



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR CYNTHIA K. HUSTAD
SPECIAL TRIAL ATTORNEY CC:WR:LC

FROM: PHYLLIS E. MARCUS
BRANCH CHIEF CC:INTL:BR.2

SUBJECT:

This Field Service Advice responds to your memorandum dated May 26, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Corp A	=
Corp B	=
Corp C	=
Individual	=
Country X	=
Country Y	=
Amount Q	=
v Percent	=
w Percent	=
x Percent	=
y Percent	=
z Percent	=
Date M	=
Year 1	=

•

2

Year 2 =
Year 3 =

ISSUE(S):

(1) Whether Corp C should be included in Corp B.'s CFC group, as defined in section 956A(d)(2) of the Internal Revenue Code, where Corp B holds no stock of Corp C but holds a note exceeding 50 percent of the value of the assets of Corp C.

(2) Whether, for purposes of determining the amount of assets of the CFC group, the adjusted basis of the assets is increased by unamortized research and experimental (R&E) expenditures because Corp A elected to capitalize and amortize such R&E expenditures under section 59(e) of the Code.

CONCLUSION:

Issue #1

A taxpayer is subject to a heightened standard of proof when it takes a position invoking the substance of a transaction that is contrary to its form. Corp A argues that Corp C is part of Corp B's CFC group because the Debt Instrument held by Corp B represents stock, rather than debt, of Corp C. Further factual development is required to determine if Corp A should be allowed to disavow the form of the Debt Instrument and assert that the Debt Instrument is equity.

Issue #2

To prevent the double counting of R&E expenditures under the rules of sections 956A(c)(3) and 1297(e) of the Code when a taxpayer has elected to amortize these expenditures, any basis adjustments under section 1016(a) cannot be taken into account. Thus, for purposes of determining the basis of assets under the passive foreign investment company regime, and by cross-reference, under section 956A, section 1297(e) provides the exclusive rule for determining the basis of R&E expenditures.

FACTS:

Corp A, a U.S. corporation, owns all of the stock of Corp B, a Country X Corporation. Corp B is a holding company that owns the stock of a number of foreign corporations. Corp A also owns v percent of the only class of stock of Corp

C, a Country Y corporation, and Individual owns the remaining w Percent of Corp C.

On or about Date M, Corp B transferred Amount Q to Corp C in exchange for a 50-year non-interest bearing debt instrument ("Debt Instrument"). The value of the Debt Instrument exceeds 50 percent of the value of the assets of Corp C.

The Debt Instrument provides that Corp C's obligation to repay Amount Q is unsecured and subordinated to all other liabilities of Corp C. The Debt Instrument further provides that Corp B has an option to cancel the Debt Instrument and to convert the full amount of the financial obligation into a number of fully paid shares of Corp C. If Corp B exercised this option, the percentage of Corp C common stock that it would acquire is the ratio of the outstanding obligation evidenced by the Debt Instrument over the market valuation of Corp C's assets on the date of conversion. Examination determined that if Corp B had exercised this option, it would have received approximately x Percent, y Percent and z Percent, of the stock of Corp C as of the end of Year 1, Year 2, and Year 3, respectively.

LAW AND ANALYSIS

In general

For tax years of a foreign corporation beginning after September 30, 1993, and on or before December 31, 1996, a U.S. shareholder is required to include in gross income the amount determined under section 956A of the Code with respect to such shareholder for the taxable year.¹

In the case of a controlled foreign corporation (CFC), the amount determined under section 956A of the Code with respect to a U.S. shareholder is the lesser of: (1) the excess of the shareholder's pro rata share of the amount of the CFC's excess passive assets for the year over the amount previously taxed under section 956A with respect to such shareholder or (2) the shareholder's pro rata share of the applicable earnings of the CFC, determined after the application of section 951(a)(1)(B).

Section 956A(c) of the Code defines the excess passive assets of a CFC as the excess of (1) the average amounts of passive assets held by the CFC as of the close of each quarter of the taxable year over (2) 25% of the average amounts of total assets held by the CFC as of the close of each quarter of the taxable year.

¹ Section 956A was repealed for tax years of a foreign corporation beginning after December 31, 1996 and for tax years of a U.S. shareholder within which or with which such tax years of the foreign corporation ends.

Issue #1 - Exclusion from CFC group

The first issue is whether Corp C should be included in Corp B's CFC group for purposes of computing the section 956A amount.

Section 956A(d)(1) of the Code provides that for purposes of determining the amount of excess passive assets under section 956A(c): (A) all CFCs that are members of the same CFC group are treated as one CFC, and (B) the amount of excess passive assets determined with respect to such CFC is allocated among the CFCs that are members of the group in proportion to their respective amounts of applicable earnings.

Section 956A(d)(2) of the Code defines a CFC group as one or more chains of CFCs connected through stock ownership with a top tier corporation that is a CFC but only if: (A) the top tier corporation owns directly more than 50 percent (by vote or value) of the stock of at least one of the other CFCs, and (B) more than 50 percent (by vote or value) of the stock of each of the CFCs, other than the top tier CFC, is owned directly or indirectly by one or more other members of the group.

Corp B does not own any of the stock of Corp C. Further, none of the other CFCs in Corp B's CFC group owns, directly or indirectly, any of the stock or Corp C. The specific issue in this case is whether Corp B can be treated as owning the stock of Corp C because it holds the Debt Instrument of Corp C.

Corp A argues that Corp B should be treated as owning the stock of Corp C because the Debt Instrument bears more indicia of equity than debt. You have requested assistance on whether a taxpayer is bound by the form in which it has chosen to structure the transaction, in this case as debt rather than equity.

In general, the substance rather than the form of a transaction governs for federal income tax purposes. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). Thus, the Commissioner has been allowed to discount the form of a transaction, and determine the tax consequences based on its substance. See Gregory v. Helvering; Spector v. Commissioner, 641 F.2d 376, 381 (5th Cir. 1981), *cert. denied*, 454 U.S. 868 (1981); Laidlaw Transportation, Inc. v. Commissioner, T.C. Memo. 1998-232.

The Supreme Court, however, has long recognized that although a taxpayer is free to structure his transaction as he chooses, "once having done so, he must accept the consequences of his choice, whether contemplated or not . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not." Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) (citations omitted). Taxpayers "have less freedom than the

Commissioner to ignore the transactional form that he has adopted”, and are ordinarily bound by the tax consequences that flow therefrom. Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1430 (1986), *aff’d* 896 F.2d 580 (D.C. Cir. 1990). See also Nestle Holdings, Inc. v. Commissioner, 152 F. 3d 83, 87 (2d Cir. 1998); Spector v. Commissioner, 641 F.2d at 381; Taiyo Hawaii Company, Ltd. v. Commissioner, 108 T.C. 590, 601-603 (1997); Estate of Durkin v. Commissioner, 99 T.C. 561, 572-75 (1992); Illinois Power Co. v. Commissioner, 87 T.C. at 1431; Little v. Commissioner, T.C. Memo. 1993-281, 65 T.C.M. (CCH) 3025, 3032 (1993). This rule seeks to avoid the uncertainty that would result from allowing the taxability of a transaction to depend on whether an alternative form exists under which more favorable tax consequences would result. National Alfalfa, 417 U.S. at 149; Television Indus., Inc. v. Commissioner, 284 F.2d 322, 325 (2nd Cir. 1960).

The case law recognizes that taxpayers are advantaged by having both the power to structure transactions in any form they choose and the access to the facts that reflect the underlying substance. In contrast, the Commissioner is disadvantaged since he does not have direct access to the facts underlying a particular transaction. Hence, the Commissioner must be allowed to rely on representations made by taxpayers in their returns and must be allowed to evaluate the resulting tax consequences based on such disclosures.

“The Commissioner is justified in determining the tax effect of transactions on the basis in which the taxpayers have molded them” Television Industries, Inc. v. Commissioner, 284 F.2d at 325. See also FNMA v. Commissioner, 90 T.C. 405, 426 (1988). To allow taxpayers to argue for alternative tax treatment of a transaction upon the examination of the returns would be tantamount to administering the tax laws based on a policy that tax consequences flow from the “transaction taxpayers have chosen or from any other form [of transaction] they might have chosen, whichever is ... [more favorable].” City of New York v. Commissioner, 103 T.C. 481, 493 (1994) (quoting Television Industries, Inc. v. Commissioner, 284 F.2d at 325). For this reason, the courts have generally subjected taxpayers to a heightened standard of proof before they are permitted to contradict the form and have the transaction taxed in accordance with substance. Spector v. Commissioner, 641 F.2d at 382; Estate of Durkin v. Commissioner, 99 T.C. at 572-75; FNMA v. Commissioner, 90 T.C. at 426; Illinois Power v. Commissioner, 87 T.C. at 1431; Little v. Commissioner, 65 T.C.M. (CCH) at 3032.

The courts have articulated this heightened standard of proof differently. See Spector v. Commissioner, 641 F.2d at 382. For example, in Commissioner v. Danielson, 378 F.2d 771 (3rd Cir. 1967), the court held that where taxpayers executed a contract containing specific terms, conditions and allocations, they may not alter or avoid the tax consequences of that agreement in the absence of fraud,

duress, or undue influence.² In contrast, the court in Sonnleitner v. Commissioner, 598 F.2d 464 (5th Cir. 1979), determined that before a taxpayer may alter or avoid the tax consequences of a contractual arrangement, the taxpayer must come forth with strong proof that the agreement lacked economic reality. See also Little v. Commissioner, 65 T.C.M. (CCH) at 3031 (strong proof requires a showing beyond a “preponderance of the evidence that the terms of the written instrument do not reflect the actual intentions of the contracting parties”). The strong proof standard has also been adopted by the Tax Court in adjudicating matters involving debt-equity disputes. Miller v. Commissioner, T.C. Memo. 1989-153, 57 T.C.M. (CCH) 46, 50-51 (1989) *aff'd in an unpublished opinion*, (6th Cir. 1990) (where taxpayers chose to characterize the advances as debt, the court was unpersuaded by their argument that the substance was equity when the advances contained both debt and equity characteristics).

The Tax Court has adopted the "strong proof" standard and has refused to apply Danielson outside the circuits that recognize it. See, e.g., Meredith Corp. v. Commissioner, 102 T.C. 406, 440 (1994); Elrod v. Commissioner, 87 T.C. 1046, 1065-66 (1986). The "strong proof" rule, as applied by the Tax Court, requires a showing of somewhat more than a preponderance of the evidence and somewhat less than Danielson. Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1434 n.15 (1986), *acq. in result*, 1990-2 C.B. 1. The burden upon the taxpayer is “far heavier when his tax reporting positions and other actions did not consistently reflect the substance which he later argues should control the form.” Miller v. Commissioner, 57 T.C.M. (CCH) at 50-51 (citing Illinois Power Co. v. Commissioner, 87 T.C. at 1430).

The Tax Court in Estate of Durkin v. Commissioner, 99 T.C. at 574-575 held that, under either a “strong proof” or Danielson standard, the taxpayer could not disavow the form they chose where: (1) the taxpayer was seeking to disavow his own tax return treatment of the transaction, (2) the taxpayer’s reporting position and other actions did not show “an honest and consistent respect for the substance of the transaction”, (3) the taxpayer was unilaterally attempting to have the transaction treated differently after it had been challenged, and (4) the taxpayer would have been unjustly enriched if he were permitted to belatedly alter the transaction after well-informed negotiations were held with the other party to the transaction.

² Only certain courts have adopted Danielson. See, e.g., Lane Bryant, Inc. v. United States, 35 F.3d 1570 (Fed. Cir. 1994); Schatten v. United States, 746 F.2d 319 (6th Cir. 1984); Bradley v. United States, 730 F.2d 718 (11th Cir. 1984), *cert. denied*, 469 U.S. 882 (1984); Spector v. Commissioner, *supra*.

The taxpayers in Durkin did not prevail in establishing that the transaction, in substance, was different from that which was initially reported in the tax return as a purchase of coal properties from their corporation at a price below fair market value. Upon examination of the returns, the Commissioner determined that the taxpayers received a constructive dividend for the difference between the price paid and fair market value of the property. After their returns were challenged by the Commissioner, the taxpayers argued that their purchase of coal properties were in substance part of one integrated transaction in which they disposed of their stock ownership to another shareholder, and thus, the transaction should be taxed as a redemption. Based on the four factors discussed above, the court determined that the taxpayers did not carry their heightened burden to show a substance that is different than their reporting position. Furthermore, the taxpayers would have been unjustly enriched if they were permitted to avoid the tax consequences of a constructive dividend.

The Ninth Circuit, which governs the present case, has never adopted the Danielson rule and, as a result, the Tax Court has followed the "strong proof" rule there. See, e.g., Fountain Valley Transit Mix, Inc. v. Commissioner, T.C. Memo. 1996-244; Salyer Grain and Milling Co. v. Commissioner, T.C. Memo. 1986-165, *aff'd*, 815 F.2d 1265 (9th Cir. 1987).³ These cases rely upon Schmitz v. Commissioner, 51 T.C. 306, 318 (1968), *aff'd sub. nom.*, Thronson v. Commissioner, 457 F.2d 1022 (9th Cir. 1972) in which the Tax Court specifically applied the "strong proof" rule, and the Ninth Circuit affirmed without reaching the issue of the application of Danielson.⁴

³ In Salyer Grain and Milling Co. v. Commissioner, 815 F.2d 1265 (9th Cir. 1987), the Ninth Circuit simply adopts the Tax Court opinion.

⁴ The Ninth Circuit has used a more stringent rule approaching Danielson. In Palo Alto Town & Country Village, Inc. v. Commissioner, 565 F.2d 1388, 1390 (9th Cir. 1977), the taxpayers were challenging provisions in their agreements regarding the purchase price of two contiguous parcels of land. The court held that taxpayers were bound by the agreements "knowingly and voluntarily made, with no suggestion of fraud." The court noted that "the tax consequences of such an agreement may be challenged by the Commissioner, but not by the taxpayer." 565 F.2d at 1390 (citations omitted). Other Ninth Circuit cases have similarly held that, in an absence of fraud, a taxpayer could not challenge the form of its transaction. See Baxter, 433 F.2d 757, 759 (9th Cir. 1970). The Tax Court has recognized that the holding of Palo Alto indicates that the Ninth Circuit may apply a rule that is more stringent than the "strong proof" rule. See Huestis v. Commissioner, T.C. Memo. 1992-159, 63 T.C.M.(CCH) 2443, 2447 (1992); Chiapetti v. Commissioner, T.C. Memo. 1996-183, 71 TCM (CCH) 2778, 2783 n.8 (1996). However, whether the Tax Court would ever apply the Palo Alto standard is questionable. In both Huestis and Chiapetti, the Tax Court determined that

Although the Danielson standard and the “strong proof” standard were both first applied in cases involving covenants not to compete, it is now clear that both standards cover a much broader range of circumstances. Estate of Robinson v. Commissioner, 101 T.C. 499, 513 (1993); Coleman, 87 T.C. 178, 202 (1986). Taxpayers have been held to their characterization of an amount as debt. See Taiyo Hawaii, Ltd. v. Commissioner, 108 T.C. 590 (1997); City of New York v. Commissioner, 103 T.C. 481 (1994); Litchfield v. Commissioner, T.C. Memo. 1994-585, *aff'd in an unpublished order*, 97-2 USTC ¶50,536 (10th Cir. 1997); Miller v. Commissioner, T.C. Memo. 1989-153. Significantly, Taiyo Hawaii was decided under Ninth Circuit precedent.

The court in Taiyo Hawaii, in holding for the Commissioner that the advances were debt, found that it was unnecessary under the facts of that case to engage in a traditional debt-equity analysis. 108 T.C. at 601-604. Working from the fundamental principle set forth in National Alfafa that a taxpayer must accept the tax consequences of its choice of transaction, the court noted that taxpayers have been permitted to assert substance over form where their “tax reporting and other actions have shown an honest and consistent respect for” the substance. *Id.* at 602 (citing FNMA v. Commissioner, 90 T.C. at 426 and Illinois Power Co. v. Commissioner, 87 T.C. at 1430). The court found that Taiyo Hawaii failed this exception. The court stated:

Petitioner has, for all purposes, treated the advances as loans and was instructed by its parent corporation to accrue interest. Under those circumstances, we reject petitioner's approach of testing its own choice of form with traditional debt versus equity considerations, such as the absence of a fixed payment schedule, maturity dates, enforcement, or formal debt instruments. We are likewise unpersuaded by petitioner's accountant's . . . after-the-fact testimony that, in retrospect, he should have considered the advances as equity and reported them as such on petitioner's tax returns.

108 T.C. at 602 (citations and footnote omitted).

their conclusions would be the same under either the “strong proof” or Palo Alto standard. Huestis, 63 T.C.M. (CCH) at 2447; Chiappetti, 1996 RIA TC Memo ¶ 96,183 at 1368 n.8. Further, after Palo Alto, the Tax Court has continued to apply the “strong proof” standard in cases appealable to the Ninth Circuit. See Salyer Grain and Milling Co., 51 T.C.M. (CCH) at 922 n.1.

In the recent opinion of Norwest Corp. v. Commissioner, 111 T.C. No. 5, 1998 U.S. Tax Ct. Lexis 41, at *72-86 (August 10, 1998), the Tax Court denied the taxpayer's request to have the transaction taxed in accordance with its substance, after it was initially reported in the return as a sale and lease-back of real property. The taxpayer argued that there had been no sale, and that the entire transaction, in substance, was merely a financing arrangement. The court concluded that the "taxpayers cannot elect a specific course of action and then when finding himself in an adverse situation extricate himself by applying the age-old theory of substance over form." Norwest Corp. v. Commissioner, 1998 U.S. Tax Ct. Lexis 41, at *84. A taxpayer's ability

to ignore the transactional form that he has adopted ... is further curtailed if ... [he] attempts to abandon his tax return treatment of a transaction ... [W]hen a taxpayer seeks to disavow his own tax return treatment ... by asserting the priority of substance only after the Commissioner raises questions with respect thereto, this Court need not entertain the taxpayer's assertion of the priority of substance ... [Due to] the tremendous load he carries, [the Commissioner] must necessarily rely in the vast majority of cases on what the taxpayer asserts to be fact. The burden is on the taxpayer to see to it that the form of business he has created for tax purposes, and has asserted in his returns to be valid, is in fact not a sham or unreal. If in fact it is unreal, then it is not he but the Commissioner who should have the sole power to sustain or disregard the effect of the fiction since otherwise the opportunities for manipulation of taxes are practically unchecked. Id. at *81-83.

We recognize that in some cases involving debt-equity disputes decided prior to Norwest and Taiyo Hawaii, courts chose to adjudicate the matter by testing the taxpayer's chosen form with traditional debt versus equity considerations. For instance, in Georgia-Pacific Corp. v. Commissioner, 63 T.C. 790 (1975), the Commissioner argued that the taxpayer was bound by the form in which affiliated corporations cast advances. The Tax Court, however, believed that such advances should be "characterized in terms of economic reality for the year at issue" and that "changing circumstances as time passes may alter the original character of an advance and transform it into equity." Id., at 795-796. It is worth noting that when applying the various debt-equity factors to reach the conclusion that the advances were debt, a recurring theme relied upon by the Court was the intent of the affiliates as evidenced by their contemporaneous actions prior to the litigation -- the manner in which the affiliates characterized the advances on their books and records, reported the advances on their tax returns and reported the advances to unrelated third parties. Id., at 796-800. The Court concluded that the advances were "clearly loans at their inception" and the taxpayer had failed to present a "concrete

demonstration of any changed intent." *Id.*, at 800. In this sense, Georgia-Pacific, which was decided only one year after National Alfafa, was a precursor to Norwest and Taiyo Hawaii. But, to the extent Georgia-Pacific reflects a court's willingness to indulge in traditional debt-equity considerations, the Tax Court in Taiyo Hawaii found the taxpayer's reliance on Georgia-Pacific unworthy of comment in light of National Alfafa and its progeny. 108 T.C. at 601.⁵

In this case, we do not have facts about Corp A, Corp B and Corp C's tax reporting and other actions in the U.S., Country X and Country Y regarding the Debt Instrument. For instance, we do not know how the Debt Instrument was treated for tax reporting purposes (including the Form 5471s of Corp B and Corp C), and for financial reporting purposes, in all three countries. Thus, more information is needed about whether the corporations took positions with respect to the Debt Instrument that Corp A is seeking to disavow and whether their reporting positions show "an honest and consistent respect for the substance of the transaction," whether they are unilaterally attempting to have the transaction treated differently after it has been challenged, and whether Corp A would be unjustly enriched if it were permitted to belatedly alter the transaction. See Estate of Durkin v. Commissioner, 99 T.C. at 574-75.

In the event it is necessary to consider whether the Debt Instrument between Corp B and Corp C constitutes debt or equity, the particular facts and circumstances must be examined. No single uniform approach has been adopted by the courts in analyzing this particular issue. The Tax Court looks to whether there was a "genuine intention to create a debt, with a reasonable expectation of repayment, and . . . [whether] that intention comport[s] with the economic reality of creating a debtor-creditor relationship." Nestle Holdings, Inc. v. Commissioner, T.C. Memo. 1995-441, 70 T.C.M. (CCH) 682, 700 (1995), *vacated and remanded on another issue* 152 F.3d 83 (2d Cir. 1998) (quoting Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973)). In this regard, the same facts concerning the tax and financial reporting of Corp A, Corp B and Corp C,

⁵/ The court in Taiyo Hawaii was likewise unimpressed with the taxpayer's reliance on J.A. Tobin Construction Co. v. Commissioner, 85 T.C. 1005 (1985) (imputation of interest under section 482 rejected, but the Commissioner did not argue that the taxpayer was held to the form of its transaction); J.A. Maurer, Inc. v. Commissioner, 30 T.C. 1273 (1958) (advances were contributions to capital); LDS, Inc. v. Commissioner, T.C.M. 1986-293 (insert summary); and Inductotherm Industries, Inc. v. Commissioner, 48 T.C.M. 167, 186-89 (1984), *aff'd. without published opinion* 770 F.2d 1071 (3d Cir. 1985) (advances characterized as equity, but the Commissioner did not argue that the taxpayer was held to the form of its transactions for such advances). 108 T.C. at 601, n. 9.

contemporaneous with the transaction, are very probative of the overall intent of the parties.

The courts have enumerated several other factors, in addition to intent, to be considered in resolving a debt-equity issue. While the following list is not exclusive and no single factor is determinative, the courts generally look to: (1) the name and presence of a written agreement demonstrating indebtedness, (2) the presence of a fixed maturity date, (3) the source of payments, e.g., whether there is anticipated cash flow to cover payments, (4) the right to enforce payment, (5) increased participation in management as the result of the advance, (6) subordination, (7) thinness of the capital structure in relation to debt, (8) the identity of interest between creditor and stockholder, (9) the source of interest payments, e.g., from earnings, (10) the ability of the corporation to obtain credit from outside sources, (11) the use of funds for capital assets or risk involved in making the advances, and (12) the failure of the debtor to repay. See Laidlaw Transportation, Inc. v. Commissioner, T.C.M. 1998-232; Nestle Holdings, Inc. v. Commissioner, 70 T.C.M. at 700; Lansall Company v. United States, 512 F.Supp. 1178, 1180 (S.D.N.Y. 1981). See also I.R.C. § 385(b) (listing debt-equity factors which could be taken into account in regulations).

In sum, further factual development will be necessary in this case to reach a conclusion as to whether the debt instrument should be treated as equity. In addition, even if the Debt Instrument is treated as equity, it is not clear from the facts presented that Corp B would be treated as directly owning more than 50 percent (by vote or value) of the stock of Corp C. You have indicated that Examination determined that if Corp B had exercised this option, it would have received approximately x Percent, y Percent and z Percent, of the stock of Corp C as of the end of Year 1, Year 2, and Year 3, respectively. You have also indicated, however, that the Debt Instrument exceeds 50 percent of the value of the assets of Corp C. Thus, even if the Debt Instrument is treated as equity, further factual development would be necessary to verify the value of Corp B's ownership interest.

Issue #2 - Adjusted basis of assets

The second issue concerns the computation of the adjusted basis of the CFC group's total assets for purposes of determining excess passive assets.

Section 956A(c) of the Code provides that for purposes of determining excess passive assets, the amount taken into account with respect to an asset is its adjusted basis as determined for purposes of computing earnings and profits.

Section 956A(c)(3) of the Code provides that, for purposes of determining excess passive assets, section 1297(e) applies. Section 1297(e) (currently

1298(e)) provides that the adjusted basis of the total assets of a CFC shall be increased by the research and experimental (R&E) expenditures, within the meaning of section 174, paid or incurred by the foreign corporation during the taxable year and the preceding two taxable years.

Section 174 of the Code provides that a taxpayer that has paid or incurred R&E expenditures in connection with his trade or business during a taxable year may treat such R&E expenditures as deductible expenses, under section 174(a), or as deferred expenses that are chargeable to a capital account and deducted ratably over a period of not less than 60 months, under section 174(b).

Section 1297(e) of the Code does not distinguish between R&E expenditures deductible under section 174(a) and R&E expenditures amortizable under section 174(b). Section 1297(e) will apply as long as such expenditures were paid or incurred during the taxable year or the preceding two taxable years.

Corp A maintains that an election by foreign subsidiaries of Corp A to amortize R&E expenditures under section 59(e) of the Code also allows the CFC group to increase the adjusted basis of the CFC group's total assets in an amount equal to the unamortized R & E expenses paid or incurred during the taxable year and the nine previous taxable years.

Section 59(e) provides that for purposes of the Code, if an election is made with respect to any portion of a qualified expenditure, it may be amortized over a ten-year period. Section 1016(a)(20) provides that proper adjustments in respect of the property shall in all cases be made for amounts allowed as deductions under section 59(e).

If a taxpayer has elected to amortize R&E expenditures, the unamortized portion of the expenditure is reflected in the basis of the property under section 1016(a) of the Code. If a taxpayer were allowed to again increase the basis of the property by the same expenditure, under section 1297(e), it would be double counting the R&E expenditure for basis purposes when it elects to amortize rather than deduct R&E expenditures. To prevent section 1297(e) from double counting R&E expenditures when a taxpayer has elected to amortize them, it must be interpreted to apply without taking into account any basis adjustments under section 1016(a). Thus, section 1297(e) provides the exclusive rule for determining the basis of R&E expenditures under the passive foreign investment company regime, and, by cross-reference, under section 956A,

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CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



If you have any further questions, please call (202) 622-3840.

/s/ Phyllis E. Marcus
PHYLLIS E. MARCUS
Branch Chief