

## International Tax Changes in the Taxpayer Relief Act of 1997

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On August 5, 1997, President Clinton signed into law the Taxpayer Relief Act of 1997 (the "Act"). While the Act's domestic provisions, such as the reduction in tax rates applicable to capital gains, have garnered the lion's share of attention, the Act does contain significant international tax changes, most notably—

- Elimination of the 35 percent excise tax of Internal Revenue Code sections 1491 through 1494 on transfers to foreign entities, albeit at the cost of introduction of a gain recognition regime and increased information reporting requirements,
- Grant of regulatory authority to prescribe new rules concerning the classification of partnerships as foreign or domestic,
- Anti-abuse provisions regarding the entitlement of owners of hybrid entities to the benefits of U.S. income tax treaties,
- Repeal of the principal office requirement and attendant demise of the "ten commandments,"
- Foreign tax credit changes, including making the indirect credit available for foreign taxes paid by certain fourth, fifth and sixth-tier subsidiaries and modification of the method for translating accrued foreign taxes,
- Introduction of an elective "mark-to-market" alternative for marketable passive foreign investment company stock,
- Additional transitional relief for trusts affected by the foreign trust provisions of the Small Business Job Protection Act of 1996 and
- Extension of foreign sales corporation benefits for computer software exported with a right to reproduce.

See "*Materials Available On-Line*" on page 11 for a list of and links to the legislative and administrative materials discussed in this bulletin.

The discussion in this bulletin of the Act's international tax changes is categorized as follows—

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### Transfers to Foreign Entities

#### *Repeal of 35 Percent Excise Tax*

The Act repeals the 35 percent excise tax and information reporting requirements of Internal Revenue Code sections 1491 through 1494, effective August 5, 1997, the date of the Act's enactment. *Act* § 1131(a), (e).<sup>1</sup> Taxpayers are now generally required to recognize gain on transfers to foreign trusts (other than grantor trusts) and foreign estates. A domestic trust which becomes a foreign trust (e.g., due to the rules enacted in the Small Business Job Protection Act of 1996) is treated as transferring its assets to a foreign trust. *Act* § 1131(b) adding I.R.C. § 684. To

prevent abuses following repeal of the 35 percent excise tax, the Act authorizes regulations which can provide that—

- The general nonrecognition rule under Internal Revenue Code section 1035 for certain exchanges of insurance policies does not apply to transfers to a foreign person (Act § 1131(c)(1), adding I.R.C. § 1035(c)),

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<sup>1</sup> The enrolled version of section 1131 of the Act contains two provisions designated subsection (b). The second of such subsections and ensuing subsections (c) and (d) are referred to herein as subsections (c) through (e), respectively.

- Gain must be recognized on transfers to foreign corporations as paid in surplus or contributions to capital which are not otherwise described in Internal Revenue Code section 367 (Act § 1131(c)(2), adding I.R.C. § 367(f)) and
- Internal Revenue Code section 721(a) does not apply to prevent recognition of gain on transfers to foreign partnerships if that gain, when ultimately realized, would be includable in the income of a person other than a U.S. person (Act § 1131(c)(3), adding I.R.C. 721(c)).

### *Information Reporting and Related Penalties*

#### *U.S. Tax Returns of Foreign Partnerships*

The Act clarifies that foreign partnerships are not generally required to file a U.S. tax return unless they have gross income either from U.S. sources or effectively connected with the conduct of a U.S. trade or business. *Act § 1141(a), adding I.R.C. § 6031(e)*. Failure to comply with applicable filing requirements now results in the loss of partnership deductions, as well as of losses and credits as under prior law. *Act § 1141(b), amending I.R.C. § 6231(f)*. These changes are effective for taxable years beginning after August 5, 1997, the date of the Act's enactment. *Act § 1141(c)*.

#### *Controlling Partners and Shareholders and 10 Percent U.S. Partners*

The Act conforms the information reporting requirements applicable to a U.S. person who controls a foreign partnership to the requirements applicable to a U.S. shareholder controlling a foreign corporation. Control is defined as the direct or indirect ownership of 50 percent or more of the capital interest or profits interest in a partnership or, to the extent provided in regulations, ownership of an interest to which 50 percent or more of partnership deductions or losses are allocated (a "50-percent interest"). A U.S. controlling partner must file an annual information return containing—

- The name, principal place of business and nature of business of the foreign partnership and the country under the laws of which the partnership is organized,
- A balance sheet listing assets, liabilities and capital,
- Information regarding related party transactions and
- Information comparable to the information required of foreign corporations regarding their equity capitalization and names, addresses and number of shares of all U.S. persons who are five percent or greater shareholders.

In the circumstances where a foreign partnership is not controlled by any one U.S. partner, but is controlled by U.S. partners each of which holds at least a 10 percent interest in the capital or profits of the foreign partnership or, to the extent provided in regulations, an interest allocated at least 10 percent of partnership deductions or losses (a "10-percent interest"), regulations may require each such 10 percent U.S. partner to provide information regarding the partnership.

Failure to provide required information can lead to imposition of a \$10,000 penalty for each annual return. In the case of returns required of U.S. controlling shareholders, the penalty under prior law was \$1,000. If the failure to comply continues for more than 90 days after notice from the Internal Revenue Service, an additional penalty of \$10,000 (\$1,000 under prior law for U.S. controlling shareholders) is imposed, up to a maximum of \$50,000 (\$24,000 under prior law for such shareholders) for each 30-day period (or fraction thereof) following expiration of the 90-day period and during which the failure to comply continues. In addition, as was already the case for U.S. controlling shareholders, noncompliance can lead to reduction of available foreign tax credits. *Act § 1142, amending I.R.C. § 6038*.

These information reporting rules and related penalties apply to annual accounting periods beginning after August 5, 1997, the date of the Act's enactment. *Act § 1142(f)*.

#### *Changes in Ownership in Foreign Partnerships and Affecting Foreign Corporations*

The Act revises Internal Revenue Code section 6046A so that a U.S. person is now required to report the acquisition or disposition of an interest in a foreign partnership only if the U.S. person directly or indirectly holds at least a 10-percent interest in the foreign partnership either before or after the transaction. Similarly, reporting of substantial changes in proportional interests is required of U.S. persons only if the change is equivalent to at least a 10-percent interest in the foreign partnership. *Act § 1143, amending I.R.C. § 6046A*.

The Act also amends Internal Revenue Code section 6679 to increase the penalty for failure to file (i) information returns regarding changes in ownership in foreign partnerships (I.R.C. § 6046A) and (ii) information returns regarding organization and reorganization of foreign corporations and acquisitions of their stock (I.R.C. § 6046) from \$1,000 to \$10,000. In addition, if the failure to comply continues for more than 90 days after notice from the Internal Revenue Service a further penalty of \$10,000 is imposed for each 30-day period (or fraction thereof) following expiration of the 90-day period during which the failure continues, subject to a maximum limitation of \$50,000. These increased penalties do not apply in the case of failure to file information returns by officers, directors or shareholders of foreign personal holding companies (I.R.C. § 6035). These revised information reporting rules and penalties apply to transactions and changes in percentage interests occurring after August 5, 1997, the date of the Act's enactment. *Act § 1143, amending I.R.C. §§ 6046A, 6679.*

#### *Transfers to Foreign Entities*

The Act imposes information reporting requirements on transfers of property by U.S. persons to foreign partnerships comparable to requirements of existing law applicable to transfers to foreign corporations. However, a U.S. person is required to report a transfer of property to a foreign partnership in a contribution described in Internal Revenue Code section 721 or in any other contribution described in regulations only if—

- The U.S. person holds (directly or indirectly) at least a 10-percent interest in the partnership immediately following the transfer or
- The value of property transferred to the partnership by the U.S. person or any related person during the 12-month period ending on the date of transfer exceeds \$100,000.

The penalty for failure to file the required information return is 10 percent of the fair market value of the transferred property, subject to a \$100,000 ceiling unless the failure to file is due to intentional disregard. This penalty also applies in the case of failures to file information returns regarding transfers to foreign corporations; prior to the Act the penalty for failures to file regarding such transfers was 25 percent of the gain in the property, with no ceiling. In addition, in the case of failure to file an information return regarding a transfer to a foreign partnership, the transferor is required to

recognize gain as if the transferred property had been sold at fair market value at the time of transfer. These new rules are effective for transfers made after August 5, 1997, the date of the Act's enactment. *Act § 1144, amending I.R.C. § 6038B.*

#### *Extension of Statute of Limitations for Foreign Transfers*

Prior to the Act, Internal Revenue Code section 6501(c)(8) extended the statute of limitations in the case of any tax imposed on any exchange or distribution by reason of subsection (a), (d) or (e) of Internal Revenue Code section 367 until three years following filing of the information required under Internal Revenue Code section 6038B. The Act expands this provision to apply to any information which is required to be reported under Internal Revenue Code section 6038 (controlled foreign corporations and foreign partnerships), 6038A (foreign-owned domestic corporations), 6038B (transfers to foreign corporations and foreign partnerships), 6046 (organization and reorganization of foreign corporations and acquisitions of their stock), 6046A (interests in foreign partnerships) and 6048 (foreign trusts). In these cases, the time for assessment of any tax imposed with respect to any event or period to which such information relates cannot expire before three years following the date on which the required information is provided. This change applies to information the due date for the reporting of which is after August 5, 1997, the date of the Act's enactment. *Act § 1145, amending I.R.C. § 6501(c)(8).*

#### *Increase in Section 6046 Reporting Threshold*

Finally, the Act also amends Internal Revenue Code section 6046 (organization or reorganization of foreign corporations and acquisitions of their stock) to increase the stock ownership threshold triggering reporting requirements from five percent (by value) to 10 percent (by either vote or value). This change is effective on January 1, 1998. *Act § 1146, amending I.R.C. § 6046(a).*

#### *Transfers of Intangibles*

The Act repeals the rule which treats as U.S. source income any deemed royalty arising under Internal Revenue Code section 367(d). *Act § 1131(c)(4), amending I.R.C. § 367(d)(2)(C).* Thus, the section 367 "super royalty" amounts will have the same source as would actual royalty payments. The Act also grants authority for regulations to apply the "super royalty" rules in the case of transfers of intangibles by U.S. persons to partnerships. *Act § 1131(c)(5), adding I.R.C. § 367(d)(3).*

### Classification of Partnerships as Domestic or Foreign

The Act grants the Internal Revenue Service regulatory authority to override the general rule of Internal Revenue Code section 7701(a)(4) which provides that a domestic partnership is one created or organized in the United States or under the law of the United States or any State. The legislative history states that it is expected that—

- The classification of a partnership as foreign or domestic will be based only on material factors such as the residence of the partners and the extent to which the partnership is engaged in business in the United States or earns U.S. source income and
- Regulations will provide guidance regarding the determination of whether an entity that is a partnership for federal income tax purposes is to be considered to be created or organized in the United States or under the law of the United States or any State.

The Conference Committee report clarifies Congressional intent by specifying that it is expected that the regulations will provide a different classification result only in unusual cases and will avoid period-by-period reclassification of partnerships. Any regulations are to apply only to partnerships created or organized after the effective date of such regulations. *Act § 1151, amending I.R.C. § 7701(a)(4).*

### Hybrid Entity Treaty Benefits

So-called “hybrid entities,” particularly entities classified as partnerships for U.S. federal income tax purposes but as corporations under the tax laws of a foreign jurisdiction (e.g., limited liability companies), present significant tax planning opportunities. An example discussed in the Act’s legislative history relates to interposition of a U.S. limited liability company between a U.S. subsidiary and its Canadian parent corporation. For U.S. federal income tax purposes, interest paid to the limited liability company (a partnership for such purposes) is deductible by the U.S. subsidiary and subject only to a 10 percent withholding tax by virtue of the U.S.–Canada Income Tax Treaty. However, for Canadian tax purposes, the Canadian parent is subject to tax only upon receipt of distributions from the limited liability company which, because the limited liability company is treated as a corporation for such purposes, are treated as exempt dividends. While the only tax avoided by this scheme is a Canadian one on interest income (as interest

paid directly by a U.S. subsidiary to its Canadian parent would be similarly deductible and subject to the same U.S. withholding tax), Congress nonetheless sought to end what it felt was an abuse of the U.S. treaty network.

Under the Act, a foreign person is not entitled to a reduced rate of U.S. withholding tax under the provisions of a U.S. income tax treaty with respect to any income derived through a partnership (or other entity treated as fiscally transparent for U.S. federal income tax purposes) if—

- The income is not treated as income of the foreign person under the laws of foreign person’s country (i.e., the partnership or other entity is not fiscally transparent under the laws of that country),
- The treaty does not address its applicability in the case of income derived through a partnership and
- The foreign country does not impose tax on the foreign person’s receipt of a distribution from the partnership or other entity.

In addition, regulations are to be prescribed to determine the extent to which a foreign taxpayer not covered by the new rules is entitled to treaty benefits with respect to payments received by or income attributable to the activities of an entity organized in any jurisdiction (including the United States) which is fiscally transparent for U.S. federal income tax purposes (e.g., a common investment trust, a grantor trust or a disregarded single member entity) but is not fiscally transparent under the laws of the taxpayer’s country of residence. *Act § 1054(a), adding I.R.C. 894(c).* The Act’s legislative history specifically states that proposed and temporary regulations published by the U.S. Internal Revenue Service in the July 2, 1997 edition of the Federal Register are consistent with the Act. *See T.D. 8722, adopting Temp.Income Tax Regs. § 1.894-1T.* The new rules are effective August 5, 1997, the date of the Act’s enactment. *Act § 1054(b).*

### Repeal of Principal Office Requirement

The Act strikes the requirement in Internal Revenue Code section 864(b)(2)(A)(ii) which treated certain foreign corporations and partnerships trading in stock or securities for their own accounts as not engaged in a U.S. trade or business only if their principal office was outside the United States. These foreign corporations and partnerships will no longer need to comply with the so-called “ten commandments” of Income Tax Regulations section 1.864-2(c)(2)(iii) to ensure that their principal

offices are treated as located outside of the United States in order to prevent their stock and security trading activities from constituting a U.S. trade or business. This change is effective for taxable years beginning after December 31, 1997. *Act § 1162, amending I.R.C. § 864(b)(2)(A)(ii).*

### Foreign Tax Credit Provisions

#### *Holding Period Requirement for Foreign Tax Credit for Dividend Taxes*

Recipients of dividends must now have held the underlying stock for more than 15 days (45 days in the case of certain dividends on preferred stock) in order to be eligible for the foreign tax credit for withholding taxes imposed on the dividend. A similar rule applies for purposes of the indirect foreign tax credit for 10-percent or greater corporate shareholders and for dividends from a regulated investment company. Certain taxes paid by securities dealers are not subject to the new rules. A shareholder's holding period for stock does not include any period during which the shareholder is protected against risk of loss, using the rules of Internal Revenue Code section 246(c) applicable to the dividends-received deduction. No deduction is available for any taxes which cannot be credited under the new provision. *Act § 1053(a), adding I.R.C. § 901(k).* The new rules apply to dividends paid or accrued more than 30 days after August 5, 1997, the date of the Act's enactment. *Act § 1053(c).*

#### *Lower-Tier Subsidiaries and the Indirect Foreign Tax Credit*

The Act extends the indirect foreign tax credit to taxes paid by certain fourth, fifth and sixth-tier foreign corporations if—

- The foreign corporation is a controlled foreign corporation,
- The U.S. corporation claiming the foreign tax credit is a United States shareholder in the foreign corporation and
- The U.S. corporation's interest in the foreign corporation aggregates at least five percent.

Further, for fourth, fifth and sixth-tier foreign corporations, the indirect foreign tax credit is available only for taxes paid or incurred in taxable years during which the foreign corporation is a controlled foreign corporation. *Act § 1113(a), (b), amending I.R.C. §§ 902(b), 960(a)(1).* These new rules apply to taxes of foreign corporations for their taxable years beginning after

August 5, 1997, the date of the Act's enactment. *Act § 1113(c)(1).* However, in the case of a chain of corporations, no liquidation, reorganization or similar transaction occurring after August 5, 1997 can have the effect of permitting otherwise noncreditable taxes to become eligible for the indirect foreign tax credit. *Act § 1113(c)(2).*

#### *Dividends from "10/50 Companies"*

Effective for taxable years beginning after December 31, 2002, the foreign tax credit limitation for dividends from noncontrolled section 902 corporations (so-called "10/50 companies") treats all 10/50 companies as one corporation with respect to dividends from earnings and profits accumulated in taxable years beginning before January 1, 2003, thus eliminating the separate limitation currently applicable to dividends from each 10/50 company. *Act § 1105(a), amending I.R.C. § 904(d)(1)(E) and adding I.R.C. § 904(d)(2)(E)(iv); Act § 1105(c).*

For dividends from post-2002 earnings and profits, and also effective for taxable years beginning after December 31, 1997, the Act adopts a look-through rule, under which the dividend is allocated among the various foreign tax credit limitation "baskets" based upon the ratio of the earnings and profits of the distributing corporation attributable to each "basket" to its total earnings and profits. Regulations may prescribe the treatment of dividends from earnings and profits for periods prior to the recipient's acquisition of stock. *Act § 1105(b), adding I.R.C. § 904(d)(4); Act § 1105(c).*

#### *Deemed 10/50 Company Status*

By repealing a provision of the Technical and Miscellaneous Revenue Act of 1988, and effective for distributions after August 5, 1997, the date of the Act's enactment, the Act eliminates the rule which treated a controlled foreign corporation as a 10/50 company with respect to any distribution out of earnings and profits accumulated while it was a controlled foreign corporation if the recipient was not a 10-percent shareholder when those earnings and profits were generated. *Act § 1111(b), amending I.R.C. § 904(d)(2)(E)(i); Act § 1111(c)(2).*

#### *Exemption from Foreign Tax Credit Limitation*

The Act specifies that individuals with no more than \$300 (\$600 in the case of a joint return) of creditable foreign taxes and whose foreign source income consists entirely of passive income may elect not to be subject to

the foreign tax credit limitation. It is expected that individuals making the election will no longer be required to file Internal Revenue Service Form 1116 to claim the foreign tax credit. However, no excess foreign taxes may be carried to or from a taxable year for which the election is effective. For purposes of this new provision passive income includes foreign personal holding company income and inclusions under the foreign personal holding company and passive foreign investment company rules. However, passive income and creditable foreign taxes are limited to amounts shown on “payee statements,” as defined in Internal Revenue Code section 6724(d)(2). *Act § 1101(a), adding I.R.C. 904(j)*. The new election is applicable to taxable years beginning after December 31, 1997. *Act § 1101(b)*.

#### *Alternative Minimum Tax Foreign Tax Credit*

##### *Elective Simplified Limitation*

Effective for taxable years beginning after December 31, 1997, a taxpayer may now elect to compute the alternative minimum tax foreign tax credit limitation using foreign source income as determined for regular tax purposes (not to exceed total alternative minimum taxable income) and thus avoid computing foreign source alternative minimum taxable income. This election will eliminate a second round of allocation of apportionment of deductions solely for purposes of the alternative minimum tax regime. The election must be made for the first taxable year beginning after December 31, 1997 for which the taxpayer claims the benefit of an alternative minimum tax foreign tax credit, applies to all subsequent taxable years and cannot be revoked without Internal Revenue Service consent. *Act § 1103, adding I.R.C. § 59(a)(3)*.

##### *Repeal of Special 1989 Exception*

Effective for taxable years beginning after August 5, 1997, the date of the Act’s enactment, the Act eliminates the special exemption for certain corporations contained in the Omnibus Budget Reconciliation Act of 1989 which permitted those corporations to credit foreign taxes against the tentative minimum tax without regard to the generally applicable 90 percent limitation. *Act § 1057, repealing I.R.C. § 59(a)(2)(C)*.

##### *Interest on Deficiencies and Refunds*

The Act provides that where a foreign tax credit carryback eliminates an earlier deficiency, interest on that portion of the deficiency is computed by treating it as

“paid” no earlier than the return filing date for the taxable year during which the foreign taxes are actually paid or accrued (*i.e.*, the taxable year from which any excess foreign taxes are carried). Similarly, where a net operating or capital loss carryback creates a foreign tax credit carryback which in turn eliminates a deficiency, interest runs on the deficiency until the return filing date for the taxable year of the net operating or capital loss. *Act § 1055(a), adding I.R.C. § 6601(d)(2)*. In the same vein, the Act clarifies prior Internal Revenue Code section 6611(g) by providing that interest on a refund created by a net operating or capital loss carryback which in turn creates a foreign tax credit carryback accrues only from the return filing date for the taxable year of the net operating or capital loss. *Act § 1055(b), adding I.R.C. § 6611(f)(2)*.

These new provisions legislatively overturn *Fluor Corp. v. United States*, 35 Fed.Cl. 520 (1996), codify the Government’s litigating position in that case and are effective for foreign tax credit carrybacks arising in taxable years beginning after August 5, 1997, the date of the Act’s enactment. *Act § 1055(c)*. No inference is intended regarding the proper computation of interest under prior law.

##### *Statute of Limitations*

The Act codifies *Revenue Ruling 84-125* (1984-2 C.B. 125) and overturns *Ampex Corp. v. United States*, 620 F.2d 853 (Fed.Cir. 1980) by providing that the 10-year limitations period applicable to refund claims attributable to foreign tax credits is determined by reference to the year in which the foreign taxes are paid or accrued (and not the year to which excess foreign taxes are carried). *Act § 1056(a), amending I.R.C. 6511(d)(3)*. This provision is effective for foreign taxes paid or accrued in taxable years beginning after August 5, 1997, the date of the Act’s enactment. *Act § 1056(b)*. No inference is intended as to the proper determination of the limitations period under prior law.

##### *Carryback Period*

The Act does not include the provision in the Senate version of the bill which would have shortened the foreign tax credit carryback period from two years to one.

##### *Foreign Tax Translation and Redetermination*

For taxpayers accruing foreign taxes, the exchange rate to be used to translate those taxes is now the average

exchange rate for the taxable year to which such foreign taxes relate unless the foreign taxes are—

- Paid more than two years following the close of the taxable year to which they relate,
- Paid in a taxable year prior to the one to which they relate or
- Denominated in an inflationary currency.

These excluded foreign taxes are to be translated using the exchange rate in effect when the taxes are paid. *Act § 1102(a)(1), amending I.R.C. § 986(a)*. However, regulations may permit the use of average exchange rates in lieu of time of payment exchange rates. *Act § 1102(b), adding I.R.C. § 986(a)(3)*. The new translation rules are effective for taxes paid or accrued in taxable years beginning after December 31, 1997. *Act § 1102(c)(1)*.

Under prior law, a redetermination of creditable foreign taxes was required if either accrued taxes when paid differed from the amounts claimed as credits or there was a refund of foreign taxes. The Act adds that a redetermination is required and no credit is available for accrued foreign taxes not paid within two years following the close of the taxable year to which they relate. If any such foreign taxes are paid following expiration of the two-year period then such foreign taxes are taken into account—

- For the taxable year in which paid (with no redetermination arising from such payment) in the case of the indirect foreign tax credit and
- For the taxable year to which they relate in the case of the direct foreign tax credit.

In the case of indirect foreign taxes, the Act permits regulations to adjust foreign corporation post-1986 foreign tax and undistributed earnings pools in lieu of requiring a redetermination. *Act § 1102(c), amending I.R.C. 905(c)*. These redetermination changes apply to foreign taxes which relate to taxable years beginning after December 31, 1997. *Act § 1102(c)(2)*.

#### *Miscellaneous Clarifications*

The Act clarifies that for purposes of the indirect foreign tax credit, a foreign corporation's post-1986 foreign income taxes include foreign income taxes with respect to prior taxable years (beginning after December 31, 1986) only to the extent such taxes are not attributable to dividends distributed by the foreign corporation in prior taxable years. *Act § 1163(a), amending*

*I.R.C. § 902(c)(2)(B)*. In addition, the Act clarifies that in computing financial services income for purposes of the foreign tax credit limitation, high-taxed income is not to be excluded. *Act § 1163(b), amending I.R.C. § 904(d)(2)(C)(i)(II)*. These changes are effective on August 5, 1997, the date of the Act's enactment. *Act § 1163(c)*.

#### **Changes Affecting Anti-Deferral Provisions**

##### *Income Classification*

##### *Notional Principal Contracts and Payments in Lieu of Dividends*

Foreign personal holding company income now includes net income from notional principal contracts. However, where a notional principal contract hedges another category of foreign personal holding company income, any income, gain, deduction or loss from the contract is included in that other category. For example, gain from a notional principal contract hedging inventory property is eligible for the exclusion from the foreign personal holding company income category of gains from property transactions in the same fashion as is sale of the underlying inventory. *Act § 1051(a), adding I.R.C. § 954(c)(1)(F)*. The Act also creates an exemption from foreign personal holding company income for certain income from transactions (including hedging transactions) in the ordinary course of business of a regular dealer in property, forward contracts, options or similar financial instruments (including notional principal contracts and instruments referenced to commodities). *Act § 1051(b), adding I.R.C. § 954(c)(2)(C)*.

Under the Act, foreign personal holding company income also includes payments in lieu of dividends derived from securities lending transactions governed by Internal Revenue Code section 1058. *Act § 1051(a), adding I.R.C. § 954(c)(1)(G)*.

These changes in the definition of foreign personal holding company income are effective for taxable years beginning after August 5, 1997, the date of the Act's enactment. *Act § 1051(c)*.

##### *Branch Profits Exemption*

The Act clarifies that, effective for taxable years beginning after December 31, 1986, effectively connected U.S. income does not cease to be excluded from subpart F income solely because of an exemption or reduction in the U.S. branch profits tax by virtue of a U.S. income tax

treaty, as long as such income is not exempt from or subject to a reduced rate of tax under any other treaty provision. *Act § 1112(c)(1), amending I.R.C. 952(b); Act § 1112(c)(2).*

#### *Banking and Financing Income*

As signed by the President, the Act contained a special one-year reinstatement of the exception from foreign personal holding company income for income derived in the active conduct of a banking, financing or similar business. However, on August 11, 1997, this provision was vetoed by the President in exercise of his new line-item veto power.

#### *Dealers in Securities or Commodities*

The Act also adds two new exceptions to the definition of U.S. property for purposes of the subpart F investment in U.S. property rules. The first exception is for deposits of cash or securities made or received on commercial terms in the ordinary course of a U.S. or foreign person's business as a dealer in securities or in commodities, but only to the extent such deposits are made or received as collateral or margin for—

- A securities loan, notional principal contract, option contract, forward contract or futures contract or
- Any other financial transaction in which the Internal Revenue Service determines that it is customary to post collateral or margin.

The second exception is for an obligation of a U.S. person to the extent the principal amount of the obligation does not exceed the fair market value of readily marketable securities sold or purchased pursuant to a sale and repurchase agreement or otherwise posted or received as collateral for the obligation in the ordinary course of business by a U.S. or foreign person which is a dealer in securities or commodities. These new exceptions apply to taxable years of foreign corporations beginning after December 31, 1997 and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end. *Act § 1173, amending I.R.C. § 956(c)(2).*

#### *Controlled Foreign Corporations*

##### *Characterization of Gain on Stock Dispositions*

Gain recognized on a disposition (or by virtue of any deemed disposition) of stock of a controlled foreign corporation by another controlled foreign corporation is

now recharacterized as a dividend under the rules of Internal Revenue Code section 1248. The “same country exception” to subpart F income for dividends does not apply to gain recharacterized as a dividend under these rules. This new provision does not affect the determination of whether a corporation whose stock is sold is itself a controlled foreign corporation. *Act § 1111(a), adding I.R.C. § 964(e).* The new rules apply to gain recognized on transactions occurring after August 5, 1997, the date of the Act's enactment. *Act § 1111(c)(1).*

##### *Section 1248 Gain Adjustment*

When a U.S. shareholder disposes of stock of a controlled foreign corporation after August 5, 1997, the date of the Act's enactment, any amount treated as a dividend under Section 1248 is treated as an actual distribution with respect to the stock involved for purposes of determining the subpart F inclusions for the taxable year of the disposition, thus potentially reducing the subpart F inclusion of the acquiror of the stock. *Act § 1112(a)(1), amending I.R.C. § 951(a)(2); Act § 1112(a)(2).*

##### *Stock Basis Adjustments*

The Internal Revenue Service is granted authority to prescribe regulations providing that upon disposition by a controlled foreign corporation of stock in another controlled foreign corporation, the amount of any subpart F inclusion for United States shareholders arising from that disposition is to be computed by first adjusting the basis of the disposed stock for prior subpart F inclusions derived from the controlled foreign corporation the stock of which is disposed. This provision is comparable to existing law regarding the adjustment to basis of stock of a first-tier controlled foreign corporation and applies for purposes of determining inclusions for taxable years of United States shareholders beginning after December 31, 1997. *Act § 1112(b)(1), adding I.R.C. § 961(c); Act § 1112(b)(2).*

#### *Passive Foreign Investment Companies*

##### *Mark-to-Market Regime*

The Act introduces a new, elective “mark-to-market” regime for marketable stock of a passive foreign investment company. Under this election, a shareholder includes each year as ordinary income any excess in the value of passive foreign investment company stock over the shareholder's adjusted basis in the stock. Any excess of basis over value is deductible as an ordinary loss, but only to the extent of

net mark-to-market gains with respect to the stock included in income in prior taxable years. Any such income or loss is also reflected as an adjustment to the stock's basis.

Stock is marketable if it is—

- Regularly traded on a national securities exchange registered with the Securities and Exchange Commission or on the national market system established under section 11A of the Securities and Exchange Act of 1934,
- Regularly traded on any exchange or market which the Internal Revenue Service determines has rules sufficient to ensure that the market price represents a legitimate and sound fair market value and
- To the extent provided in regulations, stock in any foreign corporation which is comparable to a regulated investment company and which offers for sale or has outstanding any of its own stock which is redeemable at net asset value.

Marketable stock includes any option on marketable stock, but only to the extent provided in regulations. Passive foreign investment company stock held directly or indirectly by a regulated investment company which offers for sale or has outstanding any of its own stock which is redeemable at net asset value (or, except as provided in regulations, by a regulated investment company which publishes net asset values at least annually) is also treated as marketable stock.

The general rules of Internal Revenue Code section 1291 (imposing a “throwback” tax computation and interest charge on certain distributions from and gain on the disposition of stock of passive foreign investment companies which are not qualified electing funds) do not apply to a shareholder for any taxable year for which the mark-to-market election is effective. In addition, for purposes of applying Internal Revenue Code section 1291 (e.g., should the passive foreign investment company stock cease to be marketable), a shareholder's holding period is treated as beginning immediately after the last taxable year for which the mark-to-market election is effective.

The mark-to-market election applies for the taxable year of the election and all subsequent taxable years to all marketable stock of a passive foreign investment company held (or treated under constructive ownership rules as held) by the electing shareholder unless (i) the Internal

Revenue Service consents to revocation of the election or (ii) the passive foreign investment company stock ceases to be marketable.

Special rules apply with respect to (i) controlled foreign corporations which are passive foreign investment company shareholders, (ii) passive foreign investment company stock held through foreign partnerships, estates or trusts, (iii) a deemed increase in basis to fair market value, but solely for purposes of the mark-to-market rules, for individuals becoming U.S. citizens or residents in taxable years beginning after December 31, 1997 and (iv) denial of the usual increase in basis to fair market value for passive foreign investment company stock acquired from a decedent, but again solely for purposes of the mark-to-market regime. In addition, a special coordination rule preserves the potential interest charge of Internal Revenue Code section 1291 where the mark-to-market election is not effective from the inception of the shareholder's holding period for stock. *Act § 1122, adding I.R.C. § 1296.*

#### *Other Passive Foreign Investment Company Provisions*

The Act eliminates the overlap between the controlled foreign corporation and passive foreign investment company provisions by providing that a foreign corporation is not treated as a passive foreign investment company with respect to a shareholder for any period beginning after December 31, 1997 and during which the foreign corporation is a controlled foreign corporation of which the shareholder is a United States shareholder. The new rules do not apply to stock held before commencement of the foregoing period unless the shareholder elects to recognize gain (and pay an interest charge) under Internal Revenue Code section 1298(b)(1). *Act § 1121, adding I.R.C. 1296(e).* The Act also modifies the rules regarding the measurement of assets for purposes of applying the passive foreign investment company classification tests by requiring the assets of publicly traded foreign corporations to be taken into account at fair market value. It is expected that the total assets of a publicly traded foreign corporation will generally be treated as equal to its market capitalization plus liabilities. Controlled foreign corporations which are not publicly traded continue to be required to take assets into account at adjusted basis rather than fair market value and other non-publicly traded foreign corporations can still elect to use adjusted basis in lieu of fair market value. *Act § 1123, adding I.R.C. 1297(e) following redesignation of former I.R.C. § 1296 as § 1297 by Act § 1122(a).*

### *Effective Dates*

The passive foreign investment company changes are effective for taxable years of U.S. persons beginning after December 31, 1997 and for taxable years of foreign corporations ending with or within such U.S. persons' taxable years. *Act* § 1124.

### **Changes Affecting 1996 Foreign Trust Provisions**

The Small Business Job Protection Act of 1996 drastically altered the rules for determining whether a trust is classified as domestic or foreign. Subsequent Internal Revenue Service pronouncements granted temporary transition relief to certain trusts. See our [July 1997 International Tax Bulletin](#) for a discussion of the 1996 foreign trust changes.

#### *Transition Rule for Certain Trusts*

Under the Act, nongrantor trusts which were classified as U.S. trusts prior to the change in the classification rules enacted by the Small Business Job Protection Act of 1996 are entitled to further transition relief to the extent provided in regulations. The Internal Revenue Service is granted authority to allow such trusts which under the original transition rules and implementing Internal Revenue Service pronouncements were still treated as domestic trusts on August 4, 1997, the day before enactment of the Act, to continue to be treated as domestic trusts. *Act* § 1161.

#### *Mitigation of Section 1494(c) Penalty*

No penalty is to be imposed under Internal Revenue Code section 1494(c), repealed by the Act, with respect to any transfer after August 20, 1996 (the effective date of section 1494(c)), if all applicable reporting requirements as revised by the Act are satisfied. *Act* § 1144(d)(2).

### **Computer Software as FSC Export Property**

The Act provides that computer software that is exported with a right to reproduce is eligible for the benefits of the foreign sales corporation provisions. This provision applies to gross receipts from computer software licenses attributable to periods after December 31, 1997, and no inference is intended regarding the qualification as export property of computer software licensed for reproduction abroad under prior law. *Act* § 1171, amending I.R.C. § 927(a)(2)(B).

### **Other Provisions**

#### *Like-Kind Restrictions for Personal Property*

The Act provides that personal property used predominantly within the United States is not of a like-kind with personal property used predominantly outside the United States. Thus, as was already the case for real property, gain or loss will be recognized on an exchange of foreign personal property for otherwise like-kind U.S. personal property. Predominant use is generally determined by examining the two-year period ending with the exchange, in the case of relinquished property, and beginning with the exchange, in the case of acquired property. Property described in Internal Revenue Code section 168(g)(4) (property used both within and without the United States for which accelerated depreciation is available) is treated as used predominantly in the United States and special rules apply in the case of a transaction or series of transactions designed to avoid the purposes of the new provision. *Act* § 1052(a), amending I.R.C. § 1031(h).

This new provision is effective for exchanges on or after June 8, 1997, unless pursuant to a binding written contract in effect on that date and at all times thereafter. A contract is not treated as ineligible for the binding contract exception solely because (i) it provides for a sale in lieu of an exchange or (ii) the property to be acquired was not identified before June 9, 1997. *Act* § 1052(b).

#### *Personal Transactions in Foreign Currency*

Effective for taxable years beginning after December 31, 1997, individuals disposing of foreign currency in a personal transaction (including transactions entered into in connection with a business trip) will not recognize exchange rate gain unless the gain on the transaction exceeds \$200. No change has been made to the treatment of exchange rate losses. *Act* § 1104, amending I.R.C. § 988(e).

#### *Increase in Section 911 Exclusion*

The Act increases the \$70,000 limitation on the exclusion for foreign earned income under Internal Revenue Code section 911 to \$80,000, in \$2,000 increments beginning in 1998. In addition the \$80,000 limitation is indexed for inflation beginning in 2008 (for inflation after 2006). This provision is effective for taxable

years beginning after December 31, 1997. *Act § 1172, amending I.R.C. § 911(b)(2).*

#### *Services of Foreign Ship Crew-Members*

The Act treats gross income of a nonresident alien individual, who is present in the U.S. as a member of the regular crew of a foreign vessel, from the performance of personal service in connection with the international operation of a ship as income from foreign sources, but not for purposes of pension rules and certain employee benefit provisions. In addition, for purposes of determining whether an individual is a U.S. resident, any day that such individual is present as a member of the regular crew of a foreign vessel is disregarded, but only if the individual does not otherwise engage in trade or business activity within the U.S. on such day. This provision is effective for taxable years beginning after December 31, 1997. *Act § 1174, amending I.R.C. §§ 861(a)(3), 863(c)(2)(B) and adding I.R.C. § 7701(b)(7)(D).*

#### *Other Omitted Provisions*

The Act does not contain a provision from the House bill which would have strengthened the penalties applicable to foreign persons claiming an exemption from U.S. tax on income from the international operation of ships or aircraft but who fail to comply with the filing requirements applicable to such claims. In addition, the Act omits a Senate provision which would have overturned

*Liggett Group, Inc. v. Commissioner*, 58 T.C.M. 1167 (1990) by specifying that the sale of inventory by a U.S. resident to another U.S. resident for use, consumption or disposition within the United States was to be treated as U.S. source income if the sale was not attributable to a foreign office or other fixed place of business of the seller.

#### **Materials Available On-Line**

Readers who are using Acrobat Reader 3.0 (or an Acrobat 3.0-enabled web browser) to review this bulletin can obtain the legislative and administrative materials listed below simply by following the link embedded in each list item. Alternatively, the html version of this bulletin at [www.pmstax.com/intl/bull9708.html](http://www.pmstax.com/intl/bull9708.html) contains links to the material or it can be obtained via ftp in the intl/tra97 directory at ftp.pmstax.com (file names and sizes are indicated in the list below).

- [Taxpayer Relief Act of 1997](#) (enrolled version), *Foreign Revenue Provisions*, §§ 1051-1057, pp. 153-158; *Simplification and Other Foreign-Related Provisions*, §§ 1101-1175, pp. 176-206 [hr2014.pdf, 194K].
- [Conference Committee Report, Taxpayer Relief Act of 1997](#), H.Rpt. 105-220, pp. 567-579, 612-646 [hrpt220.pdf, 259K].
- [T.D. 8722, Guidance Regarding Claims for Certain Income Tax Convention Benefits](#), F.R. 35673-35680, July 2, 1997 [td8722.pdf, 55K].