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to: General Attorney
Office of Division Counsel Large Business and International (CC:LB&I:F)

from: Marlene Oppenheim
Senior Counsel
Office of Chief Counsel (Corporate)

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Common Parent =

US Group =

Common Parent(DE) =

Member 1 =

Member 2 =

FSub-1 =

FSub-1(DE) =

RIC =

Agency =

Company =

Partnership-C =

Partnership-B =

Partnership-A =

FSub-2 =

FSub-3 =

Bank D =

State A =

Country X =

Country 2 =

G =

H =

L =

Services =

Service A =

Service B =

Activity 1 =

Activity 2 =

a =

b =

c =

f =

g =

h =

k =

r =

s =

t =

w =

x =

z =

aa =

dd =

kk =

mm =

pp =

ss =

tt =

xx =

zz =

ddd =

eee =

<u>fff</u> =

<u>hhh</u> =

<u>kkk</u> =

<u>mmm</u> =

<u>nnn</u> =

<u>rrr</u> =

<u>sss</u> =

<u>vvv</u> =

<u>zzz</u> =

Year P =

Year R =

Year S =

Year T =

Year U =

Date 5 =

Date 9 =

Date 11 =

Date 17 =

Date 19 =

Date 21 =

Date 23 =

Date 25 =

Date 29 =

Date 32 =

Date 34 =

Date 39 =

Date 41 =

Date 47 =

ISSUE

Whether Common Parent is eligible for the section 245 dividends received deduction (DRD) with respect to funds distributed from a regulated investment company to Common Parent via a Country X corporation?

CONCLUSION

No. Under the substance over form doctrine, Common Parent is not eligible for the section 245 DRD.

FACTS

Common Parent is a State A corporation and the common parent of an affiliated group of corporations that file a consolidated U.S. federal income tax return (US Group). US Group conducts a wide range of Services, including Services A and B.

Common Parent directly owns the stock of Member 1, a member of US Group. Member 1's businesses include Activity 1 (through division G). As such, Member 1 receives a significant amount of cash from its customers as collateral ("Customer Funds"). Member 1's Activity 1 is subject to regulation by Agency, which requires Member 1 generally to invest the Customer Funds only in high grade liquid assets. Member 1 is allowed to retain the difference between the amounts it earns on its investment of its Customer Funds and the amounts it pays to its customers. As of Date 21, Member 1 had approximately $ rrr in Customer Funds. Prior to the transaction discussed below, Member 1 directly invested its Customer Funds. Member 1 also is engaged in Activity 2 (through division H). Member 1's H clients post high grade liquid assets as collateral.

In Year S, Year T and Year U, Taxpayer[1] engaged in a transaction that included an internal restructuring of some of its companies[2] and the steps set forth below. Taxpayer concluded that it could earn a better after-tax return on the investment of Member 1's cash if, instead of continuing its practice of having Member 1 make direct

[1] The term "Taxpayer," as used in this memorandum, includes Common Parent and the subsidiary members of the US Group.

[2] Taxpayer reorganized certain subsidiary entities: (i) FSub-1 migrated from Country 2 to Country X; (ii) FSub-1 changed its currency to U.S. dollars; (iii) FSub-1 purchased FSub-1(DE) from a related entity.

investments, it routed the cash through a series of entities, including a Country X entity. Taxpayer's planning documents explained that the indirect investment strategy would increase the investment yield by the amount of the U.S. tax savings.

The Transaction Steps

On Date 23:

Step 1. Two divisions of Member 1 (G and H) entered into a repurchase agreement with each other. Under the terms of the agreement, G exchanged $ kkk of cash collateral for $ kkk of H's customers' collateral, which consisted of U.S. Treasuries and other high grade liquid assets. Under the terms of the repurchase agreement, G was required to return to H the exact or similar high grade liquid assets upon demand.

Step 2. Member 1 (H) wired $ kkk to Common Parent;[3]/[4]

Step 3. Common Parent wired $ mmm to FSub-1,[5] a Country X corporation, in exchange for common and preferred shares of FSub-1.[6] FSub-1 was a controlled foreign corporation (CFC) within the meaning of section 957(a) of the Internal Revenue Code[7] in Year T. FSub-1 could redeem the preferred

[3] The transfer was Member 1's repayment of an outstanding secured loan. When Member 1 repaid the loan, Common Parent returned Member 1's collateral (which consisted of high grade liquid assets).

[4] Common Parent transferred $ mmm to Common Parent(DE). Common Parent formed Common Parent(DE) in Year P in connection with a prior transaction, which was wound up in Year R. By Date 23, Common Parent(DE) was a State A limited liability company wholly-owned by Common Parent that was treated as a disregarded entity for U.S. federal income tax purposes. Because transfers between Common Parent and Common Parent(DE) have no ramifications for (certain) U.S. federal income tax purposes, such transfers are omitted from the transaction steps in this memorandum. For non-tax purposes, Common Parent treated $ hhh of the total funding as a loan with a b year term. Common Parent(DE) had an option to repay the loan early, in part or in whole, with no notice or penalty. Common Parent treated the remaining $ dd as a capital contribution to Common Parent(DE).

[5] FSub-1 previously was known as FSub-2, an entity organized under the laws of Country 2 (that was a tax resident of Country 2 until Date 17). The entity changed its name effective Date 19 and subsequently migrated to Country X. FSub-2 filed an election to be treated as a corporation for U.S. federal income tax purposes effective Date 11.

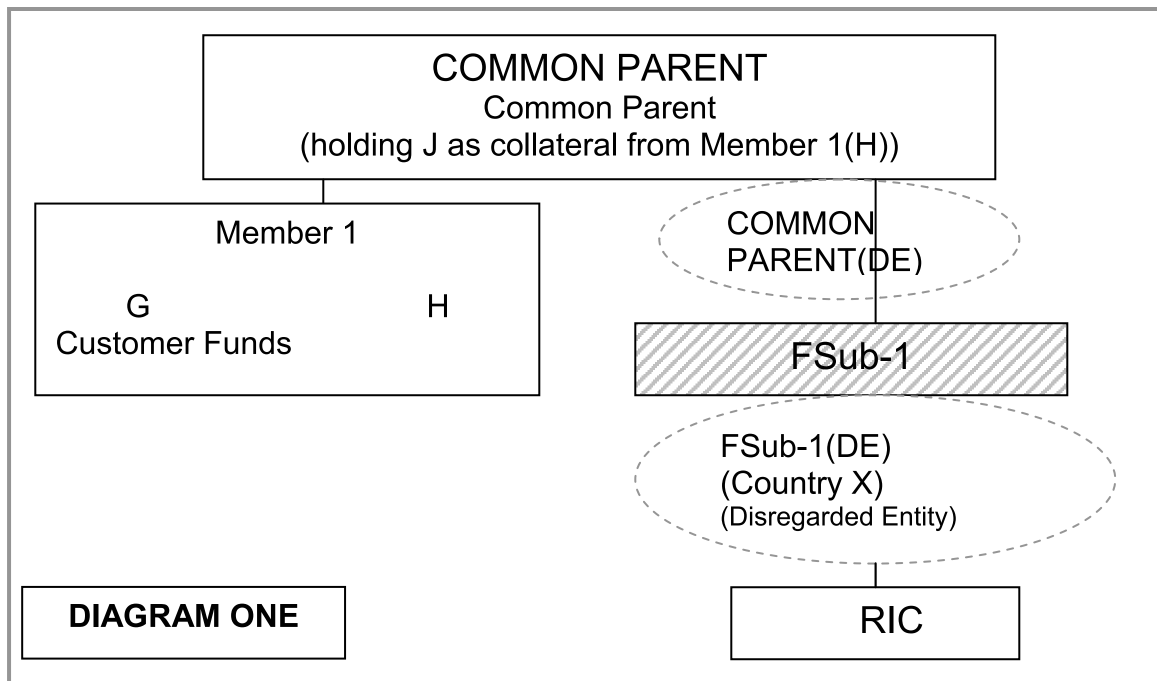
[6] Of the total funding, Common Parent(DE) transferred $ eee to FSub-1 in exchange for FSub-1 preferred shares and transferred $ zz to FSub-1 in exchange for FSub-1 common shares. Taxpayer valued each preferred and common share at $ k. For U.S. federal income tax purposes, Common Parent(DE)'s transfers are treated as transfers by Common Parent and Common Parent is treated as receiving the stock of FSub-1.

[7] All section references herein are to the Internal Revenue Code of 1986, as amended ("Code"), and the regulations thereunder, unless otherwise indicated.

shares at the issue price with no notice or penalty. FSub-1's Year T tax year ended Date 39.

Step 4. FSub-1 transferred $ fff to RIC[8] in exchange for fff Class L shares.[9]

FSub-1 (through its disregarded entity, Sub-1(DE)) used the remaining $ mm as follows: it invested $ kk in foreign money market mutual fund shares, and deposited $ r in a bank account at Bank D.



During Year T:

Step 5. RIC invested $ fff in domestic, high grade securities and primarily earned interest income on these investments. RIC paid dividends of $ tt to FSub-1[10] (this amount is net of Company's management fee). RIC took dividends paid deductions with respect to the dividends. RIC did not withhold any U.S.

[8] RIC's taxable year ended Date 5.

[9] FSub-1 transferred these funds to RIC through FSub-1(DE), its wholly-owned Country X entity which was disregarded for (certain) U.S. federal income tax purposes. FSub-1(DE) was previously known as FSub-3. The entity was created Date 9 to participate in a Country 2 transaction. It disposed of its investment on Date 13. The entity changed its name to FSub-1(DE) effective Date 19.

[10] RIC wired the dividends to FSub-1(DE)'s bank account monthly, and FSub-1(DE) wired the funds to FSub-1's account quarterly.

federal income tax on behalf of FSub-1 because FSub-1 reported to RIC that it was the beneficial owner of the RIC shares.

Step 6. Prior to the close of FSub-1's Year T tax year, FSub-1 distributed $ ss[11] to Common Parent[12] (the amount of the above-noted RIC dividends less certain claimed expenses that FSub-1 allocated to its investment in RIC).

Common Parent claimed an 80 percent DRD of $ pp under section 245(a) with respect to the $ ss distribution. Taxpayer takes the position that the $ ss is included in Common Parent's income as a dividend and not as an amount included in income under section 951(a) ("951 inclusion") because, as set forth in Step 8, Common Parent transferred its entire interest in FSub-1 to a domestic partnership, Partnership-C, just prior to the close of FSub-1's Year T tax year. (FSub-1 distributed an additional $ aa to Common Parent that it attributed to investments other than its RIC investment.)

Step 7. FSub-1 terminated its interest in RIC.[13]

Between Date 29 and Date 32, FSub-1 redeemed sss of its RIC shares for $ sss. On Date 34, FSub-1 sold the remaining RIC shares to Common Parent for $ x cash (which reflected the value of the RIC shares plus as yet undistributed RIC dividends). Taxpayer stated that FSub-1 loaned the cash it received from RIC and Common Parent to a subsidiary of Common Parent.

On Date 41, Common Parent redeemed its RIC shares for $ x (cash) and RIC went out of existence.

Step 8. Prior to the close of FSub-1's Year T, Common Parent transferred all of its FSub-1 shares to Partnership-C, a domestic partnership for approximately $ nnn. Common Parent owned g percent of Partnership-C directly and the remaining b percent indirectly (see Diagram Two, below). Taxpayer reported

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[11] FSub-1(DE) had earnings and profits of $ xx and distributed this amount to FSub-1, $ ss of which was allocated to RIC's distributions. In addition to the RIC management fee, FSub-1 and FSub-1(DE) (in the aggregate) paid $ t to Common Parent or subsidiary members of the US Group for services. (Of this total, Taxpayer allocated $ s (approximately f percent) to its investment in RIC).

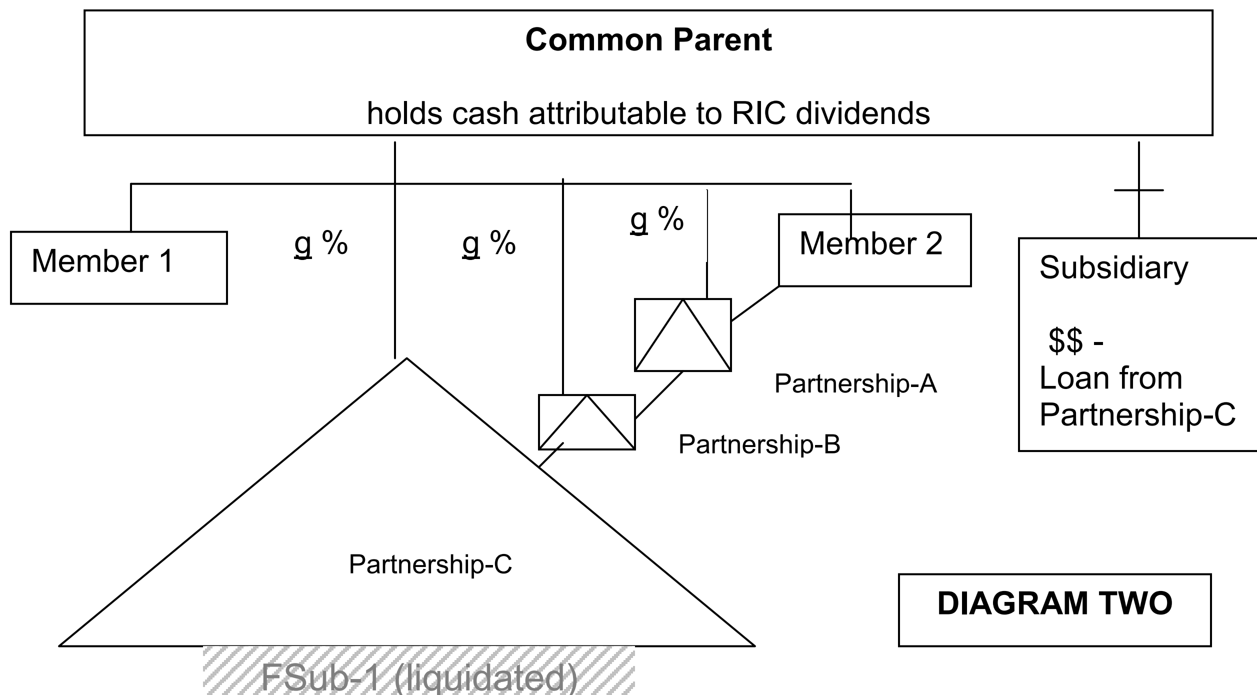
[12] FSub-1 actually distributed the funds to FSub-1(DE).

[13] FSub-1's disposal of the RIC shares in Year T may not have been part of Taxpayer's original plan. FSub-1's and Common Parent's redemption of the RIC shares in Year T was likely precipitated by unforeseen circumstances. Common Parent's (direct or indirect) retention or redemption of the RIC shares would not change the Service's legal analysis, as provided below.

this step as a sale.[14]

In anticipation of Step 8, Common Parent transferred (directly or indirectly) $ nnn to Partnership-C so that Partnership-C could transfer the funds back to Common Parent as consideration for the FSub-1 shares.[15]

Step 9. FSub-1 terminated its existence. In so doing, it distributed all of its assets (consisting primarily of a receivable from a subsidiary of Common Parent) to Partnership-C.[16]



[14] This memorandum does not address whether Taxpayer's "sale" treatment is appropriate. Arguably, Common Parent's contribution of cash to Partnership-C and Partnership's C cash payment to Common Parent would be disregarded as a circular flow of cash.

[15] Partnership-C received $ ddd (reported as a loan) and $ yyy (reported as a capital contribution) directly from Common Parent. Partnership-C received $ zzz from its b percent partner, Partnership-B (reported as a capital contribution). Common Parent (directly or indirectly) funded this $ zzz as well. Partnership-B was an LLC organized under the laws of State A that was treated as a partnership for U.S. federal income tax purposes. Common Parent directly held a g percent interest in Partnership-B and indirectly held a b percent interest in Partnership B. Partnership-A directly held the b percent interest in Partnership-B. Common Parent directly held a g percent interest in Partnership-A and Member 2 held the remaining b percent of Partnership A. Common Parent wholly-owned Member 2, a corporate member of US Group.

[16] FSub-1 distributed all but $ b to Partnership-C by Date 45. FSub-1's Certificate of Dissolution was dated Date 47. The final Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, filed with respect to FSub-1 for its (short) tax year ending Date 47 reflects the distribution of the remaining $ b. For Year T, Partnership-C included in its gross income a section 951 inclusion with respect to FSub-1 of $ h (which represented three days of FSub-1's subpart F income).

Thus, by the end of Step 9, Common Parent had received all of the interest income and capital gain attributable to its RIC investment and also held the principal amount of its investment through a subsidiary (which held the cash) and Partnership-C (which held a receivable from Common Parent's subsidiary).

Taxpayer anticipated that the transaction would allow US Group to reduce its U.S. federal income tax on the income earned on its $ fff investment by eighty percent because, under Taxpayer's analysis:

- RIC would not pay U.S. tax on its interest income as a result of a dividend paid deduction;[17] Sections 852(b)(2)(D) and 852(b)(3)(A);

- FSub-1 would not be subject to U.S. tax on the dividends that it received from RIC (and thus RIC would not be required to withhold tax on dividends distributed by RIC to FSub-1); Sections 871(k)[18] and 881(e);[19]

- Common Parent would not have a section 951 inclusion[20] with respect to FSub-1 in Year T because Common Parent would dispose of its entire interest in FSub-1

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[17] Under section 851(a), an entity generally qualifies as a regulated investment company for a taxable year if it is a domestic corporation (or entity taxed as a corporation) that is registered with the U.S Securities and Exchange Commission as a management company or unit investment trust under the provisions of the Investment Company Act of 1940, as amended. Section 851(b) provides additional rules for regulated investment company qualification. A regulated investment company that satisfies the distribution requirements of section 852(a) generally is able to take a dividends paid deduction in computing its taxable income and gains. Section 852(b)(2)(D).

[18] Section 871(k)(1)(A) generally provides that the thirty percent tax imposed under section 871(a) (on nonresident aliens and foreign corporations) is not imposed on any interest-related dividend received from a regulated investment company.

Section 871(k)(1)(C) generally defines an "interest-related dividend" as any dividend, or part thereof, which is reported by the company as an interest-related dividend in written statements furnished to its shareholders.

[19] Section 881(e)(1)(A) generally provides that, except as otherwise provided, no tax is imposed under section 881(a)(1) on any interest-related dividend received from a regulated investment company.

[20] Section 951(a) generally provides that if a foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder of the corporation and who owns stock of the corporation (within the meaning of section 958(a)) on the last day, in such year, on which the corporation is a CFC, must include an amount in income as required pursuant to section 951(a).

before the close of FSub-1's taxable year, and FSub-1 would remain a CFC after the disposition; Section 951(a)(1);

- Common Parent would include its distributions from FSub-1 (attributable to distributions from RIC) in income as dividends, the entire amount of which would be considered "U.S. source" under section 245(a)(3). Common Parent would offset this income with an 80 percent DRD under section 245(a).[21]

Additional Facts:

FSub-1: FSub-1 did not have its own employees.[22] The members of FSub-1's Board of Directors and management personnel (if any) were individuals employed by a member of US Group.[23] Employees of members of US Group were authorized to view the RIC account and trade the RIC shares. FSub-1 (through its disregarded entity, FSub-1(DE)) paid fees to one or more members of US Group, purportedly for these employees' services. Other than its role in the events described in this memorandum, FSub-1 (including FSub-1(DE)) had no activities during Year S, Year T and Year U.

RIC: Company managed RIC, a diversified mutual fund.[24] A prospectus supplement for RIC stated that as of Date 25, FSub-1(DE)[25] owned g percent of RIC, and that FSub-1(DE) was an indirect subsidiary of Common Parent. The prospectus

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[21] Section 245(a) provides that in the case of dividends received by a corporation from a qualified 10-percent owned foreign corporation, there shall be allowed as a deduction an amount equal to the percent (specified in section 243 for the taxable year) of the U.S. source portion of such dividends.

Pursuant to section 245(a)(3), the U.S. source portion of any dividend is any amount which bears the same ratio to such dividends as the post-1986 undistributed earnings bears to the total post-1986 undistributed earnings.

Section 245(a)(5)(B) defines post-1986 undistributed U.S. earnings as "any dividend received (directly or through a wholly-owned foreign corporation) from a domestic corporation at least 80 percent of the stock of which (by vote and value) is owned (directly or through such wholly owned foreign corporation) by the qualified 10-percent owned foreign corporation."

[22] Neither FSub-1 nor FSub-1(DE) had any employees.

[23] The members of FSub-1(DE)'s Board of Directors and management personnel (if any) were also individuals employed by a member of the US Group.

[24] Under Section 5(b) of the Investment Company Act, a diversified fund must have 75 percent of the value of its total assets in cash and cash items (including receivables), U.S. government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of its total assets and not more than 10 percent of the outstanding voting securities of such issuer. RIC could invest more than 5 percent of its assets in securities issued by agencies and instrumentalities of the U.S. government. Up to 25 percent of RIC's assets could be invested in affiliated money market funds.

[25] FSub-1(DE) was wholly-owned by FSub-1 and disregarded for U.S. federal income tax purposes.

explained that so long as this investor's ownership interest in RIC remained at more than 50 percent, the investor would be able to call a special meeting of RIC shareholders and cause a change to RIC's investment objective or fundamental investment restrictions. RIC's remaining investors were entities related to Company.

Holders of shares in a regulated investment company managed by Company generally pay a management fee to Company. Taxpayer (via FSub-1(DE)) paid Company approximately $ w. This $ w was purportedly a management fee for managing Taxpayer's $ fff investment.

RIC's prospectus explained that it intended to operate as a regulated investment company. It provided an explanation of the taxation of its distributions, stating that no portion of its income was expected to consist of dividends paid by U.S. corporations. It further provided that although dividends paid by RIC to non-U.S. shareholders were generally subject to withholding tax at a 30 percent rate (or a reduced treaty rate) to the extent derived from investment income and short-term capital gains, a foreign shareholder could obtain a reduced rate if the shareholder properly certified its non-U.S. status.[26]

The Date 25 Liquidity Test:

On Date 25, Common Parent carried out what it called a liquidity test. In so doing, it partially unwound Steps 1 through 4 of the transaction (as described above) and later that same day, reconstituted those steps. Common Parent stated that it took those steps in case Member 1 needed cash in a liquidity crisis scenario. Common Parent noted that FSub-1 could not sell the RIC shares on the open market (because the shares were not registered to be publicly traded) and Common Parent did not want to depend on RIC's ability to honor a redemption request in a crisis scenario. If Member 1 needed cash, Common Parent planned to move the RIC shares to Member 1 and have Member 1 transfer such RIC shares to Common Parent in exchange for cash.

Transaction Costs: Taxpayer incurred transaction costs, including but not limited to the costs incurred as a result of reorganizing its corporate structure, legal fees, and the fee paid to Company.

TAXPAYER'S POSITION

Taxpayer asserts its purpose for the transaction – to invest its Customer Funds – was a valid business purpose. However, Taxpayer acknowledges that it structured the

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[26] Including, in general, furnishing an IRS Form W-8BEN or a substitute form. It also explained that, in general, U.S. federal withholding tax would not apply to any gain or income realized by a non-U.S. shareholder in respect of any distribution of net long-term capital gains over net short-term capital losses, exempt-interest dividends, or upon the sale or other disposition of shares of RIC.

transaction, and routed the funds through FSub-1, to increase its return on the investment of the Customer Funds by the amount of the section 245 DRD it claimed on the distribution from FSub-1 to Common Parent in Year T. Taxpayer maintains that its analysis is consistent with the form of its transaction and the literal language of the relevant Code provisions.

LAW AND ANALYSIS

Substance-Over-Form Doctrine

The starting point for our analysis is the fundamental principle of income taxation: a transaction's tax consequences depend on its substance, not its form.[27] Under this doctrine, courts have disallowed the tax benefits of a transaction even if the transaction formally complies with a literal reading of the Code and its implementing regulations. Although in numerous situations the form by which a transaction is effected does influence, and may decisively control, the taxation of a transaction, the substance over form doctrine allows the courts and the Internal Revenue Service ("Service") to look beyond the superficial formalities of a transaction to determine its proper tax treatment.[28]

One of the foremost substance over form cases is Gregory v. Helvering*,* 293 U.S. 465 (1935) (hereinafter Gregory).[29] In Gregory, as in the instant case, the taxpayer took an indirect route to accomplish what could have been done more directly. The Board of Tax Appeals upheld the taxpayer's position, finding that Mrs. Gregory's transaction satisfied every element required by the reorganization statute (then in effect) and opined that the motivation of the taxpayer to reduce taxes does not change the result or make unlawful what the statute allows.[30] The Supreme Court mirrored this sentiment, stating that if a reorganization in reality was effected within the meaning of the statute, the taxpayer's ulterior motive will be disregarded, and added the often quoted statement:

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[27] *See e.g.*, Comm'r v. Court Holding Co., 324 U.S. 331 (1945); Frank Lyon Co. v. United States, 435 U.S. 561, 572-73 (1978).

[28] *See* Blueberry Land Company, Inc. v. Comm'r, 361 F.2d 93 (5th Cir. 1966).

[29] The taxpayer, Mrs. Gregory, wanted to sell the stock of a subsidiary owned by her wholly-owned corporation ("Oldco"). Motivated to avoid the dividend income that would result if Oldco directly distributed its subsidiary's stock to her, Mrs. Gregory engaged in the following transaction: (i) Mrs. Gregory created a new corporation (Newco); (ii) Oldco contributed its subsidiary's stock to Newco in exchange for Newco stock and distributed the Newco stock to Mrs. Gregory; (iii) Newco liquidated, thereby distributing the subsidiary's stock to Mrs. Gregory. Mrs. Gregory claimed that her acquisition of the subsidiary's stock was tax-free pursuant to "a plan of reorganization" within the meaning of (then in effect) section 112(g).

[30] Gregory v. Comm'r, 27 BTA 223 (1932).

"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 permits, cannot be doubted."[31]

However, the Gregory Court held that merely satisfying the statute is not enough, stating that the key "question for determination is whether what was done, apart from the tax motive, *was the thing which the statute intended*."[32] The Court explained that the reorganization statute that the taxpayer invoked was intended to allow a transfer of assets from one corporation to another in pursuance of a plan relating to the business of the corporations.[33] However, "what actually occurred" in Gregory was a transaction having no business or corporate purpose. "The whole undertaking, though conducted according to the [statutory] terms ... was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization."[34] The transaction was "a mere device ... for concealing its real character ... the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. ... [T]he corporation was nothing more than a contrivance."[35]

In the instant case, as in Gregory, a key question is whether what was done, apart from the tax motive, *was the thing which the statute intended*.

A standard formulation of the substance over form doctrine is found in Commissioner v. Court Holding Co.,[36] where the Court agreed with the Commissioner's determination that the substance of a purported corporate dividend of real property to shareholders, and subsequent sale by them of that property to a third party, was actually a sale by the corporation to a third party. The Court said

> "The incidence of taxation depends upon the substance of the transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transactions must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes

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[31] Citing United States v. Isham, 17 Wall. 496, 506, 21 L.Ed. 728 (1873); Superior Oil Co. v. Mississippi, 280 U.S. 390, 395, 396, 50 S.Ct. 169, 74 L.Ed. 504 (1930); Jones v. Helvering, 63 App.D.C. 204, 71 F.2d 214, 217 (1934).

[32] Gregory at 469. (Emphasis added.)

[33] Id. at 469.

[34] Id.

[35] Id.

[36] 324 U.S. 331 (1945)
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into a sale by another by using the latter as conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."[37]

More recently, in Frank Lyon Co. v. United States,[38] the Court refused to honor the Commissioner's determination that the substance of particular transaction had been a financing arrangement, not a lease. The Court said

"[W]here... there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties."[39]

As illustrated in these cases, the substance over form doctrine is a rule fashioned by the courts to allow the government to characterize a transaction based on its actual substance, not its form, and to tax it accordingly.[40]

Common Parent, through Member 1, is involved in a business that involves investing Customer Funds. When Member 1 invested the Customer Funds, it profited on the difference between the income (less expenses) Member 1 earned on its investment of the Customer Funds and the amount it paid to its customers. Member 1's investment options for the Customer Funds were quite limited due to regulatory restrictions. Given these restrictions and market conditions, Common Parent devised and consummated a transaction intended to increase profit by converting what would otherwise be taxable interest income into income eligible for the DRD. As illustrated in the transaction planning documents, Common Parent's so-called investment strategy

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[37] Id. 324 U.S. at 333.

[38] 435 U.S. 561 (1978).

[39] Id. 435 U.S. at 583-584.

[40] *See e.g.*, Schering-Plough Corp. v. United States, 651 F.Supp.2d 219 (D.N.J. 2009), *aff'd sub. nom.* Merck & Co., Inc. v. United States, 652 F.3d 475 (3d Cir. 2011) (substance of purported sales in interest rate swaps were loans); BB&T v. U.S.A., 523 F. 3d 461 (5th Cir. 2008)(substance of purported lease agreement was financing arrangement, and of purported loan was circular flow of funds); Rogers v. United States, 281 F.3d 1108 (10th Cir. 2002)(substance of purported loan agreement was as sale of KC Royals); Shepherd v. Comm'r, 283 F. 3d 1258 (11th Cir. 2002); (substance of purported gift of partnership interest was gift of real estate); Sather v. Comm'r, 251 F. 3d 1168 (8th Cir. 2001) (reciprocal gifts of stock left transferors in same position as prior to gifts, "reciprocal trust doctrine," a version of substance over form); and Grojean v. Comm'r, 248 F.3d 572 (7th Cir. 2000) (substance of purported lending agreement was as guaranty).

was a multi-step transaction designed to increase its return on the investment of Customer Funds by the amount of its U.S. tax savings (less transaction expenses).

Although investing the Customer Funds served a business purpose, routing the investment and investment returns through FSub-1 and RIC did not serve a meaningful business purpose. Rather, the indirect investment strategy was a contrivance to avoid U.S. federal income tax.

As we explain in detail below, Common Parent implemented a plan designed to avoid a single full level of corporate income tax on corporate earnings. If Common Parent, itself or through Member 1, directly invested the Customer Funds, Common Parent would have been subject to U.S. income tax on the interest and capital gains it earned on the investments. Likewise, if Common Parent had invested directly in RIC it would have been subject to U.S. income tax on the dividend it received from RIC (because RIC's earnings (i.e., interest and capital gains) were not earnings eligible for a DRD). To avoid this result, Common Parent routed the investment funds through FSub-1, a Country X entity, and caused FSub-1 to purchase the RIC shares. As noted above, taxpayers may arrange their affairs to reduce their U.S. income tax obligations as long as their arrangements are consistent with Congressional intent. However, as explained in detail below, Congress enacted rules in sections 243 and 854 intended to prevent taxpayers from converting interest income into dividend income eligible for the DRD. Common Parent's transaction was designed to circumvent the application of these rules.

Common Parent's plan required the use of a foreign corporation. In planning its tax savings strategy, Common Parent determined that it would acquire stock in FSub-1 and cause FSub-1 to earn investment income on the Customer Funds. Congress enacted section 951 (and related provisions) to prevent U.S. taxpayers from deferring U.S. federal income tax by earning investment income through a foreign corporation rather than earning the income directly. As Common Parent's plan involved FSub-1's receipt of income from RIC, Common Parent planned to terminate its direct ownership of FSub-1 prior to the end of FSub-1's taxable year in its effort to avoid a section 951 inclusion. The timing of Common Parent's acquisition of shares in FSub-1 and its termination of such direct ownership was not compelled by a motivation to invest, but instead, by a motivation to avoid U.S. federal income tax. Taxpayer had an ongoing need to invest the Customer Funds in short term investments year after year. However, Common Parent did not plan to maintain its ownership of FSub-1 to carry out this business need for more than a period of months. Other than FSub-1's role in Common Parent's tax savings strategy, Common Parent's use of FSub-1 did not enhance its investment of Customer Funds.

Thus, Common Parent's use of FSub-1 and RIC was necessitated by its tax planning rather than meaningful business exigencies. Arguably, routing the Customer Funds through FSub-1 and RIC was counter-productive to Member 1's liquidity needs. If Member 1's customers demanded the return of the Customer Funds or other

collateral, Member 1 had to have the wherewithal to meet such demands without delay. As indicated by the so-called liquidity test, Common Parent was not confident that it could timely extract the Customer Funds from RIC if the need arose. Thus, it had to come up with an alternative liquidity mechanism.

Moreover, Common Parent's strategy involved significant costs. But for the expected U.S. income tax savings, given the overall transaction costs and the limited yield on the investments the RIC could make with the Customer Funds, it was evident, even prior to the start of the transaction, that the strategy would reduce Taxpayer's net return on the Customer Funds. In addition to the planning costs, the strategy involved the costs associated with the shuffling and reshuffling of Common Parent's organizational structure, the documentation of loans and stock issuances, and the so-called liquidity test. As Common Parent's strategy involved the use of what was almost a wholly-owned regulated investment company, Common Parent (via its foreign subsidiary) also had to pay fees to cover essentially all of the costs of RIC's required regulatory filings and other administrative expenses.

Common Parent may argue that RIC and/or Company provided value in overseeing the investment of the Customer Funds. This argument would appear to be inconsistent with Common Parent holding itself out as one of the world's foremost experts in Services, including Service A and Service B.[41] Given Common Parent's professed expertise, one would not expect Common Parent to need to rely on RIC or Company to invest the Customer Funds in the straightforward, unremarkable investments that Agency mandated – investments that Member 1 had historically made itself.

Given the fact that Common Parent owned almost all of the interests in RIC, Common Parent did not derive the classic benefits of an investor in a regulated investment company. Common Parent states in its marketing materials that a mutual fund offers investors the following benefits:

Diversification: the allocation of money across a variety of investments. A single shareholder of a regulated investment company generally benefits from the economy of scale due to the participation of many investors. In the instant case, Common Parent provided essentially all of the funds for RIC's investments. Common Parent did not need RIC in order to diversify its investments.

Professional management: As noted above, Common Parent holds itself out as a world class provider of these services; it is inconsistent with this claim for Common Parent to maintain that it needed RIC or Company to oversee its investment of Customer Funds. Moreover, if Common Parent wanted investment advice, it could

[41] Common Parent advertises that as a premier provider of mutual fund solutions, it designs and manages families of mutual funds.

have obtained this advice for a fee; Common Parent did not need to route $fff through RIC to obtain such advice.

Liquidity: the ability to convert shares into cash and access the investment quickly. As noted above, Common Parent's use of RIC did not enhance Common Parent's or Member 1's liquidity.

Cost Efficiency: sharing fees with other mutual fund investors. Because Common Parent (via FSub-1) owned almost all of RIC, it furnished essentially all (if not all) of RIC's operating costs.

RIC noted in its prospectus that FSub-1 had certain controls over RIC's investment activities. It also noted that Common Parent controlled FSub-1. As such, Common Parent had significant control over RIC's investments. FSub-1 did not have its own employees to oversee its investment in the RIC or the RIC's investments. Rather, FSub-1 depended on employees of Common Parent (or another member of U.S. Group) to provide such oversight. The above factors clearly demonstrate that Common Parent's use of RIC and FSub-1 to invest the Customer Funds was *not* a genuine multiple-party transaction compelled by business needs, nor was the structure imbued with tax-independent considerations. And, most importantly, as explained below, Common Parent's carefully orchestrated and executed transaction and its purported U.S. federal income tax result is contrary to Congressional intent with respect to sections 243, 245, 881 and 951. Common Parent relies on its interpretation of sections 245, 881 and 951 to defend its reporting position.

What is the Intent of the Statute? -- Section 243 Dividend Received Deduction

Congress enacted the DRD provisions to give effect to the two-tiered corporate tax system: Congress intended to tax income once at the corporate level when earned by the corporation, and once to the individual shareholders when the income was distributed by the corporation to the shareholders.[42] The DRD is to apply when "the issuing corporation has already been taxed on the earnings"[43] and the dividends remain in corporate solution.

[42] Since 1917 U.S. federal tax law has allowed a DRD "to eliminate or minimize further multiples of taxation of corporate earnings as the earnings pass from one corporation to another." 134 Cong. Rec. H6319-03. In 1918, Congress explained that the corporate DRD was to allow corporations to deduct from income in ascertaining their net income the amount received as dividends from other corporations subject to the income tax in order to "avoid the multiplicity of taxation upon the same income." Revenue Act of 1918.

[43] Revenue Act of 1918. *See also*, H. Rep. No. 708, 72d Cong., 1st Sess., 12 (1932) (policy to allow a deduction for dividends received by corporate shareholders on the theory that a corporate tax has already been paid on the earnings out of which the dividends are distributed).

Section 243(a) generally allows a corporation to take as a deduction an amount equal to a percentage of the amount received as dividends from a domestic corporation that is itself subject to U.S. income tax. However, section 243(d) states that, for purposes of section 243(a), a dividend received from a regulated investment company is subject to the limitations prescribed in section 854.

The Internal Revenue Code of 1954[44] added section 854(b), which governs which dividends received from a regulated investment company give rise to a DRD. In enacting this provision, Congress stated that the purpose of the DRD is to limit the *multiple taxation* of intercorporate dividends.[45] Congress was concerned that, under prior law, a corporate shareholder of a regulated investment company might claim a DRD with respect to a dividend paid by a regulated investment company attributable to interest that the regulated investment company received on bond investments. Congress believed that there was tax avoidance under the law as in effect before the Internal Revenue Code of 1954 because the corporation that issued the bond received an interest deduction and neither the regulated investment company nor the corporate shareholder of the regulated investment company paid the full tax on the interest income.[46] Congress also thought it was inappropriate for a regulated investment company distribution to be eligible for the DRD if the distribution was attributable to dividends the regulated investment company received from a foreign corporation, which would not give rise to a DRD if directly received by the regulated investment company's corporate shareholder. Congress attempted to prevent these abuses by limiting the regulated investment company's shareholders' use of the DRD.

In 1984, Congress amended section 854 to further narrow the eligibility of regulated investment company distributions for the DRD. Under section 854(b) as originally enacted, if at least 75 percent of a regulated investment company's gross income consisted of dividends from domestic corporations, then all of the amounts distributed by the regulated investment company were treated as dividends eligible for the DRD even though up to 25 percent of the regulated investment company's gross income could consist of interest income.[47] Congress was concerned that the "foregoing rules permit a taxpayer to convert interest income into dividend income. Taxpayers have organized regulated investment companies to take advantage of this conversion opportunity." Congress explained that a change in the law was necessary because this opportunity was "unwarranted."[48] Once again, Congress attempted to prevent such inappropriate use of the DRD.

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[44] Pub. L. No. 83-591 (1954).

[45] S. Rep. No. 83-1622 (1954). Emphasis added.

[46] Id.

[47] Section 854(b) of the 1954 Code.

[48] H.R. Rep. No. 98-432(II) (1984).

Congress amended section 854 so that a shareholder of a regulated investment company may not treat any dividend received from the regulated investment company as a dividend for purposes of the DRD except to the extent the regulated investment company identifies the distribution as a dividend eligible for the DRD.[49] The amount of dividends a regulated investment company can identify as eligible for the DRD in a taxable year generally is limited to the amount of dividends that the regulated investment company receives from domestic corporations in that year that would give rise to a DRD in the hands of the regulated investment company if regulated investment companies were permitted to claim the DRD.[50]

What is the Intent of the Statute? - Subchapter M

Investments in regulated investment companies are generally subject to a single level of taxation under special rules in subchapter M (sections 851 through 860G). A regulated investment company that satisfies certain distribution requirements under section 852(a) generally is able to take a dividends paid deduction (DPD) in computing its taxable income. Section 852(b)(2)(D) and 852(b)(3)(A). Although a regulated investment company is "subject to tax" on undistributed income, a regulated investment company ordinarily makes every effort to distribute sufficient income to qualify for the DPD so that its income is passed through to its shareholders free of tax at the regulated investment company level.

Regulated investment companies are not entitled to take a DRD under section 243 or 245. However, a regulated investment company's shareholders may be able to take a DRD on taxable dividends (other than capital gain dividends) paid by the regulated investment company to the extent that the regulated investment company received dividends that would qualify for a DRD if regulated investment companies were allowed a DRD.[51]

In the instant case, RIC received no dividends that would qualify for a DRD if RIC were allowed a DRD, and therefore none of RIC's distributions were eligible for the DRD. Thus, if a member of US Group had directly invested in RIC, it would not have been entitled to offset dividends from RIC with the DRD.

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[49] Section 854(b)(1)(B). The form of such identification was changed by the Regulated Investment Company Modernization Act of 2010 (Pub. L. No. 111-325, 124 Stat. 3537) from a designation requirement to a written notice requirement. The limit on the amount of a regulated investment company dividend that may be treated as a DRD-eligible dividend remains unchanged.

[50] Under section 852(b)(2)(C), a regulated investment company is not allowed any DRD. Section 854(b) provides additional limitations and rules for applying sections 243, 246 and 246A in determining the amount of a regulated investment company's dividends that would be eligible for the DRD.

[51] Section 854(b).

What is the Intent of the Statute? - Withholding Tax Exception

In the instant case, Taxpayer claims that the distribution from RIC to FSub-1[52] is exempt from withholding tax under section 881(e). Common Parent routed its investment in RIC through FSub-1 to claim the benefits of tax provisions (section 881(c) and (e)) that Congress enacted to encourage foreign investors to invest in the United States. In the Tax Reform Act of 1984, Congress included a provision that was intended to enhance the U.S. government's and private business' access to international capital markets and to eliminate the need for U.S. borrowers to use intermediary financing affiliates.[53] The provision repealed the 30 percent withholding tax on interest received by nonresident aliens and foreign corporations from certain debt obligations issued by U.S. corporations or the U.S. government.

The legislative history of the 1984 Act indicates that Congress wanted to allow U.S. businesses and the U.S. government to raise money through the Eurobond market. Congress determined that the U.S. withholding tax on certain interest paid to foreign lenders impeded access to the Eurobond market.[54] Accordingly, Congress generally repealed the imposition of withholding on "portfolio interest" issued after July 18, 1984 so that U.S. borrowers could directly access the Eurobond market. The 1984 Act added sections 871(h) and 881(c) to the Code.

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[52] RIC distributed the funds to FSub-1(DE). FSub-1 is the owner of FSub-1(DE). FSub-1(DE) is a so-called disregarded entity. *See* Treas. Reg. § 301.7701-2 and -3.

[53] *See e.g.*, Exemptions from U.S. Taxation for Interest Paid to Foreign Persons, the Joint Committee on Taxation (June 18, 1980). Prior to the 1984 Act, a foreign person receiving interest from a U.S. corporation or the U.S. Government ("U.S. source Interest") generally was subject to U.S. federal income tax. If the interest was not connected with the foreign person's trade or business within the United States, the tax generally was collected by withholding the amount of tax liability from the interest payable to the foreign person. Sections 1441 and 1442. In some instances, the amount of the tax, generally 30 percent, was reduced by a treaty. For example, the Tax Treaty between the United States and the Netherlands, as extended to the Netherlands Antilles, generally exempts U.S. Source Interest paid to Netherland Antilles persons from the U.S. withholding tax.

Prior to the 1984 Act, U.S. corporations borrowing money in the Eurobond market used Netherland Antilles subsidiaries in structured transactions in order to avoid the U.S. withholding tax when paying interest to foreign persons. In a number of cases, the Service recharacterized the transaction, treating the U.S. corporation as the true obligor and treating the Netherlands financing subsidiary as a conduit or an agent of the U.S. corporation. Often, the taxpayer had no purpose for routing the funds through the Netherlands corporation other than the avoidance of the U.S. withholding tax. Generally, the Netherlands corporation had no business operations other than relending the funds furnished by its U.S. affiliate. The Service's arguments were supported in Aiken Industries, Inc. v. Comm'r, 56 T.C. 925 (1971). Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Tax Bill of 1984 419-21 (Comm. Print 1984).

[54] *See* S. Rep. No. 169, 98th Cong., 2d Sess., 419-421 (1984). Congress remarked that tax free access to the Eurobond market should be direct instead of through a Netherlands financing subsidiary.

Congress expanded the withholding policy relating to interest paid to foreign lenders with the addition of sections 871(k) and 881(e), which generally exempt interest-related dividends paid to a foreign person by a regulated investment company from the 30 percent withholding tax.[55] In effect, these provisions give the foreign investor in a regulated investment company that holds U.S. source interest-paying investments the same tax result as if the investor had directly invested in the underlying interest-paying investment. If the foreign investor is a CFC, any interest eligible for the section 881(e) exclusion must be included in the CFC's subpart F income without regard to certain exceptions, including the de minimis exception under section 954(b)(2) and the related party interest exception under section 954(c)(3).[56] Accordingly, as discussed below, the U.S. shareholders of a CFC generally would have section 951 inclusions based, in part, on the full amount of the interest-related dividends received by the CFC. Congress did not intend to allow U.S. taxpayers to be able to avoid U.S. income tax under section 881(e) by investing through a CFC.

The exemption from taxation of interest-related dividends received from a regulated investment company does not apply unless the withholding agent receives a statement similar to that required under section 871(h) (stating that the beneficial owner of the share is not a U.S. person). The exemption does not apply if the interest-related dividend is paid to a person in a foreign country with respect to which the Secretary has determined that the information exchange between the United States and the foreign country is inadequate to prevent evasion of U.S. income tax by U.S. persons. It is our understanding that FSub-1 provided a statement to RIC that it was the beneficial owner of the RIC stock, and that ostensibly conforming to the literal requirements of the withholding requirements, RIC did not withhold tax.

When Congress removed the withholding tax on interest paid to foreign persons in 1984, Congress recognized that U.S. persons could attempt to avoid U.S. income tax on interest income by buying U.S. bearer obligations on the Eurobond market, and claiming to be a foreign person (or buying the bonds through the assistance of a foreign

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[55] Section 881(e) provides that, except as otherwise provided, no tax shall be imposed … on any interest related dividend (as defined in section 871(k)(1)) received from a regulated investment company. Section 871(k), a temporary provision, permits a regulated investment company to designate as an "interest related dividend" a dividend that the regulated investment company pays out of certain interest income that would not be subject to tax in the hands of a shareholder that is a foreign corporation or a nonresident alien if the shareholder received it directly. More specifically, section 871(k)(1)(A) exempts any interest related dividends that foreign corporations and nonresident aliens receive from regulated investment companies from the 30 percent withholding tax. A regulated investment company must designate an interest-related dividend by written notice mailed to its shareholders. Section 871(k)(1)(C). The amount that a regulated investment company may so designate is limited to the regulated investment company's "qualified net interest income," which is the regulated investment company's "qualified interest income," reduced by certain applicable deductions. Section 871(k)(1)(D). "Qualified interest income" is the amount of the regulated investment company's U.S. source interest income that would be exempt from the 30 percent withholding tax if the shareholder received the interest directly.

[56] Section 881(e)(1)(C), which applies the rules of section 881(c)(5)(A) to interest-related dividends.

person). If the U.S. person failed to include the interest in its U.S. return and there was no withholding, the income would not be taxed and the tax avoidance would likely go unnoticed by the Service (because the obligations were in bearer rather than registered form). Congress did not want this result.[57] Congress put in place certain measures to prevent such tax avoidance. Congress expanded Treasury's authority to require registration of securities designed to be sold to foreign persons. As noted above, Congress required that the withholding agent receive a statement that the *beneficial owner* of the obligation is not a U.S. Person.[58] Congress directed the Service to adopt appropriate remedies to prevent taxpayers from engaging in back-to-back transactions.

<u>What is the Intent of the Statute? - Subpart F</u>

Common Parent[59] contends that it avoids U.S. income tax on 80 percent of the distribution it received from FSub-1[60] (attributable to the RIC distributions) pursuant to the section 245(a) DRD. Common Parent takes the position that this Year T distribution from FSub-1 is not subject to the subpart F provisions and that it is a "U.S. source" dividend within the meaning of section 245(a), and thus eligible for the section 245 DRD.

The subpart F provisions (sections 951 through 964)[61] were added to the Code in 1962 to prevent U.S. shareholders from inappropriately deferring U.S. federal income on certain income earned by CFCs. The subpart F rules provide, in part, that U.S. shareholders of a CFC are taxed currently on certain types of income ("subpart F income") earned by the CFC.

Specifically, a U.S. shareholder (as defined in section 951(b)) that owns stock of a CFC on the last day of the CFC's taxable year must include in income a section 951 inclusion, which includes the shareholder's "pro rata share" of the CFC's subpart F income.[62] The CFC's actual distributions of the earnings attributable to section 951 inclusions are excluded from the U.S. shareholder's income because the earnings were

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[57] *See* Staff of Joint Comm. On Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 391-393.

[58] *See* section 871(h)(2)B).

[59] Common Parent is the owner of USP(DE). USP(DE) is a disregarded entity. *See* Treas. Reg. §§ 301.7701-2 and -3.

[60] FSub-1 is the owner of FSub-1(DE). FSub-1(DE) is a disregarded entity. *See* Treas. Reg. §§ 301.7701-2 and -3.

[61] Section 965 was added to subpart F in 2004. American Jobs Creation Act of 2004 (P.L. 108-357).

[62] If the foreign corporation ceases to be a CFC before the end of its taxable year, a U.S. shareholder that owns stock on the last day that it was a CFC must include its pro rata share of the subpart F income earned during the year while the corporation was a CFC.

included in income by the U.S. shareholder (as a section 951 inclusion).[63] These results -- a section 951 inclusion and a tax-free distribution of the earnings attributable to the inclusion -- occur even if the CFC distributes the earnings during the same year that it earns the related subpart F income. Neither the section 951 inclusion nor the tax-free distribution of earnings and profits attributable to the section 951 inclusion is treated as a dividend for purposes of the section 245 DRD, or is otherwise eligible for the section 245 DRD.[64]

As discussed above, the amount of a U.S. shareholder's section 951 inclusion is based in part on the shareholder's "pro rata share" of the CFC's subpart F income. If the foreign corporation is a CFC for its entire taxable year, a U.S. shareholder's pro-rata share generally is the amount that would have been distributed to the shareholder with respect to its ownership interest if the CFC had distributed its subpart F income for the taxable year. Thus, "pro rata share" generally is based on the U.S. shareholder's percentage of CFC stock ownership.

Special rules for determining "pro rata share" apply when there is a change in ownership during a CFC's taxable year, and the CFC's status as a CFC is not changed. Under section 951(a)(1), the selling U.S. shareholder does not include a section 951 inclusion in income. Instead, only the acquiring U.S. shareholder includes a section 951 inclusion (provided the acquiring U.S. shareholder holds the CFC shares on the last day of the CFC's taxable year). In addition, under section 951(a)(2), the amount of the acquiring shareholder's section 951 inclusion is reduced by all or a potion of any dividends paid to the selling shareholder with respect to the transferred shares during the taxable year.[65]

The rule requiring a reduction of the section 951 inclusion for same year distributions to a previous owner of stock is not a tool for tax avoidance; rather, it is a necessary rule to prevent both the current and former shareholders from being subject to tax with respect to the same amount of the CFC's subpart F income. Similarly, the rule that provides that a U.S. shareholder does not have a section 951 inclusion when it transfers its CFC interest to another U.S. person during the CFC's taxable year is a rule for administering the subpart F regime in a year in which two U.S. persons held the

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[63] Section 959(a) provides that "... the earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when – (1) such amounts are distributed to, or (2) such amounts would, but for this subsection, be included under section 951(a)(1)(B) in the gross income of such shareholder (or any other United States person who acquires from any person any portion of the interest of such United States shareholder in such foreign corporation, but only to the extent of such portion…".

[64] Section 959(d). *See* Rodriquez v. Comm'r, 137 T.C. 174 (2011).

[65] *See* section 951(a)(2)(B). The section 951 inclusion is reduced by the lesser of the amount of the dividend or the amount of subpart F income allocable to the portion of the taxable year that the stock was owned by the previous owner

same CFC shares in order to avoid double taxation and is not meant to be used by taxpayers to manipulate the character of their income in order to avoid U.S. income tax. There is no evidence that Congress intended a former U.S. shareholder to rely on the subpart F rules to achieve a better result by transferring its interests in a CFC prior to the end of the CFC's year.

What is the Intent of the Statute? - Section 245 Dividend Received Deduction

Section 245 provides rules for determining the extent to which a dividend recipient can deduct dividends paid by foreign corporations. Congress explained that these rules generally allow the deduction *only for distributions of earnings and profits that were subject to U.S. tax*. The rules provide tests for determining which dividend amounts are attributable to such income, and provide for different percentage deductions based on the recipient's level of stock ownership in the payor. In connection with the promulgation of the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act"), Congress explained that dividends eligible for the section 245 DRD "are based on the ratio of (a) the foreign corporation's post–1986 earnings and profits *that have been subject to net-basis U.S. corporate income tax* and that have not been distributed to (b) the corporation's total accumulated earnings and profits."[66]

Congress further explained that, generally, a dividend from a foreign corporation is 100 percent deductible only if, in addition to meeting other requirements, it is paid either (i) by a wholly owned foreign subsidiary all of whose gross income is effectively connected with the conduct of a U.S. trade or business;[67] or (ii) out of earnings and profits attributable to foreign trade income for a period during which the payor was a FSC (as defined in section 245(c)(4)(C)).[68]

Congress buttressed section 245 with a specific provision which disallows the DRD for amounts treated as dividends under section 1248[69] because such deemed section 1248 dividends are "generally derived from earnings not subject to U.S. corporate income tax."[70]

It is likely that Common Parent is familiar with Congress' clearly articulated intent to allow the DRD only for earnings *that have been subject to net-basis U.S. corporate income tax*. Nonetheless, Common Parent treated its Year T distributions from FSub-1 (attributable to distributions from RIC) as section 301(c)(1) dividends that qualified for

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[66] H.R. Rep. No. 100-795, at 263 (1988).

[67] Section 245(b).

[68] Section 245(c)(1)(A).

[69] Section 245(a)(11).

[70] S. Rep. No. 100-445, at 278 (1988).

the 80 percent DRD under section 245(a). Section 245(a) allows a DRD (as specified in section 243) for that portion of a dividend paid by a "qualified 10-percent owned foreign corporation" that is equal to the "U.S. source portion" of the dividend. Common Parent's position is that FSub-1 is a qualified 10-percent owned foreign corporation, and that the "U.S. source portion" of the distribution was 100 percent. We expect Common Parent will argue that section 245 does not specifically state that the DRD is only available with respect to earnings that have been subject to U.S. corporate income tax.

The general policy of section 245 is to ensure that only a single level of corporate tax is imposed on U.S. source income distributed to a corporate shareholder, consistent with the general rule of section 243. It would be inconsistent with that policy to allow a section 245 deduction for dividends attributable to U.S. source earnings and profits that have not borne any U.S. corporate-level tax.

A CFC generally has subpart F income when it earns dividends.[71] The exceptions[72] to the general rule that dividends are included in subpart F income generally would not apply to U.S. source dividends received by a CFC from a related regulated investment company.[73] Although certain dividends received from CFCs are eligible for the section 245 DRD, the DRD is not allowed with respect to section 951 inclusions or distributions of subpart F earnings that were included in the income of a U.S. shareholder. Neither section 951 inclusions nor any distributions of earnings attributable to section 951 inclusions are treated as dividends for purposes of section 245.[74] As a result of the section 245 rules and the rules in subpart F, a section 245 DRD generally would not be available to a U.S. shareholder of a CFC with respect to the CFC's U.S. source dividends from a regulated investment company.

Application of the Substance Over Form Doctrine

We conclude that Common Parent's purported tax result is inconsistent with Congressional intent. In substance, the Customer Funds were by-in-large put into domestic interest paying investments and Taxpayer should pay tax on this interest income. Interest income is not eligible for a DRD. To a lesser extent, the Customer Funds were put into investments that gave rise to capital gains. Capital gains are not eligible for a DRD either.

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[71] *See* section 954(c).

[72] *See, e.g.,* section 954(b)(3)(A) and (b)(4).

[73] *See* section 881(c)(5)(A) and 881(e). The exceptions in section 954(b)(3) may apply to interest that does not qualify as portfolio interest under section 881(a)(2) and interest that is from a related party as defined in section 864(d).

[74] *See* Rodriguez v. Comm'r, 137 T.C. 174 (2011); section 959(a) and (d).

One can reach a result consistent with Congressional intent through different iterations of the substance over form doctrine. One approach is the application of the step transaction doctrine in which Common Parent is treated as directly investing in RIC and RIC is treated as directly making distributions to Common Parent. As such, the transaction does not implicate sections 951 and 881. The distribution of dividends from RIC to Common Parent is not eligible for the DRD. This result is consistent with the intent of sections 243 and subchapter M.

One can also reach essentially the same result by treating Common Parent's income (attributable to funds paid by RIC to FSub-1) as income subject to a section 951 inclusion. A section 951 inclusion is not eligible for a DRD. This approach is consistent with the intent of sections 881, 245 and 951. We discuss these two approaches in more detail below.

Step Transaction Doctrine

The step transaction doctrine was developed by the courts to ensure that a transaction is taxed in accordance with its substance rather than its form. It generally requires "that the interrelated steps of an integrated transaction be analyzed as a whole rather than treated separately."[75] The doctrine is "in effect another rule of substance over form; it treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result."[76]

Classic step transaction analysis supports disregarding FSub-1's middleman role between Common Parent and RIC. "Under the step-transaction doctrine, a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes."[77] A series of formally separate steps may be collapsed and treated as a single transaction if the steps are in substance integrated and focused toward a particular result.[78] However, while the step transaction doctrine may be used to collapse steps actually taken that do not have independent significance, the Tax Court opined that it cannot be employed by the government to recharacterize transactions by creating new steps that the parties in fact failed to take.[79]

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[75] 1 Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, ¶ 4.3.5 at 4-45.

[76] Penrod v. Comm'r, 88 T.C. 1415, 1428 (1987).

[77] Del Commercial Props., Inc. v. Comm'r, 251 F.3d 210, 213-214 (D.C. Cir. 2001), aff'g T.C. Memo. 1999-411; *see also* Penrod v. Comm'r, 88 T.C. 1415, 1428-30 (1987).

[78] *See* Andantech v. Comm'r, T.C. Memo. 2002-97.

[79] Turner Broadcasting System, Inc. v. Comm'r, 111 T.C. 315, 326-29 (1998).

Three tests are associated with the step transaction doctrine; the narrowest is the "binding commitment" test. Under this test, the steps are collapsed if, at the time of the first step, there was a binding commitment to undertake the later step.[80] Another test is the "interdependence" test. It focuses on whether "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."[81] It requires a determination of whether the steps had independent significance or had meaning only as part of the larger transaction – that is, the end result that the taxpayer hoped to achieve. As such, the interdependence test is sometimes viewed as a variation of the third test: the "end result" test. Under the "end result" test, the doctrine is applied if it appears that a series of formally separate steps are prearranged parts of a single transaction intended from the outset to reach the ultimate result. More than one test might be appropriate under any given set of circumstances; however, the circumstances need satisfy only one of the tests in order for the step transaction doctrine to operate.[82]

As explained below, Taxpayer interposed FSub-1 between Common Parent and RIC in order to achieve a tax result clearly not intended by Congress. Taxpayer sought to avoid 80 percent of the U.S. corporate level tax on interest income,[83] albeit, interest income routed through a RIC and a CFC.

Analysis: Certain Transfers Through FSub1 Should Be Disregarded

If Common Parent's Year T income (attributable to RIC distributions that Common Parent caused to be routed through FSub-1) is not a section 951 inclusion, Taxpayer's transaction steps should be integrated under the application of the step transaction doctrine. Taxpayer's transaction was a carefully planned and orchestrated series of steps in which (1) Common Parent would indirectly purchase shares in RIC through FSub-1, (2) RIC would pay dividends to Common Parent through FSub-1 and (3) Common Parent would dispose of its shares in FSub-1 prior to the end of FSub-1's tax year.

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[80] Greene v. United States, 13 F.3d 577, 583 (2d Cir. 1994) (stating that under the end result test, the step transaction doctrine will be invoked if it appears that a series of separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result.) A prerequisite to the application of the end result test is proof of an agreement or understanding between the transacting parties to bring about the ultimate result. Relevant to this inquiry is the taxpayer's subjective intent to reach a particular result by directing a series of transactions to an intended purpose or structuring them in a certain way. *See* True v. United States, 190 F.3d 1165, 1175 (10th Cir. 1999).

[81] Penrod, 88 T.C. at 1429-30 (1987). Steps are generally accorded independent significance if, standing alone, they were undertaken for valid and independent economic or business reasons. Green, 13 F.3d at 584; Sec. Ins. Co. v. United States, 702 F.2d 1234, 1246-47 (5th Cir. 1983).

[82] Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1527-28 (10th Cir. 1991) (finding end result test inappropriate but applying the step transaction doctrine using the interdependence test).

[83] Taxpayer also sought to avoid 80 percent of the U.S. corporate level tax on certain capital gain by routing the gain through the RIC and FSub-1.

The intermediate steps of the transaction – *i.e.*, routing funds through FSub-1 – had no independent business purpose. Each individual step of the RIC investment would have been "fruitless" without the completion of the entire preplanned series of steps. Taxpayer took each step in the transaction in furtherance of its plan to offset income with an 80 percent DRD. The objective of the transaction from the outset was to have FSub-1 distribute its RIC dividends to Common Parent and to have Common Parent dispose of its shares in FSub-1 just before the end of FSub-1's tax year. Accordingly, under the interdependence test of the step transaction doctrine, Taxpayer's use of FSub-1 to purchase the RIC shares should be ignored. Common Parent should be treated as directly purchasing the RIC shares. As such, Common Parent is precluded from offsetting income attributable to the RIC distributions with the DRD.

FSub-1 did not have an independent business purpose, other than tax avoidance, for participating in the RIC transaction. FSub-1 could not have purchased the RIC shares without the funds it received from Common Parent. Although FSub-1 reported costs associated with its RIC investment, it paid these expenses from the funds it received from Common Parent. FSub-1 did not have any of its own employees: it paid a member of US Group to carry out the activities. Employees of US Group planned the entire transaction and carried out the negotiations with RIC. FSub-1 did not itself retain any profit from its investment. Although it briefly invested the RIC dividends, which were paid monthly, before forwarding them to Common Parent on a quarterly basis, it distributed those earnings to Common Parent along with the RIC dividends. When it sold some of its RIC shares to Common Parent, it did not profit from such sale. FSub-1's role in Taxpayer's RIC investment strategy was solely to convert income ineligible for the DRD into income that ostensible qualified for an 80 percent DRD.

But for the intended tax benefits of the DRD, Taxpayer's indirect investment strategy did not make economic sense vis-à-vis its purported business purpose of increasing the return on its investments in highly liquid securities. Before entering into the transaction, Taxpayer understood that the transaction costs would reduce Taxpayer's return on its investment of Customer Funds if it did not carry out (what we describe as) Steps 6 and 8 and get the anticipated tax benefits. If FSub-1 retained the dividends from RIC, and Common Parent held the FSub-1 stock through the close of FSub-1's taxable year, then Taxpayer would not have any ostensible rationale for excluding income from US Group's income calculation.

Even under Taxpayer's analysis, if FSub-1 held the RIC dividends for its own use and Common Parent continued to directly hold its FSub-1 stock through the end of FSub-1's taxable year, Common Parent would have had to include in income a section 951 inclusion with respect to FSub-1. Alternatively, if FSub-1 retained the RIC dividends and Common Parent transferred its FSub-1 shares to Partnership-C, Common Parent as the c percent partner of Partnership-C (directly and through Partnership-A and Partnership-B) would have had a section 951 inclusion with respect

to its c percent interest in FSub-1. Member 2 would have had to include in income a section 951 inclusion with respect to the remaining a percent interest in FSub-1.

The binding commitment test of the step transaction doctrine is generally applied when the parties have entered into a binding contract to carry out the transaction steps. In the instant case, there was no need for Common Parent to enter into a written contract with FSub-1 to ensure that FSub-1 would distribute all of the RIC dividends to Common Parent. There was no risk that FSub-1 would deviate from Common Parent's plan. FSub-1 was not an independent actor; it was controlled by Common Parent. FSub-1 did not have its own employees; all of its activities were carried out by employees of members of the US Group. Thus, given the facts, the steps of Taxpayer's transaction were as controlled as any arrangement set forth in a contract. In fact, given Common Parent's control over FSub-1, the outcome of the RIC transaction was even more predictable than a contractual arrangement between unrelated parties.

Taxpayer's liquidity test further evidences Common Parent's control over the RIC investment and FSub-1's inconsequential role in the transaction. Common Parent stated that it conducted the liquidity test to make sure that Member 1 could meet its liquidity needs given the fact that Common Parent had used $ kkk of Member 1's Customer Funds to fund the purchase of the RIC shares. Common Parent stated that it did not want to rely on RIC providing immediate cash liquidity if there was a crisis. Instead, Taxpayer determined that Member 1 could better satisfy any immediate liquidity needs by gaining *immediate* access to the RIC shares and using them as collateral to borrow cash from Common Parent. To make sure that its liquidity plan worked, Common Parent moved kkk of the RIC shares from FSub-1 to Member 1 and then returned them. The liquidity test evidences FSub-1's lack of control over the RIC shares and shows how Common Parent could unwind the entire transaction at the drop of a hat!

Taxpayer's position is that Common Parent's indirect RIC investment was proper tax planning and that it is free to make investments via intermediary entities, be they domestic or foreign. However, we conclude that the step transaction doctrine must be applied to this transaction in order to prevent this taxpayer from subverting legislative purpose. Congress clearly intended at least one full corporate level of U.S. federal income tax on interest earnings. Congress attempted to prevent U.S. corporate taxpayers from using a regulated investment company or foreign entity to convert such interest payments into dividends eligible for the DRD. Accordingly, under the step transaction, as applied to the instant case, Common Parent should be treated as directly purchasing the RIC shares and directly receiving the RIC dividends. As such, Common Parent is not entitled to the DRD with respect to RIC dividends.

Alternative Analysis: "Dividend" Should Be Treated as a Section 951 Inclusion

FSub-1 is a CFC and Common Parent is a U.S. shareholder of FSub-1 within the meaning of section 951(b). The dividends FSub-1 received from RIC are foreign

personal holding company income, which is a type of subpart F income.[84] However, Common Parent takes the position that it is not required to include in income its pro-rata share of FSub-1's subpart F income under section 951(a) because Common Parent transferred its entire interest in FSub-1 to Partnership-C just prior to the end of FSub-1's taxable Year T. As noted above, Common Parent owned c percent of Partnership-C (directly or through Partnership-A and Partnership-B), and indirectly owned the remaining a percent through Member 2 (see Diagram 2). In substance, Common Parent did not dispose of its FSub-1 stock; it merely moved such stock to Partnership-C, a pass-through entity that was wholly-owned (directly and indirectly) by Common Parent.

If Common Parent had not transferred its interest in FSub-1 to Partnership-C, then it would have included an amount in income under section 951(a), and the distribution from FSub-1 would have been excluded from income under section 959. Instead, because of the transfer, Taxpayer treated the distribution from FSub-1 to Common Parent as a dividend qualifying for the 80 percent DRD, and Common Parent did not include any amount in income under section 951(a).

Common Parent continued to indirectly own FSub-1 after moving it to Partnership-C. Common Parent transferred its interest in FSub-1 to Partnership-C in order to change the character of the income that it derived with respect to FSub-1 during Year T from a section 951 inclusion that was not eligible for a section 245 DRD to a dividend, which it claims is eligible for a section 245 DRD.

Although the courts have not addressed the facts at issue in the instant case, the courts have rejected similar schemes devised to avoid section 951 inclusions multiple times since the enactment of subpart F. As early as 1961, taxpayers contrived to avoid section 951 inclusions by transferring nominal voting power to "friendly" foreign persons and then arguing that the foreign corporation did not meet the definition of a CFC under section 957 because more than half the voting control of the corporation was held by foreign persons.[85] The courts ignored these transfers for purposes of determining whether the foreign corporation was a CFC because it was clear that the U.S. shareholders, in substance, continued to control the voting power of the stock nominally held by foreign persons.[86] The courts rejected the taxpayers' arguments that the statute provided a mechanical test. Instead, the courts concluded that mere technical compliance with the statute was not sufficient, and that the rules in the statute would be applied to the substance of the transaction rather than the form of the transaction.

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[84] Section 954(c)(1)(A) provides that dividends are a type of foreign personal holding company income.

[85] Garlock, Inc. v. Comm'r, 58 T.C. 432 (1972), *aff'd.*, 489 F.2d 197 (2d Cir. 1973). *See also* Koehring Co. v. United States, 583 F.2d 313 (7th Cir. 1978); Weiskopf Est. v. Comm'r, 64 T.C. 78 (1975), *aff'd per curiam*, 538 F.2d 317 (2d Cir. 1976); Kraus v. Comm'r, 59 T.C. 681 (1973), *aff'd.*, 490 F.2d 898 (2d Cir. 1974).

[86] *Id*.

Similarly, U.S. shareholders have tried to avoid section 951 inclusions attributable to loans from their wholly owned CFCs by engaging in transactions that, in form, were outside the scope of section 956. In Jacobs Engineering v. Commissioner,[87] a U.S. shareholder frequently borrowed and repaid funds from its wholly owned CFC, with only short periods of time between repayments and new borrowings. The taxpayer carefully ensured that the loans were never outstanding on a section 956 measuring date, which would have resulted in a section 951 inclusion.[88] The court observed that under the substance over form doctrine, "the Commissioner may deny legal effect to a transaction if the sole purpose of the transaction was to avoid tax," and the court must simply decide whether the facts of the case "fall within the intended scope of the Internal Revenue Code provision at issue."[89] The court concluded that the series of loans was, in substance, a single loan outstanding for the entire year, notwithstanding that the loans were not formally outstanding on a section 956 measurement date.[90]

Furthermore, in Schering-Plough v. United States,[91] the taxpayer tried to avoid a section 951 inclusion attributable to a loan from its wholly owned CFC by arranging a series of circular interest rate swaps with the CFC and a third party. The court held that the interest rate swaps were, in substance, a loan from the CFC that resulted in a section 951 inclusion to the U.S. shareholder.[92]

In all of these cases, the courts recognized that the statutory rules in the subpart F regime are not purely mechanical. Instead, the courts applied the Gregory principle to determine whether the subject transaction met both the terms and intent of the statute. In each of the cases, the court held that even though the U.S. shareholder had structured transactions that, in form, allowed the U.S. shareholder to avoid a section 951 inclusion, the transaction lacked the substance required by the statute. Accordingly, the courts held that the U.S. shareholders were subject to tax under subpart F consistent with the substance of the transactions, which resulted in the U.S. shareholders including section 951 inclusions in income.

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[87] 1997 WL 314107 (C.D. Cal.), 97-1 USTC Par. 50,340, *aff'd* 168 F.3d 499 (9th Cir. 1999).

[88] *Id*. Under section 956, investments in United States property, including loans to U.S. shareholders, held by a CFC on particular dates generally are includible in the U.S. shareholder's section 951 inclusion.

[89] *Id.*

[90] *Id.*

[91] (651 F.Supp.2d 219) (D.N.J. 2007), *aff'd sub. nom.* Merck & Co., Inc. v. United States, 652 F.3d 475 (3d Cir. 2011).

[92] *Id.*

In the instant case, Common Parent's section 951 inclusion would have been calculated based on 100 percent of FSub-1's subpart F income if it owned FSub-1 directly for the entire Year T taxable year, irrespective of any distributions from FSub-1. Likewise, Common Parent would have included in income section 951 inclusions calculated based on nearly 100 percent of FSub-1's subpart F income as a section 951 inclusion if Partnership-C owned FSub-1 for the entire Year T taxable year, irrespective of any distributions. In either case, Common Parent would not have been eligible for the section 245 DRD with respect to its section 951 inclusion. Common Parent simply used its power as the sole shareholder of FSub-1 to compel a distribution of substantially all of FSub-1's earnings for the Year T taxable year and then changed its form of ownership of FSub-1 in order to take the reporting position that most of the income it derived with respect to FSub-1 was characterized as a dividend, purportedly eligible for a section 245 DRD.[93]

Common Parent transferred FSub-1 to Partnership-C[94] in order to change the character of its Year T income from a section 951 inclusion to a dividend. In substance, however, Common Parent owned and controlled FSub-1 throughout the entire taxable year. Common Parent should be required to include in income 100 percent of FSub-1's subpart F income, either as a result of its direct ownership or its ownership through Partnership-C. Therefore, under the substance over form principle announced in Gregory and followed in Garlock, Jacobs Engineering, and Schering-Plough, the income derived by Common Parent with respect to FSub-1 should be treated as a section 951 inclusion rather than a dividend for purposes of section 245, and Common Parent should not qualify for a section 245 DRD in respect thereof.

Summary: Taxpayer's Transaction Circumvents the Intent of the Statutes

Taxpayer relies on the form of its transaction and contends that its analysis comports with the literal language of each applicable Code provision. However, it is quite clear that Taxpayer engaged in a transaction which, under the Taxpayer's analysis, provides a result that is contrary to the intent of the DRD provisions and the exemption from withholding provisions. The Taxpayer's transaction was structured to use various Code provisions, in combination, to shelter 80 percent of certain interest income and capital gain from *all* U.S. federal income tax. As discussed above, this was clearly not Congress' intent in enacting such provisions.[95] Sections 243 and 245 were enacted to provide relief from *multiple* levels of corporate tax on earnings.

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[93] Common Parent acknowledges that its sale of FSub-1 to Partnership-C was intended to convert the character FSub-1's distributions to Common Parent (attributable to the RIC dividends) from section 951 inclusions into dividends that purportedly qualify for the section 245 DRD.

[94] As noted, Partnership-C was owned in part directly by Common Parent and in part indirectly through other entities ultimately (directly and indirectly) wholly-owned by Common Parent.

[95] *See* United States v. Georgia Railroad and Banking Co. 348 F2d. 278, (5th Cir. 1965) (the purpose of income tax statutes providing deductions for dividends received by a corporation was to eliminate multiple

Common Parent's insertion of FSub-1, a CFC, into its investment structure was an integral part of its plan to convert interest income and capital gain into income eligible for the DRD. Congress provided rules in section 854 to foreclose Common Parent from investing directly in a regulated investment company and converting interest and capital gain income into dividends. To circumvent Congressional intent and reach its tax-avoidance objective, Common Parent inserted FSub-1, a CFC, between itself and RIC, a regulated investment company. The application of the step transaction doctrine, as discussed above, restores the proper tax result. In such case, Common Parent would be treated as receiving distributions directly from RIC and would not be entitled to the DRD under sections 243 and 854.

An alternative remedy is to regard the transfers through FSub-1 and require Common Parent to include FSub-1's distributions (attributable to RIC's earnings and profits) under section 951 rather than sections 301 and 245(a). Congress generally intended that a CFC that received an interest-related dividend would include the full amount of the dividend in the CFC's subpart F income, which generally would result in a section 951 inclusion for the CFC's U.S. shareholders. A section 951 inclusion is not eligible for a DRD. Common Parent transferred its FSub-1 shares to Partnership-C prior to the end of FSub-1's Year T tax year in order to change the character of income from a section 951 inclusion to a dividend, so that it could claim the section 245 DRD. Taxpayer should not be able to manipulate the subpart F rules as part of an integrated scheme to avoid paying tax on U.S. interest income and capital gain.

Similarly, the purpose of section 881(e) is being circumvented in the instant case. The ultimate investor in the U.S. source interest-paying investments is a U.S. company – Taxpayer – rather than a foreign investor as intended by Congress.

Thus, we revisit the Gregory quote: "[t]he question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."[96] We conclude that the Taxpayer's transaction was not consistent with Congressional intent. In the words of the Gregory court, to conclude "otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."[97]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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taxation of corporate earnings which would otherwise occur whenever one corporation holds shares of stock in another).

[96] Gregory at 468-69.

[97] Id. at 470.

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