Comments Concerning
Proposed Treasury Regulation 301.7701-3(h)

These Comments represent the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation or any Committee thereof. These Comments were prepared by individual members of the Committees on Foreign Activities of U.S. Taxpayers and U.S. Activities of Foreigners and Tax Treaties of the Section of Taxation. Principal responsibility was exercised by William S. Dixon. Substantive contributions were made by Armando Gomez, Washington D.C.; Michael Hirschfeld, New York, NY; Edward Lemanowicz, Philadelphia, PA; David S. Miller, New York, NY; and Michael D. Thomson, Washington D.C. The Comments were reviewed by Alfred C. Groff, Washington D.C., of the Section’s Committee on Government Submissions and by David Raish, Boston, MA, Council Director for the Committees on Foreign Activities of US Taxpayers and US Activities of Foreigners and Tax Treaties. Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the U.S. Federal tax principles addressed herein or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person:

William S. Dixon
(212) 474-1000
wdixon@cravath.com

Date: July 31, 2000
I. Introduction

The principal purpose of our letter is to comment on Prop. Treas. Reg. section 301.7701-3(h) (referred to below as the “Proposed Regulations” or “Extraordinary Transaction Rules”), issued in November of 1999. In so doing, we have attempted to identify not only some of the technical deficiencies of the Proposed Regulations, but also some of the significant tax policy issues that they raise.

In the name of preventing taxpayers from evading certain substantive provisions of the Internal Revenue Code of 1986, as amended (the "Code") and tax treaties, the Extraordinary Transaction Rules operate to disregard a taxpayer’s otherwise valid election to treat a foreign eligible entity as a disregarded entity and instead treat such entity as an association taxable as a corporation for all purposes from the date of such election. As a result, a taxpayer’s general ability to elect the U.S. Federal income tax classification of an entity is abridged, and the targeted transaction is treated as a sale, exchange, or transfer of foreign corporation stock rather than assets. In the typical case, a taxpayer will obtain significantly different U.S. Federal income tax consequences in connection with a disposition of assets as opposed to an otherwise comparable disposition of foreign corporation stock. These differences are not limited to the amount of gain that might be recognized/realized, but also include the character, source, foreign tax credit, and basis implications of the transaction. However, because the Proposed Regulations operate to revoke an otherwise valid disregarded entity election from the date of such election, the Proposed Regulations not only alter the U.S. Federal income tax consequences resulting from the targeted transaction, they recharacterize every transaction engaged in by the relevant entity during that period as if such entity had been an association taxable as a corporation rather than a disregarded entity (i.e., as a branch). Accordingly, the application of the Extraordinary Transaction Rules would likely affect taxpayers significantly.

Although we do not necessarily believe that the distinction between, and the disparate tax treatment accorded, transfers of stock and assets is warranted on policy

---


2 See 1999-50 I.R.B. 670 ("It has become apparent to the IRS and Treasury that taxpayers may attempt to use [disregarded entities] ... to achieve results ... that are inconsistent with the policies and rules of particular Code sections or tax treaties. These regulations are intended to address inappropriate Federal tax consequences that would otherwise result from certain of these transactions under a number of international provisions of the Code.").

3 The statutory provisions specifically identified in the preamble to the Proposed Regulations relate to outbound stock transfers (Section 367 of the Code), source rules (Section 865 of the Code), foreign tax credit provisions (specifically Section 904 of the Code) and subpart F consequences relating to the disposition of ownership interests (Sections 951-64 of the Code). See 1999-50 I.R.B. 670.

4 A foreign eligible entity is a foreign business entity that is not a "per se" foreign corporation. See Treas. Reg. 301.7701-3.

5 Prop. Treas. Reg. 301.7701-3(h).

6 A foreign eligible entity with a single member generally may be treated as a disregarded entity for U.S. Federal income tax purposes (i.e., a foreign branch of its member). See Treas. Regs. 301.7701-2, -3.

7 Table I briefly highlights some of the different U.S. Federal income tax consequences of a sale of foreign corporation stock versus a sale of assets used in the active conduct of a trade or business by a foreign branch.
grounds, we recognize the distinction is well-established under current law. Thus, this comment letter proceeds on the assumption that such distinction should be viewed as the operative paradigm for purposes of commenting on the Proposed Regulations. Furthermore, this comment letter is written against the backdrop of current U.S. Federal income tax law, which provides different tax treatment for numerous economically similar arrangements based on various categorical distinctions. In fact, each of the four sections of the Code identified in the preamble to the Proposed Regulations (the "Preamble") plainly treats a sale of foreign corporation stock differently from a sale of assets used in the active conduct of a trade or business.

II. Executive Summary

1. The Proposed Regulations Attack the Potential Abuses in the Wrong Manner. We do not believe that the IRS/Treasury should attempt to respond to the potential abuses leading to the Proposed Regulations by amending the check-the-box regulations. Instead, we believe that the IRS/Treasury should apply existing statutory and regulatory provisions as well as common law to the substantive provision(s) of the Code or treaties that might be abused by certain taxpayers.

2. The Proposed Regulations Undo Many of the Accomplishments of the Check-the-Box Regulations. By amending the check-the-box regulations, the IRS/Treasury would unnecessarily erode the simplicity and certainty achieved by the check-the-box regulations generally.

3. The Proposed Regulations Attack the Potential Abuses Too Broadly. The Proposed Regulations attack the unidentified, potential problem(s) too broadly for a number of reasons:

   • The Proposed Regulations apply to transactions between related parties even where there is no intention to transfer the relevant assets outside the control group.

   • When invoked, the Proposed Regulations not only cause the transaction at issue to be recharacterized, but also recharacterize every transaction involving the relevant entity from the date of the disregarded entity election.

---

8 For example, it is well established that a shareholder-taxpayer can liquidate a corporation and sell the liquidated assets to an unrelated party and such transactions will be treated as a liquidation subject to Sections 332 and 381 of the Code followed by a sale of the liquidated assets. See, e.g., United States v. Cumberland Pub. Svc., 338 U.S. 451 (1950). In addition, many of the differences in the U.S. Federal income tax consequences of a sale of foreign corporation stock versus a sale of assets used in the active conduct of a trade or business have existed since the promulgation of the subpart F regime in 1962.

9 For example, form and direction continue to play a significant role in the U.S. Federal income taxation of business transactions. See, e.g., Lewis R. Steinberg, Form, Substance and Directionality in Subchapter C, 52 Tax Law. 457 (1999).

10 See note 7 above.
The Proposed Regulations apply to transactions involving only a 10% change in ownership as opposed to a change in control.

The Proposed Regulations utilize a one-year testing period to identify offensive transactions, a very long period of time in today’s competitive world markets.

The Proposed Regulations could be interpreted to apply to transactions covered by the moratorium on hybrid branch payments.

4. The Proposed Regulations Run the Risk of Altering Existing Substantive Law. U.S. Federal income tax law often treats seemingly synonymous transactions differently based upon numerous categorical distinctions. In fact, each of the Code categories identified in the Preamble treats a sale of stock and assets differently. In large measure, the Proposed Regulations seem to be an attempt by the IRS/Treasury to alter a taxpayer’s ability to plan his affairs in response to plain, well-established objective rules.

5. IRS/Treasury Has Not Yet Described Its Concerns in Detail. Although the Proposed Regulations offer a sweeping solution, the IRS/Treasury has not yet clearly and explicitly identified the purported abuses involving the use of foreign disregarded entities.

6. If Adopted, the Final Version of the Proposed Regulations Should Make a Number of Changes and Clarify a Number of Issues. A number of recommended changes and clarifications are set forth in Section VII below.

III. Description of the Proposed Regulations/Extraordinary Transaction Rules

The Proposed Regulations provide that, absent an exception, if the preconditions to the Basic Rule or Shelf Entity Rule (each of which is described below) are met, the Extraordinary Transaction Rules will apply and a foreign eligible entity will be treated as an association taxable as a corporation rather than a disregarded entity.

A. Basic Rule

Under the Extraordinary Transaction Rules, an election to treat a foreign eligible entity as a disregarded entity election would be ignored where

- at least 10% of such foreign eligible entity was sold, exchanged, transferred, or otherwise disposed of in one or more transactions (collectively, “Extraordinary Transactions”) in the period commencing one day before and ending 12 months after the effective date of such foreign eligible entity’s change in classification to disregarded entity status, and

- such foreign entity had been classified as an association taxable as a corporation at any time within the 12-month period prior to the date of the commencement of the Extraordinary Transaction.11

If the Basic Rule applies, the foreign eligible entity will be treated as an association taxable as a corporation from and including the date that such foreign eligible entity ceased to be classified as an association taxable as a corporation.12

B. Shelf Entity Rule
Under the Extraordinary Transaction Rules, an election to treat a foreign eligible entity as a disregarded entity election would be ignored where

- such disregarded entity acquires assets of one or more foreign business entities which were classified as associations taxable as corporations at any time within the 12-month period prior to the date of the commencement of the Extraordinary Transaction in a transaction (or series of transactions) in which gain or loss was not recognized, in whole or in part, for U.S. Federal tax purposes,13 and

- subsequent to the consummation of the acquisition transaction(s), the acquired assets comprise more than 80% of the value of the assets of the acquiring disregarded entity (the "asset ratio"),14 and

- the acquiring disregarded entity is involved in an Extraordinary Transaction within 12 months of the date on which the acquisition transaction (or the last of a series of acquisition transactions) is completed.15

If the Shelf Entity Rule applies, the foreign eligible entity will be treated as an association taxable as a corporation from and including the date of the acquisition transaction (or the last of a series of acquisition transactions).16

When calculating the asset ratio under the Shelf Entity Rule, an entity’s cash and marketable securities will not be included in such calculation to the extent that such cash and marketable securities exceed the “reasonable needs” of such entity’s business.17

C. Exception to the Basic and Shelf Entity Rules
Under the Proposed Regulations, neither the Basic Rule nor the Shelf Entity Rule would apply if a taxpayer establishes to the “satisfaction” of the Commissioner that the classification of the applicable foreign eligible entity as a disregarded entity does not “materially alter” the U.S. Federal tax consequences of the Extraordinary Transaction.18

---

D. Effective Date

As currently drafted, the Proposed Regulations would become effective on or after the date final regulations are published in the Federal Register.19

IV. Purpose of the Proposed Regulations

Although the Preamble asserts in a matter-of-fact fashion that taxpayers may be using disregarded entities in a manner that conflicts with the underlying purposes of various international provisions of the Code and treaties,20 the Preamble does not meaningfully identify or describe the purported abuses.21 The Preamble similarly fails to identify or discuss the underlying tax policies allegedly being frustrated as a result of such abuses. Consequently, a chief difficulty encountered in preparing this comment letter was our lack of understanding as to the IRS/Treasury’s precise concerns and perception of the abuses being committed in connection with the use of disregarded entities.

Despite the lack of guidance in the Preamble, we suspect that the IRS/Treasury’s chief concern relates to a taxpayer’s potential ability to “game” the system with respect to opportunistic disregarded entity elections followed by an immediate (or near-immediate) sale of the equity interests in the relevant entity.22 In such case, the transaction would constitute a sale of assets rather than a sale of foreign corporation stock.23 As a result, the taxpayer would obtain the benefits of asset sale treatment without incurring the consequences of disregarded entity status for a sufficiently long period of time. Because actual liquidations are not similarly captured by the Proposed Regulations, we suspect another concern is the IRS/Treasury’s increasing distaste for U.S. taxpayers seeking to obtain relatively favorable U.S. tax consequences without incurring similar adverse non-U.S. tax implications as a result of the differences between the relevant systems of taxation (e.g., a deemed liquidation for U.S. tax purposes without an actual (or deemed) liquidation for non-U.S. tax purposes).24 Finally, we suspect that IRS/Treasury must also


20 See note 2 above.

21 Instead, the Preamble simply lists four provisions of the Code which encompass a significant portion of the U.S. Federal income tax law applicable to international transactions. See note 2 above.

22 Indeed, each example in the Proposed Regulations illustrate the application of the Basic Rule and Shelf Entity Rule to this fact pattern.

23 A disregarded entity election made with respect to an existing foreign eligible entity currently taxed as a corporation is treated as a liquidation of such corporation. See Treas. Reg. 301.7701-3(g)(1)(iii). Thus, upon making the disregarded entity election, the sole owner of the foreign eligible entity becomes the direct owner of the assets of the foreign eligible entity for U.S. Federal income tax purposes. See Section 332, of the Code; Treas. Reg. 1.367(e)-2(c)(3)(i). Consequently, a subsequent sale of the equity interests in such foreign eligible entity is considered a sale of assets for U.S. Federal income tax purposes.

24 See, e.g., Section 894(c) of the Code; Temp. Treas. Reg. 1.894-1T; IRS Notice 98-11, 1998-1, C.B. 433; Prop. Treas. Reg. 1.954-9. For example, the IRS/Treasury may be disturbed by the lack of non-U.S. legal consequences (i.e., local law consequences other than tax consequences) generally associated with a deemed liquidation for U.S. Federal income tax purposes and may believe that the current rules were promulgated under the understanding that actual foreign consequences typically would result in connection with transactions which were treated as a liquidation of a foreign corporation.

Of course, one of the fundamental consequences of the check-the-box regulations is that they potentially treat an entity as one type of entity for U.S. purposes even though such entity will be treated in another manner for non-U.S. tax purposes. This is not unique to the check-the-box regulations because dissimilar
have other concerns because the Proposed Regulations would appear to apply to intragroup restructuring transactions where there is no present plan or intent to dispose of the transferred assets to a third party.

Without specifically addressing the prudence of curbing such purported abuses by modifying the entity classification provisions of the check-the-box regulations rather than modifying or issuing guidance under the applicable substantive Code (or treaty) provision(s), we believe that the IRS/Treasury should identify with far greater specificity the types of transactions that have generated their concern. In addition, we note that the Preamble is silent with respect to a number of important issues, including

- the need for the Proposed Regulations,
- why, and if so, how, the IRS/Treasury believe the transactions covered by the Proposed Regulations undermine existing tax policy,
- why it is necessary to recharacterize all of the other transactions engaged in by the relevant entity during the period commencing on the date of the disregarded entity election and ending on the date of the Extraordinary Transaction—in other words, what substantive provision of the tax law would be undermined by respecting the form of those earlier transactions,
- why the IRS/Treasury now seek to change the law with respect to making a disregarded entity election not only as compared to current law, but also as compared to pre-check-the-box law,25
- the other alternative measures considered to address the purported abuses and why the IRS/Treasury determined such alternative measures were less favorable than the Proposed Regulations,26
- the merit of undermining the simplicity afforded by the entity classification provisions of the check-the-box regulations,
- why deemed and actual liquidations are treated differently under the Proposed Regulations,27

25 Disregarded entities appear to have existed under pre-check-the-box law. See, e.g., PLR 8737100 (June 19, 1987); PLR 8533003 (May 7, 1985); GCM 39395 (Aug. 5, 1985). See also Francis J. Wirtz & Kenneth L. Harris, Tax Classification of the One-Member Limited Liability Company, 59 Tax Notes 1829, 1833-34 (June 28, 1993). In addition, a taxpayer presumably could have altered the operative documents of a single-member entity so as to transform such entity from corporate to disregarded entity status. Thus, a taxpayer could have made a synthetic disregarded entity election. Obviously, current law provides a more expeditious and less cumbersome means to obtain that result.

26 Although the Preamble states that “[t]he IRS and Treasury considered several responses to these transactions and determined that a special rule completely revoking the entity’s classification was the most equitable and administrable approach,” no alternatives are identified and there is no discussion of the relative strengths and weaknesses of such possible alternatives. See 1999-50 I.R.B. 670. The Preamble also states, without explanation, that the Proposed Regulations offered the greatest “certainty” to all parties involved in the transactions covered by the Proposed Regulations. Id.
• why it is necessary to disregard completely an otherwise valid check-the-box election rather than merely undo or recharacterize the event giving rise to the Extraordinary Transaction,\(^\text{28}\)

• why the Proposed Regulations apply only to entities that changed from corporate to disregarded entity status,

• why the use of a U.S. limited liability company treated as a disregarded entity would not give rise to the same concerns that are purportedly being addressed in the Proposed Regulations, and

• the rationale for treating intragroup and non-intragroup restructurings alike.

V. General Comments on the Proposed Regulations

Although, as stated above, we do not believe that we have been fully apprised of the totality of the IRS/Treasury’s concerns which led to the Proposed Regulations,\(^\text{29}\) we believe that the tax law should be construed and applied in a manner consistent both with its language and purpose. In contrast to the conclusion set forth in the Preamble, we are not convinced that the best way to curb the (unidentified) abuses of concern to the IRS/Treasury is to amend the entity classification provisions of the check-the-box regulations. For a number of reasons, we believe that the IRS/Treasury should address the potential abuses directly (i.e., by interpreting existing law or modifying or issuing guidance under the applicable substantive provision(s) of the tax law) rather than indirectly (i.e., by modifying the check-the-box regulations).

A. Existing Law Enables the IRS/Treasury to Combat Transactions Generally Covered by the Proposed Regulations

In our view, the Proposed Regulations are too broad, and it would be preferable to address the purported abuses leading to those regulations by interpreting or directly modifying the relevant substantive law as necessary. In addition, to the extent that the transactions covered by the Proposed Regulations

\(^{27}\) The Proposed Regulations apply to deemed, but not actual, liquidations. This implies that the IRS/Treasury are less concerned with the U.S. Federal income tax consequences which obtain in connection with an actual liquidation in spite of the fact that they are identical to the consequences that obtain in the case of a deemed liquidation. But see ITA 199937038 (gain from sale treated as subpart F income) discussed in Section IV.A.2. herein. However, if, as the Preamble purports, the U.S. Federal income tax results obtained are "inappropriate" when derived in connection with the use of a disregarded entity election, why are such results not similarly inappropriate when resulting from an actual liquidation? Perhaps this dissimilar treatment illustrates that the IRS/Treasury consider the non-U.S. Federal income tax consequences to be especially important when evaluating whether a particular U.S. Federal income tax consequence is proper. Query whether this is proper in light of the United States Supreme Court's statement to the effect that, absent affirmative Congressional guidance to the contrary, U.S. Federal income tax principles should operate and apply to international transactions without regard to local consequences. See Biddle v. Comm'r, 302 U.S. 573, 578 (1938); U.S. v. Goodyear Tire & Rubber, 439 U.S. 132, 145 (1989).

\(^{28}\) This was the approach utilized in ITA 199937038 discussed in Section IV.A.2. herein.

\(^{29}\) See Section IV above.
would actually be abusive,\textsuperscript{30} we believe that the IRS/Treasury fail to appreciate that they are already sufficiently well-equipped under existing law to deal with such transactions. We also believe that the IRS/Treasury are sufficiently well-equipped under existing law to challenge other kinds of transactions covered by the Proposed Regulations on the theory that such transactions violate, fail to carry out, or frustrate applicable substantive provisions or underlying policies of the tax law. For example, vital common law doctrines such as the step-transaction and economic substance doctrines exist. The IRS/Treasury may also apply Section 269 of the Code as well as numerous existing anti-abuse provisions (such as those under Sections 701, 865 and 7701 of the Code) to curtail the purported abuses. Finally, we believe that the IRS/Treasury could correctly interpret and apply substantive provisions of current law to undo some of the transactions covered by the Proposed Regulations. To the extent that the IRS/Treasury were not able successfully to undo certain transactions, it would likely reflect not that the aforementioned methods are ineffective or obsolete, but that the tax law, for numerous reasons, treats (and historically has treated) seemingly similar economic transactions differently based upon the form of the transaction and the parties thereto.\textsuperscript{31} The government has regularly used all of these well-established methods to attack and disallow numerous transactions. Two recent sources of guidance demonstrate that the IRS/Treasury believe in the usefulness of these provisions.

1. \textit{Preamble to Outbound Stock Transfer Regulations}

   In the preamble to the outbound stock transfer regulations,\textsuperscript{32} the IRS/Treasury indicated that they would apply the step-transaction doctrine and existing law to a situation where a taxpayer attempted to use a disregarded entity election in order to avoid incurring an obligation to file a gain recognition agreement in connection with a planned transfer.\textsuperscript{33} In the example set forth in the preamble, a U.S. transferor has two wholly-owned direct foreign subsidiaries (each a "controlled foreign corporation" within the meaning of Section 957(a) of the Code a ("CFC"), CFC-1 and CFC-2. The U.S. transferor transfers the stock of CFC-1 to CFC-2 in an

\textsuperscript{30} We are not convinced that all of the transactions covered by the Proposed Regulations would constitute abusive transactions. For example, notwithstanding ITA 199937038, discussed below, most of the drafters of these Comments believe that existing law provides that the form of the transaction illustrated in Example 1 of the Proposed Regulations should be respected.

\textsuperscript{31} It might also be argued that by virtue of providing disparate treatment for seemingly similar economic transactions, the tax law expressly allows taxpayers to plan their transactions and requires such taxpayers to accept the related consequences. See, e.g., Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 148-149 (1974)("while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not"); Glacier State Electrical Supply v. Comm'r, 80 T.C. 1047, 1057 (1987)("cornerstone of tax planning is that the same economic or business result may be validly achieved through a variety of routes, each with differing tax consequences").


\textsuperscript{33} Ordinarilly, if a U.S. person transfers foreign corporation stock in exchange for stock of a foreign transferee corporation in a 351 exchange or "B" reorganization and owns 5% or more of the transferee's stock immediately after such exchange, the U.S. person must file a 5-year gain recognition agreement in order to obtain nonrecognition treatment in connection with such exchange. See Treas. Reg. 1.367(a)-3(b).
exchange that would otherwise qualify as a Section 351 exchange or "B" reorganization. The U.S. transferor elects to treat CFC-1 as a disregarded entity, and the election is made effective immediately before the transfer. If the election were respected, the transaction generally would qualify for nonrecognition treatment. In the event the transferred assets were to be disposed of "in connection with the transfer" to CFC-2, the preamble advances two theories as to why the initial transfer would not qualify for nonrecognition treatment. First, the step-transaction doctrine might apply. Second, the active trade or business anti-avoidance rule would apply.

2. IRS Technical Assistance 199937038

The IRS has also recently considered whether either an actual or deemed liquidation of a second-tier CFC made immediately prior to a sale transaction would be treated as a sale of stock rather than a sale of assets. Under the facts presented in the ITA, CFC-3, a holding company, sells the equity interests in its wholly-owned subsidiary, CFC-4, to an unrelated party. Immediately prior to such sale, however, CFC-4 is liquidated (either by way of an actual liquidation or a deemed liquidation as a result of a disregarded entity election) for the express purpose of treating the transaction as a sale of assets, rather than stock, for U.S. Federal income tax purposes. In the ITA, the IRS respected the liquidation and, therefore, the sale of CFC-4 constituted a sale of assets rather than foreign corporation stock. However, even though the transfer constituted a sale of assets, the IRS also declared that the gain on such sale would constitute subpart F income and would not qualify for exclusion from subpart F income status typically afforded to sales of property used in the active conduct of a trade or business because CFC-3 did not use (or hold for use) the assets of CFC-4 for a sufficiently long enough period and/or with the appropriate intent as required by the applicable Treasury Regulations.

34 The exchange would generally constitute a deemed exchange of assets to CFC-2, provided CFC-2 used the transferred assets in the active conduct of a trade or business outside the U.S. See Section 367(a)(3) of the Code; Temp. Treas. Reg. 1.367(a)-2T.

35 Temp. Treas. Reg. 1.367(a)-2T(c)(1). Generally, Section 367(a)(1) of the Code does not apply to a transfer of property to a foreign corporation where such property is transferred for use by the transferee corporation in its active conduct of a trade or business outside the U.S. and the U.S. transferor complies with the requisite reporting requirements of Section 6038B of the Code and related Treasury regulations. See Section 367(a)(3) of the Code; Temp. Treas. Reg. 1.367(a)-2T(a). This exception does not apply, however, where, pursuant to the same transaction, the transferee foreign corporation subsequently transfers such assets to an unrelated party. See Temp. Treas. Reg. 1.367(a)-2T(c)(1). For this purpose, subsequent transfers occurring within six months of the prior transfer are considered part of the same transaction. Id. In addition, although the preamble to the outbound stock transfer regulations seem to indicate that transfers occurring more than six months after the prior transfers will generally be respected, the applicable Treasury regulation clearly states that the step-transaction doctrine may still apply to such transfers. Compare T.D. 8770 and Temp. Treas. Reg. 1.367(a)-2T(c)(1)(final sentence).

36 ITA 199937038 (June 28, 1999).

37 The IRS also considered the case where CFC-4 is liquidated at the time CFC-3 has entered into a contract to sell CFC-3 but the actual transfer occurs after the actual or deemed liquidation, as the case may be, and reached the same conclusion.

The IRS reasoned that CFC-3 held CFC-4’s historic assets for investment, rather than for use in a trade or business, because the purpose of the (actual or deemed) liquidation was solely to facilitate an advantageous sale of such assets for U.S. Federal income tax purposes, and CFC-3 never intended to conduct CFC-4’s trade or business. Consequently, under Section 954(c)(1)(B)(iii) and the related Treasury regulations, the sale of CFC-4’s historic business assets constituted subpart F income. The conclusion reached in the ITA has been criticized by various commentators.

39 Section 954(c)(1)(B)(iii) of the Code generally provides that gain from the sale or exchange of property that “does not give rise to any income” will constitute subpart F income. Applicable Treasury regulations provide that, except as specifically excepted by regulation, the term property that does not give rise to income includes all rights and interests in property. See Treas. Reg. 1.954-2(e)(3). Those excepted types of property include: (i) goodwill or going concern value, (iii) real property that does not give rise to rental or similar income, and (iv) tangible personal property that would be subject to Sections 167 and 168 of the Code, in each case only to the extent such property is used or held for use in the relevant CFC's trade or business. Id. The use or purpose for which such property is used or held is the use or purpose for which such property was used or held for the majority of the period during which the relevant CFC held the property. See Treas. Reg. 1.954-2(a)(3). In the ITA, the IRS determined that CFC-3 never used CFC-4's historic assets in a trade or business.

40 See, e.g., David S. Miller, The Strange Materialization of Tax Nothings, 87 Tax Notes 665, 687 n.12 (May 1, 2000)(noting the conclusion reached in ITA is "controversial"); Thomas R. May, Warning: Hybrid Entities—Procede with Caution, 86 Tax Notes 533 (January 24, 2000)(criticizing the validity of the conclusion in ITA, especially with respect to the trade or business cases cited therein); Laraine S. Rothenberg & Lowell D. Yoder, Subpart F—Foreign Base Company Income, 928-2d TMP (BNA) at A-62 (same); Rev. Rul. 77-375, 1977-2 C.B. 106 (same); PLR 9836027 (Jun. 9, 1998)(same); PLR 9751012 (Sep. 15, 1997)(purported like kind exchange respected, and the liquidated corporation's use of the property to the upper-tier CFC made qualifies for partial liquidation treatment); PLR 99902001 (Sep. 30, 1998)(parent's distribution of sale proceeds derived from disposition of stock of its direct subsidiary where Section 338(h)(10) election made qualifies for partial liquidation treatment); TAM 9252001 (Feb. 12, 1992)(same conclusion in the "A" reorganization context); PLR 9152010 (Sep. 13, 1991)(same conclusion reached in the "C" reorganization context). The aforementioned rulings in the Section 1031(a) context, however, did note that one of the reasons for the conclusion reached therein was the fact that there was no "cashing out" of the investment; obviously, that is not the case under the facts of the ITA. At minimum, we find it odd that the ITA failed to consider the application of Section 381 at all. In addition, even if the result reached in the ITA is correct, under current law, such result could be easily avoided by well-advised taxpayers. Suppose
B. The Proposed Regulations Undermine the Simplicity and Certainty Achieved by the Check-the-Box Regulations

We not only believe that the IRS/Treasury could use current law to combat many of the alleged abuses addressed by the Proposed Regulations, but also that the overbroad approach fostered by the Proposed Regulations undermines the valuable policies underlying the entity classification provisions of the check-the-box regulations. We find the approach taken in the Proposed Regulation particularly troubling because the check-the-box regulations and the substantive provisions of the tax law, including those identified in the Preamble, are intended to address separate matters and achieve different policies.

The check-the-box regulations became effective on January 1, 1997, replacing the four-factor “Kintner” test applicable under pre-check-the-box law. The principal purposes of the check-the-box regulations were to simplify entity classification and ameliorate the administrative burdens associated with monitoring such classification. The adoption of the check-the-box regime reflected the IRS/Treasury’s sensible understanding that, under prior law, well-advised taxpayers virtually always obtained the treatment they desired merely by resorting to form and (high-priced) legal advice. By allowing taxpayers to select the form of their entities, the administrative burdens of enforcing the prior regulations were eliminated, thereby benefiting both the government and taxpayers-at-large. The check-the-box regulations also promoted certainty as to the U.S. Federal income tax classification of entities. The check-the-box regulations, however, did not and were not intended to change substantive tax law. Moreover, the adoption of the check-the-box regulations did not enable taxpayers to obtain U.S. Federal income tax consequences that were previously unavailable. While it was recognized that the check-the-box regulations enabled taxpayers to select their entity classification, especially in the case of subsidiaries of parent companies.

CFC-4 had negotiated directly for the sale of its assets and then effectuated the disregarded entity election. Under Comm'r v. Court Holding Co., the transaction would be treated as a sale of assets by CFC-4 followed by a liquidation thereof. See 324 U.S. 331 (1945). In such case, there would be no question as to CFC-4's use or intent with respect to its assets, and the gain derived from the sale of assets would not constitute subpart F income.


42. Under prior law, an entity was treated as an association taxable as a corporation, rather than a partnership (or, in the case of a single member entity, what is currently referred to as a disregarded entity) if three of the following four criteria were present: (1) continuity of life, (2) centralized management, (3) limited liability, and (4) free transferability of interests. See old Treas. Reg. 301.7701-2(a)(3).

43. T.D. 8697; IRS Notice 95-14, 1995-1 C.B. 297 (taxpayers and IRS “expend considerable resources” in determining proper classification of entities).


45. Technically speaking, taxpayers cannot unilaterally determine the tax classification of any type of entity. For example, domestic and foreign per se corporations are automatically classified as corporations for U.S. Federal income tax purposes. See Treas. Reg. 301.7701-2. However, a very large group of commercially viable entities are available and, therefore, taxpayers frequently have the opportunity to select their entity classification, especially in the case of subsidiaries of parent companies.
taxpayers to more easily attain their desired entity classification, that alone was not (and should not be) deemed problematic. Indeed, one of the key rationales advanced in favor of the check-the-box regulations was to cease using the entity classification rules as a back-handed way to curb the attainment of certain substantive tax results. Accordingly, to the extent that the IRS/Treasury believed that facilitating a taxpayer’s ability to obtain a particular entity classification was a cause of concern, it was attributable to the relevant underlying substantive provision(s), not the check-the-box regulations. Accordingly, the most appropriate way to respond to those concerns would be to address the relative substantive provision(s) directly, rather than by modifying the check-the-box regulations.

The Proposed Regulations would alter the entity classification provisions of the check-the-box regulations for the purported purpose of preventing taxpayers from realizing undue tax benefits under substantive areas of the income tax law. Notwithstanding the supposed benefit of curbing such transactions, in so doing, the Proposed Regulations limit taxpayers’ ability to plan their transactions within the context of the existing substantive rules, a principle which is well-established in our tax law and one of the precise things that the check-the-box regulations were intended to avoid.

In exchange for a bright-line test, the Proposed Regulations create a latent trap for taxpayers who make a disregarded entity election without any present plan or intent to effectuate an Extraordinary Transaction. The Proposed Regulations actually inject uncertainty into the check-the-box regulations, whose success was largely attributable to their certainty, an obvious fruit of simplicity.

---

46 See, e.g., Michael L. Schler, Initial Thoughts on the Proposed “Check-the-Box” Regulations, 71 Tax Notes 1679, 1681-82 (June 17, 1996). The check-the-box regulations admittedly make obtaining such results less difficult.

47 Generally speaking, it is well-established that taxpayers may order their commercial affairs as they deem fit, including by structuring their affairs in a manner that reduces their U.S. Federal income tax liability. See, e.g., Gregory v. Helvering, 293 U.S. 465, 469 ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permit cannot be doubted"); Gregory v. Helvering, 69 F.2d 809, 810 (2d Cir. 1934), aff'd 293 U.S. 465 (1935)(J.Hand)(any taxpayer "may arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes"); Pacific SW Rlty. Co. v. Comm'r, 128 F.2d 815, 818 (1942)("taxpayer may arrange his business transactions so they may or may not be under the phraseology of the taxing act"); Ach v. Comm'r, 358 F.2d 342 (6th Cir. 1966), aff'g 42 T.C. 114 (1964); (same); Estate of Stranahan v. Comm'r, 472 F.2d 867, 869 (6th Cir. 1973)(same); Estate of Lucas v. Comm'r, 71 T.C. 838, 847-48 (1979)(same).

48 See note 2 above.

49 See note 47 above.

50 The language of the Preamble suggests that the IRS/Treasury believe that the Proposed Regulations would operate in a manner affording all parties (which presumably includes the IRS/Treasury) a high level of certainty with respect to the associated U.S. Federal income tax consequences. See 1999-50 I.R.B. 670.

51 For example, the Proposed Regulations do not distinguish between a transfer made pursuant to a binding contract entered into prior to the disregarded entity election and a transfer made subsequent to such election as a result of unforeseen market forces, circumstances, or opportunities.

52 This certainty extends not only to the classification of the entity but also to the tax results that would subsequently obtain in connection with future transactions.
Unlike under prior law, once made, a valid election under the check-the-box regulations provides certainty with respect to the tax classification of the relevant entity. The Proposed Regulations undo this noteworthy accomplishment in at least two ways. First, under the Proposed Regulations, an entity which is transformed from corporate to disregarded entity status is effectively put on probation for one year (i.e., from the time of the disregarded entity election). This probationary status is imposed without regard to the taxpayer’s motive when the election is made. Even if the election was made with every intention to accept the attendant benefits and detriments associated with such election (e.g., in the case of a foreign branch, flow-through treatment of income), the Proposed Regulations would spring to life if, for any reason, the taxpayer engages in an Extraordinary Transaction within the 12-month period subsequent to making such election.

Second, because the Proposed Regulations operate to treat the relevant entity as an association taxable as a corporation from the date of the now-revoked disregarded entity election, each transaction transpiring during the period starting on the date of such election and ending just prior to the Extraordinary Transaction is recast. We fail to see how any substantive Code (or treaty) provision is protected or advanced by recharacterizing such prior transactions. Penalizing taxpayers with no present intent to manipulate a tax system based principally on objective rules is unwarranted.

C. The Proposed Regulations Should not Apply to Transactions Covered by the Hybrid Branch Regulations

In January of 1998, the Treasury issued Notice 98-11 in which it announced that taxpayers were utilizing “hybrid branches” in a manner contrary to the policies of subpart F. In particular, taxpayers were using hybrid branches to make payments to related parties that would not constitute subpart F income if the disregarded entity election were respected, but would constitute subpart F income if made between separate corporations. Thereafter, the IRS issued proposed and temporary Treasury regulations relating to such hybrid branch payments (the "preliminary hybrid branch regulations"). Both Notice 98-11 and the preliminary hybrid branch regulations generated significant controversy. In July of 1998, the Treasury issued Notice

---


54 Under the Treasury’s formulation, a hybrid branch is an entity that is treated as part of a CFC for U.S. Federal tax purposes (e.g., a disregarded entity that is a branch of a CFC) but is treated as an entity separate from its owner for purposes of foreign law. See IRS Notice 98-11, 1998-1 C.B. 433.

55 The Notice indicates that although subpart F is supposed to facilitate a foreign corporation's ability to engage in an active business to compete in its local market, subpart F was intended to limit the ability of a U.S. shareholder (as defined in Section 951(b) of the Code) of a CFC to defer certain types of income earned by a CFC. See IRS Notice 98-11, 199801 C.B. 433.

56 For example, suppose CFC-5 is located in Country A and is the sole owner of CFC-6 located in Country B. If CFC-5 made a loan to CFC-6, the interest payments paid by CFC-6 to CFC-5 with respect to such loan generally would constitute subpart F income. See I.R.C. 954(c). However, if CFC-6 were treated as a disregarded entity, the interest payments made on such loan would not constitute subpart F income.


58 See, e.g., David Cay Johnston, "Corporate Push to Save Break on Foreign Tax," N.Y. Times, Apr. 28, 1998, at D1 (reporting that all of the Republican and most of the Democratic members of the House Ways
98-35 announcing that the preliminary hybrid branch regulations would be withdrawn, but that it intended to issue a notice of proposed rulemaking covering hybrid branch payments. In July of 1999, the IRS issued proposed Treasury regulations dealing with hybrid branch payments (the "hybrid branch regulations"). The hybrid branch regulations would not become effective, however, until five years after they are finalized; in addition, such regulations would grandfather certain existing arrangements.

Because the Proposed Regulations recast every transaction executed by a entity as if it were a separate foreign corporation, it is possible that the Proposed Regulations, as currently drafted, would cover transactions that we believe should be protected by the moratorium on the hybrid branch regulations. Although the language of the Preamble and remarks made by William Morris of the Treasury Department at the public hearing relating to the Proposed Regulations held in January of 2000, indicate that the Proposed Regulations will not, and were not intended to, cover the transactions described in the hybrid branch regulations, we recommend that such position be unambiguously stated in the final regulations and related guidance.

D. Ignoring the Entity Classification Election Altogether is an Overbroad Remedy for the Likely Problem

As stated above, notwithstanding the IRS/Treasury’s failure to articulate with specificity the concerns which led to the Proposed Regulations, we believe that the remedy utilized in the Proposed Regulations is too drastic. That remedy is also unduly harsh, especially as it relates to taxpayers who had no plan or intention to engage in an Extraordinary Transaction at the time they made the disregarded entity election because, when invoked, the Proposed Regulations would not only change the U.S. Federal income tax consequences associated with the Extraordinary Transaction but also every transaction taking place since the making of such election. Accordingly, even if the Proposed Regulations are finalized, we suggest they be modified so as to treat an entity as an association taxable as a corporation only for purposes of recharacterizing the U.S. Federal income tax consequences of the Extraordinary Transaction itself.

59 The preliminary hybrid branch regulations were withdrawn. See T.D. 8827, 1999-30 I.R.B. 120.
64 1999-50 I.R.B. 670, 671 (Proposed Regulation "does not apply to the transactions described in the 'hybrid branch regulations'").
65 Reported Transcript of IRS Hearing held January 31, 2000 (quoting Mr. Morris, "it is our intention" that the Proposed Regulations will not affect the moratorium on hybrid branch regulations) <http://www.bna.com/taxcore> (accessed June 6, 2000).
Our recommendation is consistent with the IRS’ recent approach. For example, in ITA 199937038 the IRS determined that the gain was subpart F income, but did not ignore the disregarded entity election. Similarly, under both the preliminary hybrid branch regulations and hybrid branch regulations, the relevant disregarded entity would be respected even though the hybrid branch payment would, subject to certain limitations, constitute subpart F income. 66

Our recommendation would also be generally consistent with the application of the step-transaction doctrine. 67 In addition, it constitutes a more refined and fair method in that it would be tailored to address solely the transaction purportedly giving rise to the improper manipulation of the tax law (i.e., the Extraordinary Transaction). In short, our recommendation would further the IRS/Treasury’s aim of preventing taxpayers from reaping U.S. Federal income tax benefits that are not consistent with the underlying substantive provisions of applicable tax law, but yet would protect prior transactions from being recast unnecessarily.

VI. Intragroup Restructuring Transaction

The Proposed Regulations do not distinguish between intragroup and non-intragroup transactions. As a result, virtually all intragroup international restructuring transactions are covered by the Proposed Regulations. We believe the extension of the Proposed Regulations in the context of intragroup restructurings is unduly stringent and prevents the realization of commercially reasonable goals. This is particularly true in cases where there is no present plan or intent to transfer assets outside of the transferor’s group at the time the disregarded entity election is made. We believe the Proposed Regulations should not apply to intragroup restructuring transactions. Rather, the provisions should be targeted toward transactions involving the disposition of assets outside the transferor’s group.

VII. Specific Technical Comments on the Proposed Regulations/Extraordinary Transaction Rules

A. Basic Rule

1. The 10% Triggering Threshold is Too Low.

The Extraordinary Transaction Rules are triggered in connection with a sale, exchange, transfer or other disposition of a 10% or greater interest in the relevant entity. In our view, this 10% ownership threshold is simply too low. By using such a low threshold, the Proposed Regulations would frustrate many common types of business transactions that we do not believe impair the general objectives of the substantive sections of the tax law listed in the Preamble. For example, as currently drafted, the Proposed Regulations would apply if another party were to become a minority investor in the disregarded entity. The Proposed Regulations would also be triggered if the relevant disregarded entity

66 See IRS Notice 98-11, 1998-1 C.B. 433; IRS Notice 98-35, 1998-2 C.B. 34 (hybrid branch regulations “will make clear that the CFC and the hybrid branch [i.e., the disregarded entity]…will be treated as separate corporations only to recharacterize non-subpart F income”).

entered into a 50/50 joint venture with an unrelated party. We do not believe that either example represents an abuse of the current system even if they occurred within the 12-month period subsequent to the making of the disregarded entity election. To the contrary, these transactions further bona fide commercial objectives, are rarely solely tax-motivated, and were allowable under pre-check-the-box law. In addition, by using such a low threshold, the Proposed Regulations create an opportunity for taxpayers who regret making a disregarded entity election to trip the Extraordinary Transaction Rules intentionally by selling only a very small stake in the relevant entity. Consequently, because we believe that the Extraordinary Transaction Rules should be framed in a manner that does not adversely affect normal business transactions, including 50/50 joint ventures, we recommend that the ownership percentage be increased to a “greater than 50%” (vote and value) threshold and perhaps as high as 80%.

2. It Is Unclear How the 10% Ownership Threshold Is Measured.

Because the Proposed Regulations do not specify how the 10% ownership threshold is to be determined, this should be made clear in the final regulations. For example, it is not apparent whether an ownership interest representing 11% of the value but only 3% of the voting power of the relevant entity would satisfy the 10% limit applicable under the Basic Rule. It is also unclear how the 10% ownership threshold would apply to entities with multiple classes of ownership interests and whether or to what extent any attribution rules might apply. Lastly, the final regulations should provide guidance regarding the treatment of options and warrants to purchase interests in the relevant entity as well as other similar interests, such as convertible debt instruments.

3. The IRS/Treasury Should Shorten the Testing Period.

It should go without saying (but perhaps bears repeating) that within a 12-month period, a commercial enterprise can be subject to a vast change in circumstances, including competitive threats. Indeed, significant changes in the commercial landscape regularly occur with little or no notice. We believe it is critical that the Proposed Regulations avoid limiting or punishing a taxpayer’s legitimate need to respond to competitive threats and take advantage of opportunities in the global marketplace. Accordingly, we believe that the 12-month period for the applicable testing period is too long and recommend that the length of the testing period be reduced to 90 days. In addition, the 90-day testing period should include a provision that Extraordinary Transactions

68 For example, sales of minority interests in businesses represent a common source of financing in many sectors of the international economy. In addition, the 50/50 joint venture is a common commercial structure that allows parties to share business risk and expertise.

69 If an 80% percent threshold were to be adopted, we have various views as to how the test should be structured. Some would prefer to see a control test based on the principles of the control tests found in Section 368(c) or 1504(a) of the Code; others would prefer a "substantially all the assets" test.

70 We want to emphasize that rapid change appears to affect not only large multinational corporations but also small- and medium-sized enterprises.
occurring pursuant to a binding agreement or contract reached during the 90-day period subsequent to the making of the disregarded entity election should be subject to the Extraordinary Transaction Rules.

B. Shelf Entity Rule

1. *It Is Unclear How 80% Is Measured.*
   The final regulations should clearly instruct taxpayers how to calculate the 80% value threshold for purposes of the asset ratio, especially as it relates to leverage. In essence, taxpayers need to know whether the test will utilize a gross or net value baseline.

   Although we can appreciate the difficulty in delineating in regulations the "reasonable needs" prong of the Shelf Entity Rule, we believe the final regulations should include examples which illustrate the application of the rule.

C. Exception

Given the broad scope of the Proposed Regulations, we believe that a meaningful exception to the Proposed Regulations will be extremely important to limit the chilling effect they would likely have on numerous transactions. Unfortunately, for a number of reasons, we fear that the exception to the Proposed Regulations, as currently drafted, may prove to be of dubious value.

   We believe the manner in which the phrase “materially alter” is interpreted and applied will be critical to the usefulness of the exception to the Extraordinary Transaction Rules. In order to enhance taxpayers’ understanding of the standard, we believe the final regulations should specifically describe the factors relevant in determining whether the consequences of particular transactions are “materially altered,” and how such factors will be applied.

   In formulating its notion of the phrase "materially alter," the IRS/Treasury should recognize the dynamics surrounding a taxpayer’s entity classification decision. As an initial matter, the IRS/Treasury should presume that a taxpayer would make an election to treat a foreign eligible entity as a disregarded entity with the distinct aim of obtaining different tax results in the future (presumably, advantageous tax results). Such different tax results are possible because of the categorical distinctions created under the Code and other tax law; many such differences, such as the difference between the treatment of stock and assets, have long been part of our tax system. Accordingly, by

---

71 This should come as no surprise to the IRS/Treasury. The check-the-box regulations simply reduced the administrative costs associated with taxpayers choosing the form of their entities by complying with the Kintner test. Taxpayers did not start to plan their affairs based on the categorical distinctions set forth in the Code merely upon the adoption of the check-the-box regulations.
transforming an entity from corporate to disregarded entity status, one would expect such action to alter the tax consequences associated with a future, even if unforeseen, transaction.

3. **It Is Unclear What Procedure a Taxpayer Should Use to Obtain the Benefit of the Exception.**

   The Proposed Regulations do not advise taxpayers as to the procedure to be utilized in satisfying the Commissioner. If it is expected that taxpayers will seek a ruling, we predict the exception will be of little or no value because the amount of time involved in obtaining a ruling would prove prohibitive. Clearly, the Proposed Regulations should be designed to facilitate non-tax motivated business transactions without generating undue uncertainty.

D. **Effective Date**

   As currently drafted, the Proposed Regulations simply provide that they will apply on or after the date final regulations are published in the Federal Register (the “Effective Date”). It is unclear whether this means that the Proposed Regulations apply to an Extraordinary Transaction involving a foreign eligible entity when that transaction is undertaken after the Effective Date and the relevant taxpayer has made a disregarded entity election prior to the Effective Date. Based on public comments, it is our understanding that the final regulations would apply to such situations. Assuming the Proposed Regulations are finalized, we believe they should not apply retroactively with respect to Extraordinary Transactions involving a foreign eligible entity for which a disregarded entity election was made prior to the Effective Date.

E. **Amended Returns**

   As we have already noted, once invoked, the Proposed Regulations operate to treat the relevant entity as an association taxable as a corporation from the date of the otherwise valid disregarded entity election. Because a disregarded entity election may take place in one tax year and an Extraordinary Transaction in the next tax year, it is possible that an otherwise properly filed U.S. Federal income tax return will understate a taxpayer’s U.S. Federal income tax liability. Absent relief, a taxpayer would be liable for any underpayment of its tax liability, including, inter alia, interest and penalties. This is particularly troubling in the case where, at the time the disregarded entity election was made, there was no present plan or intent to engage in an Extraordinary Transaction. Consequently, the final regulations should provide that a taxpayer shall not be liable for any interest or other penalties attributable solely to an Extraordinary Transaction.

---

72 See Lee A. Sheppard, "Putting Checks on Check-the-Box Rules," 85 Tax Notes 1353, 1356 (Dec.13, 1999) (reporting William Morris has stated publicly a letter ruling mechanism may be used).

73 Prop. Treas. Reg. 301.7701-3(h)(5).

74 See Lee A. Sheppard, "Putting Checks on Check-the-Box Rules," 85 Tax Notes 1353, 1356 (Dec.13, 1999)(reporting William Morris has stated publicly that the Proposed Regulations "would apply to transactions that straddle the prospective effective date").
where the Extraordinary Transaction was consummated in a tax year subsequent to the tax year in which the disregarded entity election was made.\footnote{Alternatively, the final regulations could generally extend such relief provided the relevant taxpayer had no present plan or intent to engage in the Extraordinary Transaction at the time of making the disregarded entity election.}
<table>
<thead>
<tr>
<th></th>
<th>Sale of Stock</th>
<th>Sale of Assets by Foreign Branch</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Outbound 367</strong></td>
<td>In an exchange of foreign corporation stock for foreign purchaser’s stock, the transferor generally is required to file a gain recognition agreement if the seller is a 5% or greater holder of buyer’s stock immediately after the exchange of shares (Treas. Reg. 1.367(a)-3(b)).</td>
<td>In an exchange of assets of a foreign branch used in an active trade or business followed by an exchange thereof, the transferor generally is not required to file a gain recognition agreement (I.R.C. 367(a)(3); Treas. Reg. 1.367(a)-2T).</td>
</tr>
<tr>
<td><strong>Foreign Tax Credit:</strong></td>
<td>Generally is included in the “passive income” basket (I.R.C. 904(d)(1)(A), (d)(2)(A)(i)); limited opportunity to utilize.</td>
<td>Generally, is included in the “general limitation” basket (I.R.C. 904(d)(1)(I); generally relatively easier to utilize general basket credits to offset U.S. income taxes on other items of income.</td>
</tr>
<tr>
<td><strong>Subpart F:</strong></td>
<td>Sale of a lower-tier CFC stock by an upper-tier CFC generally results in subpart F income (I.R.C. 954(c)(1)(B)(i)).</td>
<td>Sale of a lower-tier CFC which is a disregarded entity is generally treated as an asset transaction and typically does not constitute subpart F income.</td>
</tr>
<tr>
<td><strong>Source</strong></td>
<td>Generally is U.S. source (I.R.C. 865(a)); limited exception for sales of “active trade or business” or under certain treaties (I.R.C. 865(e), (f)).</td>
<td>Generally is foreign source (I.R.C. 865(c) (sale of depreciable personal property), (d) (sale of amortizable intangible property used outside the U.S., (d) (sale of goodwill attributable to business conducted outside the U.S.).</td>
</tr>
</tbody>
</table>