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International Tax Planning

Something Old, Something New, Something Borrowed, Something Blue—A Blushing Bride's Report on the Subpart F Changes in TIPRA

by Joseph B. Darby III (Greenberg Traurig)

When it comes to tax legislation, the U.S. Congress usually behaves like a love-struck bridegroom: It just cannot keep its hands off the Internal Revenue Code.

Succumbing once again to its long-standing infatuation, the Congress recently passed yet another significant tax law—this the fourth major overall of the Code in the past six years—and gave the new law the politically eye-catching name of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). Much of the new legislation deals with old and familiar themes (including extension of the current 15 percent tax rate on capital gains and dividend income) that are always headline-grabbers. However, no modern tax law is truly complete and ready for prime time unless Congress also tries to pull off yet another ambush make-over of Subpart F.

Taxing Controlled Foreign Corporations

Subpart F, of course, is the portion of the Code dealing with controlled foreign corporations (CFCs), and in particular defines the circumstances in which income earned by CFCs will be subject to current U.S. tax. Under the Subpart F rules, 10 percent U.S. shareholders[1] in a CFC are subject to U.S. tax currently on certain types of income earned by the CFC, whether or not such income is actually distributed to shareholders. Income subject to current inclusion under subpart F includes, among other things, insurance income and foreign base company income. Foreign base company income, in turn, includes (among many other things) dividends, interest, royalties, rents, annuities, income that is the equivalent of interest, and income from notional principal contracts.

Temporary exceptions under Subpart F were enacted in 1998, and subsequently extended several times, that exclude from the coverage certain income derived from the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").

Subpart F is always a Congressional favorite when contemplating tax changes, primarily because the Congress is wrestling with the fact that the U.S. system of worldwide taxation often makes U.S.-based companies disastrously uncompetitive from a tax standpoint, and Subpart F is often a significant part of the problem. Basically, Congress is perpetually trying to figure out how (and whether) it can put U.S.-based companies on a fair and competitive footing with foreign corporations without gutting most or all of Subpart F. As will be examined more fully below, the answer to that question is far from clear.

Congress is perpetually trying to figure out how (and whether) it can put U.S.-based companies on a fair and competitive footing with foreign corporations without gutting most or all of Subpart F.

Given that Congress lavishes attention on Subpart F like a bride at a wedding, it is perhaps fitting that the recent TIPRA changes meet the classic specifications of bridal wedding attire: something old, something new, something borrowed, and something blue.

Extending—Again—the "Active Financing Income" Exception

The "something old" refers to Congress's extension of the "temporary" exception for so-called "active financing income," i.e., for income derived in the active conduct of a banking, financing or similar business, or in the conduct of an insurance business. This "temporary"

Subpart F Changes, continued on page 13

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More Foreign Corporations to Qualify for Nonrecognition Treatment under Changes to FIRPTA Regulations

by Kenneth G. Appel, Howard Berger, Jill Schwieterman and Karen Jacobs (Ernst & Young)

On May 24, 2006, the IRS and Treasury issued Notice 2006-46 (Notice) announcing forthcoming final regulations under Section 897(d) and (e) of the Internal Revenue Code (Code) for certain transfers of U.S. real property interests (USRPIs). The most significant aspect of the Notice is its announcement that Foreign Investment in Real Property Act (FIRPTA) regulations will be amended to reflect recent changes to "A" reorganization regulations. In January 2006, the Service and Treasury issued final regulations (T.D. 9242) expanding the definition of an "A" reorganization to include mergers of foreign corporations. The Notice says that forthcoming changes to the FIRPTA regulations will allow "A" reorganizations involving foreign corporations to qualify for nonrecognition treatment under the FIRPTA rules.

In addition, the Notice announces several other changes to the current FIRPTA guidance, including:

- the look-back period for imposing taxes and accrued interest on prior dispositions of foreign corporation stock under Temp. Reg. Section 1.897- 5T(c)(2), (4), and Treas. Reg. Section 1.897-3(c)(5), (d) in many cases will be shortened;
- nonrecognition requirements in Temp. Reg. Section 1.897-6T(b)(1)(iii) for certain Section 351 transactions and "B" reorganizations will be relaxed; and
- five conditions in Temp. Reg. Section 1.897-6T(b)(2) required for nonrecognition treatment in foreign-to-foreign exchanges will be eliminated.

Sections of the final regulations addressing distributions, transfers, or exchanges in "A" reorganizations involving foreign corporations will apply to transactions on or after January 23, 2006 (the effective date of the foreign merger regulations). The other portion of the final regulations generally will apply to transactions occurring on or after May 23, 2006. A taxpayer may apply the other changes to all dispositions, transfers, or exchanges before May 23, 2006, for any taxable year not closed by the statute of limitations, provided the taxpayer applies the other changes to all such dispositions, transfers, and exchanges in all open years.

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Detailed Analysis

Section 897(a) provides that the disposition of a USRPI by a foreign corporation or nonresident alien individual is taxable under Sections 882(a)(1) or 871(b)(1), respectively, as effectively connected income (ECI). In general, a USRPI is any interest (other than an interest solely as a creditor) in real property or a U.S. corporation, unless the taxpayer demonstrates such corporation was not a U.S. real property holding corporation (USRPHC)

Taxpayers have been relying upon temporary regulations and Notice 89-85 (collectively "current guidance") to determine the application of Section 897 to some nonrecognition transactions.

at any time during the shorter of the five-year period ending on the date of the disposition of such interest (the five-year taint) or the period the taxpayer held such interest.[1] A corporation is a USRPHC if the fair market value of its USRPIs is greater than or equal to 50 percent of the sum of the fair market value of *(i)* its real property interests located outside of the United States, *(ii)* its USRPIs, and *(iii)* any of its other assets used or held for use in a trade or business.[2]

Under Section 897(d)(1), a foreign corporation generally recognizes gain on the distribution (including a distribution in liquidation or redemption) of a USRPI in a transaction that otherwise qualifies for nonrecognition under the Code. Temp. Reg. Section 1.897-5T provides rules, exceptions, and limitations regarding Section 897(d) distributions in the context of Sections 332, 355, and 361.[3]

Section 897(e)(1) generally provides that nonrecognition provisions apply only for an exchange of a USRPI for an interest the sale of which would be taxable under Chapter 1 of the Code. Moreover, Temp. Reg. Section 1.897-6T(a)(1) provides nonrecognition treatment for a USRPI transfer by a foreign person on which gain is realized only if the transferred USRPI is exchanged for a USRPI which, immediately following the exchange, would be subject to U.S. tax upon its disposition, and the transferor complies with certain filing requirements.

Nonrecognition Treatment, continued on page 10

Inversion Guidance Provides Safe Harbor for 'Substantial Business Activities'; Crack Down on Use of Foreign Partnerships and Options

by Elizabeth Magin (Deloitte)

The Internal Revenue Service on June 5 released temporary regulations (T.D. 9265) under section 7874, which were enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357) to limit tax avoidance resulting from corporate inversions. The new guidance addresses the definition of "substantial foreign presence" for purposes of determining whether a foreign entity is treated as a surrogate foreign corporation under section 7874(a)(2)(B). The new rules also contain anti-abuse provisions to target the use of publicly-traded foreign partnerships and the use of options and similar interests to avoid the scope of section 7874.

The Service previously issued guidance on the affiliate-owned stock rule under section 7874(c)(2).

Acquisitions of Stock

The regulations clarify that a foreign corporation that acquires stock in a domestic corporation is considered to have indirectly acquired a proportionate amount of the properties held by the domestic corporation. The same result applies if a foreign corporation acquires an interest in a partnership that holds stock in a domestic corporation, but not if the foreign corporation acquires stock in a second foreign corporation that holds stock in a domestic corporation.

In addition, a foreign corporation will be treated as having acquired a proportionate amount of a domestic corporation's stock or assets if the acquisition is effectuated by a corporation (domestic or foreign) controlled by the foreign corporation and in exchange for the stock of the controlling foreign corporation.

Substantial Business Activities

The regulations provide two tests for determining whether an expanded affiliated group (EAG) has substantial business activities in the acquiring foreign entity's country of incorporation:

- *"Facts and Circumstances"*—The regulations include a non-exclusive list of factors the Service will consider in making this determination.
- *Safe Harbor*—This test looks to the EAG's employees, assets, and sales. To meet the safe harbor, after the acquisition, 10 percent of the EAG's employees and asset value must be based or located in the foreign country. In addition, during a 12-month testing period (ending on the last day of the monthly or quarterly accounting period in which the acquisition is completed), group sales made in the foreign country must account for at least 10 percent of total group sales.

An EAG that fails to satisfy the safe harbor test may still satisfy the facts and circumstances test.

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Foreign Partnerships Targeted

The new regulations crack down on "structures" that seek to avoid the scope of section 7874 through the use of publicly-traded foreign partnerships. Under these rules, the IRS will treat a publicly-traded foreign partnership as a foreign corporation for purposes of determining whether it is a surrogate foreign corporation. For purposes of the substantial business activities test, interests in the foreign partnership will be treated as stock of a foreign corporation.

The IRS will treat a public-traded foreign partnership as a foreign corporation for purposes of determining whether it is a surrogate foreign corporation.

The regulations contain an exception from the scope of section 7874 for a partnership's deemed acquisition of assets and liabilities upon a partnership's termination due to change of ownership.

Options Treated as Stock

The regulations contain a second anti-avoidance rule that treats options held by a former shareholder of the expatriated entity as exercised for purposes of the ownership test. The same rule applies to "similar interests" held by a former partner of the expatriated entity. The Service will apply this rule to the extent that the effect is to treat the foreign corporation or partnership as a surrogate foreign corporation.

Effective Date

The temporary regulations apply to acquisitions completed on or after June 6, 2006. Taxpayers may apply the regulations to acquisitions completed before that date, but must apply them consistently to all covered acquisitions.

Proposed regulations were released along with the temporary regulations. The text of the temporary rules serves as the text of the proposed rules. ❑

New Protocol to U.S. / Germany Income Tax Treaty to Eliminate Withholding Tax on Some Dividends from Subsidiaries to Parent Corporations

by Gary M. Friedman, Robert J. Staffaroni, Matthew O'Halloran, Friedrich Hey and Peter F.G. Schuur (Debevoise & Plimpton LLP)

On June 1, 2006, the United States and the Federal Republic of Germany signed a Protocol amending the income tax treaty between those countries.

Dividends

The Protocol provides a complete exemption from withholding tax on certain dividends from subsidiaries to parent corporations. The exemption applies only if the parent owned "directly" 80 percent or more of the voting power of the subsidiary for the 12-month period ending on the date the entitlement to the dividend is determined. In addition, the parent must either:

- satisfy the limitation on benefits provisions relating to companies that:
- are publicly traded (or are more than 50 percent owned by five or fewer qualifying publicly traded companies);
- (a) are at least 50 percent owned by qualifying residents of their home country, (b) derive the dividend in connection with or incidental to an active trade or business in their home country, and (c) meet a base erosion test; or
- meet the new "derivative benefits" provision described below; or
- obtain a competent authority determination.

The Protocol also provides a complete exemption for dividends paid to a qualifying pension fund and not derived from a business activity of the fund.

For dividends not eligible for exemption, the withholding rate generally continues to be 5 percent if the recipient is a corporation that "directly" owns at least 10 percent of the voting stock of the payer and 15 percent in other cases. Note that, with regard to the "direct" ownership required for the new parent-subsidiary exemption and the 5 percent rate, Germany has interpreted "direct" ownership strictly such that, e.g., ownership through a tax-transparent partnership or limited liability company does not qualify. (In the U.S., the IRS has issued a ruling to one company that ownership through a disregarded entity satisfies the comparable "direct" ownership requirement in the U.S./ U.K. treaty). As Germany no longer allows individuals a tax credit for dividends paid by German companies, the Protocol deletes provisions of the current treaty granting an additional 5 percent reduction in German withholding tax on dividends to U.S. recipients entitled to the 15 percent rate (and requiring grossed-up income inclusions and credits for U.S. tax purposes).

The Protocol provides a complete exemption from withholding tax on certain dividends from subsidiaries to parent corporations.

In the case of dividends from certain German-regulated mutual fund vehicles (German Investment Funds and *Investmentaktiengesellschaft*), U.S. regulated investment companies (RICs) and U.S. real estate investment trusts (REITs):

- neither the parent-subsidiary exemption nor the 5 percent rate applies;
- the exemption for dividends received by qualifying pension funds applies (apparently even if paid by German mutual funds, many of which are not treated as "companies"), but dividends from German real estate investment companies will not qualify for this exemption if Germany institutes a regime that exempts such companies from tax;
- dividends from RICs and German mutual funds are eligible for the 15 percent rate; and
- the 15 percent rate applies to dividends from REITs only in the case of (a) an individual owning a 10

New Protocol, continued on page 6

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percent or smaller interest in the REIT, (b) dividends on a publicly-traded class of stock to a person owning a 5 percent or smaller interest in any class of stock of the REIT or (c) dividends paid by a diversified REIT to a person owning a 10 percent or smaller interest in the REIT.

Branch Profits Tax

A complete exemption from branch profits tax applies for a company that satisfies specified limitations on benefits provisions similar to those that apply to the new parent-subsidiary dividend exemption; otherwise, the rate continues to be 5 percent. The Protocol deletes the current treaty provision that limits the imposition of branch profits tax by Germany when the rate of German tax on German branches exceeds the rate on distributed profits of German companies, since the tax rates for resident and non-resident companies are now equal.

Limitation on Benefits

The Protocol adds a new "derivative benefits" provision under which a company is eligible for treaty benefits if (a) at least 95 percent of the total voting power and value of its shares are owned by seven or fewer persons who are either *(i)* qualifying residents of member states of the European Union, the European Economic Area or NAFTA and, in the case of dividend, interest and royalty payments, who would be entitled to the same or a lower withholding rate if they received such payments directly or *(ii)* U.S. or German residents that meet certain specified provisions under limitations on benefits article and (b) it satisfies a base erosion test. Other changes to the limitation on benefits article include the following:

- in the case of a publicly-traded company, either its principal class of shares must be traded in, or its "primary place of management" must be located in, its home country;
- a company that is at least 50 percent owned by five or fewer qualifying publicly-traded companies would no longer have to satisfy a base erosion test;

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- limits are imposed on relief for a permanent establishment in a third country that is subject to a lower tax rate than applies in the home country; and
- in the case of a German Investment Fund or *Investmentaktiengesellschaft*, at least 90 percent of the shares or other interests in such entity must be owned by German residents that satisfy specified limitations on benefits provisions (procedures for determining ownership are to be established by the competent authorities).

Transparent Entities

The Protocol provides that an item of income derived by or through an entity that is fiscally transparent for either U.S. or German tax purposes is treated as income of a resident of the U.S. or Germany to the extent the item is treated as income of a resident by such country. This appears to mean that income of a limited liability company that is treated as a partnership (or disregarded if there is a single member) for U.S. tax purposes may qualify for treaty relief to the extent the income is attributable to U.S. resident members, even though Germany might otherwise treat the limited liability company as a corporate entity.

The Protocol provides for mandatory binding arbitration of some issues that cannot be resolved by the tax authorities.

Pension Plans

An individual who participates in a qualifying pension plan in one country and thereafter is employed (or self-employed) for a period in the other country will not be subject to tax in the other country on contributions (whether by the individual or the employer) to the plan, or benefits accruing under the plan, during such period. Any contributions to the plan by the employer will be deductible by the employer in computing its business profits in the other country. In each case, the relief is limited to the relief the other country provides to its own residents and to pension plans of a type recognized by the other country. (The Protocol includes a list of recognized types of plans.) In addition, if an individual resident of one country participates in a qualifying pension plan in the other country, income earned by the plan is taxable only when and to the extent paid to or for the benefit of individual (and not rolled over to another plan in the other country).

Additional benefits are provided to U.S. citizens who are resident in Germany and employed by a German employer, and who work and pay tax in Germany. Such individuals can participate in a German pension plan subject to section 1 of the German law on employee pension plans (*Betriebsrentengesetz*) without being subject to current tax in the U.S. on contributions (whether by the individual or the employer) to the plan or benefits accruing under the plan. These benefits are available only to the extent the contributions or benefits qualify for tax relief in Germany and may not exceed the relief allowable by the U.S. to U.S. residents for contributions or accrued plan benefits. There is no corresponding provision for German citizens who work in the U.S.

Relief from Double Taxation

Income or capital that is exempt from U.S. tax under the treaty, or that could be taxed by the U.S. under the treaty but is not taxed under U.S. domestic law, will not be exempt from German tax. The Protocol also makes a number of other changes to Article 23 of the treaty.

Arbitration

The Protocol provides for mandatory binding arbitration of certain issues that cannot be resolved by the competent authorities within a specified time. For other issues, the competent authorities may agree to binding arbitration. Detailed rules are provided for the conduct of arbitration proceedings.

Entry into Force

The Protocol will only enter into force after ratification by the U.S. and Germany. The withholding tax provisions generally will apply for amounts paid on or after the first day of the January of the year in which the Protocol enters into force. Other provisions relating to income taxes generally will apply for taxable years beginning on or after the first day of January next following the date the Protocol enters into force. The provisions relating to taxes on capital generally will apply for items owned on or after the first day of January next following the date the Protocol enters into force. Persons who would be entitled to greater benefits under the current treaty provisions may elect to apply those provisions for a 12-month period from the date the Protocol takes effect. The new arbitration provisions apply to cases under consideration by the competent authorities as of the date the Protocol enters into force and cases coming under consideration after that date. ❑

2006 Federal Tax Act: International Tax Implications

by Mark K. Leeds (Greenberg Traurig)

On May 17, 2006, President Bush signed H.R. 4297 into law. This law, referred to as the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), contains a substantial number of provisions that affect business and investment. This article discusses several of the changes that have important implications for international tax planning.

In reviewing this summary, please note that many of the provisions contained in TIPRA, like so many tax statutes enacted in recent years, have sunsets; that is, the provisions are effective for only a limited period of time. Of course, it is much too early to say whether any of these provisions will have long lives and, given the partisan nature surrounding the enactment of TIPRA, whether they would survive a change in the balance of power between Republicans and Democrats.

Controlled Foreign Corporation (CFC) Banking and Insurance Provisions Extended

Insurance

The general rules for insurance income earned by a CFC, which includes both premium income and income earned on reserves, requires the CFC's "U.S. shareholders" to include such income currently as ordinary subpart F income. A CFC provision, enacted in 1998, and effective beginning in 1999, created a category of "exempt insurance income" and was set to expire at the end of 2006. Exempt insurance income includes certain insurance of non-U.S. risks written by qualifying insurance companies. This provision, which has been extended twice before, has been extended again, this time through the end of 2008.

Banking

Income earned in banking or financing businesses by CFCs is usually treated as passive income and included in the income of the U.S. shareholders. The 1999 insurance rule described above has a companion in the banking and finance area that exempts banking and financing income from subpart F treatment when earned by a CFC predominantly engaged in the active conduct of a financial business. This provision was set to expire at the end of 2006 and has been extended through the end of 2008.

Moving Money Among CFCs

Prior to TIPRA, payments between CFCs generated subpart F income, that is, income subject to current inclusion by the U.S. shareholders of the CFC, unless the so-called "same country exception applied." Under TIPRA, from 2006 through the end of 2008, payments of dividends, rents, royalties and interest by a CFC to a related CFC are not treated as subpart F income to the extent attributable to non-subpart F income of the payor. When this relief is added to the banking and insurance extenders described above, U.S.-based financial conglomerates now have substantial flexibility in structuring their off-shore arrangements in a way that makes the most sense without the financial drag of U.S. tax on such capital movements.

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Note: Foreign tax credit planning may need to be revisited. To the extent that U.S.-based multinational corporations were using payments among CFCs to generate foreign-source subpart F income to use foreign tax credits (FTCs), such payments will no longer generate the income necessary to use the FTCs. In addition, there is some uncertainty as to whether the new rules apply to certain off-shore restructurings. Specifically, although sales of one CFC to another CFC are characterized as dividends (see Section 964(e) of the Tax Code), it is not clear that the exception from subpart F income for dividends extends to such deemed dividends.

Expansion of Earnings Stripping Rules

The U.S. earnings stripping rules (equivalent to many European thin capitalization rules) limit the ability of U.S. corporations to deduct interest expense paid to, or guaranteed by, foreign related parties if certain conditions are satisfied. (Specifically, the rules apply if the payor's debt-to-equity ratio exceeds 1.5 to one and net interest expense exceeds 50 percent of adjusted taxable income.) TIPRA codifies a proposed Treasury Regulation requiring that a U.S. corporation take into account interest expense and indebtedness incurred by partnerships in which the U.S. corporation is a partner, with certain modifications, effective for taxable years beginning after May 17, 2006. Indebtedness of the partnership is allocated to the U.S. corporation in the same proportion that the U.S. corporation includes the interest expense of the

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TIPRA *(from page 8)*

partnership. An anti-abuse rule prevents circumvention of the rule by allocating interest expense away from partners.

Revisions to FIRPTA (Foreign Investment in Real Property Tax Act) Rules

Since 1980, gains recognized by foreign persons from the disposition of U.S. real property interests have been subject to U.S. federal income tax, even if the U.S. real property interest is not held in connection with a U.S. trade or business or through a U.S. permanent establishment. U.S. real property interests include interests in U.S. real property holdings companies (USRPHCs) as well as direct interests in real property. (In general, a corporation is a USRPHC if 50 percent or more of its assets are U.S. real property interests.) In order to balance the policy of extracting federal income tax from U.S. real property gains realized by non-U.S. persons against the policy of encouraging foreign investment in U.S. capital markets, special exceptions have been created for mutual funds (regulated investment companies—RICs) holding real property interests and for real estate investment trusts (REITs). TIPRA refines these rules further.

Foreign tax credit planning may need to be revisited.

Retroactive RIC Exemption

Prior to TIPRA, if a mutual fund recognized a gain from a disposition of a real property interest, it was required to withhold tax on the distribution of such gain to its non-U.S. shareholders. TIPRA changes this rule effective for taxable years beginning in 2005. Under the revised rules, a RIC is required to withhold FIRPTA tax on distributions of gain attributable to the disposition of U.S. real property interests only if the RIC is a USRPHC. In determining whether a mutual fund is a USRPHC, the mutual fund is required to look through stock in other RICs and REITs that it holds, if such portfolio holdings are themselves USRPHCs. The retroactive nature of this provision creates refund opportunities for affected non-U.S. persons. The recharacterization of such gains as non-FIRPTA income, however, does not mean that such distributions are necessarily tax-free; regular dividend withholding rules could then apply.

Tiered RIC and REIT Structures

Prior to TIPRA, if a RIC or REIT distributed cash attributable to the disposition of a real property interest to a non-U.S. person, such gain was generally subject to FIRPTA withholding and tax. If, however, the RIC or REIT distributed such gains to an upper-tier RIC or REIT which, in turn, distributed such gains to a non-U.S. person, many persons believed that such gains were not subject to FIRPTA taxes. TIPRA amends the Tax Code, effective as of January 1, 2006, to provide that such gains retain their character as FIRPTA gains subject to withholding as cash attributable to such gains pass through upper-tier RICs and REITs. As a result, upper-tier REITs and RICs will now be required to collect FIRPTA taxes on distributions of such gains to non-U.S. persons.

Withholding Exemption for Publicly-Traded REITs and RICs is Expanded

Prior to TIPRA, a non-U.S. person who held 5 percent or less of the publicly-traded stock of a REIT or RIC was subject to U.S. tax on distributions attributable to gains recognized by the REIT or RIC from its own disposition of U.S. real property interests, but was not subject to U.S. tax on gains from the disposition of stock in the REIT or RIC. Effective as of January 1, 2006, TIPRA conforms the rules for distributions attributable to gains recognized from the dispositions of U.S. real property interests to stock gains. Specifically, distributions of gains attributable to dispositions are no longer treated as FIRPTA gains to foreign persons. Instead, solely with respect to non-U.S. persons, such distributions are treated as ordinary REIT or RIC dividends. Ordinary dividends can be subject to the default 30 percent withholding tax attributable to dividends paid to non-U.S. persons or can be eligible for a lower tax treaty rate if the recipient is eligible to claim the benefits of the treaty. This rule applies to distributions attributable to capital gain distributions received from other REITs or RICs as well.

FIRPTA Swaps and Wash Sales

Special new rules have been enacted, effective as of June 16, 2006, to curtail certain financial transactions that previously had the benefit of allowing non-U.S. persons to avoid FIRPTA taxes on capital gain distributions from RICs and REITs. (TIPRA legislative history expressly reserves on the efficacy of these strategies under current law.) In order for the new rules to apply, the non-U.S. person engaging in the strategy must have been subject to FIRPTA if it had received the distribution directly from the REIT or RIC. The new rules are written broadly, and clearly encompass wash sale transactions.

Wash Sale Example. For example, if *(i)* a non-U.S person sells RIC or REIT stock, *(ii)* the RIC or REIT then pays a capital gain distribution that would have been subject to FIRPTA withholding if received directly by the non-U.S. person, and *(iii)* within the 61-day period beginning 30 days prior to the disposition, the non-U.S. person re-establishes his position in the RIC or REIT stock, the non-U.S. person is subject to FIRPTA taxes in the

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TIPRA *(from page 9)*

amount that it would have incurred if it had held the stock instead of engaging in the wash sale. Mercifully, the new rule is not enforced through withholding, so financial institutions will not be required to police the activities of the transactions on U.S. securities markets engaged in by their non-U.S. customers.

Securities Loans are also Encompassed. Capital market participants engaged in cross-border securities lending transactions know that U.S. rules treat substitute dividend payments in the same manner as actual dividend payments, with the result that if withholding would have been required on an actual dividend payment, withholding is required on the substitute dividend payment. In a footnote in the legislative history (fn. 534), Congress has made clear that substitute capital gain distribution payments are now subject to withholding in the same manner that an actual capital gain distribution would have been subject to U.S. withholding. Accordingly, securities lending transactions will no longer provide any shelter from FIRPTA taxes.

Forwards, Options and Swaps. The new rules apply not only to traditional wash sales, but also to transactions in which the long exposure is re-established pursuant to "a contract or option to acquire such an interest." This expansive definition of a wash sale mirrors a recent amendment to the regular wash sales which pick-up a broad array of financial derivatives within the definition of re-established positions. In that context, many practitioners have advised their clients that stock dispositions coupled with synthetic long positions under swaps could be encompassed by the wash sales rules. It appears that similar caution is warranted here. ❏

Upper-tier REITs and RICs will now be required to collect FIRPTA taxes on distributions of such gains to non-U.S. persons.

INVESTMENTS IN U.S. REAL PROPERTY

Nonrecognition Treatment *(from page 3)*

Temp. Reg. Section 1.897-6T(b) provides exceptions to this rule for certain exchanges in foreign-to-foreign nonrecognition transactions.

After the release of Temp. Reg. Sections 1.897-5T and 1.897-6T, the Service and Treasury issued Notice 89-85 announcing revisions to the application of certain exceptions set forth in the temporary regulations. Taxpayers have been relying upon temporary regulations and Notice 89-85 (collectively "current guidance") to determine the application of Section 897 to certain nonrecognition transactions. Notice 2006-46 announces that the Service and Treasury will issue final regulations under Sections 897(d), (e), and (i) that generally incorporate the rules of Treas. Reg. Section 1.897-3 and Temp. Reg. Sections 1.897-5T and -6T, and Notice 89-85, except as described below. The changes update the current guidance to incorporate "A" reorganizations involving foreign corporations as nonrecognition transactions and to make certain other changes deemed appropriate by the IRS and Treasury.

Final Regulations Addressing Distributions, Transfers, or Exchanges in "A" Reorganizations involving Foreign Corporations

Temp. Reg. Section 1.897-6T(a)(1) generally provides that nonrecognition applies to a transfer by a foreign person of a USRPI if the foreign person receives a USRPI in such exchange and certain requirements are met. These requirements include: (1) U.S. taxation on the transferee's subsequent disposition of the transferred USRPI;[4] (2) satisfaction of certain filing requirements;[5] (3) existence of one of the five conditions in paragraph (b)(2); and (4) that the exchange takes one of the three forms of exchange described in paragraph (b)(1). Moreover, temporary regulations provide specific requirements for the permissible forms of exchange, namely "D" reorganizations, "C" reorganizations, "B" reorganizations, and certain Section 351 transactions.

Under the forthcoming final regulations, "A" reorganizations involving foreign corporations (including reorganizations satisfying Section 368(a)(2)(D) or (E)) may qualify for nonrecognition treatment by satisfying the same requirements as "C" reorganizations in Temp. Reg. Section 1.897-6T(b)(1)(ii).

Moreover, the final regulations will modify the stock ownership requirement of Temp. Reg. Section 1.897-6T(b)(1)(ii) whereby the transferor corporation's shareholders must own more than 50 percent of the transferee corporation's voting stock immediately after the reorganization. The modification will provide that where the transferee corporation owns more than 50 percent of the transferor corporation prior to the reorganization, shareholders of the transferee corporation

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Nonrecognition Treatment *(from page 10)*

prior to the reorganization that continue to be shareholders of the transferee after the reorganization will be treated as shareholders of the transferor corporation before the reorganization. For example, assume that U.S. Parent and Foreign Transferee Corporation own 49 percent and 51 percent, respectively, of the outstanding stock of Foreign Transferor Corporation. Foreign Transferor Corporation transfers all of its assets to Foreign Transferee Corporation in exchange for Foreign Transferee Corporation stock which it then distributes to U.S. Parent in liquidation. Assume further that the transaction qualifies as either an upstream "A" or "C" reorganization. The final regulations will clarify that shareholders of Foreign Transferee Corporation before the reorganization will be treated as shareholders of the Foreign Transferor Corporation for purposes of applying the "more than 50 percent" ownership test. Thus, the 50 percent control requirement will be satisfied, notwithstanding the fact that U.S. Parent receives a less than 50 percent stock interest in Foreign Transferee Corporation in the transaction.

The final regulations will dramatically affect most Canadian corporations with USRPI that want to amalgamate.

Under the current guidance, on an inbound reorganization involving the transfer by a foreign corporation of a USRPI to a domestic corporation (that is a USRPHC immediately after the transfer) in a Section 368(a)(1)(C), (D), or (F) reorganization the foreign corporation must recognize gain when it distributes the stock of the USRPHC to its shareholders under Section 361(c),[6] unless it pays a "toll charge" equal to any taxes that FIRPTA would have imposed on all foreign persons who had disposed of interests in the transferor foreign corporation after June 18, 1980, as if it were a domestic corporation on the date of each such disposition and if certain other conditions were met. In the final regulations, corporate distributions resulting from inbound "A" reorganizations involving foreign corporations (including by reason of Sections 368(a)(2)(D) or (E)) will be subject to this same "toll charge" regime (as modified by the Notice) as currently applies to inbound "C," "D," and "F" reorganizations.

Other Changes

The IRS and Treasury will also make other changes in the final regulations. These other changes are generally favorable to the taxpayer. For example, the final regulations will shorten the look-back period for computing the "toll charge" (1) to achieve gain nonrecognition treatment for inbound reorganizations,[7] (2) to achieve gain nonrecognition treatment for the distribution by a foreign corporation of a USRPI to a domestic parent corporation in a Section 332 liquidation,[8] and (3) to enable certain foreign corporations to make a Section 897(i) election to be treated as if they were domestic corporations solely for purposes of FIRPTA.[9] Although the look-back period is based on a taxpayer's specific facts, the look-back period will generally be shortened from the period all the way back to June 18, 1980, up until the date of the transaction (or Section 897(i) election), to just a ten-year period ending on the date of the transaction (or Section 897(i) election).

Additionally, the final regulations will update Temp. Reg. Section 1.897- 6T(b)(1) to provide two additional exceptions for nonrecognition treatment; relax the

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Nonrecognition Treatment *(from page 11)*

nonrecognition requirements in Temp. Treas. Reg. Section 1.897-6T(b)(1)(iii) for certain Section 351 transactions and "B" reorganizations; and eliminate the five conditions in Temp. Treas. Reg. Section 1.897-6T(b)(2) required for nonrecognition treatment in foreign-to-foreign exchanges.

Implications

On January 23, 2006, the Service and Treasury issued final regulations (T.D. 9242) revising the definition of an "A" reorganization to include mergers of foreign corporations. This change allowed more flexibility in structuring transactions. For example, assume that a foreign corporation desires to acquire the assets of an unrelated foreign corporation that owned a USRPI. Previously, to qualify for nonrecognition treatment, it was necessary to satisfy the voting stock and other requirements of a "C" reorganization, or to satisfy the requirements of one of the other two forms of exchange permitted by the regulations under Temp. Treas. Reg. Section 1.897-6T(b)(1). Under the Notice, the foreign corporation holding the USRPI may also qualify for nonrecognition treatment under FIRPTA if the foreign-to-foreign reorganization is characterized as an "A" merger under the January 23, 2006 regulations, and if the conditions set forth in the Notice for such qualifying "A" reorganizations were met (essentially a transfer of assets effectuated by operation of an applicable statute).

In particular, the final regulations will dramatically affect most Canadian corporations with USRPI that want to amalgamate. Prior to the January 23, 2006 change in definition, a Canadian amalgamation did not qualify as an "A" reorganization. After the change in definition, many Canadian amalgamations had to be treated as "A" reorganizations, and thereby could not qualify for gain nonrecognition treatment under the FIRPTA rules in effect prior to issuance of the Notice.[10] As a result of the Notice, most Canadian amalgamations involving USRPIs treated as mergers under the January 23, 2006 regulations should qualify for gain nonrecognition treatment under FIRPTA.

Another potentially significant change for foreign-to-foreign reorganizations involving USRPIs is elimination of the five conditions formerly required to achieve gain nonrecognition treatment for the permitted forms of exchange. This means for example, that it will be easier for a foreign investor to shift ownership of its USRPI to another foreign corporation outside its home jurisdiction if so desired.

Although the Notice includes several favorable changes to Section 897 regulations, it appears those regulations will still lack clarity in certain areas. The IRS has asked for comments from practitioners on issues addressed in the Notice before the regulations are issued in final form. Some areas which may be appropriate for comment include: (1) clarifying whether the filing requirements to achieve gain nonrecognition treatment in the existing regulations continue to be suspended as provided in IRS Notice 89-57, (2) clarifying how constructive ownership rules might apply to the stock ownership requirements in the modified "B" reorganization and Section 351 exceptions provided in the Notice, (3) clarifying the mechanics of how tax must be paid if there is a violation of the one year (formerly three year) requirement to own stock of the transferee foreign corporation in the modified "B" reorganization and Section 351 exceptions, (4) clarifying the wording of the two additional exceptions that provide a foreign corporation with nonrecognition treatment on its transfer of a USRPI in certain foreign-to-foreign asset reorganizations under Section 1.897-6T(b)(1).

It will be easier for a foreign investor to shift ownership of its USRPI to another foreign corporation outside its home jurisdiction.

Once issued, final regulations addressing distributions, transfers, or exchanges in an "A" reorganization involving foreign corporations will apply to transactions on or after January 23, 2006. Other portions of the final regulations generally will apply to transactions occurring on or after May 23, 2006. However, a taxpayer may apply these other changes to all dispositions, transfers, or exchanges before May 23, 2006, for any taxable year not closed by the statute of limitations, provided the taxpayer applies the other changes to all such dispositions, transfers, and exchanges in all open years.

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[1] Section 897(c)(1).
[2] Section 897(c)(2).
[3] Temp. Reg. Section 1.897-5T(c)(2), (3), and (4).
[4] Temp. Reg. Section 1.897-5T(d)(1).
[5] Temp. Treas. Reg. Section 1.897- 5T(d)(1)(iii).
[6] Section 897(d)(1) and Temp. Reg. Section 1.897-5T(c)(4)(i).
[7] Temp. Treas. Reg. Section 1.897- 5T(c)(2).
[8] Temp. Treas. Reg. Section 1.897- 5T(c)(4).
[9] Treas. Reg. Section 1.897-3(d)(2).
[10] The IRS issued T.D. 9259 on April 25, 2006, allowing taxpayers, if certain conditions were met, to be governed by the FIRPTA rules, if in effect prior to issuance of the Notice, as if the January 23, 2006, regulations defining mergers had not been issued. ❑

Subpart F Changes *(from page 2)*

exception was first introduced in 1998, and has since been extended in 1999, 2002, and now in 2006, with the most recent extension pushing the sunset date from the end of 2006 to the end of 2008.

The "something borrowed" refers to the fact that the "temporary" exception for active financing income (which above all else covers lending transactions) now seems headed toward a kind of permanent status—although Congress may continue to disguise the full tax impact of this decision for a while through the mechanism of periodic "temporary" extensions. This legislative technique (the tax credit under Code section 41 existed as a "temporary" measure for years before it was finally enacted as "permanent" legislation) basically pretends that a "temporary" provision might actually sunset, and therefore the full tax cost of the provision does not need to be taken into account for budgeting purposes. It amounts to a Congressional agreement to suspend disbelief when engaged in budgetary tax projections.

A new exemption for CFC-to-CFC dividends is, as usual, tortuously complicated and sometimes maddeningly unclear.

Active vs. Passive Income

What makes the active-financing-income exception a likely "permanent" provision is that the exception makes sense: It treats insurance, banking, finance and similar businesses conducted in offshore jurisdictions as "active" rather than "passive" businesses, and thus does not attempt to treat the income earned by these real, legitimate non-U.S. businesses as "interest" or other passive types of income that normally would be subjected to current U.S. taxation under the Subpart F regime. Similar or analogous concepts have been enacted over the years, for example, under the personal holding company tax regime, where "royalties" from software licensing are treated as good or "active" income for purposes of the personal holding company rules (i.e., not subject to the PHC Tax) so long as the licensor is actively engaged in the software business and meets certain tests.

The active financing income exception requires that a CFC be engaged in the active conduct of a banking, financial or other similar business, and that it conduct substantial activity for such business in order to qualify for the exception. In addition, certain nexus requirements apply, which provide that income derived by a CFC or by a qualified business unit (QBU) of the CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. The exceptions can also apply to income derived from certain cross-border transactions, provided that certain requirements are met.

In the case of insurance, the temporary exception applies for certain income of a qualifying insurance company for risks located within the CFC's country of creation or organization. In addition, temporary exceptions can apply for certain income of a qualifying branch of a qualifying insurance company for risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Likewise, temporary exceptions can apply for certain income of certain CFCs or branches for risks located in a country other than the United States, provided that the requirements to these exceptions are met.

Comment: These "temporary" exceptions from Subpart F are designed to treat insurance, banking and other finance activities as "real" activities conducted offshore and thus not subject to immediate taxation. The pragmatic recognition of Congress is that financial services can and will be conducted through tax-efficient means, and that if Subpart F forces immediate U.S. taxation of this income, these financing activities simply will not be done by U.S.-owned entities. That problem is not going to magically disappear on January 1, 2009, when the latest "sunset" expires—and that is why this "temporary" provision is likely to continue indefinitely.

Dividends from Related CFC

The "something new" in TIPRA is a brand-new provision that addresses another dysfunctional aspect of Subpart F. Prior to TIPRA, if a U.S. parent corporation owned a CFC (first-tier sub) which in turn owned a foreign corporation (second-tier sub), Subpart F income would generally include dividend distributions made by the second-tier sub to the first-tier sub, even if the income of the second-tier sub was not otherwise subject to the Subpart F regime (e.g., because the income was earned through active business operations within the country of incorporation of the second-tier sub). There was an existing "same country" exception where the second-tier sub was organized and operated in the same foreign country in which the first-tier sub was organized, and also an exception for rents and royalties paid by the second-tier sub for use of property within the country in which the first-tier sub was organized.

Under TIPRA, a brand new "temporary" exception is enacted for 2006 through 2008 that treats dividends, rents and royalties received by one CFC from a related CFC as exempt from Subpart F to the extent the applicable

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Subpart F Changes *(from page 13)*

payment is properly allocable to non-subpart-F income of the payor. For these purposes, a related CFC is a CFC that controls or is controlled by the other CFC, or by a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control for these purposes.

Complicated and Unclear

The "something blue" refers to the fact that this new and well-intentioned TIPRA exception for CFC-to-CFC dividends is, as usual, tortuously complicated and sometimes maddeningly unclear. For example, Code section 964(e) provides that, on the sale of a CFC by a related CFC, the gain must be characterized as dividend income, even though there is no actual "distribution" event. It is not clear whether the new TIPRA exception extends beyond actual CFC dividends to "deemed" dividends under Code Section 964(e), i.e., whether the sales proceeds are eligible for the new exclusion from Subpart F.

Comment: Although this new exception is obviously intended to be a benefit to U.S. parent corporations and corporate groups, be aware that these new rules apply retroactively to January 1, 2006, on a non-elective basis. This could obviously have disruptive consequences to corporations that have organized their tax planning based on the assumption that cross-border payments between CFCs would be treated as Subpart F income. For example, a corporation may be aiming for a particular amount of Subpart F income in order to claim the related foreign tax credits. Those credits have now vanished along with the subpart F income.

The good news is that Congress is trying to mitigate the burdens imposed by Subpart F on international business operations of U.S. corporations, particularly major banks and insurance companies. This can only help U.S. businesses that compete in the international financial services area. After all, while Congress may love the Internal Revenue Code, most taxpayers do not, and one rock-solid certainty of life is that money will flow away from tax burdens—and ultimately away from the United States—unless those burdens are mitigated.

As always, Congress loves to fiddle with the Internal Revenue Code—and, in this case, the TIPRA changes turned into a very nice valentine from Congress to certain U.S.-owned international financial businesses.

[1] That is, U.S. persons (as defined in Code section 957(c)) who own, or are considered as owning through attribution, ten (10) percent or more of the total combined voting power or all classes of stock of the CFC entitled to vote. ❑

INBOUND TRANSACTIONS

Six Bank Branches are Single Permanent Establishment

by Shawn N. Carson (BDO Seidman)

The six branches of the UKís National Westminster Bank in the U.S. constitute a single permanent establishment of the bank in the U.S., the U.S. Court of Federal Claims has held. This means essentially that the bank, and other banks in similar circumstances, may file a single tax return for the branches and effectively aggregate the results of loss-making branches with those of profitable branches. The Internal Revenue Service had argued that the six branches were each a separate permanent establishment of the bank in the U.S.

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Although the case was decided by reference to the old U.S.-UK tax treaty, the wording of the business profits articles of the new U.S.-UK treaty and other U.S. double tax treaties is similar, so in principle the decision can be applied by other foreign banks with more than one branch in the U.S.

However, it is an open question to what extent the judgment applies to foreign businesses other than banks, especially where the branches do not carry on a single integrated business, as the judgment was partly based on the treatment that the UK tax authorities apply to foreign banks with several branches in the UK. In any case, the wording of no two treaties is exactly alike, and each case must be carefully considered on the basis of its own facts. ❑

European Court Tax Decisions Could Impact U.S. Taxpayers' Foreign Tax Credits

by David Rosenbloom (Caplin & Drysdale)

U.S. taxpayers with operations in Europe would be well advised to keep an eye on recent developments involving the European Court of Justice (ECJ). The March 2001 decisions of the ECJ in *Hoescht and Metallgesellschaft* found certain aspects of the U.K. Advance Corporation Tax (ACT) to violate the freedom of establishment enshrined in the European Community Treaty. These decisions had a significant potential for impacting the foreign tax credit position of U.S. persons.

Following the *Hoescht and Metallgesellschaft* decisions, a number of U.S. companies (as well as other companies not based in the European Union (EU)) initiated litigation in the U.K. High Court of Justice, Chancery Division, seeking to make the case that the nondiscrimination article of the U.S.-U.K. Income Tax Convention would justify a decision similar to those of the ECJ with respect to ACT. U.S. participants in the litigation were motivated in part by a concern that, if they did not press their case, ACT they had paid to the United Kingdom might be considered a noncompulsory amount not qualifying for a U.S. foreign tax credit under section 1.901-2(e)(5) of the Treasury Regulations.

No Private Right of Action

The initial decision, rendered in November 2003 in *NEC Semi-Conductors*, was adverse to the claimants, but for a somewhat surprising reason. The High Court held that ACT might indeed be discriminatory insofar as the tax treaty was concerned but that the nondiscrimination provisions of treaties, insofar as they applied to ACT, were not incorporated in the law of the United Kingdom and did not afford a private right of action against the U.K. fisc. This was news, and a clear contrast with prevailing law in the United States. The decision is on appeal.

More recently, two separate Advocates General have come out with opinions to the ECJ on issues that could similarly affect foreign tax credits. (Such Advocate General opinions are adopted by the ECJ at least 80 percent of the time.) On March 17, in *Banco Popolare di Cremona*, the Advocate General took the view that the Italian regional tax on production, "IRAP," was invalid as an EU-prohibited second turnover tax substantially similar to a VAT. The creditability of IRAP has long been grist for discussions between the United States and Italy, and interim rules on this issue were announced in IRS News Release IR-INT-98-6, March 31, 1998, pending renegotiation of the U.S.-Italy Income Tax Convention (currently stalled). If the Advocate General's position becomes final, whether by adoption by the ECJ or otherwise, IRAP cannot stand. If an ECJ decision were to be applied retroactively and Italy were required to issue refunds, U.S. taxpayers who failed to apply might be charged with having made noncompulsory payments and denied their U.S. foreign tax credits.

Marks & Spencer Case

That same concern is even more relevant—or at least relevant to a broader audience—with respect to the opinion of another Advocate General in *Marks & Spencer PLC*, rendered on April 7. Here the question was whether losses of a foreign subsidiary had to be counted in the tax base of a U.K. corporate group. To the surprise of some observers, the opinion found that inclusion was required unless the losses were accorded equivalent tax treatment (i.e., allowed as losses for tax purposes) elsewhere. There are numerous questions about the implications of this "equivalent treatment" concept (computation of losses, effect of carryovers, application to permanent establishments, etc.), and it is too early to consider the matter closed. If anything remotely similar to *Marks & Spencer* becomes ECJ law, however, the effect could be considerable for groups in the United Kingdom. Moreover, there are a number of other EU jurisdictions that do not allow losses of foreign affiliates in their domestic group computations, and some that do allow such losses have more stringent requirements than an eventual decision of the ECJ might contemplate.

Thus, *Marks & Spencer* cannot reasonably be limited to the United Kingdom and could affect groups in many countries. To the extent U.S. persons have invested in such groups, they would have an even more direct entitlement to relief than U.S. persons whose U.K. affiliates paid ACT (the Hoescht situation) , since ultimate U.S. ownership would not be relevant in a *Marks & Spencer* context. The groups would have the same standing in the ECJ as *Marks & Spencer* itself had, and there would be no need to make the case that an income tax convention contains requirements similar to those of the EC Treaty. To the extent relief was not sought by U.S.-owned groups through appropriate claims, there could again be issues relating to Treasury Regulations section 1.901-2(e)(5).

Stay tuned. The pace of the ECJ decisions in the tax field has been accelerating. As of today the Court must be seen as a major indirect player in the U.S. domestic context, and anyone having business in Europe must come to grips with its sometimes unpredictable decisions. ❑

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Tax on Limited Liability Companies has been Declared Unconstitutional

Companies need to File Refund Claims

by Keith Martin (Chadbourne & Parke)

California collects an annual fee on limited liability companies doing business in the state. The fee runs from $900 for LLCs with incomes between $250,000 and $500,000 up to $11,790 for LLCs with incomes above $5 million a year. The state makes no attempt to determine how much of the income was earned in California as opposed to other states.

A California superior court ruled in March that this failure to base the fee solely on income earned in the state makes the fee unconstitutional. The commerce clause of the U.S. constitution requires that a state limit any tax to business activities within the state. The court said the LLC "fee" was in reality a form of tax. The state is expected to appeal the decision.

Four-Year Statute of Limitations

In the meantime, LLCs that have paid the fee should file refund claims. There is a four-year statute of limitations in California on audits and refunds. The four years begin to run on April 15 of each year or, if later, when a tax return was filed. Thus, most LLCs should be able to file refund claims back to 2002. Some may still be able to seek refunds for 2001 taxes depending on when their returns were filed in 2002. The maximum refund for four years of fees is only $59,000, but back interest could double the amount. The case is *Northwest Energetic Services, LLC v. California Franchise Tax Board*. A second LLC fee case, called *Ventus Finance I LLC v. California Franchise Tax Board*, was scheduled for trial on May 8.

LLCs that are registered to do business in the state must also pay a minimum franchise tax of at least $800 each year—in addition to the LLC fee.

Separately, the California State Board of Equalization ruled in March that an out-of-state LLC that owns interests in other LLCs and partnerships in California is itself doing business in California and must pay both the annual LLC fee and minimum franchise tax. The ruling was in a case called *In re International Health Institute LLC*. The board takes a broad view of what it means to be doing business in the state.

In an unrelated development, a California appeals court held in April that Toys "R" Us could not count as sales income both the principal and interest payments that its treasury department earned from investments in short-term instruments to manage cash flow. The toy company earns most of its income around Christmas. Its treasury department then invests the funds until they are needed to start rebuilding inventory during the summer.

California, like other states, figures out what share of income a multinational company like Toys "R" Us earned in California by looking, among other things, at the share of its total sales that are in California. The company's treasury department is in New Jersey. The appeals court said it could count as sales revenue the interest earned on the investments, but not repayments of principal.

The court said that if principal also counted, a company could cause a huge shift of allocable income outside the state merely by moving its treasury department with a handful of employees across state lines. The case is *Toys "R" Us Inc. v. California Franchise Tax Board*. ❏

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City ____
State/Country ____ Zip ____
Telephone ____
Fax ____