the foreign acquiring corporation; this exception only applies, however, to a shareholder that exchanges stock of the foreign acquired corporation for stock of the domestic corporation in an exchange described under section 354 or 356. Thus, the exception provided by these regulations does not apply where the U.S. transferor receives stock of a domestic controlling corporation for stock of a foreign acquired corporation in a section 361 exchange.[185]

Currently, the Service has determined that requiring the U.S. transferor to include the section 1248 amount in income may not be necessary in cases where the section 1248 amount attributable to the stock of the foreign acquired corporation can be preserved. Accordingly, the 2008 Proposed Regulations under section 367(b) provide an additional exception that applies to certain transfers of stock of a foreign acquired corporation by a U.S. transferor to a foreign acquiring corporation in a section 361 exchange. In this case, the U.S. transferor must include in income the section 1248 amount attributable to the stock of the foreign acquired corporation only if immediately after the section 361 exchange the foreign acquiring corporation or the foreign acquired corporation is not a CFC with respect to which the U.S. transferor is a section 1248 shareholder.[186]

§ 78:13.2 Special Rules for Outbound Triangular Asset Reorganizations

Existing regulations require the U.S. transferor to include in income the section 1248 amount attributable to stock of a foreign acquired corporation transferred to a foreign acquiring corporation in a section 361 exchange that is part of a triangular asset reorganization, even if the corporation that controls the foreign acquiring corporation is domestic.[187] These regulations, however, do not preserve the section 1248 amount attributable to the stock of the foreign acquired corporation in such a case.[188] The 2008 Proposed Regulations would provide an exception to the general rule in such triangular asset reorganizations.[189]

185. *See* Treas. Reg. § 1.367(b)-4(b)(1)(i); T.D. 9243.
186. *See* Prop. Treas. Reg. § 1.367(b)-4(b)(1)(iii), ex. 4.
187. *See* Treas. Reg. § 1.367(b)-13.
188. *See* Preamble to REG-2009006-89.
189. *See* Prop. Treas. Reg. § 1.367(b)-4(b)(1)(ii); Prop. Treas. Reg. § 1.367(b)-4(b)(1)(iii), ex. 5.

§ 78:14 Distributions of Foreign Stock—Section 1248(f)

Section 1248(f)(1) provides that if a domestic corporation that is a section 1248 shareholder with respect to a foreign corporation distributes the stock of that foreign corporation in a distribution described in section 311(a), 337, 355(c)(1), or 361(c)(1), then the domestic distributing corporation must include in income, as a dividend, the section 1248 amount attributable to such stock.[190] This inclusion is required because the section 1248 amount may not be preserved in the hands of the distributee shareholders, so section 1248(f)(1) does not apply to the extent the domestic distributing corporation otherwise recognizes gain on the distribution, in which case the gain recognized would be recharacterized as a dividend under section 1248(a), as appropriate.[191]

Section 1248(f)(2), on the other hand, provides that section 1248(f)(1) does not apply to a domestic distributing corporation's distribution of stock of a foreign corporation to a domestic corporation that is treated as holding the stock for the period during which the stock was held by the domestic distributing corporation and that, immediately after the distribution, is a section 1248 shareholder with respect to the foreign corporation.[192]

§ 78:14.1 Transfer of Property—Section 367

Section 367(a)(1) generally provides that if a U.S. person transfers property to a foreign corporation in connection with an exchange described in section 332, 351, 354, 356, or 361, then the foreign corporation will not be considered a corporation for purposes of determining the extent to which the U.S. person recognizes gain on the transfer. Sections 367(a)(2) and 367(a)(3), respectively, provide exceptions to this general rule, for: (1) transfers of stock or securities of a foreign corporation that is a party to the exchange or reorganization; and (2) for certain property used in an active foreign trade or business.[193]

Section 367(a)(5) generally provides that the exceptions under section 367(a)(2) and (a)(3) do not apply to a transfer of property by a domestic corporation to a foreign corporation in an exchange described in section 361(a) or (b).[194]

Section 367(b)(1) provides that where there is no transfer of property in one of the above-referenced types of exchanges, a foreign corporation will be treated as a corporation, except as otherwise pro-

190. I.R.C. § 1248(f)(1).
191. *See* Preamble to REG-2009006-89.
192. I.R.C. § 1248(f)(2).
193. *See* I.R.C. § 367(a)(1).
194. *See* I.R.C. § 367(a)(5).

vided in regulations "necessary or appropriate to prevent the avoidance of Federal income taxes."[195] The Service says a fundamental policy of section 367(b) is to preserve the potential application of section 1248 following the acquisition of the stock or assets of a foreign corporation by another foreign corporation.[196]

Section 367(c)(1) provides that, under section 367, a distribution described in section 355 is treated as an exchange—whether or not it is an exchange.[197]

Section 1248(a) provides that a U.S. person includes in gross income as a dividend any gain recognized on the sale or exchange of stock of a foreign corporation that was a controlled foreign corporation (CFC) at any time during the five-year period ending on the date of the sale or exchange—but only if the U.S. person owned 10% or more of the total combined voting power of the foreign corporation at any time during that five-year period (that is, was a "section 1248 shareholder"). This amount of gain recognized as a dividend is generally limited to the foreign corporation's E&P attributable to the stock sold or exchanged that was accumulated while the stock was held by the U.S. person, and while the foreign corporation was a CFC.[198]

Section 1248(e) generally provides that if a U.S. person sells or exchanges stock of a domestic corporation used principally for holding foreign corporation stock, the transaction will be treated as a sale of foreign corporations held by the domestic corporation.[199]

Section 1248(f)(1) generally provides that where a domestic corporation distributes stock of a foreign corporation in a distribution to which section 311(a), 337, 355(c)(1), or 361(c)(1) applies, the domestic corporation includes in gross income as a dividend the excess of the fair market value of such stock over its adjusted basis—but only to the extent of the E&P of the foreign corporation attributable to that stock, and that was accumulated while the stock was held by the domestic corporation, and while the foreign corporation was a CFC.[200]

§ 78:14.2 2013 Regulations

The 2008 Proposed Regulations on outbound transfers were replaced in March 2013 by final, temporary, and proposed regula-

195. *See* I.R.C. § 367(b)(1).
196. *See* Preamble to REG-209006-89.
197. *See* I.R.C. § 367(c)(1).
198. *See* I.R.C. § 1248(a).
199. *See* I.R.C. § 1248(e).
200. *See* I.R.C. § 1248(f)(1).

tions.[201] Some changes made to the regulations include the following.

Pursuant to a comment, the final regulations provide an exception for dispositions of property occurring in the ordinary course of business.[202]

The 2008 Proposed Regulations provided that members of an affiliated group are treated as a single corporation for purposes of the control requirement of section 367(a)(5). Comments stated concern that affiliated group members would also be treated as a single corporation for other purposes, such as to determine the amount of stock basis adjustments. The final regulations revise the aggregation rule to clarify that affiliated group members are treated as a single corporation only for purposes of the control requirement.[203]

The 2008 Proposed Regulations had a reasonable cause relief provision, pursuant to which a control group member's failure to comply will be deemed not to have occurred if the failure was due to reasonable cause and not willful neglect. There is a favorable presumption if the control group member requesting relief is not notified by the IRS within 120 days of its acknowledgment of receipt. The Temporary Regulations of T.D. 9614 eliminate this 120-day provision.[204]

The proposed regulations provided that an increase in basis under section 362 for gain recognized by the U.S. transferor under section 367(a) is allocated among the transferred property in proportion to the gain realized. The final regulations clarify this rule to provide that if gain is recognized under section 367 with respect to a particular item of property, the foreign transferee corporation increases its basis in that item of property for such gain. Also, any gain recognized that is not with respect to a particular item of property (such as under the branch loss recapture rules) is then allocated in proportion to the gain realized by the U.S. transferor with respect to all items of property transferred—after taking into account gain recognized under other provisions of section 367.[205]

§ 78:14.3 2016 Final Regulations

Treasury Decision 9803 contains final regulations under sections 367 and 6038B, finalizing the 1986 temporary regulations of Trea-

201. *See* T.D. 9614, T.D. 9615 (temporary), and REG-122706-12, issued in Mar. 2013, replacing REG-2009006-89.
202. *See* Treas. Reg. § 1.6038B-1(c)(6)(iii)(A)(3).
203. *See* Treas. Reg. § 1.367(a)-7(d).
204. *See* Temp. Treas. Reg. § 1.1248(f)-3T(a), issued in accompanying T.D. 9615.
205. *See* Temp. Treas. Reg. § 1.367(a)-1T(b)(4)(i)(B).

sury Decision 8087, along with proposed regulations that were released in September 2015.

The Preamble to Treasury Decision 9803 reviews that the proposed regulations generally provided five substantive changes from the 1986 temporary regulations:

(1) eliminating the favorable treatment for foreign goodwill and going concern value by narrowing the scope of the active trade or business exception under section 367(a)(3) (ATB exception) and eliminating the exception under Temporary Treasury Regulations section 1.367(d)-1T(b) that provides that foreign goodwill and going concern value is not subject to section 367(d);

(2) allowing taxpayers to apply section 367(d) to certain property that otherwise would be subject to section 367(a);

(3) removing the twenty-year limitation on useful life for purposes of section 367(d) under Temporary Treasury Regulations section 1.367(d)-1T(c)(3);

(4) removing the exception under Temporary Treasury Regulations section 1.367(a)-5T(d)(2) that permits certain property denominated in foreign currency to qualify for the ATB exception; and

(5) changing the valuation rules under Temporary Treasury Regulations section 1.367(a)-1T to better coordinate the regulations under sections 367 and 482.

The Preamble to Treasury Decision 9803 states that these regulations generally finalize the 2015 proposed regulations, along with portions of the 1986 temporary regulations of Treasury Decision 8087, "with some amendments," but adding that the final regulations are not intended to be interpreted as making substantive changes to those regulations.[205.1]

§ 78:15 The "Coordination Rule"—Regulation § 1.367(a)-3(d)(2)(vi)(A)

Under existing regulations, the "coordination rule" provides that if, in connection with an indirect stock transfer, a U.S. person transfers assets to a foreign corporation in a section 351 or section 361 exchange, the rules of section 367 and the regulations thereunder shall first apply to the direct asset transfer and then to the indirect

205.1. *See* Treas. Reg. §§ 1.367(a)-1 *et seq.* (issued as T.D. 9803).

stock transfer.[206] An exception provides that section 367(a) and (d) do not apply to the extent that assets transferred by a domestic acquired corporation to a foreign acquiring corporation in an asset reorganization are retransferred to a domestic corporation controlled by the foreign acquiring corporation, but only if the domestic controlled corporation's basis in the retransferred assets is not greater than the domestic acquired corporation's basis in those assets (along with other conditions).[207]

Notice 2008-10[208] addresses transactions the Service says are intended to use the coordination rule exception inappropriately to repatriate earnings and profits of foreign corporations without the recognition of gain or a dividend inclusion.[209] The notice announced that the conditions for the application of the coordination rule exception would be revised to clarify that any adjustment to basis required under section 367(a)(5) must be made to the basis of stock of the foreign acquiring corporation received by the control group members in the asset reorganization so that the appropriate amount of built-in gain in the property transferred by the domestic acquired corporation to the foreign acquiring corporation is reflected in such stock. The notice clarifies that the control group members cannot satisfy the basis adjustment requirement by adjusting the basis of stock of the foreign acquiring corporation held before the reorganization. The notice further states that the revised regulations would confirm that, to the extent the appropriate amount of built-in gain in the property transferred by the domestic acquired corporation cannot be preserved in the stock received by the control group members in the reorganization, then the domestic acquired corporation's transfer of property to the foreign acquiring corporation shall be subject to section 367(a) and (d).[210]

The 2008 Proposed Regulations incorporate, with modifications, the clarifications to the conditions for the application of the coordination rule exception announced in Notice 2008-10.[211]

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206. *See* Treas. Reg. § 1.367(a)-3(d)(2)(vi)(A).
207. *See* Treas. Reg. § 1.367(a)-3(d)(2)(vi)(B)(1).
208. 2008-1 C.B. 277.
209. *Id.*
210. *See id.*
211. *See* Prop. Treas. Reg. § 1.367(a)-3(d)(2)(vi)(B).