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subject: Availability of Foreign Tax Credits for Purported Sale of Shares of Foreign Corporation

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

LEGEND

Taxpayer =
Seller =
Hedge Fund =
Shares =
Options =

Issuer =
Country X =
Country Y =
Year 1 =

Year 2 =
Date 1 =
Date 2 =
Date 3 =
Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
Amount 6 =
Amount 7 =
Amount 8 =
Amount 9 =
Amount 10 =
Amount 11 =
Amount 12 =
Amount 13 =
Amount 14 =
Amount 15 =
Amount 16 =
Amount 17 =
Amount 18 =
Amount 19 =
Amount 20 =
Amount 21 =
Employee 1 =
Employee 2 =
Disregarded Entities =

ISSUE

Whether Taxpayer may claim foreign tax credits arising from a multi-step transaction in which Taxpayer purported to acquire from Seller ownership of disregarded entities that held shares in a foreign corporation, hedged its risk on the shares by executing options with Seller, and transferred title to the shares back to Seller when those options expired approximately two months later?

CONCLUSION

No. Taxpayer's purported acquisition of the disregarded entities should be disregarded under the economic substance and step transaction doctrines. The substantial record developed to date indicates that Taxpayer had no business purpose or reasonable expectation of profit with respect to the transaction apart from the substantial foreign tax credit benefits. In addition, the facts indicate that Taxpayer's disposition of the Shares was prearranged from the outset and Taxpayer had no interest in retaining its transitory interest in the Shares. Under these circumstances, the transaction undertaken by Taxpayer should be disregarded for U.S. tax purposes and, therefore, the foreign tax credits arising from the transaction should be disallowed.

FACTS

This memorandum analyzes a series of interrelated transactions undertaken by Taxpayer and Seller in which Taxpayer purportedly acquired from Seller legal title to certain Disregarded Entities, caused the Disregarded Entities to sell shares of stock in a foreign corporation to Seller (which triggered a foreign tax on built-in gain on the stock), and claimed foreign tax credits of Amount 1. Taxpayer and Seller are both U.S. corporations engaged in the financial services business. In connection with the audit of this transaction, the Service interviewed representatives of both Taxpayer and Seller.

1. Taxpayer's Acquisition of the Disregarded Entities from Seller

Prior to the transaction involving Taxpayer, Seller acquired a substantial portfolio interest in shares of Issuer, a publicly-traded Country X corporation, on behalf of Hedge Fund, an unrelated foreign hedge fund. Seller held the legal title to a series of special purpose Disregarded Entities that held the Shares, but passed all of the economic benefits and burdens of ownership in the shares to Hedge Fund through a series of options. Seller granted each of the options to Hedge Fund for a premium equal to the entire purchase price of the Shares plus a fee, and Hedge Fund had the right to exercise each option for one penny. Upon exercise, Hedge Fund would receive the Shares and an amount equal to dividends that accrued during the term of the exercised option. The options also provided that Hedge Fund would generally bear the cost of the Country X taxes "incurred by the Option Seller in connection with the exercise of the option, any subsequent sale of the Shares and subsequent conversion of the proceeds of such sale to U.S. Dollars and remittance to an account outside [Country X]."

One of these options, issued in October of Year 1, provided that Seller would bear the first Amount 2 of Country X income taxes. A copy of an e-mail provided by Seller indicates that this term was adopted to transfer to Hedge Fund some of the economic benefit of Seller's ability to claim foreign tax credits with respect to Country X taxes imposed on a sale of the Shares.[1] After the Shares had appreciated, Seller undertook what it described as a series of "bed and breakfast" transactions in which it purported to transfer and immediately reacquire the Shares at their appreciated value. Seller explained that one of its employees "constantly used it [the phrase "bed and breakfast"

[1] The e-mail states, in relevant part, that "[Seller] agrees to pass on to the Fund the net return on the [Issuer] shares plus an amount equal to the benefit received by [Seller] of any tax credits resulting from the payment of [Country X] tax liabilities on the gains on the shares up to a maximum of [Amount 2] of [Country X] tax in [Year 1]. The tax department is not yet in a position to determine what the [Seller's] tax credit capacity position is for [Year 2] and no representations to any future tax credit capacity has been made to the Fund."

transaction] to refer to a transaction where you are not incurring economic risk, yet you are triggering a tax on certain appreciation in the asset."

By the end of Year 1, however, Seller indicated that it was concerned about its ability to continue to claim credits for Country X taxes due to the foreign tax credit limitation. It also expressed increasing doubt that the foreign taxes attributable to the bed and breakfast transactions were properly creditable for U.S. tax purposes. Accordingly, subsequent options provided that Hedge Fund would bear all of the costs of such taxes.

In December of Year 1, after Seller had concluded that it was not in a position to claim additional foreign tax credits that would arise from the sale of the Shares, it approached Taxpayer and proposed the transaction that is the focus of this memorandum. Seller contacted Employee 1,[2] an employee of Taxpayer who worked, as she described it, in Taxpayer's "derivative business and financing business where . . . [Taxpayer is] not taking any volatility risk on the underlying stocks." Taxpayer considered the proposal over the next two months, during which time Employee 1 discussed the U.S. tax ramifications of the transaction with both inside and outside counsel.[3] The proposal was ultimately brought before and approved by Taxpayer's New Products Committee, which included the heads of the major departments within Taxpayer. By February of Year 2, Taxpayer and Seller reached agreement on the terms of the proposal and executed the transaction on Date 1.

The first leg of the transaction was a purported sale on Date 1 from Seller to Taxpayer of seventeen Disregarded Entities that indirectly held the Shares for Amount 3. An internal Taxpayer memorandum indicates that the purchase price was derived by valuing the Shares at Amount 4 and subtracting a Country X tax liability of Amount 5 that would be imposed when the built-in gain in the Shares was recognized for Country X tax purposes.[4]

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[2] Employee 1 was trained in accounting and had significant prior work experience in the international tax department of Taxpayer and another U.S.-based multinational financial services provider.

[3] Taxpayer indicated that it had obtained an opinion from a major U.S. law firm on the U.S. tax ramifications of the transaction but did not provide a copy of the opinion on the grounds that the opinion was protected by the attorney-client privilege.

[4] The Amount 4 value was based on a valuation of each Share at Amount 6 in Country X currency. Taxpayer did not adequately explain how it derived the Amount 6 per Share valuation. The Shares were publicly traded on the Country X stock exchange at the time and Taxpayer indicated that the closing price of the Shares immediately prior to the transaction was Amount 7 per share, which was approximately 20% less than Amount 6. Taxpayer noted that volumes on the exchange were sometimes too low to accurately value shares and did not reflect the value of a large block of shares such as the one sold by the Disregarded Entities. However, Taxpayer offered no documentation or further explanation of how either of these factors might have affected the price used by the parties. It appears that the Shares represented approximately one percent of the outstanding shares of Issuer at the time of the transaction. In addition, Taxpayer did not explain why the Amount 6 valuation used to acquire the Disregarded Entities substantially exceeded the exercise price of the Options, discussed below, which Taxpayer claimed reflected the forward price of the Shares at the time of the original purported sale. Taxpayer also produced a memorandum from its research department opining that the market value of the Shares was likely to fall in the foreseeable future.

2. Put and Call Options

The second leg of the transaction, also executed on Date 1, was a pair of options entered into by subsidiaries of Seller and Taxpayer.[5] Both options were cash-settled European-style options exercisable on Date 2, approximately six weeks after the purported sale of the Disregarded Entities.[6] Taxpayer acquired a put Option that gave it the right to a payment from Seller of the excess of Amount 8 over the value of the Shares at exercise, less any dividends accrued over the term of the option. Seller acquired the call Option that gave it the right to a payment from Taxpayer of any excess of the value of the Shares at exercise over Amount 8, plus any dividends accrued over the term of the option. Both options put Taxpayer in the economic position of selling the Shares back to Seller for Amount 8. If the Shares were worth less than Amount 8 on the exercise date, Seller would make Taxpayer whole for any such reduction in value (less accrued dividends) under the put Option and, conversely, if the Shares were worth more than Amount 8, Taxpayer would make Seller whole for their increase in value (plus accrued dividends) under the call Option.

In addition, at Taxpayer's request, both options included a provision that the parties referred to as a "knockout" or collar. Under Taxpayer's put Option, this feature reduced the amount payable to Taxpayer by the amount of any Country X tax savings associated with a sale of the Shares at exercise for less than Amount 9 per share. Similarly, under Seller's call Option, the amount payable by Taxpayer was reduced by any additional Country X tax associated with a sale of the Shares at exercise for more than Amount 10 per share. The collar had the effect of eliminating Taxpayer's exposure to changes in the Country X tax liability imposed on a sale of the Shares for less than Amount 9 or more than Amount 10. The Options also provided that Seller would make Taxpayer whole for any costs incurred in converting the proceeds from the sale of the Shares from Country X currency to U.S. dollars and transferring such amounts outside Country X.

3. Settlement of the Options and Sale of the Shares back to Seller

Prior to the expiration of the Options, Seller informed Taxpayer that it had identified a buyer willing to purchase the Shares for Amount 11, and Taxpayer accepted that price as the value of the Shares for purposes of settling the call Option, which Seller

[5] In Taxpayer's case, the entity that executed the Options was a wholly-owned controlled foreign corporation resident in Country Y. For purposes of this memorandum, unless otherwise indicated, references to Taxpayer and Seller include their respective wholly-owned subsidiaries.
[6] The original expiration date of the Options (Date 2) was extended to Date 3 after Taxpayer discovered that selling the Shares on Date 2 would result in certain Country X tax penalties.

exercised on Date 3.[7] Accordingly, Taxpayer was obligated to pay Seller the excess of Amount 11 (plus accrued dividends) over the Amount 8 strike price.

Taxpayer also agreed to sell the Shares on the exercise date of the Option for Amount 11 by causing the Disregarded Entities to transfer the Shares to the buyer, which was a wholly-owned subsidiary of Seller.[8] Taxpayer indicated that it understood that the Shares were purchased for the benefit of an unidentified client of Seller. Following the transfer of the Shares, the Disregarded Entities paid Country X income taxes on the sale of the Shares of Amount 1, and Taxpayer repatriated the balance of the funds remaining in the Disregarded Entities. Taxpayer's representative stated in the interview that Taxpayer planned to liquidate the Disregarded Entities following the repatriation of the net proceeds, but had not yet done so because it determined that a liquidation was more costly than maintaining the Disregarded Entities as shell companies. Taxpayer also indicated that the Disregarded Entities have not engaged in any business activities since the transaction at issue was executed.

Both Taxpayer and Seller indicated that they expected from the outset that Taxpayer would sell and Seller would repurchase the Shares when the Options expired. Both also indicated that they were not generally in the business of taking volatility risks on securities and that both Seller and Taxpayer would have been exposed to such risks if Taxpayer did not sell the Shares and Seller did not repurchase the Shares (or an equivalent number of shares of Issuer) when the Options expired. Moreover, Taxpayer indicated that it believed the Shares were more likely to fall in value and, therefore, did not expect to retain the Shares after the Options expired. Taxpayer also indicated that, prior to entering the transaction, the only exit strategy it considered was a sale of the Shares rather than a sale of its interests in the Disregarded Entities that owned the Shares. Similarly, a document prepared by Taxpayer that purported to estimate Taxpayer's expected "profit" from the transaction, described more fully below, assumes that a Country X tax would be imposed on a sale of the Shares by the Disregarded Entities upon expiration of the Options. Finally, Seller indicated that it had negotiated with Hedge Fund prior to Taxpayer's transaction such that Hedge Fund would pay Seller for the Country X taxes to be imposed on the subsequent sale of the Shares by an unrelated party.[9] Because that tax would only be incurred if Seller repurchased the

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[7] The value of the Shares on the Country X stock exchange on Date 3 was approximately 20 percent less than Amount 11. Because Taxpayer's pre-U.S. tax return increased in inverse relationship to the price of the Shares, Taxpayer should have had an interest in assuring that the Shares were not sold for more than their fair market value. Taxpayer, however, did not exercise its right under the Call Option to solicit additional bids.

[8] When Taxpayer subsequently had difficulty repatriating the proceeds from Country X, Employee 2 wrote that Taxpayer might "declare the ending value of the shares under the options to be something less than the [amount] previously agreed . . . [but that] would create a huge relationship problem with [Seller]." One might infer from that discussion that the value used by the parties may have been influenced by factors other than the fair market value of the Shares at the time of the transaction.

[9] A representative of Seller explained at the interview that Hedge Fund had agreed to reimburse Seller for Amount 12 of Country X tax expense because "It was a cost in connection with the holding of the Issuer shares. My guess is that it wasn't clear in the derivative contract that we would be entitled to that

Shares, Seller's negotiation with Hedge Fund to be compensated for the Country X tax payment indicates that it planned to repurchase the Shares from the outset of the transaction.

Taxpayer claimed foreign tax credits of Amount 1 for the Country X taxes paid by the Disregarded Entities upon the sale of the Shares to Seller. Taxpayer was in an excess limitation position in Year 2 and used the credits to offset U.S. tax on unrelated foreign source income.

4. Economic Consequences of the Transaction

Based upon the terms of the original purported transfer of the Disregarded Entities and the Options, Taxpayer was ensured that it would receive a net payment of Amount 8 prior to satisfying its Country X tax liability on the sale of the Shares. Taxpayer had paid Amount 3 to purchase the Disregarded Entities. Therefore, the only variable potentially affecting Taxpayer's return on the transaction (prior to U.S. tax consequences) were the amount of Country X income tax on the sale of the Shares back to Seller and any Country Y tax imposed on the option proceeds. As noted above, the amount of Country X tax depended, in the first instance, on the price at which Seller reacquired the Shares, but the collar imposed under the Options limited Taxpayer's exposure to Country X taxes to between Amount 13 and Amount 14.[10] Therefore, the economic effect of the transaction after taking into account Taxpayer's payment of the Country X tax liability was fixed from the outset of the transaction to be between a positive Amount 17 and a negative Amount 18. The amount of the Country Y tax exposure depended on the amount received by Taxpayer under its put Option. Similar to the Country X tax, any Country Y tax would further reduce the possible profit from the Transaction prior to taking into account its U.S. tax consequences.

Taxpayer provided a copy of a document titled "Explanation of Probabilities Used in Analyzing the [. . .] Transaction," prepared sometime prior to the audit of the years at issue, which purported to analyze the probabilities and expected return from the

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reimbursement so he had to negotiate that with Hedge Fund to clarify that he is about to do this Taxpayer trade, there is going to be a Country X tax basis step up which is good for everybody. But there is going to be a cost. We are going to have to pay Taxpayer. I don't actually think he mentioned Taxpayer or mentioned the price. But because of the cost he has got to get a payment from Hedge Fund. And he in fact got a payment from Hedge Fund." Seller's representative suggested that the amount of the reimbursement from Hedge Fund was negotiated in advance of the transaction with Taxpayer, but it appears more likely that Hedge Fund simply agreed to reimburse Seller based on whatever amount of tax was subsequently imposed on the sale of the Shares. In this connection, we noted that when the Amount 12 reimbursement is added to the Amount 2 of tax expense that Seller agreed to absorb in one of the options, the total amount very closely approximates the amount of Country X tax that Taxpayer paid and claimed as a credit.

[10] The collar had the effect of hedging Taxpayer's exposure to any Country X taxes attributable to sales for less than Amount 9 or more than Amount 10 per share. Because the Shares had an average Country X tax basis of approximately Amount 15 per Share, the minimum and maximum tax exposure based on the Country X tax rate of Amount 16 was as little as approximately Amount 13 and as much as Amount 14.

transaction.[11] Taxpayer characterized this document as the culmination of all of its prior analysis and the basis for its decision to undertake the transaction. The document states that Taxpayer determined there was a 49% chance that the Shares would sell for Amount 19 or less, in which case Taxpayer would earn a "cash profit" after Country X tax of up to Amount 17.[12] The document also indicates that these probabilities were derived by using a "lognormal distribution with a mean of Amount 7/share (the closing price of [the Shares] the day prior to trade date) and an historic volatility of 85%." As noted above, however, the Amount 7 price was the price of the Shares on the Country X exchange immediately prior to the transaction and Taxpayer and Seller valued the Shares approximately 20% above the exchange price. In addition, although not explicitly stated in Taxpayer's analysis, it follows from that analysis that, even accepting the assumptions used by Taxpayer, Taxpayer also had a 51% probability of an economic loss on the transaction. By applying the methodology used by Taxpayer to estimate its possible profit, the maximum possible loss on the transaction was Amount 18, *i.e*., more than four times as much as Taxpayer's maximum possible profit. In the aggregate, therefore, Taxpayer's own analysis appears to indicate that it anticipated an economic loss from the transaction before U.S. tax benefits were taken into account.[13] When asked whether it would have entered the transaction if it had not been able to claim foreign tax credits, Taxpayer indicated "it may be that the transaction would not have met the required return."

LAW AND ANALYSIS

The courts have long recognized the primacy of substance over form when interpreting the Internal Revenue Code. *See Helvering v. Lazarus & Co*., 308 U.S. 252, 255 (1939) ("In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding."). In *Gregory v. Helvering*, the Supreme Court established that taxpayers are not permitted to reduce their income tax by undertaking "an operation having no business or corporate purpose -- a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan . . . ." 293 U.S. 465, 469 (1935). "The doctrine of *Gregory v. Helvering* . . . means that in construing words of a tax statute which describes commercial or industrial transactions we are to understand

[11] The Service asked Taxpayer who prepared this document and when and why it was prepared. Taxpayer responded that it believed Employee 2, a former employee who worked on the transaction and had a tax law background, prepared the document. The document clearly was prepared at least several months after the Shares were purportedly sold back to Seller because a footnote in the document references the price of the Shares two months after the date of that sale. Taxpayer did not explain the timing or its rationale for preparing such an analysis after the transaction was completed.

[12] The document states that the after-Country X tax profit is 23 percent of the Country X tax at the bottom end of the collar. Because, as explained at n. 10, the tax expense at the bottom end of the collar would be approximately Amount 13, the cash profit would necessarily be approximately Amount 17.

[13] When interviewed about the Transaction, Employee 1 indicated that the transaction provided a minimum return of Amount 18. This return, however, reflected the "profit" from the transaction to Taxpayer after taking into account foreign tax credits.

them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." *Comm'r v. Transport Trading & Terminal Corp.,*176 F.2d 570, 572 (2d Cir. 1949).

The courts employ a variety of closely related doctrines, *e.g*., economic substance, business purpose, step transaction, and sham transaction, in applying these principles, but common to each of these inquiries is whether the transaction, or step in a series of transactions, presented the taxpayer with a real potential for profit apart from its purported tax benefits. *See, e.g., Long-Term Capital Holdings v. United States,* 330 F. Supp. 2d 122, 171 (D. Conn. 2004), *aff'd per curiam*, 2005 U.S. App. LEXIS 20988 (2d Cir. Sept. 27, 2005) ("The terminology used, whether sham, profit motivation, or economic substance, is not critical, rather the analysis evaluates both the subjective business purpose of the taxpayer for engaging in the transaction and the transaction's objective economic substance."). For the reasons discussed below, we conclude that under the economic substance and step transaction doctrines, the foreign tax credits claimed by Taxpayer from the transaction at issue should be disallowed.

<u>Economic Substance</u>

The assessment of a transaction's economic substance generally turns on two related inquiries – whether the taxpayer had a bona fide business purpose and whether the transaction had any economic effects other than the creation of tax benefits. *See, e.g., Bail Bonds by Marvin Nelson, Inc. v. Comm'r,* 820 F. 2d 1543, 1549 (9th Cir. 1987); *Rice's Toyota World, Inc. v. Comm'r,* 752 F.2d 89, 91 (4th Cir. 1985). The subjective business purpose determination focuses on whether the taxpayer was motivated to derive an economic advantage apart from securing a tax benefit. *See, e.g., Goldstein v. Comm'r,* 364 F.2d 734, 740 (2d Cir. 1966), *aff'g* 44 T.C. 284 (1965) ("the Tax Court was justified in concluding that petitioner entered into the . . . transactions . . . 'solely' in order to secure a large interest deduction . . . ."). The inquiry into the transaction's objective economic substance examines whether "the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits." *Gilman v. Comm'r*, 933 F.2d 143, 146 (2d Cir. 1991); *Long-Term Capital Holdings*, 330 F. Supp. 2d at 172 (emphasizing "critical objective measurement demonstrating the taxpayer could not reasonably have expected to recoup his investment").[14]

The courts have also held that "transactions whose sole function is to produce tax deductions are substantive shams, regardless of the motive of the taxpayer." *See*

[14] Several courts have explained that both the subjective and objective prongs of the economic substance test should be considered. *See, e.g., Gilman*, 933 F.2d at 148 (approving examination of both subjective and objective tests in light of "flexible nature of the analysis"). In *Long Term Capital Holdings*, the district court concluded that the application of the two prongs of the test should be flexible and that, particularly in a case involving a sophisticated investor, the absence of a reasonable expectation of profit illuminates the taxpayers' subjective motivation. 330 F. Supp. 2d at 180. Regardless of whether taxpayers are required to prove one or both prongs of the economic substance test, we conclude that this transaction lacked economic substance because we believe that Taxpayer had neither a subjective business purpose nor an objective reasonable expectation of profit.

Mahoney v. Comm'r, 808 F.2d 1219, 1220 (6th Cir. 1987) (inquiry is whether transaction has any practical economic effects beyond the creation of tax benefits); *Boynton v. Comm'r,* 649 F.2d 1168, 1172 (5th Cir. Unit B 1981) (transactions that have no economic effect other than creation of tax losses are shams); *Tolwinsky v. Comm'r,* 86 T.C. 1009, 1037 (1986) ("where transactions serve no 'purpose, substance, or utility apart from their anticipated tax consequences' they are disregarded for tax purposes"); *Julien v. Comm'r,* 82 T.C. 492 (1984) (interest expenses incurred in silver straddles disallowed under I.R.C. § 162(a) because transactions served no economic purpose beyond generating interest deductions); *cf. Frank Lyon Co. v. United States,* 435 U.S. 561, 583-84 (1978) (where "there is a… transaction…imbued with tax-independent considerations, and. . . not shaped solely by tax-avoidance features, the transaction is not a sham.").

A pair of Circuit Court decisions addressed the appropriate method of measuring pre-tax economic profit in cases involving foreign tax credits. *See Compaq Computer Corp. v. Comm'r*, 277 F.3d 778 (5th Cir. 2001); *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001). These decisions reversed the Tax Court and district court, respectively, and concluded it was inappropriate to deduct the cost of foreseeable foreign taxes imposed on the transaction in determining the expected pre-tax profit of a transaction Neither the Supreme Court nor any other Circuit Court has considered this issue.

<u>Taxpayer had No Reasonable Expectation of Economic Profit</u>

Based on the substantial factual record developed to date, we conclude that Taxpayer did not have a realistic expectation of profit before U.S. tax benefits are taken into account. As noted above, Taxpayer produced a document that purported to describe its probable return on the transactions and which Taxpayer conceded represented the culmination of all of its analysis. Even if the assumptions used in that document are accepted at face value, the analysis described in the document indicates that Taxpayer expected to suffer a loss on the transaction before U.S. tax benefits were taken into account. That is, the document indicates that Taxpayer had a 49% chance of earning an economic profit of up to approximately Amount 17. If Taxpayer had a 49% chance of earning a pre-U.S. tax profit, it necessarily follows that Taxpayer also had a 51% chance of earning a pre-U.S. tax loss. Moreover, an examination of the possible outcomes from the sale of the Shares and the Options reveals that the maximum possible loss on the transaction was likely at least four times as large as the maximum possible profit.[15] A rational investor plainly would not have engaged in the transaction given a negative expected return if it were not for the substantial benefit conferred by the foreign tax credit. Taxpayer's representative all but conceded this point in its interview by acknowledging that, but for the U.S. tax benefits arising from the transaction, "it may be that the transaction would not have met the required return."

[15] The maximum loss on the transaction would be incurred if the Shares were sold at or above Amount 10 (i.e., the upper value used in the collar feature of the Options). At that price, the gain recognized on the sale of the Shares reduced by the Country X tax expense and the amount owed by Taxpayer under the call Option would have been a loss of approximately Amount 18.

It also appears that Taxpayer's analysis of the expected return from the transaction may have materially understated the expected loss arising from the transaction for at least two reasons. First, Taxpayer's document indicates that the probability that the value of the Shares would fall enough for Taxpayer to earn a net profit was derived based on a starting value of the Shares of Amount 7 per share, rather than the substantially higher Amount 6 value used to determine the actual purchase price of the Disregarded Entities. We believe that if the Taxpayer's methodology were applied using the higher value, the probability that the value of the Shares would fall below Amount 19 by the expiration of the Options would necessarily be lower and, in turn, the expected loss would necessarily be larger. Second, the calculations in Taxpayer's analysis included only the anticipated Country X tax in determining the pre-U.S. tax profit from the transaction, even though substantial Country Y taxes would have been imposed in any fact pattern in which Taxpayer might have recognized a pre-U.S. tax profit.[16] Taxpayer did not quantify those taxes, but it appears that they may have substantially reduced, if not eliminated, any possible pre-U.S. tax profit arising from the transaction. For these reasons, we conclude that Taxpayer failed to establish that it reasonably expected to earn a pre-U.S. tax profit from the transaction and, therefore, it failed the objective prong of the economic substance test.

In reaching this conclusion, we note that Taxpayer resides in the Second Circuit, which is not bound to follow the portions of the Fifth and Eighth Circuit decisions in *Compaq* and *IES* that conclude that, for purposes of the economic substance analysis, the pre-tax profit should be determined without taking into account the cost of the expected foreign tax on the transaction. The failure of those courts to subtract the economic cost to the taxpayer of the foreign tax undermines the test's purpose of determining whether the taxpayer had a real potential for profit apart from the transaction's U.S. tax benefits (*i.e.*, the foreign tax credit). In determining whether a taxpayer had a reasonable possibility of economic profit, all of a taxpayer's items of income and expense must be taken into account. Economically, a foreign tax is no different from any other expense, and therefore foreign taxes are properly treated as a cost that reduces economic profit. If a taxpayer's return is negative before U.S. tax consequences are taken into account, as is the case here, it necessarily follows that the benefit of the foreign tax credit motivated the transaction. Ignoring foreign taxes as a cost in determining the pre-U.S. tax return on a transaction would deprive the economic substance test of the very measure it is designed to illuminate – the return on the transaction prior to the claimed U.S. tax benefits. Additionally, it is noteworthy that the bulk of Taxpayer's own analysis

[16] Taxpayer's opportunity to earn an economic profit arose only in cases where the gain on the put Option exceeded the losses from the other elements of the transaction. As a consequence of those relationships, Taxpayer's after-Country X profit would increase as the ending value of the Shares decreased and, conversely, it would suffer larger losses as the ending value of the Shares increased. As indicated in Taxpayer's analysis, Taxpayer would have earned a net profit after Country X tax only if the ending price of the Shares fell below Amount 19. The gain on the put Option in any such "profitable" outcome would have been subject to Country Y tax because the put Option was held by Taxpayer's Country Y subsidiary.

of its probable return from the transaction subtracted the Country X tax in determining its expected “cash profit.”

Taxpayer had No Business Purpose

Taxpayer provided only minimal and self-serving evidence of the requisite business purpose. Employee 1 asserted that Taxpayer entered the transaction to “make money,” but the only evidence provided by Taxpayer of its probability of making money apart from U.S. tax benefits was the document described above. For the reasons explained in connection with the objective test, the analysis in that document only serves to undermine Taxpayer’s self-serving explanation. Rather than demonstrating that Taxpayer expected to make money, it establishes that Taxpayer expected to lose money apart from the claimed tax benefits.

The facts of this case are analogous to those in *Goldstein*, in which the taxpayer claimed deductions for the prepaid interest on certain loans used to fund the acquisition of Treasury bonds. The Second Circuit upheld the disallowance of the interest deductions on the ground that the transaction had “no substance or purpose aside from the taxpayer’s desire to obtain the tax benefit of the interest deduction; and a good example of such purposeless activity is the borrowing of funds at 4% in order to purchase property that returns less than 2% and holds out no prospect of appreciation sufficient to counter the unfavorable interest rate differential.” 364 F.2d at 741-42 (emphasis added). In this case, the Taxpayer purported to acquire the Disregarded Entities based on its valuation of the Shares on Date 1 at Amount 4. However, Taxpayer simultaneously committed to put itself in the economic position of selling the Shares back to Seller six weeks later for Amount 8 (i.e., approximately 10 percent less than Amount 4). Just as one would not purposely borrow at 4% to earn interest at 2%, one would not rationally buy an asset with a value of Amount 4 and simultaneously commit to sell it for substantially less.[17] Such a transaction is the kind of ”purposeless activity” that the Tax Code was not intended to reward. On the contrary, Taxpayer’s purported acquisition of the Disregarded Entities and its agreement to put the parties in the position of selling the Shares back to Seller for less than the value at which they were purchased is best understood as a payment for tax benefits. Either the purchase price of the Disregarded Entities or the exercise price of the Options (or both) must have failed to reflect their fair market value. *See also Rice’s Toyota World*, 81 T.C. at 210 (purported down payment for asset based on inflated purchase price recharacterized as “fee to purchase tax savings”).

[17] This also further distinguishes the transaction from those addressed in *Compaq* and *IES*. The *Compaq* and *IES* courts placed significant weight on the taxpayers’ exposure to the risks of ownership of the ADRs, even if only for a brief period. *See Compaq*, 277 F.3d at 787; *IES*, 253 F.3d at 355. In this transaction, however, Taxpayer hedged its risk with respect to the Shares by synthetically committing to sell the Shares for the consideration stated in the Options. By fixing the exercise price for the sale of the Shares under the Options and agreeing to make Seller whole for any dividends declared in the interim, Taxpayer relinquished both the benefits and burdens of ownership of the Shares from the outset of the transaction.

Transaction was Inconsistent with the Purpose of the Foreign Tax Credit

Taxpayer's attempt to claim the foreign tax credits arising from the transaction fails the fundamental test identified by the Supreme Court in *Gregory* -- "whether what was done, apart from the tax motive, was the thing that the statute intended." 293 U.S. at 469. The foreign tax credit was intended to alleviate double taxation in order to prevent taxes from unduly changing taxpayers' business behavior. *See American Chicle Co. v. United States*, 316 U.S. 450 (1942); *Burnet v. Chicago Portrait Co*., 285 U.S. 1 (1932). During the floor debate surrounding the enactment of the foreign tax credit, the Chairman of the Ways and Means Committee explained the credit's rationale as follows:

> That is not only a just provision, but a very wise one. It is wise from the standpoint of the commerce of the United States, of the expansion of business in the United States. …We would discourage men from going out after commerce and business in different countries if we maintained this double taxation. They would take their corporations that are American corporations and reorganize them, getting their charters in such foreign countries, if we did not do this, and we might not be able to tax their income and profits at all. Another thing: If we did not do that, a man would become a citizen of another country instead of retaining his citizenship here in order to escape the large and double taxation imposed.

56 Cong. Rec. App. 677 (1918) (statement of Mr. Kitchin). Congress thus intended the foreign tax credit to <u>reduce</u> the influence of taxes on business decisions.

The foreign tax credit was never intended to motivate taxpayers to engage in transactions that are expected to result in an economic loss. Similarly, the court in *Friendship Dairies, Inc. v. Comm'r*, 90 T.C. 1054,1065-67 (1988), stated that "[t]he [investment tax] credit was not intended to serve as a substitute for economic profit," and "[i]t would be a distortion of congressional intent to conclude that it was intended that petitioner be induced to engage in a paper transaction that did not in any way affect" the market. Instead, the foreign tax credit was intended to allow taxpayers to evaluate various business options based on their economic merits without considering the possibility of double taxation. The credit was thus meant to reduce tax distortion of profit-oriented transactions, not to encourage purely tax-motivated transactions like this one. As the Second Circuit in *Goldstein* explained with respect to the interest deduction:

> to allow a deduction for interest paid on funds borrowed for no purposive reason, other than the securing of a deduction from income, would frustrate Section 163(a)'s purpose; allowing it would encourage transactions that have no economic utility and that would not be engaged in but for the system of taxes imposed by Congress.

364 F.2d at 742.

Taxpayer's transaction falls well outside the intended purpose of the foreign tax credit. Rather than using the foreign tax credit to mitigate the double taxation of its income, Taxpayer and Seller separated the foreign tax credits from the income to which they related, shifted the foreign tax credit to a party willing and able to claim the credits and passed part of the value of such credits to Hedge Fund. Congress did not intend the foreign tax credit to encourage investments in foreign companies by non-U.S. persons. Therefore, the transaction undertaken by Taxpayer was not "the thing the statute intended." *Gregory*, 293 U.S. at 469.

Taxpayer's attempt to secure foreign tax credits in this case is defective because the transaction lacked a bona fide business purpose, a reasonable expectation of profit apart from tax benefits and was contrary to the legislative purpose of the foreign tax credit regime. Accordingly, Taxpayer should be treated for U.S. tax purposes as if it had not undertaken the transaction and, therefore, Taxpayer should not be entitled to claim any foreign tax credits arising from the transaction.

Step Transaction

"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." *Del Commercial Properties, Inc. v. Comm'r*, 251 F.3d 210, 213 (D.C. Cir. 2001); *cf. Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613 ("The preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands, so transparently artificial that further discussion would be a needless waste of time."). "Whether invoked as a result of the 'binding commitment,' 'interdependence,' or 'end result' tests, the doctrine combines a series of individually meaningless steps into a single transaction." *Esmark v. Comm'r*, 90 T.C. 171, 194 (1988), *aff'd*, 886 F.2d 1318 (7th Cir. 1989) (rejecting application of step transaction doctrine to public tender followed by redemption on the basis that "respondent has pointed to no meaningless or unnecessary steps that should be ignored").

The courts have applied three distinct formulations of the step transaction doctrine: (1) the end result test, (2) the mutual interdependence test, and (3) the binding commitment test. Under the end result test, a series of transactions are stepped together if they are prearranged parts of a single transaction intended from the outset to reach a specific end result. *Penrod v. Comm'r*, 88 T.C. 1415, 1429 (1987). The end result test focuses on the actual intent of the parties at the beginning of the series of transactions. *Greene v. United States*,13 F.3d 577, 583 (2d Cir. 1994) ("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."). Under the mutual interdependence test, the separate steps are analyzed to determine if the legal relationships created by one transaction would be fruitless without the completion of the entire series of transactions. *Redding v. Comm'r*, 630 F.2d 1169, 1177 (7th Cir. 1980), *cert. denied*, 450 U.S. 913 (1981). Under the binding commitment test, a series of transactions will be stepped together if there is a binding commitment to undertake the later steps. *Comm'r v. Gordon*, 391 U.S. 83 (1968).

In *Long-Term Capital Holdings*, 330 F. Supp. 2d at 122, the district court applied the step transaction doctrine and held that a purported acquisition of interests in a partnership subject to a put option to dispose of those interests was properly disregarded under the end result test. The court concluded that the transactions at issue were conceived solely to transfer a substantial built-in capital loss to the taxpayer from a foreign entity unable to utilize such losses. This was effected by the contribution of the built-in loss property to the partnership in return for the partnership interests, the execution of a put option to dispose of those interests approximately fifteen months thereafter, and a subsequent sale of the interests to the prior owners of the partnership. The court also concluded that, in light of the absence of any non-tax motives for the foreign entity's investment in the partnership and the put option insuring the foreign entity's ability to dispose of its interests promptly, the ultimate disposition of the partnership interests was part of a pre-arranged plan to transfer the built-in loss property to the partnership in return the net proceeds paid to the foreign entity. *Id*. at 191-92. The Second Circuit affirmed the district court's application of the step transaction doctrine. *Long-Term Capital Holdings v. U.S.,* 2005 U.S. App. LEXIS 20988 (2d Cir. Sept. 27, 2005).

In Notice 2004-20, 2004-1 C.B. 608, Treasury and the Service identified as a listed transaction a fact pattern in which a domestic corporation claims foreign tax credits arising from its transitory ownership of certain foreign assets. The transaction described in the Notice involves a series of prearranged steps under which the intermediary corporation (Midco) acquires shares in a foreign entity and shortly thereafter sells the assets of the foreign entity to an unrelated purchaser, recognizing no gain for U.S. tax purposes but triggering a foreign income tax on the asset sale for which Midco claims foreign tax credits. The Notice states:

> The Service will challenge the purported tax results to Midco of the transaction described in this notice by applying principles of existing law. *See* Notice 2001-16, 2001-1 C.B. 730 (announcing that the Service may challenge the purported tax consequences of a purported sale of stock to a tax-indifferent intermediary corporation that then purports to sell the target's assets). For example, the Service may challenge the purported tax results to Midco under the step transaction doctrine or the substance over form doctrine.

Based on the substantial record developed to date, Taxpayer's purported acquisition of legal title to the Disregarded Entities is substantially similar to the facts of *Long-Term Capital* and Notice 2004-20.[18] Like those cases, the facts in this instance indicate a pre-arranged plan to dispose of the Shares at the expiration of the Options. Both parties conceded that they expected Taxpayer to sell the Shares upon expiration of the Options and that the failure to realize that expectation would have been inconsistent with both parties' established business practice of avoiding volatility risks on their investments generally. Taxpayer also indicated that, even if it were inclined in limited instances to take an unhedged position on an investment, this would not be such a case because Taxpayer's research department had opined that the Shares were expected to fall in value. Taxpayer also stated that, before agreeing to enter the transaction, it determined its probable return from the transaction by assuming it would pay Country X taxes on the sale of the Shares upon expiration of the Options. Seller had also engaged in similar sale and repurchase transactions involving the Shares prior to the transfer to Taxpayer and, in this case, negotiated in advance with Hedge Fund to be made whole for Country X taxes incurred on the subsequent repurchase of the Shares from Taxpayer. Therefore, the evidence strongly supports the conclusion that Taxpayer's sale of the Shares was prearranged at the time of the initial transfer of title.

Indeed, in various respects, the facts in this case present a more compelling case than those in *Long-Term Capital Holdings* or Notice 2004-20 for disregarding Taxpayer's transitory acquisition of the Disregarded Entities and the Shares. The district court in *Long-Term Capital Holdings* cited the put option as evidence of pre-arrangement, but Taxpayer's transaction involved a pair of put and call options with identical exercise prices. The presence of both put and call options is significant because it essentially guaranteed that either Seller or Taxpayer would exercise its right to effectively sell the Shares at the expiration of the Options.[19] Therefore, Taxpayer's intent to dispose of the Shares is substantially clearer on these facts. We also believe it is significant that one controlled group – Seller and its wholly-owned affiliates – was both the seller and the end-purchaser in the transaction at issue. As noted above, Seller had engaged in similar sale/repurchase transactions before undertaking the transaction at issue and approached an unrelated party (Taxpayer) only after determining it could not claim the foreign tax credits from another such sale. The fact that the same controlled group was involved in the beginning and ending steps in the transaction strongly suggests that the ultimate outcome was planned from the outset. *Cf*. *Frank Lyon Co.,* 435 U.S. at 583 (respecting intermediary's sale-leaseback where "there is a genuine multi-party transaction"). Accordingly, we conclude that the end result test is satisfied under these facts.

[18] Taxpayer did not disclose the transaction on its Year 2 tax return. However, Year 2 preceded the effective date of disclosure obligations for transactions described in Notices 98-5 and 2004-20 and under the brief asset holding period rules. *See* Treas. Reg. §1.6011-4**.**

[19] The only circumstance in which exercise might not occur would be if the value of the Shares was exactly equal to the strike price on the exercise date. We believe that the probability of that event was trivial.

We also conclude that the mutual interdependence test is satisfied under these facts. Neither Taxpayer nor Seller had any interest in making a real investment in Issuer. Seller's interest was limited to holding the Shares for the benefit of Hedge Fund and Taxpayer's interest in the Shares was offset by its position under the Options. Neither party would have undertaken the original transfer of the Disregarded Entities without the subsequent sale and repurchase of the Shares because the failure to complete the transaction would have exposed both parties to unwanted investment risks. Seller was compelled to reacquire the Shares (or the same number of shares of Issuer) upon expiration of the Options to maintain its hedged position relative to Hedge Fund and, similarly, Taxpayer was compelled to dispose of the Shares to avoid taking an unhedged position in the Shares once the Options expired. Taxpayer also indicated that it believed that the Shares were a poor investment at the time it acquired legal title to the Disregarded Entities. Therefore, the record indicates that Taxpayer would not have purchased the Disregarded Entities (which held the Shares) unless it was also going to dispose of the Shares at the expiration of the Options. Under these circumstances, Taxpayer's initial acquisition of title to the Disregarded Entities and the transfer of title to the Shares to Seller approximately two months later were mutually interdependent.

Therefore, under either the end result or mutual interdependence tests, the substance of the transaction was a transfer of title to the Shares from the Disregarded Entities (owned by Seller at the time) to one of Seller's wholly-owned affiliates. Taxpayer's sole purpose for its transitory participation in the transaction was to obtain foreign tax credits attributable to the foreign taxes imposed on the transfer of the Shares within the Seller's controlled group. Because Taxpayer in substance did not acquire the Disregarded Entities that held the Shares, it cannot claim any foreign tax credits for the Country X taxes imposed on the Disregarded Entities. U.S. law assigns the right to claim credits to the taxpayer with legal liability for the tax under foreign law. Treas. Reg. §1.901-2(f)(1). Country X viewed the Disregarded Entities as the party with legal liability for the taxes. Because Taxpayer did not, in substance, acquire the Disregarded Entities, it is not eligible to claim the credits for the Country X tax imposed on the Disregarded Entities.[20]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[20] No inference is intended as to whether Seller may claim any U.S. tax benefits arising from its transfer of the Shares from the Disregarded Entities to its affiliate. As noted above, Seller had no economic interest in the Shares under its options with Hedge Fund and, therefore, is not generally regarded as the owner of the Shares for U.S. tax purposes. *See* Rev. Rul. 82-150 ("option" acquired for 70% of value of underlying shares amounted to purchase of underlying stock for tax purposes).

[redacted]

[redacted]

[redacted]

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