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date: May 23, 2016

to: Senior Counsel (Large Business & International)

from: Senior Counsel (Corporate)

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subject: Application of Section 245 to the Transaction

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

LEGEND

Common Parent =

Sub B =

Sub C =

Sub D =

Sub E =

Sub 1 =

Sub 2 =

Sub 3 =

Sub 4 =

Sub 5 =

Sub 6	=
Sub 7	=
Sub 6 RIC	=
F-DE	=
Bank 1	=
Bank 2	=
Agency 1	=
Agency 2	=
Person 1	=
Person 2	=
Business N	=
Business O	=
Document 1	=
Document 2	=
Document 3	=

Address 1 =

State S =

State T =

Country U =

Country V =

Year W =

Year X =

Year Y =

Year Z =

Year AA =

Year BB =

Date 2(W) =

Date 4 =

Date 5 =

Date 7(W) =

Date 9(W) =

Date 11(W) =

Date 12(W) =

Date 13(X) =

Date 14(X) =

Date 15(X) =

Date 18(X)	=
Date 20(X)	=
Date 22(X)	=
Date 23(Y)	=
Date 30(Y)	=
Date 40(Y)	=
Date 45(Y)	=
Date 50(Y)	=
Date 55(Y)	=
Date 57(Y)	=
Date 60(Y)	=
Date 65(Y)	=
Date 72(Z)	=
Date 75(Z)	=
Date 80(AA)	=
Date 85(BB)	=
Date 90(BB)	=
Date 100(BB)	=
Date 110(BB)	=
b	=
d	=
e	=

f =

g =

h =

k =

l =

m =

o =

p =

q =

r =

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w =

x =

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uu =

vv =

ww =

yy =

zz =

aaa =

bbb =

ccc =

ddd =

eee =

fff =

ggg =

<u>hhh</u> =

Quote 1 =

Quote 2 =

Quote 3 =

Quote 4 =

Quote 5 =

Quote 6 =

Quote 7 =

Quote 8 =

ISSUE

Whether Sub 3 is eligible for a dividends received deduction ("DRD") under section 245 of the Code[1] (the "section 245 DRD") with respect to the funds distributed from a regulated investment company within the meaning of section 851 ("RIC") to Sub 3 via Sub 4 during Year Y?

CONCLUSION

No. Sub 3 is not eligible for the section 245 DRD with respect to the funds distributed from the RIC to Sub 3 via Sub 4 during Year Y.

FACTS

I. Ownership Structure and Business Operations

Common Parent is a State T corporation and the common parent of an affiliated group of corporations that file a consolidated U.S. federal income tax return ("US Group" or "Taxpayer"). Common Parent is a publicly-traded company. Its taxable year ends Date 4. Common Parent owns numerous entities, some of which are described in this memorandum. US Group generally engages in Business N.

Certain members of US Group, including Sub C, engage in Business O (collectively, the "Business O Entities"). In connection with this business, the Business O Entities ("Customer Funds"),

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, title 26 of the United States Code, as amended, and as in effect during the years at issue.

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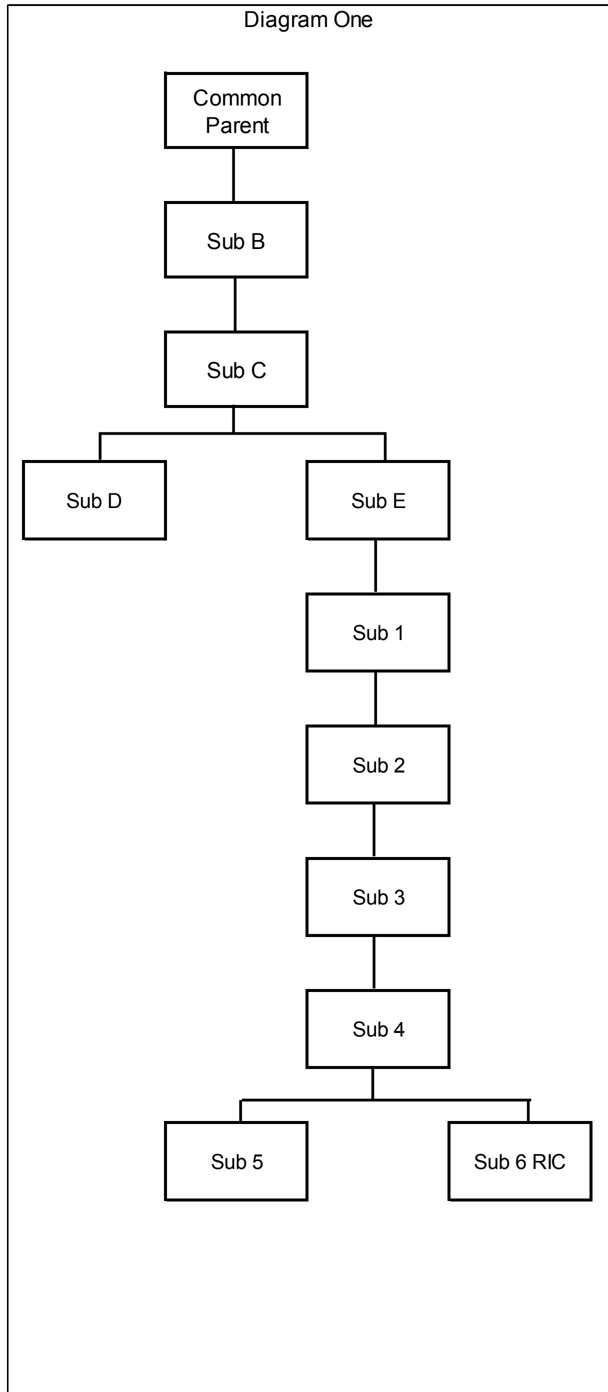
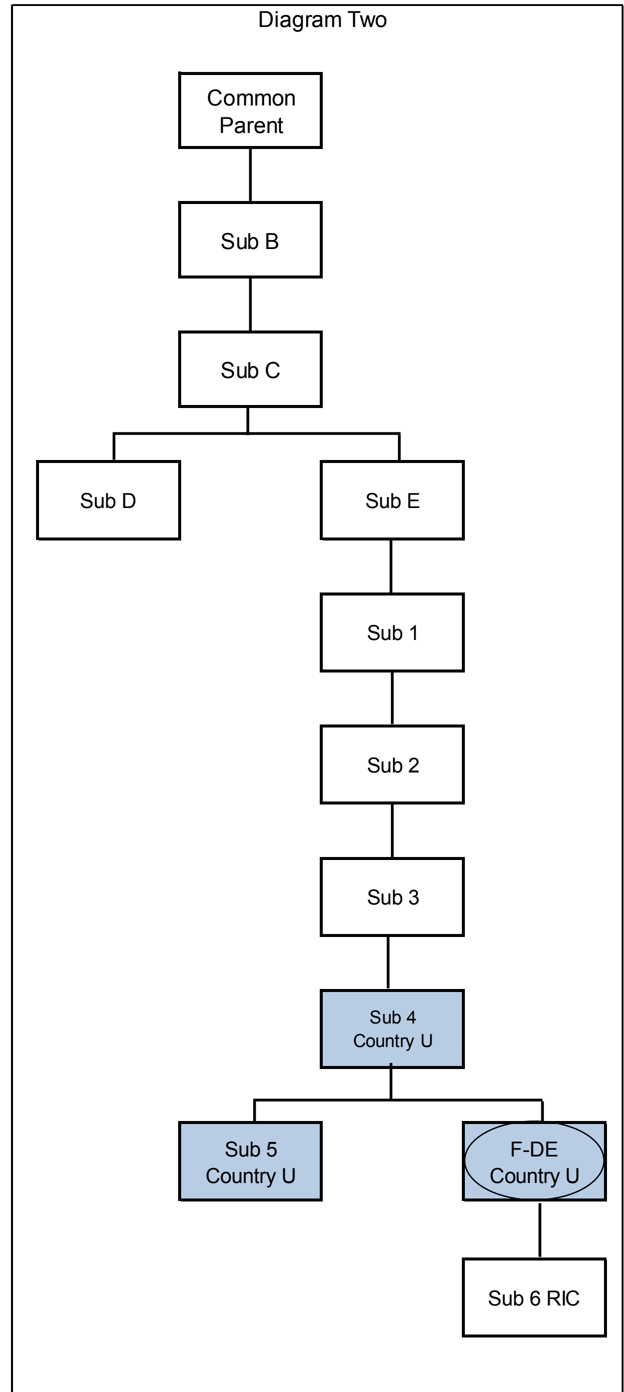
Business O is subject to regulatory requirements administered by Agency 1 and Agency 2. Pursuant to Agency 1 regulations, the Business O Entities must invest the Customer Funds in high-grade, domestic liquid assets ("Business O Eligible Investments") and cannot invest the funds in dividend-paying stock of unrelated corporations. Accordingly, the Business O Eligible Investments generally produce interest income, and, to a lesser extent, capital gain or loss.

Taxpayer began planning the transaction that is the subject of this memorandum (the "Transaction") prior to Year X. During Year X, Common Parent directly held all of the stock of Sub B, which directly held all of the stock of Sub C, which directly held all of the stock of Sub D, and Sub E. Sub E directly held all of the stock of Sub 1. Sub 1 held all of the stock of Sub 2, which in turn, held all of the stock of Sub 3, which held all of the stock of Sub 4. Sub 1, Sub 2, Sub 3, and Sub 4 were all State T corporations. Sub 4 directly held all of the membership interests in Sub 5 and Sub 6. Sub 5 and Sub 6 were State T limited liability companies that were treated as corporations for U.S. federal income tax purposes. Sub C, Sub D, Sub E, Sub 1, Sub 2, Sub 3, Sub 4, Sub 5, and Sub 6 were all members of US Group. See Diagram One for the pre-transaction ownership structure at the beginning of Year W.





In furtherance of the Transaction, Common Parent caused certain US Group members to deconsolidate from US Group. Specifically, Sub 4 and Sub 5 re-domiciled into Country U and Sub 6 became a RIC. See Diagram Two.

II. Taxpayer's Planning of the Transaction

A. Intent of the Transaction

Common Parent planned the Transaction with the stated principal goal of increasing US Group's after-tax return on the Business O Eligible Investments by claiming an 80 percent DRD with respect to income attributable to the interest and capital gain derived from the investments. As reflected in its planning documents, Taxpayer calculated that the post-Transaction yield on the investments would be 130 percent of the pre-Transaction yield,[2] with the increased yield due to a decrease in Taxpayer's U.S. federal income tax liability. The Transaction would result in a better after-tax return only if the DRD were allowed; if the DRD were not allowed, Taxpayer's after-tax return would decrease because of the costs associated with the Transaction.[3]

B. Taxpayer's Expected U.S. Federal Income Tax Treatment of Transaction

Prior to commencing the Transaction, Taxpayer anticipated the treatment of the Transaction for U.S. federal income tax purposes as follows:

1. Sub 6 (hereinafter referred to as "Sub 6 RIC" during the period after its conversion to a RIC) would not pay U.S. federal income tax. Sub 6 RIC would invest in Business O Eligible Investments (similar to investments purchased by US Group in years prior to Year X) and make distributions to its sole shareholder, Sub 4, during Year Y.[4] Thus, Sub 6 RIC would not pay U.S. federal income tax on its interest or capital gain income because its income would be offset by a dividends paid deduction ("DPD"). Sections 852(b)(2)(D)[5] and 852(b)(3)(A).[6]

2. Sub 4 would not pay U.S. federal income tax. Sub 4 would not be subject to U.S. federal income tax on the distributions that it received from Sub 6 RIC, and Sub 6 RIC would not be required to withhold tax on its distributions to Sub 4 during Year Y. Sections 871(k) and 881(e).[7]

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[2] Document 2.

[3] Id.

[4] Pursuant to the Transaction, the taxpayer interposed F-DE, a foreign entity that was disregarded as an entity separate from its owner for U.S. federal income tax purposes, between Sub 4 and Sub 6 RIC.

[5] When a RIC meets certain requirements, section 852(b)(2)(D) allows the RIC a deduction in computing its investment company taxable income for dividends paid (as defined in section 561), but the amount of dividends with respect to which the deduction applies is computed without regard to capital gain dividends and exempt-interest dividends. Net capital gains are separately excluded from the definition of investment company taxable income. Section 852(b)(2)(A).

[6] Section 852(b)(3)(A) imposes on a RIC a tax, determined as provided in section 1201(a), on the excess, if any, of the net capital gain over the deduction for dividends paid (as defined in section 561) determined with reference to capital gain dividends only.

[7] Section 881(a) generally imposes a 30 percent tax on certain income received from sources within the United States by a foreign corporation, unless otherwise excepted. Except as otherwise provided, section

3. Sub 3 would not pay U.S. federal income tax. Sub 3 would not have an inclusion under section 951(a)(1) (a "section 951 inclusion") with respect to Sub 4 as a result of the distributions from Sub 6 RIC.[8] The Sub 6 RIC distributions received by Sub 4 would constitute foreign personal holding company income (within the meaning of section 954(c)) and, thus, would be subpart F income (within the meaning of section 952(a)). However, Sub 3 would not have a section 951 inclusion with respect to Sub 4 in Year Y because Sub 3 would dispose of its Sub 4 stock before the close of Sub 4's taxable year ending in Year Y and Sub 4 would remain a CFC after the disposition. Section 951(a)(1).

4. Sub 2 would pay, at most, a small amount of U.S. federal income tax. Sub 2 would have a section 951 inclusion with respect to Sub 4 in Year Y because Sub 2 would hold all of the stock of Sub 4 on the last day of Sub 4's taxable year. However, Sub 2's pro rata share of Sub 4's subpart F income would be reduced by the amount of Sub 4's distribution to Sub 3 during Year Y. Section 951(a)(2)(B).

5. Sub 3 would claim an 80 percent DRD. Sub 4 would distribute the amounts that it received from Sub 6 RIC to Sub 3 during Year Y before Sub 3 disposed of its Sub 4 stock. Sub 3 would include the distribution in income as a dividend, and treat the entire amount as a U.S.-source dividend for purposes of section 245. Thus, Sub 3 would offset the dividend income with an 80 percent DRD. Sections 245(a) and 861(a)(2)(B).

6. Sub 4 would change its taxable year at the outset of the Transaction so that its taxable year would differ from US Group's taxable year.

7. In Date 15(X) and Year Y, Sub 6 RIC would distribute its Year X and Year Y income to Sub 4, and, in turn, Sub 4 would distribute the funds to Sub 3. Thus, by changing Sub 4's taxable year to a year different from US Group's taxable year, US Group would be able to defer including the income attributable to Sub 6 RIC's Year X earnings in US Group's income until Year Y.[9]

881(e) provides an exception to the tax imposed by section 881(a) for any interest-related dividend (as defined in section 871(k)) from a RIC.

[8] If a foreign corporation is a controlled foreign corporation ("CFC") for an uninterrupted period of 30 days or more during any taxable year, section 951(a) generally imposes a tax on every person who is a U.S. shareholder (as defined in section 951(b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a CFC.

[9] The propriety of US Group's deferral of tax on income attributable to Business O Eligible Investments by investing through a captive RIC rather than making these investments directly is beyond the scope of this memorandum, and no inference should be drawn as to the U.S. federal income tax treatment of that

III. Transaction Steps

After preliminary restructuring steps,[10] US Group undertook the following steps in connection with the Transaction:

1. On Date 9(W), Sub 6 changed its name. In anticipation of becoming a RIC, Sub 6 sold all of its assets prior to Date 11(W), so that it only held cash on Date 11(W).[11]

2. Effective Date 11(W), Sub 4 and Sub 5 converted from State T corporations to Country U corporations, thereby deconsolidating from US Group. On Date 11(W), Sub 5 had approximately $b of investments.

3. On Date 11(W), Sub 4 formed F-DE, a wholly-owned Country U subsidiary, which made an election to be disregarded as an entity separate from Sub 4 for U.S. federal income tax purposes effective as of the date of its formation. Sub 4 contributed all of its Sub 6 shares to F-DE.

4. On Date 11(W), Sub 6 registered as an investment company under the Investment Company Act of 1940 ("Investment Company"). Effective Date 13(X), Sub 6 elected to be taxed as a RIC for its Year X taxable year.

5. Effective Date 13(X), Sub 4 and Sub 5 each changed its taxable year end to Date 5 from Date 4.

6. On Date 18(X), Sub 1 directly wired $d to Sub 6 RIC. Common Parent treated this transfer, in relevant part, as a contribution of $d by Sub 3 to Sub 4, and then by Sub 4 (through F-DE) to Sub 6 RIC. (Common Parent stated that due to internal control restrictions, Sub 1 directly wired the cash to Sub 6 RIC's deposit account at Bank 2. Common Parent reflected its treatment of the contributions through accounting entries.)

7. On Date 20(X), Sub 6 RIC entered into an agreement with Bank 1, authorizing Bank 1 to act as placement agent for the private sale of Sub 6 RIC notes due in Year Y, one year from issuance. On Date 22(X), Sub 6 RIC issued notes with a

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aspect of the Transaction, or any other aspect of the Transaction not addressed in this memorandum.

[10] As part of the preliminary restructuring, on Date 7(W), Sub 4 (while still a member of US Group) distributed its entire interest in Sub 7 to Sub 3. Effective on Date 7(W), Sub 7 elected to be disregarded as an entity separate from its owner for U.S. federal income tax purposes.

[11] Sub 6 held $e on Date 11(W).

principal amount of approximately $e. Taxpayer directed Bank 1 to issue Sub 6 RIC's notes to more than 100 investors, at least one of which was not a "qualified purchaser."[12] Sub 6 RIC paid Bank 1 $f for the placement of the notes.

8. During Year Y, one or more members of US Group transferred an additional $g to Sub 6 RIC in a transaction that Common Parent treated, in relevant part, as a contribution of $g by Sub 3 to Sub 4, and then by Sub 4 (through F-DE) to Sub 6 RIC.

9. During Year X, Sub 6 RIC purchased Business O Eligible Investments. [During Year X, Sub 6 RIC derived interest income and capital gains from the investments in the amount of $p. During Year Y, Sub 6 RIC derived interest income and capital gains from the investments in the amount of $y.]

10. During Year Y, Sub 6 RIC distributed $k to Sub 4 as follows:

Date	Amount
Date 30(Y)	$h[13]
Date 40(Y)	$l[14]
Date 50(Y)	$m
Date 60(Y)	$o

11. During Year Y, Sub 4 distributed $aa, an amount in excess of $k, to Sub 3 as follows:

Date 23(Y)	$bb
Date 45(Y)	$cc
Date 55(Y)	$dd

12. On Date 57(Y), Sub 3 distributed all of its shares in Sub 4 to Sub 2.

[12] Taxpayer caused the notes to be issued in this manner in order to treat Sub 6 RIC as an Investment Company, which requires Sub 6 RIC to register with the U.S. Securities and Exchange Commission ("SEC") as an Investment Company.

[13] Taxpayer takes the position that the dividend of $h paid on Date 30(Y) was a "time certain" dividend deemed to have been paid on December 31 of Year X for purposes of Sub 6 RIC's DPD. Sub 6 RIC declared the dividend on Date 14(X).

[14] Taxpayer treated the dividend of $l paid on Date 40(Y) as having been paid in Year X for purposes of Sub 6 RIC's DPD. Section 855(a). For tax years beginning before December 22, 2010, a dividend to which a RIC elects to apply section 855(a) must be declared by the due date of the RIC's return (with extensions), and paid within 12 months.

IV. Taxpayer's Treatment of the Transaction

A. Sub 6 RIC

Sub 6 RIC reported income and deductions related to the Transaction for Year X and Year Y as follows:

(i) Year X. On its U.S. federal income tax return for its Year X taxable year, Sub 6 RIC reported income as follows:

Ordinary income (net of expenses):	$r[15]
Long and short-term capital gains:	$s[16]
Total taxable income before DPD:	$p

Sub 6 RIC deducted $p as a DPD for its Year X taxable year, but did not distribute any of the amount until Year Y.[17] Sub 6 RIC made two distributions during Year Y totaling $p, which RIC treated as having been paid during Year X for purposes of Sub 6 RIC's DPD.

(ii) Year Y. On its U.S. federal income tax return for its Year Y taxable year, Sub 6 RIC reported income as follows:

Ordinary income (net of expenses):	$w[18]
Long and short-term capital gains:	$x[19]
Total taxable income before DPD:	$y

[15] Sub 6 RIC reported $u of interest income and $t of dividends on its Year X Form 1120-RIC.

[16] Sub 6 RIC reported $ v in short term capital gain on its Year X Form 1120-RIC.

[17] Sub 6 RIC distributed only a separate amount, $q, to Sub 4 in Year X. In one document, it characterized this distribution as a return of capital. In another, it stated that this amount constituted a dividend of Sub 6's undistributed income for the period Date 11(W) through Date 12(W), a period prior to Sub 6 becoming a RIC. Common Parent reported that the distribution qualified for an 80 percent DRD. The amounts used in this memorandum are taken from several different documents. Any discrepancies between the amounts of the distributions as stated in this memorandum and Taxpayer's tax filings do not impact the legal analysis in this memorandum.

[18] Sub 6 RIC reported $ss of interest income and $tt in dividends on its Year Y Form 1120-RIC.

[19] Sub 6 RIC reported $uu of gain offset by capital loss of $vv on its Year Y Form 1120-RIC.

Sub 6 RIC deducted $y as a DPD for its Year Y taxable year.

B. US Group

On the US Group's amended Form 1120X for taxable year Year Y, Common Parent reported that Sub 3 had U.S.-source dividend income of $ee, which was reduced by an 80 percent DRD of $ii. This deduction gave rise to a tax savings of $jj. The Form 1120 also reported a section 951 inclusion for Sub 2 but did not report a section 951 inclusion for Sub 3. Common Parent asserts that Sub 3 did not have a section 951 inclusion with respect to Sub 4 because it did not hold any Sub 4 stock on the last day of Sub 4's Year Y taxable year. In addition, Common Parent takes the position that Sub 2 was able to reduce the amount of its section 951 inclusion with respect to Sub 4 by the amount of Sub 4's distributions to Sub 3 during Year Y.

V. Additional Facts

A. Taxpayer's Asserted Business Purpose for the Transaction

Common Parent maintains that the predominant purpose for creating and implementing the Transaction was to invest in, and earn a return on, investment securities. In addition, Common Parent states that one of its objectives was to reduce expenses relating to the investment, including tax expenses. Thus, Common Parent states that it used "tax planning" to reduce its expenses.

B. Sub 6 RIC

Common Parent asserts that Sub 6 RIC is properly treated as a RIC under the Code. Common Parent notes that a RIC offers advantages over non-RIC investment entities: (i) a RIC receives preferable tax treatment under the Code relative to a non-RIC corporation provided it distributes nearly all of its earnings annually; and (ii) certain investors that are concerned about misinformation and fraud are more likely to invest in a RIC than a non-RIC because a RIC is subject to SEC oversight.

Sub 6 RIC did not have any employees. Sub D, a member of US Group and a registered investment advisor, acted under an asset management agreement as the investment advisor to Sub 6 RIC. Sub D directed Sub 6 RIC's investment portfolio in accordance with the guidelines for certain of US Group's investments, as it did for other members of US Group. Bank 2 provided accounting, custody, and transfer agent services to Sub 6 RIC.

Common Parent indirectly maintained beneficial ownership and complete control of Sub 6 RIC. Although at least two of Sub 6 RIC's directors were required to be independent, Common Parent, through Sub 4, had the right to remove the directors.

The information memorandum provided to prospective Sub 6 RIC note holders stated that: Quote 7.[20]

As evidenced by its accounting practices, US Group did not derive the customary benefits of using a RIC, such as pooling of funds and obtaining the Investment Company's professional investment management services. Under generally accepted accounting principles ("GAAP"), a RIC generally is required to file audited financial statements on a stand-alone basis with the SEC. However, Common Parent determined that it was not required to use the specialized accounting required for an Investment Company, and, instead, consolidated Sub 6 RIC's financials with those of US Group on Common Parent's financial statements.[21] Common Parent based this decision on the definition of an investment company for GAAP purposes as an "entity that pools shareholders' funds to provide the shareholders with professional management." Common Parent concluded that Sub 6 RIC did not meet the definition of an Investment Company under GAAP because Quote 8.[22]

Sub 6 RIC elected to be disregarded as an entity separate from its owner for U.S. federal income tax purposes effective Date 100(BB), and filed a final U.S. federal income tax return for its year ended Date 90(BB). In addition, Sub 6 RIC filed Form N-8F with the SEC to deregister its status as a RIC on Date 110(BB).

C. Sub 4

Taxpayer's planning Document 1 states that Sub 4, Sub 5, and F-DE would conduct all of their operations in the United States and that their only contacts with Country U would be to satisfy certain statutory requirements (e.g., maintaining a registered office/agent). For all other purposes, these entities would do business only in the United States and would maintain their books and records in the United States.[23]

Common Parent provided the following reasons for causing Sub 4 to become a Country U corporation:

1. For a variety of political, regulatory, and tax reasons, it is easier and cheaper to attract investment capital from non-U.S. investors for certain types of investments by using an entity organized in Country U rather than in the United States.

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[20] When entities act as a group, as defined in Section 13(d)(3) of the Securities and Exchange Act, they are required to separately file a Schedule 13D pursuant to Rule 13d-1. The following entities filed as "group members" and each was designated as a beneficial owner of all of the RIC shares: Sub 4, Sub 3, Sub 1, Common Parent, Sub B, and Sub C.

[21] See Document 3.

[22] Id. at p. 10.

[23] Document 1 at p. 11.

2. An investment in Country U may be viewed more favorably by some non-U.S. investors because the investors would not be subject to withholding tax on interest payments made by an entity formed in Country U but would be subject to U.S. federal withholding tax if they invested in debt of U.S. entities.

3. Non-U.S. investors, who often invest funds obtained from international sources, may prefer to invest relatively less in the United States and relatively more in other jurisdictions for political and reputational reasons. Common Parent states that, in previous transactions, non-U.S. investors have specifically requested that Common Parent use a foreign subsidiary for these reasons.

4. Non-U.S. investors prefer to invest in an entity formed in Country U rather than the United States because they would be treated more favorably if Common Parent declared bankruptcy. For example, if Common Parent declared bankruptcy in the United States, Common Parent's creditors in the United States would have more difficulty reaching the assets of a subsidiary in Country U than reaching the assets of a domestic subsidiary.

5. Another significant benefit of having a subsidiary in Country U instead of State T is that the government of Country U provided a "binding undertaking" that any entities formed by the US Group in Country U would not be taxed by Country U for at least 20 years. State T did not offer similar tax relief.

D. Taxpayer Noted Disadvantages of the Transaction

Common Parent's planning documents for the Transaction noted that the Transaction structure had several disadvantages:

1. The assets of Sub 6 RIC could not be pledged;

2. In the event that Sub 6 RIC's assets were sold at a loss, the losses would not pass through to the Sub 6 RIC shareholders;
3. If the Transaction was successfully challenged by the Internal Revenue Service (IRS), the Taxpayer's investment return would be lower than if it had not engaged in the Transaction, due to the costs of the Transaction; and

4. The Transaction would create a risk to Common Parent's reputation due to adverse publicity for engaging in "tax arbitrage."

E. Taxpayer's Correspondence with Agency 1

As noted above, Sub C is engaged in Business O, is subject to Agency 1's rules, and must invest only in Business O Eligible Investments. Under Agency 1's guidelines, Sub 4 and Sub 6 RIC only could make investments that Sub C could make directly.

Taxpayer maintained that it did not need formal approval from Agency 1 to implement the Transaction because Sub 6 RIC would hold only Business O Eligible Investments and Common Parent had received prior approval from Agency 1 to establish operating subsidiaries to hold the assets. Nonetheless, in Year W, prior to engaging in the Transaction, Common Parent informed Agency 1 that Sub 6 RIC would not be Quote 1 and asked for a determination that Quote 2.[24]

In seeking assurances from Agency 1, Taxpayer told Agency 1 that Sub C planned to make an indirect investment in a closed-end diversified fund that would principally hold Quote 4. At the time of the communication, Sub C planned to make the RIC investment through an entity organized in Country V that was treated as a pass-through entity for U.S. federal income tax purposes.[25] Taxpayer assured Agency 1 that the Country V entity would limit its activities to holding the RIC shares, which Sub C was permitted to hold directly.[26] In a follow-up communication, Common Parent informed Agency 1 that it changed the transaction structure, stating that: Quote 5.

Taxpayer told Agency 1 that Sub 4's principal office would be located at Address 1 in State S, and that all of its activities would be in the United States. Further, Taxpayer stated that all of Sub 4's officers and directors would be United States residents and employees of Common Parent, a U.S.-based affiliate of Common Parent, or another domestic entity. Sub 4's only contact with Country U, other than its incorporation and appointment of a resident agent, would be annual meetings held in Country U, which could be carried out by proxy granted to the resident agent. Common Parent further noted that Sub 4's annual meetings could be limited to the authorization of a one page filing required by Country U law. Moreover, Common Parent would indirectly provide funds to Sub 6 RIC on behalf of Sub 4. Although Sub 4 did not receive funds, because they were wired directly from a member of US Group to Sub 6 RIC, Taxpayer advised Agency 1 that Sub 4's use of the funds was limited to purchasing interests in F-DE, which would, in turn, purchase interests in Sub 6 RIC. Sub 6 RIC's use of the funds was limited to acquiring Business O Eligible Investments.

F. Taxpayer's Transaction Costs

Common Parent incurred significant costs in connection with the Transaction, including planning costs, and costs for setting up the Transaction structure and maintaining Sub 6 RIC. Common Parent estimated that an initial investment in Sub 6 RIC of $ff, with a minimum investment by Sub 6 RIC in Business O Eligible Assets of

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[24] Date 2(W) e-mail from Person 2, of Common Parent, to Person 1, of Agency 1.

[25] Id.

[26] Id. This e-mail states that Sub C would Quote 3.

$gg, was necessary in order for the U.S. federal income tax savings to be greater than the costs of implementing and maintaining the Transaction structure. In Year X, the cost to register and maintain Sub 6 RIC was $mm, and the amount of a payment to Bank 1 in connection with Sub 6 RIC's note issuance was $kk. In Year X, Sub 6 RIC claimed expenses of $hh (including $oo in interest to noteholders). In Year Y, Sub 6 RIC claimed expenses of $pp (including $qq in interest to noteholders).

G. Taxpayer's Potential Claims for the DRD in Subsequent Tax Years

On Date 65(Y) and Date 72(Z), Sub 6 RIC made distributions to Sub 4, the total of which was $ww. Taxpayer reported this amount in income under Section 951.

On Date 75(Z) and Date 80(AA), Sub 6 RIC made distributions to Sub 4, the total of which was $yy.

Prior to the end of Sub 4's Year AA tax year, Sub 2 distributed the stock of Sub 4 to Sub 1. Taxpayer reported that Sub 2 received dividends from Sub 4 in Year AA and reported the U.S. source portion was $zz. It is our understanding that Taxpayer intends to have Sub 2 claim an 80 percent DRD of $aaa at a future date. This deduction would result in a tax savings of $bbb.

On Date 85(BB) and Date 90(BB), Sub 6 RIC made distributions to Sub 4, the total of which was $ccc.

Prior to the end of Sub 4's Year BB tax year, Sub 1 distributed the stock of Sub 4 to Sub E. Taxpayer reported that Sub 1 received dividends from Sub 4 in Year BB and reported the U.S. source portion was $ddd. It is our understanding that Taxpayer intends to have Sub 1 claim an 80 percent DRD of $ eee at a future date. This deduction would result in a tax savings of $ fff.

Adding the amounts for Years AA and BB to the amounts for Year Y, discussed above, Taxpayer's claim and potential future claims from this transaction give rise to an aggregate DRD of $ggg and an aggregate tax savings of $hhh.

TAXPAYER'S POSITION

Taxpayer asserts that its U.S. federal income tax reporting position is consistent with the form of the Transaction and the literal language of the Code. Taxpayer states that its business purpose for the Transaction was to maximize the return on its investments. As discussed in greater detail in the FACTS section of this memorandum, Taxpayer maintains that it used Sub 4, an entity formed under the laws of Country U, in the Transaction in order to attract non-U.S. investors and because Country U agreed not to tax any entities formed in Country U for a twenty-year period.

LAW AND ANALYSIS

I. Statute

Section 245 allows a corporation a DRD on dividends received from a qualified foreign corporation. Section 316(a)(1) generally defines the term "dividend" as any distribution of property (as defined in section 317) made by a corporation to its shareholders out of earnings and profits ("E&P"). Treas. Reg. § 1.312-6(b) provides that income exempted from taxation by statute is included in E&P. Sub 4 increased its E&P by the amount of the distributions it received from Sub 6 RIC. Taxpayer argues that Sub 4's distributions to Sub 3 were dividends within the meaning of section 316(a) because the distributions were made out of E&P accumulated after February 28, 1913, or out of the current taxable year, and asserts that the dividends qualify for the section 245 DRD.

Section 245(a)(1) limits the amount of the section 245 deduction to an "amount equal to the percent (specified in section 243 for the taxable year) of the U.S. source portion of such dividends." The "U.S. source portion" of any dividend is any amount which bears the same ratio to such dividends as the post-1986 undistributed U.S. earnings bears to the total post-1986 undistributed earnings.[27] Section 245(a)(3).

During the years that Taxpayer engaged in the Transaction, section 245 did not contain an explicit limitation that would have prevented distributions from a RIC from being taken into account in determining the "U.S.-source portion" of a dividend paid by a "qualified 10-percent owned foreign corporation." Section 326 of the Protecting Americans from Tax Hikes Act of 2015 (Public Law 114-113, 129 Stat. 2242) (the "PATH Act") added section 245(a)(12) to provide that, with respect to dividends received on or after December 18, 2015, for purposes of the definition of post-1986 undistributed U.S. earnings in section 245(a)(5)(B), a domestic corporation does not include a RIC or a real estate investment trust. Accordingly, distributions from Sub 4 attributable to distributions from Sub 6 RIC explicitly would not be eligible for the section 245 DRD under the revised statute. Consistent with the indication in section 326(c) of the PATH Act, the Joint Committee on Taxation states that, "[n]o inference is intended with respect to the proper treatment under section 245 of dividends received from RICs or REITs before such date."[28]

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[27] Section 245(a)(4) defines the term "post-1986 undistributed earnings" as having the same meaning given to such term by section 902(c). Section 902(c) defines the term as "the amount of earnings and profits of the foreign corporation (computed in accordance with sections 964(a) and 986) accumulated in taxable years beginning after December 31, 1986 – (A) as of the close of the taxable year of the foreign corporation in which the dividend is distributed, and (B) without diminution by reason of dividends distributed during such taxable year." Section 964(a) provides that the earnings and profits of a foreign corporation are calculated according to rules substantially similar to those applying to domestic corporations except as otherwise provided.

[28] Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2.

Section 245(a)(5) limits the definition of “post-1986 undistributed U.S. earnings” to:

(A) income of the … foreign corporation which is effectively connected with the conduct of a trade or business within the United States and is subject to tax under this chapter, or

(B) any dividend received (directly or through a wholly-owned foreign corporation) from a domestic corporation at least 80 percent of the stock of which (by vote and value) is owned (directly or through such wholly owned foreign corporation) by the qualified 10-percent owned foreign corporation.

The funds that Sub 4 received from Sub 6 RIC are not “post-1986 undistributed U.S. earnings” within the meaning of section 245(a)(5)(A) because Sub 4 did not have income that was effectively connected with the conduct of a trade or business within the United States, and subject to U.S. federal income tax.[29]

Pursuant to section 245(a)(5)(B), “post-1986 undistributed U.S. earnings” includes a “dividend” received from a domestic corporation. Section 854(a) states that a capital gain dividend received from a RIC “shall not be considered a dividend” for purposes of determining whether a shareholder is entitled to the DRD under section 243.[30]

Section 854(b)(1) applies to distributions from a RIC other than those to which section 854(a) applies. It states that in computing any deduction under section 243, there shall be taken into account only the portion of such dividend reported by the RIC as eligible for such deduction in written statements furnished to its shareholders.

The shareholder of a RIC is only eligible for the section 243 DRD with respect to

[29] Moreover, Sub 4 did not have fixed or determinable annual or periodic income that was subject to tax. Section 881(a)(1) generally imposes a 30 percent flat tax on, among other things, interest and dividends. Under Taxpayer’s analysis, neither Sub 6 RIC nor Sub 4 was subject to U.S. federal income tax on the interest generated by the Business O Eligible Investments or income attributable thereto, because Sub 6 RIC distributed amounts attributable to the interest to Sub 4, and Sub 4 treated the distribution as exempt from tax under sections 881(e)(1)(A) and 871(k)(1)(A). Similarly, under Taxpayer’s analysis, neither Sub 6 RIC nor Sub 4 were subject to U.S. federal income tax on any short-term capital gain generated by the Business O Eligible Investments or income attributable thereto because Sub 6 RIC distributed amounts attributable to the gain and Sub 4 treated the distribution as exempt from tax under sections 881(e)(2) and 871(k)(2). However, any capital gain dividend other than a short-term capital gain dividend, although not effectively connected with a U.S. trade or business, would be subject to tax under section 881(a).

[30] Under section 243, certain taxpayers are allowed a deduction for certain dividends received from a domestic corporation.

those distributions that are designated by the RIC as dividends eligible for such a deduction. The amount that a RIC designates for a taxable year generally cannot exceed the amount of dividends the RIC receives from domestic corporations that would be eligible for the DRD if RICs were permitted to claim the DRD. Sub 6 RIC generally held only debt instruments and its income therefore consisted of interest and capital gain rather than dividends.

Sub 6 RIC did not issue a statement to Sub 4 that qualified any of the Sub 6 RIC distributions as dividends eligible for a DRD. Accordingly, Sub 4 could not claim a section 243 DRD with respect to Sub 6 RIC's distributions due to the application of sections 854(a) and (b). If Sub 3 had directly held the Sub 6 RIC shares, it could not have claimed the section 243 DRD either. Because Sub 3 would have been precluded from claiming a DRD under section 243 on direct distributions from Sub 6 RIC, Taxpayer inserted a foreign corporation between Sub 3 and Sub 6 RIC in order to claim a DRD under section 245 with respect to dividends attributable to the Sub 6 RIC distributions. Section 854 does not discuss whether or not RIC distributions are to be taken into account in calculating the amount of dividends eligible for the DRD under section 245.

Although the Sub 6 RIC distributions to Sub 4 are not "dividends" eligible for the DRD under section 243, Sub 4 treats them as "dividends" received from a domestic corporation in calculating Sub 4's post-1986 undistributed U.S. earnings for the purpose of section 245(a)(5)(B). Under Taxpayer's position, even though a member of US Group would not have been able to claim a DRD with respect to the interest income and capital gain derived on the Business O Eligible Investments if it had received it directly, and likewise would not have been able to claim a DRD if it had received distributions from Sub 6 RIC attributable to such income, distributions attributable to such income are dividends eligible for the 80 percent section 245 DRD if funneled through Sub 4.

II. Section 1502 and Treas. Reg. § 1.1502-13(h)

A. Statute and Regulation

Congress enacted the consolidated return regime to levy tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation.[31] Article 631 of Treas. Reg.

[31] See Atlantic City Elec. Co. v. Comm'r, 288 U.S. 152 (1933) (citing Art. 631 of Treas. Reg. No. 45). See also, S. Rep. No. 960, at 14 (1928), which states "[t]he permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. The mere fact that by legal fiction several corporations owned by the same stockholders are separate entities should not obscure the fact that they are in reality one and the same

No. 45[32] states in pertinent part:

> [w]here one corporation owns the capital stock of another corporation or corporations, or where the stock of two or more corporations is owned by the same interests, a situation results which is closely analogous to that of a business maintaining one or more branch establishments. In the latter case, because of the direct ownership of the property, the invested capital and net income of the branch form a part of the invested capital and net income of the entire organization. When such branches are owned and controlled through the medium of separate corporations, it is necessary to require a consolidated return in order that the invested capital and net income of the entire group may be accurately determined. Otherwise opportunity would be afforded for the evasion of taxation by the shifting of income through price fixing, charges for services and other means by which income could be arbitrarily assigned to one or another unit of the group. In other cases without a consolidated return excessive taxation might be imposed as a result of purely artificial conditions existing between corporations within a controlled group.

Congress' concern about corporate taxpayers avoiding tax also is evidenced in section 1502, in which Congress grants authority to the Secretary to:

> prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns.

A legislative regulation is "issued under a specific grant of authority to prescribe a method of executing a statutory provision."[33] The Supreme Court explained that the power of an administrative agency to administer a congressionally created program

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business owned by the same individuals and operated as a unit… Much of the misapprehension about consolidated returns will be removed when it is realized that it is only when the corporations are really but one corporation that the permission to file consolidated returns is given, and that no ultimate advantage in the tax laws really results."

[32] Regulations relating to the Income Tax and War Profits and Excess Profits Tax under the Revenue Act of 1918.

[33] Dresser Indus. v. Comm'r, 911 F.2d 1128, 1137 (5th Cir. 1990) (internal quotations and citations omitted).

"'necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.'"[34] When Congress explicitly leaves a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. These legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.

The Supreme Court stated that it has "long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer, and the principle of deference to administrative interpretations has been consistently followed by this Court."[35] Congress explicitly left a large gap for the IRS and the Department of the Treasury to fill by regulation in order to administer the consolidated return regime, and granted explicit authority in section 1502 for the Secretary to issue regulations to prevent tax avoidance.

B. Intercompany Transactions

Treas. Reg. § 1.1502-13 provides rules for taking into account items of income, gain, deduction, and loss of members derived from intercompany transactions. The purpose of these rules is to "clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding or deferring consolidated taxable income (or consolidated tax liability)."

An "intercompany transaction" is a transaction between corporations that are members of the same consolidated group immediately after the transaction. Treas. Reg. § 1.1502-13(b)(1)(i). "S" is the member transferring property or providing services and "B" is the member receiving the property or services. Intercompany transactions include distributions by S to its shareholder, B. In the Transaction, Sub 3's distribution of its Sub 4 stock to Sub 2 is an intercompany transaction. Sub 3 is the member transferring property and Sub 2 is the member receiving property.

Treas. Reg. § 1.1502-13(b)(2) defines "intercompany items" to include, generally, S's income, gain, deduction, and loss from an intercompany transaction. Thus, Sub 3's gain, if any, from the distribution of its Sub 4 stock to Sub 2 would be its intercompany gain.

Treas. Reg. § 1.1502-13(b)(2) further provides that "[a]n item is an intercompany item whether it is directly or indirectly from an intercompany transaction." Taxpayer maintains that Sub 3 changed the character of the income derived from Sub 4 from an

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[34] Chevron, U.S. A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843-44 (1984) (quoting Morton v. Ruiz, 415 U.S. 199, 231 (1974)).

[35] Id. at 844 (citations omitted).

amount required to be included in income pursuant to section 951 to a dividend that qualifies for the section 245 DRD because Sub 3 transferred its Sub 4 stock to Sub 2 before the end of Sub 4's taxable year. Accordingly, although it is not a change with respect to Sub 3's gain or loss on the transfer of the Sub 4 stock, this purported change in the character of Sub 3's income is the result of the intercompany transaction.

Treas. Reg. § 1.1502-13(a)(2) explains that the participants in an intercompany transaction, S and B, are treated as separate entities for some purposes, but as *divisions of a single corporation* for other purposes. The "*amount* and *location* of S's intercompany items and B's corresponding items are determined on a separate entity basis (separate entity treatment)." However, the "*timing,* and the *character, source,* and other *attributes* of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined under this section to produce the effect of transactions between divisions of a single corporation (single entity treatment)." Accordingly, although the character of Sub 3's income from Sub 4 is initially determined on a separate entity basis, under the general principles of Treas. Reg. § 1.1502-13(a), it must be redetermined to produce the same effect as though Sub 3 merely transferred the Sub 4 stock from one division to another division of a single corporation. Thus, all of Sub 3's and Sub 2's income from Sub 4 that is attributable to distributions from Sub 6 RIC is includible in income under section 951.[36]

C. The Anti-Avoidance Rule

In addition to the general principles set forth in Treas. Reg. § 1.1502-13(a), Treas. Reg. § 1.1502-13(h), a legislative regulation that addresses Congress' concerns about tax avoidance, sets forth an anti-avoidance rule, which states:

> If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section.

Treas. Reg. § 1.1502-13(h)(2) provides several examples of the application of the anti-avoidance rule. In Example 1, member "S" of a consolidated group owns land with a $10 basis and $100 value. Instead of selling the land directly to "X" (an unrelated party) in Year F, S contributes the land to a partnership in exchange for a 10 percent partnership interest. Section 721 applies to the transfer and the partnership does not have a section 754 election in effect. S then sells its partnership interest to another member of its consolidated group, "B," for $100. As a result, B's basis in the partnership interest is $100. S's $90 gain (or income) is deferred under the

[36] The distributions from Sub 4 would be treated as distributions of E&P described in section 959(c)(2) ("PTI distributions") to the extent they are included in income pursuant to section 951(a)(1)(A). The PTI distributions would be excluded from income under section 959(a), and would not be treated as dividends for purposes of chapter 1 of the Code pursuant to section 959(d).

consolidated return rules. B has net operating losses from separate return years that are subject to limitation under Treas. Reg. § 1.1502-21(c). The partnership then sells the land to X in Year G. Under section 704(c), the partnership's $90 gain is allocated to B, and B's basis in its partnership interest increases to $190 under section 705. The $90 partnership gain would ordinarily increase B's separate return limitation year ("SRLY") limitation. In a later year, B sells its partnership interest to a nonmember for $100, thereby realizing a $90 loss, which is not subject to limitation under the SRLY rules. The example disallows the $90 increase in B's unlimited SRLY loss. Accordingly, B is not able to offset its $90 gain upon its sale of the partnership interest.

Example 1 states that S's contribution of property and its sale of its partnership interest were part of a plan, a principal purpose of which was to achieve a reduction in consolidated tax liability. If S had directly sold its land to X in Year F, immediately after the sale:

(1) S would have held $100;
(2) X would have owned the land; and
(3) S would have had $90 of gain (or income) which would have been includable in the group's consolidated tax computation.[37] S's $90 profit would not have been offset by B's losses.

The rationale underlying the Treas. Reg. § 1.1502-13(h) adjustment in Example 1 is consistent with the rationale underlying such common law doctrines as the step transaction doctrine and the economic substance doctrine. S likely had a business purpose for the overall transaction: selling its land. However, rather than sell the land directly to X in Year F, S engaged in a number of steps so that it indirectly transferred the land to X in Year G. The extra steps did not increase the group's profit (other than the purported tax savings) because X paid only $100 for the land in Year G. Aside from the tax benefits of the transaction, taking the time value of money into account, and the costs of planning and engaging in the transaction, S would have been better off selling the land directly to X for $100 in Year F, and investing the proceeds.

Example 4 of Treas. Reg. § 1.1502-13(h) shows that the tax avoidance aspect of a transaction is not cured by stretching steps of a transaction out over an extended period of time, a legitimate business operation, or a third-party participant. In Example 4, two members of a consolidated group, M-1 and M-2, engage in a partnership mixing bowl transaction in order to shift $100 of basis from M-2's nondepreciable asset (land) to M-1's asset (which could be amortized but had a $0 basis). M-1 contributed an intangible asset to the partnership and M-2 contributed land. An unrelated third party contributed cash. The partnership engaged in a legitimate business for over 5 years before liquidating. In connection with the liquidation, M-1 received the land (which then had a $0 basis in M-1's hands) and M-2 received the intangible asset (which then had a

[37] The example does not state whether S held the land as inventory or as an investment.

$100 basis in M-2's hands). The basis exchange does not escape the application of Treas. Reg. § 1.1502-13(h).

D. Application of Treas. Reg. § 1.1502-13(h) to the Transaction

In the Transaction, as in Example 1 of Treas. Reg. § 1.1502-13(h), instead of carrying out a direct transaction, a consolidated group carried out a multi-step plan that included an intercompany transaction in order to alter the group's consolidated income tax ("CIT"). In each case, the taxpayer used the combination of steps to get a tax result that distorted the intended results of the consolidated return regulations.

Taxpayer takes the position that Sub 3 did not own any stock of Sub 4 on the last day of Sub 4's Year Y taxable year and that Sub 3's only inclusions in income with respect to Sub 4 for Year Y were dividends eligible for the section 245 DRD, rather than inclusions under section 951. Had Sub 3 held the Sub 4 stock on the last day of Sub 4's Year Y, Sub 3 would have been required under section 951 to include in income its pro rata share of Sub 4's subpart F income, which would have included the distributions received by Sub 4 from Sub 6 RIC. Had Sub 3 merely moved the Sub 4 stock from one branch of Sub 3 to another, it would not have changed the character of Sub 3's income with respect to Sub 4 from a section 951 inclusion to a dividend eligible for an 80 percent section 245 DRD. Although the consolidated return rules respect Sub 3's transfer of the Sub 4 stock to Sub 2, they treat the transfer as between divisions of a single corporation. Treas. Regs. §§ 1.1502-13(a)(2) and -13(c). Determined accordingly, the character of Sub 3's income with respect to Sub 4 is an inclusion under section 951.

Taxpayer attempted to change the character of Sub 3's income through the use of an intercompany transaction: Sub 3's distribution of its Sub 4 stock to Sub 2. Taxpayer's characterization of Sub 3's income with respect to Sub 4 as taxable dividends eligible for the section 245 DRD distorts the tax liability of Sub 3. In addition, as the income of Sub 3 is used to calculate the CIT liability of US Group,[38] Taxpayer's characterization distorts US Group's CIT liability. As each member of a consolidated group is severally liable for the CIT, Taxpayer's characterization of Sub 4's distributions to Sub 3 distorts the tax liability of every member of US Group.[39] Taxpayer's position does not clearly reflect the taxable income of the group as a whole. Accordingly, as discussed in Part II.B of the LAW AND ANALYSIS section of this memorandum, although Sub 3's income from Sub 4 is initially determined on a separate entity basis, it then must be redetermined to produce the same effect as though Sub 3 transferred the stock of Sub 4 from one division to another division of a single corporation.

[38] Treas. Reg. § 1.1502-11.

[39] Treas. Reg. § 1.1502-6.

III. Common Law Doctrines

A. Overview

Taxpayer asserts that Sub 3 is eligible for an 80 percent section 245 DRD because the Transaction complied with the literal requirements of the Code. Although U.S. federal tax law is based on statute, the tax treatment of a transaction is also subject to common law doctrines, including the economic substance doctrine and the substance over form doctrine.[40]

When determining whether a taxpayer is entitled to a deduction or loss, courts generally review the text and purpose of the applicable statute and analyze whether mere compliance with the statute is sufficient. Courts generally conclude that a taxpayer's formal compliance with a statute is not sufficient if the transaction's form is inconsistent with its substance or if the transaction is a sham. One commentator suggests that common law doctrines may be considered to be a method of statutory interpretation or that "the legislature assumes that [such doctrines] will be used to interpret the statutes it enacts."[41] This view is consistent with Judge Learned Hand's analysis in Commissioner v. Transport Trading & Terminal Corp.[42] Judge Hand stated that "in construing words of a tax statute which describe commercial or industrial transactions we are to understand 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."[43] The proposition that statutory law is applied only to the extent that it is consistent with the economic substance of an underlying transaction is also supported by the analysis of the Court of Appeals for the Federal Circuit in Coltec Industries, Inc. v. United States,[44] which treated economic substance as a *prerequisite* to the application of any Code provision that provides favorable tax treatment for a taxpayer.[45]

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[40] Wells Fargo & Co. v. United States, 641 F. 3d 1319, 1325 (Fed. Cir. 2011) ("judicial anti-abuse doctrines 'prevent taxpayers from subverting the legislative purpose of the tax code'") (quoting Coltec Indus., Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006)). Although income tax determination is generally rule based, there are a set of standards that overlay the rules. Some are built into the rules, such as anti-abuse provisions. Other standards are judicially created.

[41] Joseph Bankman, The Economic Substance Doctrine, 74 S. Cal. L. Rev. 5 (2000) (suggesting that under this latter theory, the common law doctrines have been implicitly adopted as part of the statute).

[42] 176 F.2d 570 (2d Cir.1949).

[43] Id. at 572.

[44] 454 F.3d 1340 (2006).

[45] Id. at 1355-56.

Even if Taxpayer satisfied the literal requirements of section 245 as in effect for the relevant taxable years, Sub 3 is not entitled to the section 245 DRD with respect to the dividends that it received from Sub 4 attributable to Sub 6 RIC's distributions because moving funds through a Country U corporation lacked economic substance.[46] Alternatively, Sub 3 is not entitled to the section 245 DRD under the substance over form doctrine.

B. Economic Substance Doctrine

Although one of the fundamental principles of taxation is that taxpayers can structure their transactions to minimize their tax liabilities, the economic substance doctrine requires a court to disregard a transaction that a taxpayer enters into without a business purpose in order to claim tax benefits not consistent with the purpose of the Code or regulations thereunder.

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1. Case Law

The economic substance doctrine is founded in several Supreme Court cases, including Gregory v. Helvering.[47] In Gregory, Mrs. Gregory owned all of the shares of the United Mortgage Corporation ("Mortgage") which owned some of the shares of Monitor Securities Corporation ("Monitor"). If Mortgage sold its Monitor shares, it would incur a corporate level tax on its significant capital gain and Mrs. Gregory would incur a shareholder level tax when Mortgage distributed the cash proceeds to her as a dividend. To reduce her tax liability, she caused Mortgage to transfer the stock of Monitor to Averill Corporation (a newly formed corporation, wholly owned by Mrs. Gregory) under an agreement pursuant to which Averill issued all of its stock to Mrs. Gregory in exchange for the Monitor shares. The transaction satisfied the literal terms of the reorganization provisions then in effect. A few days after receiving the Averill stock, Mrs. Gregory caused Averill to dissolve. In connection with its dissolution, Averill distributed all of its Monitor stock to Mrs. Gregory and she then sold the Monitor stock. The Court opined that the issue to be determined was "whether what was done, apart from the tax motive, was the thing which the statute intended."[48] In interpreting the reorganization statute, the court concluded that the transfer of assets by one corporation to another required a transfer in pursuance of a reorganization of corporate

[46] Taxpayer entered into the Transaction before the effective date of section 7701(o), which codified the economic substance doctrine. Accordingly, this memorandum does not address the application of section 7701(o) to the Transaction.

[47] 293 U.S. 465 (1935).

[48] Id. at 469.

business. The Court concluded Mrs. Gregory's transaction was an operation "having no business purpose,"[49] but was instead a mere device to transfer shares to Mrs. Gregory in the guise of a corporate reorganization. Although the Court acknowledged that Averill was a valid corporation, it found that Averill was "nothing more than a contrivance"[50] to accomplish Mrs. Gregory's plan. The Court denied the transaction reorganization treatment, stating that to "hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."[51]

In the Eighth Circuit, "under the common law 'sham transaction' or 'economic substance' doctrine, 'even if a transaction is in 'formal compliance with Code provisions' a deduction will be disallowed if the transaction is an economic sham.'"[52] Under this analysis, Sub 3's section 245 DRD is disallowed if the steps in the transaction that result in the deduction constitute an economic sham, even if the transaction otherwise satisfies the literal terms of the relevant Code provisions.

Although the Eighth Circuit also traces the origin of the economic substance doctrine to the Supreme Court's holding in Gregory, it attributes the current application of the doctrine to Frank Lyon Co. v. United States.[53] In Frank Lyon, a bank wanted to build a new building for its headquarters. After determining that federal and state laws and regulations prohibited it from constructing and financing a new building through more conventional means,[54] it entered into a sale-and-leaseback arrangement with Frank Lyon Company ("Lyon"), an unrelated entity. Lyon was owned by a member of the bank's Board of Directors. The bank selected Lyon to enter the arrangement following a competitive proposal process that involved independent potential investors.[55] Lyon obtained construction financing and a mortgage loan from two independent lenders.[56] The lease agreement between Lyon and the bank provided the bank with

[49] Id.

[50] Id.

[51] Id. at 470.

[52] WFC Holdings Corp. v. United States, 728 F.3d 736, 742 (8th Cir. 2013) (quoting Dow Chem. Co. v. United States, 435 F.3d 594, 599 (6th Cir. 2006)) (quoting Am. Elec. Power Co., Inc. v. United States, 326 F.3d 737, 741 (6th Cir. 2003)).

[53] 435 U.S. 561 (1978).

[54] Id. at 563-64.

[55] Id. at 564-65.

[56] Id.

both a purchase option and a lease renewal option for the building.[57] Although Lyon bore the risk that the bank would default or fail to exercise either of its options, the agreement terms were such that Lyon would receive payments sufficient to cover its mortgage payments as well as a return of its initial investment plus 6% interest compounded on the amount of the investment.[58] The IRS disallowed Lyon's rental income and expenses for interest and depreciation with respect to the bank building after determining that Lyon was "not the owner for tax purposes of any portion" of the building.[59] The IRS took the position that the transaction should be disregarded because it was a sham designed to produce tax deductions. The Supreme Court disagreed and indicated that a transaction should be respected for tax purposes:

> where…there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.[60]

In its 1990 decision in Shriver v. Commissioner,[61] the Eighth Circuit applied the two-part test set forth in Rice's Toyota World Inc. v. Commissioner,[62] but did not adopt it. Under Rice's Toyota World, a transaction is a sham if it (1) lacks a business purpose apart from obtaining tax benefits, and (2) has no economic substance "because no reasonable possibility of a profit exists."[63] Even though the Eighth Circuit analyzed the Shriver transaction under both parts of the test, it said in dictum, "[W]e do not read Frank Lyon to say anything that mandates a two-part analysis."[64] The Eighth Circuit also considered the economic substance doctrine in IES Industries, Inc. v. United States[65] in 2001. In IES, the court concluded that the transactions at issue had both economic substance and a business purpose but did not decide whether the doctrine required a two-part analysis. It noted, however, that Shriver suggests that the failure of

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[57] Id. at 566.

[58] Id. at 567.

[59] Id. at 568.

[60] Id. at 583-84.

[61] 899 F.2d 724 (8th Cir. 1990).

[62] 752 F.2d 89 (4th Cir. 1985).

[63] Id. at 91.

[64] Id. at 727.

[65] 253 F.3d 350 (8th Cir. 2001).

one test would result in the conclusion that the transaction in question is a sham for U.S. federal income tax purposes.[66] In WFC Holdings Corp. v. United States,[67] a more recent decision, the Eighth Circuit noted that that the courts of appeals do not have a consistent approach on the application of the economic substance/sham transaction doctrine.[68] It outlined the following approaches taken by various courts of appeal:

(1) a disjunctive analysis, under which a transaction is valid if it has a business purpose *or* has economic substance;

(2) a conjunctive analysis, under which a transaction is valid only if the transaction has both a business purpose *and* economic substance beyond tax objectives;

(3) an analysis under which a lack of economic substance is sufficient to sham a transaction even if the taxpayer has motives other than tax avoidance; and

(4) an analysis under which the objective and subjective prongs of the two-part test are factors to consider in determining whether a transaction has any practical economic effects other than with respect to taxes.

After setting forth the possible ways to apply the doctrine, the court held that the transaction at issue had neither economic substance nor a business purpose and, accordingly, noted that it did not need to reach a conclusion about which test to apply.

The Ninth Circuit has explained in case law that the Commissioner's determination that a transaction is a sham is presumptively correct and Taxpayers have the burden of producing evidence to rebut the deficiency determination and the burden of persuasion to substantiate the deduction.[69]

The Ninth Circuit's application of the economic substance doctrine focuses on both the subjective aspect of whether the taxpayer intended to do anything other than acquire tax deductions and the objective aspect of whether the transaction had any

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[66] Id. at 353.

[67] 728 F.3d 736 (8th Cir. 2013).

[68] See id. at 744, n. 3.

[69] Reddam v. Comm'r, 755 F.3d 1051, 1059 (9th Cir. 2014) (quoting Sochin v. Comm'r, 843 F.2d 351, 355 n. 9 (9th Cir. 1988)).

economic substance other than the creation of tax benefits. However, Ninth Circuit case law emphasizes that the economic substance doctrine is not a rigid two-step analysis. Rather the court focuses holistically on whether the transaction had any practical economic effects other than the creation of income tax losses.[70]

In its most recent pronouncement on the economic substance doctrine, the Federal Circuit reiterated that it follows the disjunctive test for determining whether a transaction should be disregarded as an economic sham.[71] That is, a transaction should be disregarded if it "lacks objective economic substance or if it is subjectively shaped solely by tax avoidance motives."[72]

With regard to the objective prong, the court stated that a transaction lacks economic reality if it does not alter "the taxpayer's economic position in any meaningful way apart from their tax consequences, typically entailing no risk and no significant possibility of profit other than as a result of tax consequences."[73] Importantly, the fact that a transaction lacks the potential for economic profit is not dispositive of the lack of economic reality. In Salem Financial, Inc. v. United States,[74] the court cited the following characteristics of the transaction to support its finding that it lacked economic reality: circular cash flows that had no real economic effect other than tax benefits; the transfer of income producing assets to controlled entities that had no incremental effect on the taxpayer's activities; a lack of genuine economic risk; and, an "unlimited capacity to generate gains, without any additional exposure or commitment of resources."[75]

In considering the lack of a business purpose for the transaction, the Salem court relied on evidence establishing that the transaction had been designed to save taxes and had been promoted as a prepackaged tax strategy.[76] Without incremental profit potential other than tax benefits and risk other than tax risk, the court found that the

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[70] Sochin v. Comm'r, 843 F.2d 351, 354 (9th Cir. 1988).

[71] Salem Fin., Inc. v. United States, 786 F.3d 932, 942 (Fed. Cir. 2015).

[72] Stobie Creek Inv. v. United States, 82 Fed. Cl. 636, 697 (2008).

[73] Salem, 786 F.3d at 942.

[74] 786 F.3d 932 (Fed. Cir. 2015).

[75] Id. at 951.

[76] Taxpayer maintains that it did not purchase the Transaction that is the subject of this memorandum as a prepackaged tax strategy. However, this tax strategy has not been limited to Taxpayer's use; a very similar transaction is discussed in a Chief Counsel advisory memorandum dated January 18, 2013 (CCA 201320014).

transaction was created "solely" to generate tax savings and therefore lacked a business purpose.[77]

As stated by the court in Stobie Creek Investments v. United States,[78] "the disjunctive approach reflects the more flexible and considered approach to the Supreme Court's economic substance doctrine as set forth in Frank Lyon."[79]

In its overview of the economic substance doctrine in Coltec, the Court of Appeals for the Federal Circuit explained that over many years, the doctrine has "required disregarding, for tax purposes, transactions that comply with the literal terms of the tax code but lack economic reality,"[80] and noted that the economic substance doctrine is a "judicial effort to enforce the statutory purpose of the tax code."[81] It is a tool "to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that … lack economic reality simply to reap a tax benefit."[82] The court stated that the economic substance doctrine incorporates the following principles:

(1) Although a taxpayer has a right to decrease taxes by means which the law permits, a taxpayer may not reap tax benefits from a transaction that lacks economic reality. The Gregory case gives support to disregarding transactions that do not serve a business purpose, do not vary control, or do not change the flow of economic benefits. The economic substance doctrine may apply if the taxpayer's sole subjective motivation is tax avoidance, even if a transaction has economic substance; but if a transaction has no economic substance, it may also be disregarded, even if tax avoidance is not the taxpayer's sole motive.[83]

(2) When a taxpayer claims a tax benefit, the taxpayer must prove that the transaction has economic substance. It is a heavy burden for the taxpayer to demonstrate that Congress intended to give favorable tax treatment to a transaction that would not have occurred but for the motive of tax avoidance.[84]

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[77] Salem, 786 F.3d at 953.

[78] 82 Fed. Cl. 636 (2008).

[79] Id. at 698.

[80] Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1352 (Fed. Cir. 2006).

[81] Id. at 1353.

[82] Id. at 1354.

[83] Id. at 1355.

[84] Id. at 1355-56.

(3) "[T]he economic substance of a transaction must be viewed objectively rather than subjectively."[85] Black & Decker Corp. v. United States[86] explains that the economic substance inquiry requires an "'objective determination of whether a reasonable possibility of profit from *the transaction* existed.'"[87]

(4) "[T]he transaction to be analyzed is the one that gave rise to the alleged tax benefit."[88]

(5) "[A]rrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny."[89]

2. Application of the Economic Substance Doctrine to Taxpayer's Transaction

a. The Transaction to Be Analyzed

A "preliminary step of the economic substance inquiry is to identify the transaction to be analyzed."[90] As discussed in Coltec, the economic substance doctrine should be applied to the transaction steps that gave rise to the alleged tax benefit.

If a member of US Group had invested directly in Business O Eligible Investments, it would have had to include the resulting interest and capital gain in its income without any offsetting DRD.[91] Similarly, if a member of US Group had invested

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[85] Id. at 1356.

[86] 436 F.3d 431, 441-42 (4th Cir. 2006) (explaining that shamming a corporation under Moline Prop. v. Comm'r, 319 U.S. 436 (1943), is a different analysis than shamming a transaction with a controlled corporation under the objective prong of the economic substance doctrine).

[87] Id. at 441 (quoting Rice's Toyota World Inc. v. Comm'r, 752 F.2d 89, 94 (4th Cir. 1985)).

[88] Coltec, 454 F.3d at 1356. The court describes, as an example, the transaction in Basic Inc. v. United States, 549 F.2d 740 (Ct. Cl. 1977). In Basic, in anticipation of the sale of its carbon business to a third party, a parent corporation caused its first-tier subsidiary to distribute the stock of a second-tier subsidiary to the parent. The parent corporation then sold both subsidiaries to the buyer. As a result of the distribution, the parent corporation's tax liability with respect to the sale was lower than it would have been if the first-tier subsidiary had sold the stock of the second-tier subsidiary to the buyer. The Basic court did not allow the business purpose for the ultimate sale to justify the intermediate transfer.

[89] Coltec, 454 F.3d at 1357.

[90] Bank of N.Y. Mellon v. Comm'r, 801 F.3d 104, 115 (2d Cir. 2015).

[91] Clearly, a member of US Group could not offset interest and capital gain income through the use of the section 243 DRD because such income would comprise dividends.

directly in a RIC, such as Sub 6 RIC, it would have had to include its interest-related dividend distributions and capital gain distributions in income without an offsetting section 243 DRD.[92] Taxpayer treated Sub 3 as contributing funds to Sub 4 and receiving dividend distributions from Sub 4 in order to avoid the application of section 854, and, instead, claim the section 245 DRD. Taxpayer moved funds through Sub 4 in order to convert interest and capital gain income into section 316 dividends of U.S.-source earnings from a foreign corporation that would qualify for an 80 percent DRD under section 245. In furtherance of its plan to eliminate almost all U.S. federal income tax on the income from the Business O Eligible Investments, Taxpayer also caused Sub 3 to distribute the stock of Sub 4 to Sub 2 in order to avoid the application of section 951 with respect to most of Sub 4's subpart F income.

Taxpayer will likely maintain that the Transaction, viewed in its entirety, served the business purpose of investing in Business O Eligible Investments. Having identified a business activity, Taxpayer may assert that it should be able to structure this activity in a manner that is advantageous from a tax savings perspective. Although Taxpayer's investments in Business O Eligible Investments produced a profit and served a valid business purpose, the transaction at issue in this economic substance inquiry is not the investment activity itself, but rather the "part of a larger series of steps . . . 'that generated the claimed deductions.'"[93] Elements of the larger series of steps in the Transaction did not generate any incremental profit other than tax benefits and, being strictly among controlled entities, entailed no risk other than tax risk.

In order to avoid the application of section 854, invoke the section 245 DRD, and avoid section 951,Taxpayer (i) re-domiciled Sub 4 to Country U; (ii) funneled investment funds and the return on investment through a Country U corporation; and (iii) transferred the Sub 4 stock from Sub 3 to Sub 2 before the end of Sub 4's Year Y taxable year. Accordingly, this part of the larger Transaction is analyzed under the economic substance doctrine. If these elements of the Transaction lack economic substance, they are not given effect, and Sub 3 does not get the benefit of the section 245 DRD.

In the alternative, Taxpayer will fail to sustain its position that Sub 3 qualifies for the section 245 DRD if Taxpayer's use of the Country U corporation to funnel funds between US Group and Sub 6 RIC in and of itself lacks economic substance. If just this part of the Transaction lacks economic substance, the Country U corporation's participation in the Transaction is not given effect, and accordingly, Sub 3 does not get the benefit of the section 245 DRD.

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[92] As discussed in Part III.B.2.d.i of the LAW AND ANALYSIS section of this memorandum, the section 243 DRD would have been precluded under section 854(a).

[93] Bank of N.Y. Mellon, 801 F.3d at 115 (quoting Nicole Rose Corp. v. Comm'r, 320 F.3d 282, 284 (2d. Cir. 2003)).

b. The Economic Substance Test

The objective economic substance prong focuses on whether a transaction has an effect on a taxpayer's economic position apart from U.S. federal income tax effects. Under this prong, a transaction does not have economic substance if there is not a reasonable possibility of deriving a profit from the transaction.

As discussed in Part I of the FACTS section of this memorandum, one or more members of US Group historically invested the Customer Funds in Business O Eligible investments and sought to make a profit on such investments. During certain periods of time, Business O Eligible Investments produced a very low return. Therefore, Taxpayer planned to increase its net investment profit by paying less U.S. federal income tax.

Taxpayer's investment of the Customer Funds in Business O Eligible Investments had economic substance. However, the transaction, in which Taxpayer moved Sub 4 to Country U, routed funds through Sub 4, and moved the location of the Sub 4 stock within US Group, did not provide a potential for increasing US Group's investment return other than by the amount of the tax savings attributable to the section 245 DRD. A taxpayer "cannot avoid the requirements of economic substance simply by coupling a routine economic transaction generating substantial profits with no inherent tax benefits to a unique transaction that otherwise has no hope of turning a profit."[94] Courts have opined that "transfers of income-producing assets to controlled entities do not imbue an arrangement with substance if the transfer has no incremental effect on the taxpayer's activities."[95]

Engaging in the Transaction in order to ultimately invest in Business O Eligible Investments did not increase Taxpayer's profit potential on such investments (independent of tax savings). To the contrary, it reduced profitability by adding substantial transaction costs. Taxpayer candidly acknowledged that it expected its profits to be reduced as a result of the multi-step transaction if the IRS disallowed the deduction because of the costs of creating and implementing the Transaction. Taxpayer's contemporaneous documents reflect that it did not have a reasonable expectation of increasing its pre-tax profit on its Business O Eligible Investments

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[94] Long Term Capital Holdings v. United States, 330 F.Supp. 2d 122, 183 (D. Conn. 2004).

[95] Salem Fin., Inc. v. United States, 112 Fed. Cl. 543, 586 (2013), aff'd in part, rev'd in part, and remanded by Salem Fin., Inc. v. United States, 786 F.3d 932 (Fed. Cir. 2015). See also Southgate Master Fund v. United States, 659 F.3d 466, 491-92 (5th Cir. 2010) (disregarding partnership used to acquire loan receivables); ACM P'ship v. Comm'r, 157 F.3d 231, 249-52 (3d Cir. 1998) (disregarding returns on Citicorp notes where economic returns on capital were unaffected by the transaction); Zmuda v. Comm'r, 731 F.2d 1417, 1421 (9th Cir. 1984) (disregarding contribution of income producing assets to foreign trusts).

because of its indirect investment strategy; Taxpayer's documents show that the increase in profit from the Transaction was to result solely from the DRD.

Taxpayer's indirect investment of Customer Funds in Business O Eligible Investments through Sub 4 did not provide a reasonable opportunity for economic profit, other than the profit that would have been earned had Taxpayer invested directly in Sub 6 RIC or directly in the Business O Eligible Investments.

Sub 4 did not provide investment advice with respect to the Business O Eligible Investments. Rather, Sub D, a member of US Group and a registered investment advisor, operated as Sub 6 RIC's investment advisor. Sub D managed Sub 6 RIC's investments in accordance with US Group's investment guidelines. Moreover, the Business O Eligible Investments continued to be subject to Agency 1's oversight and restrictions even though US Group held them indirectly through Sub 4 (a Country U entity). Taxpayer sought assurances from Agency 1 that the Transaction would not cause "safety and soundness" issues because Sub C (a member of US Group) needed to take the Business O Eligible Investments into account in determining whether it satisfied certain of Agency 1's requirements. To this end, Taxpayer informed Agency 1 that Quote 6. In addition, Taxpayer informed prospective note holders of Sub 6 RIC that Quote 7.

The funds used to invest in the Business O Eligible Investments came from one or more members of US Group. Employees of a member of US Group determined what investments were to be made. Taxpayer did not increase its profit on the Business O Eligible Investments by accounting for the funds as if they were routed from US Group members through Sub 4 on their way to Sub 6 RIC, or by having Sub 4 hold distributions from Sub 6 RIC for a transitory period before transferring the funds to Sub 3.

We conclude that Taxpayer fails to satisfy the objective prong of the economic substance test. Moving Sub 4 to Country U, funneling funds through Sub 4 as a Country U corporation, and moving the Sub 4 stock from Sub 3 to Sub 2, did not give Taxpayer any reasonable expectation of economic profit over and above the profit it could expect if a member of US Group directly invested in Business O Eligible Investments or invested in a RIC that invested in Business O Eligible Investments. Taxpayer took these steps to avoid the application of section 854, which prevents Sub 3 from offsetting its income attributable to Sub 6 RIC's distributions with the section 243 DRD and to avoid an inclusion under section 951 with respect to Sub 3.

In the alternative, we conclude that Taxpayer fails to satisfy the objective prong of the economic substance test with respect to its funneling of investment funds and its investment returns through a Country U corporation. Taxpayer routed its Customer Funds and its return on investment through Sub 4 to circumvent the application of section 854. Routing funds through Sub 4 did not give Taxpayer any reasonable expectation of economic profit over and above the profit it could expect if a member of

US Group directly invested in Business O Eligible Investments or invested in a RIC that invested in Business O Eligible Investments.

c. The Business Purpose Test

The subjective business purpose prong of the economic substance test focuses on whether the taxpayer acted with a business purpose other than tax avoidance. A sophisticated and well-advised taxpayer is aware of the business purpose prong of the economic substance doctrine analysis. Likely anticipating a challenge by the IRS, Taxpayer included a list of purported business purposes for the use of a Country U corporation in its planning documents.

Taxpayer claims that it used a corporation organized in Country U in the Transaction for the business purpose of attracting foreign investors. Taxpayer maintains that foreign investors would be subject to U.S. federal withholding taxes on distributions from a domestic entity but would not be subject to similar withholding taxes on payments made by an entity organized in Country U. This justification is unpersuasive because Taxpayer relied on sections 871(k) and 881(e) to exempt distributions from Sub 6 RIC to Sub 4 from U.S. federal withholding taxes. Non-U.S. investors would have likewise been exempt from U.S. federal withholding taxes under sections 871(k) and 881(e) if they had invested directly in Sub 6 RIC. Thus, there is no support for Taxpayer's claim that it was necessary to use a Country U corporation as an investment vehicle for potential foreign investors in order to reduce U.S. federal withholding taxes.

Taxpayer presents additional justifications to support its purported business purpose for using a Country U corporation. Taxpayer suggests that non-U.S. investors may prefer to invest in U.S. assets indirectly through non-U.S. entities so that they appear to be investing in a country other than the United States for non-tax personal reasons. However, there is no evidence that Taxpayer actually sought, or planned to seek, non-U.S. investors for Sub 4. To the contrary, Taxpayer assured Agency 1 that Quote 5. Taxpayer would not have made this representation to Agency 1 if it intended to issue Sub 4 stock to non-U.S. investors.

In addition, Taxpayer claims that non-U.S. investors would prefer to invest in a corporation organized in Country U because they would be afforded better protection in the event that Common Parent declared bankruptcy, as the creditors would have more difficulty reaching assets of a Country U subsidiary. Taxpayer assured Agency 1 that the assets would be held in the United States. Taxpayer's continued reliance on the Business O Eligible Investments for purposes of satisfying the safety and soundness requirements of Sub C is inconsistent with Taxpayer's alleged business purpose of moving the assets out of the reach of U.S. creditors. Accordingly, Taxpayer's argument that it used an entity organized in Country U in order to attract non-U.S. investors has no merit.

Another claimed business purpose for having Sub 3 hold Sub 6 RIC stock indirectly through Sub 4, rather than holding the stock directly or through another subsidiary organized in State T, was to avoid tax that State T would have imposed on distributions received by a State T subsidiary from Sub 6 RIC. Country U had agreed to not subject Sub 4 to income tax under the laws of Country U for at least twenty years, but no such agreement had been reached with State T. As planned, by the end of Year Y, Taxpayer caused Sub 4 to distribute its earnings to Sub 3, a State T corporation. Thus, income attributable to the Business O Eligible Investments was apparently subject to State T tax. Taxpayer has not substantiated the difference between the state tax that Sub 3 would have had to pay had it directly invested in the Business O Eligible Investments, invested in the stock of Sub 6 RIC through another State T subsidiary, or directly invested in the stock of Sub 6 RIC, and the amount of state T tax it paid because it received a distribution from Sub 4. Even assuming that there were State T tax savings, any savings must be offset by the Transaction costs and, as Taxpayer noted, the potential loss of valuable public goodwill. Taxpayer's claimed business purpose of using a Country U corporation in order to save State T tax is unpersuasive.

It is notable that Taxpayer's asserted business purposes for using an entity formed in Country U in the Transaction do not include operating a business in Country U. In connection with obtaining Agency 1's approval for the Transaction structure, Taxpayer, in effect, asked Agency 1 to disregard Sub 4 and look through to Sub 6 RIC and Sub 6 RIC's underlying investments. Taxpayer assured Agency 1 that Sub 4 would conduct only de minimis activities in Country U. In fact, in its correspondence with Agency 1, Taxpayer referred to Sub 4 as a "domestic operating" subsidiary.[96]

The funds used to invest in the Business O Eligible Investments came from one or more members of US Group. Employees of a member of US Group determined what investments were to be made. Taxpayer's transaction planning documents make it clear that Taxpayer did not intend that Sub 4 itself would benefit from the investment funds or the investment return on the Business O Eligible Investments. Members of US Group directly wired the investment funds to Sub 6 RIC; Sub 4 did not have any opportunity to control the funds before Sub 6 RIC used them to purchase Business O Eligible Investments in accordance with Taxpayer's Transaction plan. Before commencing the Transaction, Taxpayer determined that Sub 4 would distribute the funds it received from Sub 6 RIC to Sub 3 before the end of Sub 4's Year Y.[97] Taxpayer

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[96] Taxpayer has not explained its treatment of the corporation organized in Country U as a "domestic operating" subsidiary in its dealings with Agency 1.

[97] Taxpayer claims that Sub 4 received funds from Sub 6 RIC in Year Z and did not distribute them to Sub 2 before the end of Sub 4's Year Z taxable year. We understand that Sub 2 did not claim a section 245 DRD in Year Z. However, in Year AA and Year BB, Taxpayer carried out the Transaction again. It is our understanding that in Years AA and BB, Taxpayer intends to have a member of US Group claim the benefit of the section 245 DRD. The dollar amount of the funds held by Sub 4 in Year Z and included by Sub 2 as a section 951 inclusion was small compared to the amounts Taxpayer treated and may treat as dividends qualifying for the 80 percent section 245 DRD in Years Y, AA and BB. Sub 4's retention of

carried out the Transaction consistent with its plan.

There is evidence to support the inference that Taxpayer's only purpose for moving funds from Sub 6 RIC to Sub 4 before returning the funds to a member of US Group was tax avoidance. Taxpayer's contemporaneous documents discuss the deduction that the Transaction was to provide, rather than any increased business profit or other valid business purpose. The documents evaluate the success of the Transaction solely in terms of its tax consequences. Taxpayer moved funds through a foreign corporation in order to create a dividend eligible for a DRD. Taxpayer did not have a legitimate business purpose for funneling the income derived from the Business O Eligible Investments through a CFC.

We conclude that Taxpayer fails to satisfy the business purpose prong of the economic substance test. Taxpayer's business purpose for the Transaction was to invest in Business O Eligible Investments so as to maintain the safety and soundness of Sub C. Taxpayer has not provided a plausible business purpose for moving Sub 4 to Country U, funneling funds through Sub 4 as a Country U corporation, and moving the Sub 4 stock from Sub 3 to Sub 2.

Taxpayer also fails to satisfy the business purpose prong of the economic substance test specifically with respect to its funneling investment funds and its investment returns through a Country U corporation. Funneling the Customer Funds and the return on investment through a Country U corporation did not enhance Taxpayer's profit potential on the Business O Eligible Investments (other than the tax savings) and did not serve any other non-tax business purpose.

d. Congressional Intent

The economic substance doctrine does not apply when a taxpayer's treatment of an item is consistent with the congressional intent underlying the relevant Code sections. Thus, in addition to the two-pronged test discussed earlier in this memorandum, the economic substance doctrine requires an analysis of the Congressional intent underlying the Code sections at issue. This section of the memorandum analyzes the Congressional purpose for enacting the DRD provisions, as well as other Code sections relied on by Taxpayer with respect to its treatment of the Transaction for U.S. federal income tax purposes.

Prior to the enactment of sections 881(e) and 871(k), which exempt *foreign* shareholders from withholding tax on interest-related dividends received from a RIC, such dividends were subject to withholding tax. As explained below, Congress provided tax relief to *foreign* investors in sections 881(e) and 871(k) to encourage them to invest

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funds in Year Z, and interest earned on the funds during this time, does not change our economic substance analysis. Any interest earned by Sub 4 on the funds it received from Sub 6 RIC is dwarfed by the magnitude of the tax deduction that Taxpayer's use of Sub 4 was designed to generate.

in the United States. Section 245 gives tax relief to *domestic* shareholders of foreign corporations. Congress did not amend section 245 upon enacting sections 881(e) and 871(k) to expressly forbid *domestic* corporations from using foreign conduits to convert RIC interest-related and capital gain dividends into dividends eligible for a section 245 DRD. Taxpayer took the lack of such a specific statutory prohibition as permission to do so. Taxpayer's DRD should be disallowed under the economic substance doctrine because, as set forth below, there is clear evidence that Congress did not intend taxpayers to be able to convert interest income and capital gains into dividends eligible for the DRD.

i. Section 243 and Subchapter M

RICs are generally subject to taxation under special rules in subchapter M (sections 851 through 860G). A RIC that satisfies the requirements under section 852(a) is generally able to take a DPD in computing its taxable income.[98] Thus, a RIC can eliminate tax at the entity level by properly distributing its income. RICs generally make timely distributions to their shareholders in order to take advantage of the DPD.

Corporate earnings are generally subject to two levels of tax: the corporation is taxed on its earnings and the corporation's shareholders are taxed on the corporation's distributions of its earnings. The taxation of RICs under subchapter M provides an exception from the corporate level tax on corporate earnings. The DRD provides another exception from the multiple layers of tax on corporate earnings. When originally enacted in 1917, the DRD was intended "to eliminate or minimize further multiples of taxation of corporate earnings as the earnings pass from one corporation to another."[99] Accordingly, as noted upon amendment of the DRD provisions in 1932, "[w]here … the distributing corporation is exempt from tax, there is no reason why the dividends should be deducted from the gross income of the stockholder corporation."[100]

Section 243(a) generally allows a corporation to take as a deduction an amount equal to a specified percentage of the amount received as dividends from a domestic corporation that is itself subject to U.S. federal income tax. However, section 243(d) states that, for purposes of section 243(a), a dividend received from a RIC is subject to the limitations prescribed in section 854. The Internal Revenue Code of 1954[101] added section 854, which governs which dividends received from a RIC give rise to a DRD. In

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[98] Sections 852(b)(2)(D) and 852(b)(3)(A).

[99] 134 Cong. Rec. H6319-03.

[100] H. Rep. No. 708, 72d Cong., 1st Sess., at 12 (1932) (noting also, "[d]ividends received by a corporation are allowed as a deduction in computing the net income of a corporation, upon the theory that a corporate tax has already been paid upon the earnings out of which the dividends are distributed.").

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

enacting this provision, Congress noted that the purpose of the DRD is "to limit the *multiple* taxation of intercorporate dividends."[102] Congress was concerned that, under prior law, a corporate shareholder of a RIC might claim a DRD with respect to a dividend paid by a RIC attributable to interest that the RIC received on bond investments. Congress believed that this resulted in tax avoidance because the corporation that issued the bond received an interest deduction and neither the RIC nor the corporate shareholder of the RIC paid the full tax on the interest income.[103] Section 854 was Congress' attempt to prevent this abuse by limiting the use of the DRD with respect to RIC distributions.

In 1984, Congress amended section 854 to further narrow the eligibility of RIC distributions for the DRD. Under section 854(b) as originally enacted, if at least 75 percent of a RIC's gross income consisted of dividends from domestic corporations, then all of the RIC's distributions were treated as dividends eligible for the DRD. Thus, up to 25 percent of the RIC's gross income could consist of interest income.[104] Congress was concerned that the original "rules permit a taxpayer to convert interest income into dividend income. Taxpayers have organized RICs to take advantage of this conversion opportunity."[105] Congress explained that a change in the law was necessary because this opportunity was "unwarranted."[106]

To prevent such inappropriate use of the section 243 DRD, Congress amended section 854 so that a shareholder of a RIC cannot treat any dividend received from the RIC as a dividend for purposes of the DRD except to the extent that the RIC can identify the distribution as eligible for the DRD.[107] The amount of dividends a RIC can identify as eligible for the DRD in a taxable year generally is limited to the amount of dividends that the RIC receives from domestic corporations in that year that would give rise to a DRD in the hands of the RIC if RICs were permitted to claim the DRD.[108]

In the instant case, Sub 6 RIC did not receive any dividends that would qualify for

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[102] S. Rep. No. 1622, 83rd Cong., 2d Sess., at 103 (1954) (emphasis added).

[103] Id. at 103-104.

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

[105] H.R. Rep. No. 432(II), 98th Cong., 2d Sess., at 1183 (1984).

[106] Id.

[107] Section 854(b)(1)(A). The rule for identifying dividends eligible for a DRD was changed by the Regulated Investment Company Modernization Act of 2010 (Pub. L. No. 111-325, 124 Stat. 3537 (2010)), from a designation requirement to a written notice requirement. The limit on the amount of a RIC dividend that may be treated as a DRD-eligible dividend remains unchanged.

[108] See sections 854(b)(2) and (3). Under section 852(b)(2)(C), a RIC is not allowed a DRD.

a DRD if Sub 6 RIC were allowed a DRD, and, therefore, none of Sub 6 RIC's distributions were eligible for the DRD. Thus, Sub 6 RIC did not provide notice to its shareholder that the distributions were dividends eligible for the section 243 DRD.

ii. Portfolio Interest Exception

In the instant case, Taxpayer claims that the distributions from Sub 6 RIC to Sub 4 are exempt from withholding tax under section 881(e). Taxpayer needs to rely on sections 881(c) and (e) in order to avoid withholding tax on the distribution to Sub 4, which is necessary to achieve its tax savings on the Transaction. Congress enacted sections 871(h) and 881(c) in the Tax Reform Act of 1984 (the "Tax Reform Act"),[109] to encourage foreign investors to invest in the United States, to enhance the U.S. government's and U.S. business' access to international capital markets, and to eliminate the need for U.S. borrowers to use intermediary financing affiliates.[110]

Prior to 1984, a foreign person that received U.S.-source interest income was generally subject to U.S. federal income tax on the interest. If the interest was not connected with the foreign person's trade or business within the United States, the tax generally was collected by withholding the amount of tax from the interest when it was paid to the foreign person.[111] The legislative history of the Tax Reform Act indicates that Congress wanted to allow U.S. businesses and the U.S. government to raise money through the Eurobond market. Congress determined that the U.S. federal withholding tax on certain interest paid to foreign lenders impeded access to the Eurobond market.[112] The portfolio interest provisions in the Tax Reform Act eliminated the 30 percent withholding tax on interest received by nonresident aliens and foreign corporations with respect to certain debt obligations issued by U.S. corporations or the U.S. government after July 18, 1984, through the addition of sections 871(h) and 881(c) to the Code.

In 2004, Congress expanded the portfolio interest exemption with the addition of sections 871(k) and 881(e),[113] which generally exempt interest-related dividends paid to a foreign person by a RIC from the 30 percent withholding tax.[114] In effect, these

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[109] Pub. L. No. 98-369, 98 Stat. 494 (1984).

[110] See S. Rep. No. 169(I), 98th Cong., 2d Sess., at 417-421 (1984).

[111] Sections 1441 and 1442.

[112] See S. Rep. No. 169(I), 98th Cong., 2d Sess., at 417-421 (1984).

[113] American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

[114] Section 881(e) provides that, except as otherwise provided, "no tax shall be imposed … on any interest-related dividend (as defined in section 871(k)(1)) received from a regulated investment company." An "interest related dividend" is generally a dividend that the RIC pays out of certain interest income that would not be subject to tax in the hands of a shareholder that is a foreign corporation or a nonresident

provisions give a foreign investor in a RIC that holds investments that generate U.S.-source interest the same U.S. federal income tax result as if the investor had directly invested in the underlying investments. When the foreign investor is a CFC, any interest-related dividends eligible for the section 881(e) exclusion must be included in the CFC's subpart F income without regard to certain exceptions, including the de minimis exception under section 954(b)(2), and the related party exception under section 954(c)(3).[115] Accordingly, the U.S. shareholders of a CFC generally would have section 951 inclusions based, in part, on the full amount of the interest-related dividends received by the CFC. Congress did not intend to allow U.S. taxpayers to be able to avoid U.S. federal income tax under section 881(e) by investing through a CFC.[116]

When Congress eliminated tax on portfolio interest paid to foreign persons in 1984, Congress recognized that U.S. persons could attempt to evade U.S. federal income tax on interest income by buying U.S. bearer obligations on the Eurobond market, and claiming to be a foreign person or by buying the bonds through the assistance of a foreign person. If the U.S. person failed to include the interest in its U.S. return and there was no withholding, the income would not be taxed and the tax avoidance would likely go unnoticed by the IRS, because the obligations were in bearer rather than registered form. In order to prevent this tax avoidance, Congress enacted certain measures, including an expansion of the Department of the Treasury's authority to require registration of securities designed to be sold to foreign persons.[117] Furthermore, Congress required that the withholding agent receive a statement that the beneficial owner of the obligation is not a U.S. person,[118] and empowered the Department of the Treasury to make certain determinations that could prevent taxpayers from engaging in back-to-back transactions.[119]

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alien if the shareholder received it directly. More specifically, section 871(k)(1)(A) exempts any interest-related dividends that foreign corporations and nonresident aliens receive from RICs from the 30 percent withholding tax. A RIC must designate an interest-related dividend by written notice provided to its shareholders. Section 871(k)(1)(C). The amount that a regulated investment company may so designate is based on the RIC's "qualified net interest income," which is the RIC's "qualified interest income," reduced by certain deductions. Section 871(k)(1)(D). "Qualified interest income" is the amount of the RIC's U.S. source interest income that would be exempt from the 30 percent withholding tax if the shareholder received the interest directly. Section 871(k)(1)(E).

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

[116] See S. Rep. No. 169(I), 98th Cong., 2d Sess., at 423 (1984).

[117] See Staff of Joint Comm. on Taxation, 98th Cong. 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 393 (1984).

[118] See section 871(h)(2)(B)(ii)(I).

[119] See sections 871(h)(5) and (h)(6).

The exemption from taxation of interest-related dividends received from a RIC does not apply unless the withholding agent receives a statement similar to that required under section 871(h), stating that the beneficial owner of the stock is not a U.S. person.[120] It is our understanding that Sub 4 provided a statement to Sub 6 RIC that it was the beneficial owner of the Sub 6 RIC stock, and, accordingly, that, ostensibly conforming to the literal requirements of the withholding rules, Sub 6 RIC did not withhold tax on its distributions to Sub 4.

iii. Subpart F

Taxpayer contends that under section 245(a), Sub 3 is entitled to an 80 percent DRD to offset the distributions that Sub 3 received from Sub 4, which are "U.S.-source" dividends within the meaning of section 245(a) because they are attributable to distributions Sub 4 received from Sub 6 RIC.

Subpart F was added to the Code in 1962 to prevent U.S. persons from inappropriately deferring U.S. federal income tax on certain income earned by CFCs.[121] The subpart F rules provide, in part, that U.S. shareholders of a CFC are taxed currently on certain types of income ("subpart F income") earned by the CFC under section 951. Specifically, a U.S. shareholder that owns stock of a CFC on the last day of the CFC's taxable year has a section 951 inclusion with respect to the CFC, which includes the shareholder's "pro rata share" of the CFC's subpart F income. To the extent that the CFC's subpart F income is included in the U.S. shareholder's income as a section 951 inclusion, the CFC's actual distributions to the U.S. shareholder are excluded from the U.S. shareholder's income under section 959 so that the amounts are not included in the U.S. shareholder's income twice. Neither the section 951 inclusion nor the tax-free distribution of earnings and profits attributable to the section 951 inclusion is treated as a dividend for the purposes of the section 245 DRD, or is otherwise eligible for the section 245 DRD.[122]

If the foreign corporation is a CFC owned by a U.S. shareholder for its entire taxable year, the U.S. shareholder's pro rata share of the CFC's subpart F income is generally the amount that would have been distributed to the shareholder with respect

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[120] See section 871(k)(1)(B)(ii); see also sections 871(h)(2)(B)(ii)(I) and (h)(5). The exemption also does not apply if the interest-related dividend is paid to a person in a foreign country with respect to which the Secretary has determined that the information exchange between the United States and the foreign country is inadequate to prevent evasion of U.S. federal income tax by U.S. persons. Sections 871(k)(1)(B)(iii) and (h)(6)(A).

[121] As originally enacted, subpart F consisted of section 951 through 964. Section 965 was added to subpart F in 2004. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

[122] See Rodriguez v. Comm'r, 137 T.C. 174 (2011), aff'd 722 F.3d 306 (5th Cir. 2013); section 959(a) and (d).

to the stock that it owns (within the meaning of section 958(a)) if the CFC had distributed its subpart F income for the taxable year. Thus, its "pro rata share" generally is based on the U.S. shareholder's percentage of CFC stock ownership (including certain stock owned indirectly by the U.S. shareholder). Special rules for determining a U.S. shareholder's "pro rata share" apply when there is a change in ownership during a CFC's taxable year, and the CFC's status as a CFC is not changed. Under section 951(a)(1), the U.S. shareholder that disposes of its stock prior to the end of a CFC's taxable year does not have a section 951 inclusion with respect to the CFC's undistributed income. Instead, only the acquiring U.S. shareholder has a section 951 inclusion, assuming the acquiring U.S. shareholder holds the CFC stock on the last day of the CFC's taxable year. In addition, under section 951(a)(2), the amount of the acquiring shareholder's section 951 inclusion is reduced by all or a portion of any dividends paid to the disposing shareholder with respect to the transferred shares during the taxable year.[123]

The rule requiring a reduction of the section 951 inclusion for the current U.S. shareholders of a CFC for the same year distributions to the previous owner(s) was intended to prevent both the current and former shareholders from being subject to tax with respect to the same amount of the CFC's subpart F income. Similarly, the rule that provides that a U.S. shareholder does not have a section 951 inclusion when it transfers its CFC interest to another U.S. person during the CFC's taxable year is a rule for administering the subpart F regime in a year in which two U.S. persons held the same CFC shares in order to avoid double taxation. Neither rule was intended to allow taxpayers to structure transactions that avoid subjecting any U.S. shareholder to U.S. federal income taxation with respect to subpart F income of a CFC.

iv. Section 245

Section 245 provides rules for the deduction of dividends received from certain foreign corporations. In connection with the promulgation of the Technical and Miscellaneous Review Act of 1988 (the "1988 Act"), Congress explained that dividends eligible for the section 245 DRD "are based on the ratio of (a) the foreign corporation's post-1986 earnings and profits *that have been subject to net-basis U.S. corporate income tax* and that have not been distributed to (b) the corporation's total accumulated earnings and profits."[124] The statutory rules include tests for determining when dividends are attributable to previously-taxed corporate income, and provide rules on deductibility based in part on the recipient's level of stock ownership in the payor. In addition, Congress specifically disallowed the DRD for amounts treated as dividends

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[123] See section 951(a)(2)(B). The amount of the acquiror's section 951 inclusion is reduced by the lesser of the amount of the distributions made to the disposing shareholder and the subpart F income allocable to the portion of the taxable year for which the CFC's stock was owned by the previous owner.

[124] H.R. Rep. No. 795, 100th Cong., 2d Sess., at 263 (1988) (emphasis added).

under section 1248[125] because the deemed section 1248 dividends are "generally derived from earnings not subject to U.S. corporate income tax."[126]

Common Parent likely is familiar with Congress' clearly articulated intent to allow the DRD only for earnings that have been subject to net-basis U.S. federal corporate income tax. Nonetheless, Sub 3 treated its Year Y distributions from Sub 4 (attributable to distributions from Sub 6 RIC) as section 301(c)(1) dividends that qualified for the 80 percent DRD under section 245(a). Section 245(a) allows a DRD (as specified in section 243) for that portion of a dividend paid by a "qualified 10-percent owned foreign corporation" that is equal to the "U.S.-source portion" of the dividend. Common Parent's position is that Sub 4 is a qualified 10-percent owned foreign corporation, and that the "U.S.-source portion" of the distribution was 100 percent. It is anticipated that Common Parent will argue that section 245 does not specifically state that the DRD is only available with respect to earnings that have been subject to U.S. federal corporate income tax.

However, Sub 3 should not be able to treat distributions from Sub 4 attributable to distributions from Sub 6 RIC as dividends eligible for the section 245 DRD when, under sections 243 and 854, Sub 3 could not have claimed a DRD if it had directly received the distributions from Sub 6 RIC. The general policy of section 245 is consistent with that of section 243: to ensure that only a single level of corporate tax is imposed on U.S. source income distributed to a corporate shareholder.[127] It is inconsistent with that policy to allow section 245 deductions for distributions attributable to interest income and capital gains distributed by a RIC (through a foreign intermediary) that have not borne any U.S. federal corporate-level income tax. That has been made even clearer by the addition of section 245(a)(12) to the Code in 2015.[128]

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

[126] S. Rep. No. 445, 100th Cong., 2d Sess., at 278 (1988).

[127] See S. Rep. No. 313, 99th Cong., 2d. Sess., at 375 (1986) ("The committee recognizes that in a two-tiered tax system such as in the United States, double taxation will occur (one tax at the corporate level and a second tax at the individual level at the time of distributions). The dividends received deduction is intended to prevent more than one full corporate level tax on the same earnings.")

[128] Section 245(a)(12) is discussed in Part I of the LAW AND ANALYSIS section of this memorandum. A Senate Report explanation of an earlier bill that contained a similar provision to that ultimately enacted explained that, "[a]n IRS chief counsel advisory memorandum concluded that dividends attributable to interest income of an 80-percent owned RIC are not entitled to be counted in determining the dividends received deduction under section 245. … The Committee wishes to preclude any remaining potential that taxpayers might take the position that any RIC or REIT dividends are eligible for the dividends received deduction under section 245. … No inference is intended with respect to the proper treatment under section 245 of dividends received from RICs or REITs before the date of enactment. S. Rep. 114-25, 114th Cong., 1st Sess., at 10 (April 14, 2015).

e. Conclusion of Economic Substance Analysis

Taxpayer fails to satisfy the economic substance test with respect to moving Sub 4 to Country U, funneling funds through Sub 4 as a Country U corporation, and moving the Sub 4 stock from Sub 3 to Sub 2.

In the alternative, we conclude that Taxpayer fails to satisfy the economic substance test with respect to its funneling investment funds and its investment returns through a Country U corporation.

In both cases:

(1) These steps did not provide Taxpayer with a realistic possibility of profit over and above its return on the Business O Eligible Investments, other than the planned tax savings from the section 245 DRD.

(2) Other than tax savings, Taxpayer did not have a business purpose that withstands scrutiny.

(3) Taxpayer's use of the DRD is not consistent with congressional intent.

Thus, Sub 3's section 245 DRD is disallowed under the economic substance doctrine, regardless of whether the literal requirements of section 245 and the other Code sections at issue have been technically satisfied.

C. Substance Over Form Doctrine

A transaction's tax consequences depend on its substance, not its form.[129] Under this fundamental principle of income taxation, courts have disallowed the tax benefits of a transaction despite its formal compliance with the Code and its implementing regulations. Although the form by which a transaction is effected does influence, and in certain situations, may decisively control the taxation of a transaction, the substance over form doctrine allows the courts and the IRS to look beyond the superficial formalities of a transaction to determine its proper tax treatment.[130]

The Supreme Court described the substance over form doctrine in Commissioner v. Court Holding Co.,[131] in which the Court agreed with the Commissioner's

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

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

[131] 324 U.S. 331 (1945).

determination that the substance of a purported corporate dividend of real property to shareholders, and subsequent sale by the shareholders of that property to a third party, was actually a sale by the corporation to the third party directly.[132] The Court stated:

> The incidence of taxation depends upon the substance of the transaction. The tax consequences which arise from gains from the sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.[133]

The substance over form doctrine allows the government to characterize a transaction based on its actual substance, regardless of its form, and to tax it accordingly.[134] Courts recast transactions where the taxpayer's form does not comport with the reality of the transaction.[135] The court has never regarded the simple expedient of drawing up papers as controlling for tax purposes when the objective economic realities are to the contrary.[136] The substance over form doctrine is used to effect the underlying purpose of a statute.[137] The purpose of the substance over form doctrine is to deny legal effect to transactions that comply with the literal terms of a statute but contravene the purpose of the statute.[138] The substance of a transaction is assessed in

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[132] Id. at 334.

[133] Id. at 333.

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

[135] See Court Holding, 324 U.S. at 334.

[136] Merck, 652 F.3d at 481 (quoting Frank Lyon v. United States, 435 U.S. 561 (1978)).

[137] Consol. Edison Co. of N.Y. v. United States, 703 F.3d 1367, 1374 (Fed. Cir. 2013).

[138] See Stewart v. Comm'r, 714 F.2d 977, 988 (9th Cir. 1983).

light of all the facts and circumstances.[139] The substance over form doctrine requires viewing the transaction as a whole.[140]

1. Step Transaction Doctrine

a. Overview of the Step Transaction Doctrine

One variation of the substance over form doctrine is the step transaction doctrine. The step transaction doctrine was developed by the courts to ensure that a transaction is taxed in accordance with its substance "'by ignoring for tax purposes, steps of an integrated transaction that separately are without substance.'"[141] The "well-established" doctrine has been "expressly sanctioned" by the Supreme Court, which has noted that "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction."[142]

Courts have outlined three basic tests to establish the circumstances under which the application of the step transaction doctrine applies. Under the narrowest approach, the "binding commitment" test, the steps are collapsed if, at the first step, there was a "'binding commitment to undertake the later step' in a series of transactions."[143] The interdependence test focuses on "whether 'the steps [are] so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.'"[144] It requires a determination of whether the steps had independent significance or had meaning only as part of a larger transaction – that is, a transaction with the end result that the taxpayer hoped to achieve. Accordingly, the interdependence test is sometimes viewed as a variation of the third test: the "end result" test. Under the end result test, the doctrine is applied if it appears that "separate transactions were 'really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result.'"[145]

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[139] Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221 (1981).

[140] John Hancock Life Ins. v. Comm'r, 141 T.C. 1 (2013).

[141] The Falconwood Corp. v. United States, 422 F.3d 1339, 1349 (Fed. Cir. 2005) (quoting Dietzch v. United States, 498 F.2d 1344, 1346 (Ct. Cl. 1974)).

[142] Comm'r v. Clark, 489 U.S. 726, 738 (1989).

[143] Falconwood Corp., 422 F.3d at 1349 (quoting Penrod v. Comm'r, 88 T.C. 1415, 1429 (1987)).

[144] Id. (quoting King Enter., Inc. v. United States, 418 F.2d. 511, 516 (Ct. Cl. 1969)).

[145] Id. (quoting King Enter., Inc. v. United States, 418 F.2d. 511, 516 (Ct. Cl. 1969)).

b. Step Transaction Doctrine Analysis

The Transaction consisted of a carefully planned and orchestrated series of steps, as set forth in Part III of the FACTS section of this memorandum, which included, in part, the following:

(Step 6 and Step 8) One or more members of US Group transferred funds that were to be invested in Business O Eligible Investments directly to Sub 6 RIC (which Taxpayer treated as transfers going directly or indirectly to Sub 3, from Sub 3 to Sub 4, and from Sub 4 to Sub 6 RIC);

(Step 9) Sub 6 RIC purchased Business O Eligible Investments in accordance with the advice of a member of US Group;

(Step 10) Sub 6 RIC made distributions of its earnings with respect to the Business O Eligible Investments to Sub 4; and

(Step 11) Sub 4 made distributions of the funds it received from Sub 6 RIC to Sub 3.

Sub 3's (deemed) transfers to Sub 4, Sub 4's (deemed) transfers to Sub 6 RIC, Sub 6 RIC's transfers to Sub 4, and Sub 4's transfers to Sub 3, as enumerated above, should be disregarded. As this memorandum sets forth in the discussion of the economic substance doctrine, these steps, which served only to route funds through Sub 4, served no independent business purpose.

Taxpayer planned the entire Transaction before moving funds from one or more members of US Group to Sub 6 RIC. The Transaction plan required Sub 4 to transfer the funds to Sub 6 RIC and required Sub 6 RIC to use the funds to invest in Business O Eligible Investments. Moreover, the plan required Sub 6 RIC to distribute its earnings on the Business O Eligible Investments back to one or more members of US Group, routing the funds through Sub 4. Taxpayer carried out the steps in the Transaction in accordance with the plan.

Application of the Interdependence Test. The interdependence test analyzes the relationship between the intermediate steps of a complex transaction.[146] This test focuses on whether the intervening steps in a series of steps would have been fruitless or meaningless if the other steps in the series had not taken place.[147]

The steps in which Taxpayer moved funds through Sub 4, as enumerated above, are interdependent and should be disregarded under the interdependence test because

[146] Assoc. Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1523 (10th Cir. 1991).

[147] Penrod v. Comm'r, 88 T.C. 1415, 1430 (1987).

each of the steps would have been "fruitless" in the larger Transaction if the other steps had not taken place. Sub 3's contribution of funds to Sub 4 would have been fruitless unless Sub 4 contributed the funds to Sub 6 RIC so that Sub 6 RIC could invest in the Business O Eligible Investments. Sub 4's receipt of distributions from Sub 6 RIC would have similarly been fruitless unless Sub 4, in turn, distributed the return on investment back to Sub 3 so that Sub 3 could claim the DRD.

In its application of the interdependence test, the Tax Court, in Barnes Group v. Commissioner,[148] focused its inquiry on whether there was a non-tax business purpose for each of the separate steps in the transaction.[149] As set forth in the discussion of the economic substance doctrine in Part III.B of the LAW AND ANALYSIS section of this memorandum, the steps of the Transaction that Taxpayer took to move funds through Sub 4 did not have an independent business purpose. As in Barnes Group, the lack of a non-tax business purpose for these steps supports disregarding the routing of funds through Sub 4. Accordingly, Sub 3 should be treated as directly contributing funds to Sub 6 RIC and Sub 6 RIC should be treated as making direct distributions to Sub 3, to which section 243 would not apply as a result of section 854.

Application of the End Result Test. The end result test analyzes whether a series of steps are prearranged parts of a single transaction that, from the outset, is designed to achieve a specific end result.[150] The test focuses on the parties' subjective intent when they structure the transaction.[151]

Taxpayer's planning documents reflect that Taxpayer took steps to move funds through Sub 4 in order to generate a DRD that it could not obtain if one or more members of US Group directly invested in Business O Eligible Investments or invested in them through Sub 6 RIC. Taxpayer planned and carried out these steps to achieve the end result of providing Taxpayer with a return on the Business O Eligible Investments, avoiding the application of section 854, and ostensibly qualifying for a section 245 DRD. Under the application of the end result test, these steps should be disregarded and Sub 3 should be treated as directly contributing funds to Sub 6 RIC and directly receiving distributions from Sub 6 RIC in Year Y, which were not eligible for a DRD.

Application of the Binding Commitment Test. As previously discussed, Sub 4 did not have an independent business purpose, other than tax avoidance, for participating

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[148] T.C. Memo. 2013-109, aff'd by ruling by summary order, 593 Fed. Appx. 7 No. 13-4298 (Nov. 5, 2014).

[149] Id.

[150] True v. United States, 190 F.3d 1165, 1175 (10th Cir. 1999).

[151] Superior Trading, LLC v. Comm'r, 137 T.C. 70, 89 (2011).

in the acquisition of the Business O Eligible Investments. Common Parent's control over Sub 4 resulted in a transaction whose steps were as controlled as any contractual arrangement. The binding commitment test of the step transaction doctrine is generally applied when the parties have entered into a binding contract to carry out the transaction steps. In the instant case, there was no need for the parties to enter into binding contracts to ensure that each step of the transaction would take place as planned. There was no risk that Sub 4 would deviate from Taxpayer's plan. As noted in the FACTS section of this memorandum, Sub 4 was not an independent actor; it was at all times controlled by Taxpayer. Sub 4 did not have its own employees; all of its activities were carried out by employees of members of the US Group. Importantly, members of US Group directly transferred funds to Sub 6 RIC to invest in the Business O Eligible Investments. Thus, there was not even the opportunity for Sub 4 to control the funds on their journey from members of US Group to Sub 6 RIC and divert the funds for its own use. The outcome of the Sub 6 RIC transaction was even more pre-ordained than would be the outcome of a transaction pursuant to a contractual arrangement between unrelated parties. Accordingly, under the binding commitment test Sub 4's participation in the Transaction should be disregarded in determining how the Transaction is taxed.

Moreover, the Transaction deserves "particular scrutiny" because it was carried out among related parties.[152] Even if Sub 4 did not have a binding commitment to move funds to Sub 6 RIC or make distributions to a member of US Group, there is ample authority for linking prearranged steps under the interdependence test and end result test in the absence of a contractual obligation or financial compulsion to follow through with the steps.[153]

No statutory or regulatory provisions have been implemented to prevent application of the step transaction doctrine in the context of the Transaction. A transaction's steps may be integrated under the step transaction doctrine unless the application of the doctrine has been "turned off" by legislative or regulatory mandate. For example, Congress enacted statutes in response to the Supreme Court's application of the step transaction doctrine in Helvering v. Bashford.[154]

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[152] In re Uneco, Inc., 532 F.2d 1204, 1207 (8th Cir. 1976) ("Advances between a parent corporation and a subsidiary or other affiliate are subject to particular scrutiny 'because the control element suggests the opportunity to contrive a fictional debt.'") (quoting Cuyuna Realty Co. v. United States, 382 F.2d 298, 300-01 (Ct. Cl. 1967)).

[153] See, e.g., Kornfeld v. Comm'r, 137 F.3d 1231, 1235-1236 (10th Cir. 1998); McDonald's Rest. v. Comm'r, 688 F.2d 520, 525 (7th Cir. 1982).

[154] 302 U.S. 454 (1938).

A discussion of the Bashford decision, necessitates a preliminary discussion of Groman v. Commissioner.[155] In the Groman case, Glidden corporation formed a new corporation, "Ohio," to acquire all of the shares of an unrelated corporation, "Indiana." The shareholders of Indiana, including Mr. Groman, received in exchange for their shares, stock in Glidden, stock in Ohio, and cash. Under the reorganization provision then in effect, Mr. Groman would not recognize gain to the extent he exchanged his Indiana shares for shares of a corporation that was a party to the reorganization. The Commissioner determined Glidden was not "a party to the reorganization" and the Court agreed. Accordingly, Mr. Groman was taxed on the cash he received and on the Glidden shares.

The Bashford transaction had facts similar to those in the Groman case. In Bashford, the "Atlas" corporation wanted to acquire the stock of three of its corporate competitors. In pursuance of the transaction, Atlas caused the formation of a new company. The shareholders of the three target corporations received, in exchange for their shares, stock in the new company, stock in Atlas and cash. The Commissioner determined that, under the law then in effect, Atlas was not a party to the reorganization and the shareholders of the target corporations were to be taxed on their receipt of the Atlas shares. Mr. Bashford, a shareholder of one of the target corporations, attempted to distinguish his transaction from the Groman transaction. He explained that Atlas directly acquired the shares of target corporations and Atlas provided all of the consideration (which included both Atlas shares and shares of the new company). Accordingly, Mr. Bashford argued Atlas was a party to the reorganization. Only after acquiring the target stock did Atlas transfer the shares to the new corporation.

The Court applied the step transaction doctrine, disregarding Atlas' acquisition of the target corporations because "[a]ny direct ownership by Atlas [of the target corporations] was transitory and without real substance; it was part of a plan which contemplated the immediate transfer of the stock or the assets or both of the three reorganized companies to the new Atlas subsidiary."[156] Accordingly, the Court found the distinction in form between the Groman transaction and the Bashford transaction was not of legal significance. To override the effect of the Bashford decision, Congress enacted section 368(a)(2)(C), which allows transactions otherwise qualifying as reorganizations not to be "disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring the assets or stock." In effect, section 368(a)(2)(C) prevents the application of the step transaction doctrine to the facts of a transaction such as the one described in Bashford.

[155] 302 U.S. 82 (1937).

[156] Bashford, 302 U.S. at 458. The Court did not specifically state that it was applying the step transaction doctrine.

There are no statutes or regulations that prevent the application of the step transaction doctrine to the Transaction. Therefore, under the application of the step transaction doctrine, Sub 3 is treated as directly acquiring stock in Sub 6 RIC and receiving distributions from Sub 6 RIC with respect to such stock. Accordingly, Sub 3 does not qualify for a DRD under section 245 or section 243.

c. Conduit Analysis

In the context of the step transaction doctrine, the Ninth Circuit has identified a "class of cases in which the form of the transaction is particularly suspect. Where a party acts as a 'mere conduit' of funds – a fleeting stop in a predetermined voyage toward a particular result – [the court has] readily ignored the role of the intermediary in order appropriately to characterize the transaction."[157] Taxpayer's moving funds through Sub 4 had no purpose or effect other than as steps to facilitate Taxpayer's reduction of tax through the use of the section 245 DRD.

In Robino v. Commissioner,[158] the Ninth Circuit integrated a series of steps to find that two individuals sold a parcel of land to a developer and that they used their tax-exempt trusts as conduits to accomplish this result. The individuals, Mr. Filler and Mr. Schlosberg, purchased the land in 1981 as tenants in common. During that same year, Mr. Schlosberg was approached by a builder, who wanted to build on the land. Mr. Schlosberg was the sole trustee and beneficiary of a tax-exempt pension trust that purchased an option to buy Mr. Filler's interest in the land. Mr. and Mrs. Filler set up a similar trust to buy an identical option to purchase Mr. Schlosberg's interest in the land. The Fillers and Mr. Schlosberg signed the cross-options in 1981 under which each would sell for $5,000 an option to buy a half share in the land within two years for $275,000. Notwithstanding that the Fillers and Mr. Schlosberg granted options to the trusts, they also offered options to buy the property to a real estate agent working on behalf of the builder. They agreed to an option price of about $1.3 million. Later that same year, the trusts exercised their options to buy the parcel of land and a few weeks later, sold the land to the builder. Filler and Schlosberg each reported gain of approximately $50,000, the difference between each individual's basis in the land of $225,000 and the $275,000 paid by the trust to exercise its option. The IRS determined that the trusts were merely conduits and thus treated Mr. Filler and Mr. Schlosberg as selling their respective rights in the land to the builder.

The Ninth Circuit agreed with the Commissioner, finding that Mr. Filler and Mr. Schlosberg: (i) sold options to the trusts at below market prices; (ii) negotiated the terms of the builder's option to purchase the land; (iii) structured the transaction through the trusts to avoid taxes and had little justification for using the trusts other than tax

[157] Brown v. United States, 329 F.3d 664, 672 (9th Cir. 2003).

[158] 894 F.2d 342 (1990).

avoidance; and (iv) as the transaction was carried out, at each moment retained complete control over the property. The court, focusing on the realities of the transaction rather than the refinements of legal title, the verbiage of written instruments, or the chronological order of formal events, found that, in substance, Mr. Filler and Mr. Schlosberg directly sold their property interests to the builder.

Under the conduit theory of the substance over form doctrine, the use of an entity may be disregarded if it is a mere conduit in a transaction. As set forth in the discussion of the economic substance and step transaction doctrines, Taxpayer planned and oversaw the entire Transaction in which Sub 4 was a mere intermediary in routing funds between Taxpayer and Sub 6 RIC. Taxpayer structured the transaction to move funds through a Country U corporation to avoid taxes by circumventing the application of section 854 and instead, claiming the section 245 DRD. Taxpayer had little, if any, justification for moving funds through a Country U corporation other than tax avoidance. Sub 4's role in the Transaction, which was predetermined by Taxpayer and under Taxpayer's control, had no substantive effect on US Group's investment in the Business O Eligible Investments. Moreover, throughout the Transaction, Taxpayer retained complete control of the funds it held in Sub 4. Thus, Sub 4's role should be disregarded as that of a conduit. Sub 3 should be treated as directly contributing funds to Sub 6 RIC and as directly receiving distributions from Sub 6 RIC in Year Y.

2. Alternative Substance Over Form Analysis

Sub 4 is a CFC and Sub 3 is a U.S. shareholder of Sub 4 within the meaning of section 951(b). The dividends received by Sub 4 from Sub 6 RIC during Year Y are foreign personal holding company income (FPHCI), which is a type of subpart F income.[159] However, Taxpayer takes the position that Sub 3 is not required to include in income its pro rata share of Sub 4's subpart F income under section 951(a) because Sub 3 distributed its entire interest in Sub 4 to Sub 2 just prior to the end of Sub 4's Year Y taxable year. As noted in Part I of the FACTS section of this memorandum, Sub C directly owned all of the stock of Sub 1 and indirectly owned the stock of Sub 2, Sub 3, Sub 4, and Sub 6 RIC. Throughout Sub 4's Year Y taxable year, Sub C used the Business O Eligible Investments and the income they produced to satisfy its safety and soundness requirements without regard to whether the Business O Eligible Investments were held directly or through one or more of its subsidiaries that were members of US Group or Sub 6 RIC.

Sub C indirectly wholly owned Sub 4 prior to Sub 3's distribution of Sub 4 shares to Sub 2, and Sub C continued to own indirectly Sub 4 after the distribution of the shares to Sub 2. For purposes of subpart F, a U.S. shareholder of a CFC includes a United States person who is considered as owning 10 percent or more of the total

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[159] Section 954(c)(1)(A) provides that dividends are a type of FPHCI. None of the exceptions to FPHCI apply to the dividends received by Sub 4 from Sub 6 RIC during Year Y.

combined voting power of all classes of stock entitled to vote by applying the rules of ownership of section 958(b), which incorporates the constructive ownership rules of section 318 subject to certain exceptions not relevant here. Accordingly, as members of a 100 percent-owned chain of domestic corporations, Common Parent and each intervening domestic subsidiary in the US Group, including each of Sub C, Sub 1, and Sub 2, was a U.S. shareholder of Sub 4 throughout Year Y (and during Year Z and Year BB) for subpart F purposes, because each was considered under sections 951(b) and 958(b) as owning 100 percent of the total combined voting power of Sub 4.[160] Unlike cases in the subpart F area in which parties varied voting rights in order to avoid U.S. shareholder status, in this case it is undisputed that all corporations of US Group in the chain of ownership of Sub 4 were U.S. shareholders under subpart F and potentially subject to section 951 inclusions.

In order to avoid the double counting of income inclusions in a chain of corporations, subpart F limits the income inclusion to only those corporations in the chain that own interests in the CFC on the last day of the CFC's taxable year directly or through foreign entities.[161] But when a chain of 100 percent U.S. shareholders holds the CFC on every day of the taxable year, these statutory provisions were not intended to result in the exclusion of all subpart F income merely by manipulating which U.S. shareholder in the chain owned a direct interest in the CFC on the last day of the year, as Taxpayer did in the Transaction. If Sub 3 had owned the stock of Sub 4 on the last day of Sub 4's Year Y taxable year, it would have had an income inclusion under section 951(a) because Sub 3 owned 100 percent of Sub 4's stock within the meaning of section 958(a).[162] That income inclusion would have been based on the full amount of Sub 4's subpart F income because Sub 3 would have owned the stock on every day of Sub 4's Year Y taxable year. Instead, Sub 3 transferred its interest in Sub 4 to Sub 2 days before the end of Sub 4's Year Y taxable year and claimed that it did not have a subpart F inclusion because it did not hold the stock on the last day of the taxable year. Sub 3 did so in order to change the character of the income that it derived with respect to Sub 4 during Year Y from a section 951 inclusion that was not eligible for a section 245 DRD to a dividend, which Taxpayer claims is eligible for a section 245 DRD.

If Sub C, or any other U.S. shareholder in US Group, had directly owned the stock of Sub 4 every day of Sub 4's Year Y taxable year, it would have been required to include in income amounts under section 951 with respect to all of Sub 4's income that

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[160] See Schering-Plough Corp. v. United States, 651 F. Supp. 2d 219, 225, aff'd sub. nom. Merck & Co., Inc. v. United States, 652 F. 3d 475 (3d Cir. 2011) ("Schering-Plough (through its domestic subsidiaries) was a United States shareholder within the meaning of I.R.C. §§ 951(b) and 958(a)").

[161] Sections 951(a) and 958(a).

[162] See the discussion of the subpart F rules described in Part III.B.2.d.iii of the LAW AND ANALYSIS section of this memorandum.

was attributable to the Business O Eligible Investments.[163] Sub C and these other members were U.S. shareholders of Sub 4 for subpart F purposes throughout the year, yet other than a small section 951 inclusion reported by Sub 2, none of these U.S. shareholders included amounts in income under section 951 with respect to the subpart F income earned by Sub 4. Taxpayer's structuring ensured that no *single* member of US Group that was a U.S. shareholder of Sub 4 owned, within the meaning of section 958(a), all of the stock of Sub 4 on every day of Sub 4's Year Y taxable year. However, each member of US Group that was a U.S. shareholder of Sub 4, including Sub 3, retained ownership (within the meaning of section 958(b)) of voting power with respect to Sub 4 at all times during Sub 4's Year Y taxable year. Moving the stock of a CFC between related U.S. shareholders at the end of the CFC's taxable year to avoid a section 951 inclusion is contrary to the purposes of subpart F, which require amounts to be included in income under section 951(a) when U.S. shareholders control a foreign corporation.

Although there are no cases that address the avoidance of section 951 with the same facts as those in the Transaction, courts have rejected schemes devised to avoid section 951 inclusions since the enactment of subpart F. As early as 1961, taxpayers contrived to avoid section 951 inclusions by transferring nominal voting power to "friendly" foreign persons, and then arguing that the foreign corporation did not meet the definition of a CFC under section 957 because more than half the voting control of the corporation was held by foreign persons.[164] The courts ignored these transfers for purposes of determining whether the foreign corporation was a CFC because it was clear that the U.S. shareholders, in substance, continued to control the voting power of the stock nominally held by foreign persons.[165] Further, the courts rejected the taxpayers' arguments that the statute provided a mechanical test. Instead, the courts concluded that mere technical compliance with the statute was not sufficient, and that the rules in the statute would be applied to the substance of the transaction, rather than the form of the transaction.

Similarly, U.S. shareholders have tried to avoid section 951 inclusions attributable to loans from their wholly-owned CFCs by engaging in transactions that, in form, were outside the scope of section 956. In Jacobs Engineering v.

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[163] Sub 4's subpart F income subject to inclusion by such U.S. shareholder would not have been reduced by a DRD because Sub 4's income is calculated as if it were a domestic corporation. See Treas. Reg. § 1.952-2. Therefore, Sub 4 would not have been able to claim a DRD under section 243 due to the application of section 854.

[164] Garlock, Inc. v. Comm'r, 58 T.C. 423 (1972), aff'd., 489 F.2d 197 (2d Cir. 1973). See also Kraus v. Comm'r, 59 T.C. 681 (1973), aff'd, 490 F.2d 898 (2d Cir. 1974); Weiskopf Est. v. Comm'r, 64 T.C. 78 (1975), aff'd per curiam, 538 F.2d 317 (2d Cir. 1976); Koehring Co. v. United States, 583 F.2d 313 (7th Cir. 1978).

[165] See supra note 165.

Commissioner,[166] a U.S. shareholder frequently borrowed and repaid funds from its wholly-owned CFC, with only short periods of time between repayments and new borrowings. The taxpayer carefully ensured that the loans were never outstanding on a section 956 measuring date, which would have resulted in a section 951 inclusion.[167] The court observed that under the substance over form doctrine, "the Commissioner may deny legal effect to a transaction if the sole purpose of the transaction was to avoid tax," and the court must simply decide whether the facts of the case "fall within the intended scope of the Internal Revenue Code provision at issue."[168] The court concluded that the series of loans was, in substance, a single loan outstanding for the entire year, notwithstanding that the loans were not, in form, outstanding on a section 956 measurement date.[169]

Furthermore, in Schering-Plough v. United States,[170] the taxpayer tried to avoid a section 951 inclusion attributable to a loan from its wholly-owned CFC by arranging a series of circular interest rate swaps with the CFC and a third party. The court noted that when applying the substance over form doctrine, "transactions between related parties merit extra scrutiny."[171] The court held that the interest rate swaps were, in substance, a loan from the CFC that resulted in a section 951 inclusion to the U.S. shareholder and found that the third party, a large unrelated bank, was a mere conduit between the U.S. parent and the CFC in the tax avoidance scheme.[172]

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

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[166] 79 A.F.T.R. 2d 97-1673 (C.D. Cal. 1997), aff'd by unpublished decision, 168 F.3d 499 (9th Cir. 1999).

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

[168] Id.

[169] Id.

[170] 651 F .Supp. 2d 219 (D. N.J. 2007), aff'd sub. nom. Merck & Co., Inc. v. United States, 652 F.3d 475 (3d Cir. 2011).

[171] Merck, 652 F.3d at 481.

[172] Id.

In the instant case, Sub 3 would have had a section 951 inclusion calculated based on 100 percent of Sub 4's subpart F income if it owned Sub 4 directly for the entire Year Y taxable year, irrespective of any distributions from Sub 4. Likewise, any member of US Group, including Sub 2 and Sub C, would have included in income section 951 inclusions calculated based on 100 percent of Sub 4's subpart F income as a section 951 inclusion if such member directly owned Sub 4 for the entire Year Y taxable year, irrespective of any distributions from Sub 4. If any member of US Group held the stock of Sub 4 throughout the year, the member would not have been eligible for the section 245 DRD with respect to any part of the section 951 inclusion attributable to the entire Year. Instead, members of US Group shuffled the stock of Sub 4 from one member to another, all of whom were U.S. shareholders of Sub 4 potentially subject to an income inclusion under section 951, in furtherance of its tax avoidance plan. Accordingly, under the substance over form principles announced in Gregory and followed in Garlock Inc. v. Commissioner,[173] Jacobs Engineering, and Schering-Plough, a member of US Group that was a U.S. shareholder of Sub 4 during Sub 4's Year Y taxable year should be required to include in income 100 percent of Sub 4's subpart F income pursuant to section 951(a).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[173] 58 T.C. 423 (1972).

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call if you have any further questions with regard to this memorandum generally or with regard to the argument in Part III.C.2 of the LAW AND ANALYSIS section of this memorandum.