Recent Private Rulings of Interest

*By William Skinner and Kris Hatch**

In this article, we discuss several private rulings (LTRs and a CCA) issued by the IRS in recent months with interest to international tax practitioners. Some of the rulings, while not specifically addressed to international issues, have interesting implications for international tax planning and cross-border transactions.

Source of Hedging Gains and Losses—LTR 202140016

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The first LTR revisits an issue that many may have forgotten: there is no specific rule for sourcing gain or loss from derivatives and similar transactions under Code Secs. 861 through 865. Congress enacted a Code Section delegating authority to the Secretary to write regulations on this topic, Code Sec. 865(j)(2), but such authority has not been exercised. While one might have assumed that such gains or losses are sourced to the residence of the seller under Code Sec. 865(a), this LTR provides different guidance where such a source result would produce inappropriate results. In so doing, it falls back on the common law hedging doctrine and, specifically, *Corn Products Refining Co*.[1]

In the fact pattern addressed by the LTR, a U.S.-based multinational was engaged in production and sale of inventory property sourced under Code Secs. 861 and 863(b). Such inventory was sold to third parties and also sold to related parties outside of the consolidated group for resale. Some inventory was sourced under the place of production rule, Code Sec. 863(b), whereas other inventory sales were sourced under the title passage rule, Code Secs. 861(a)(6) and 862(a)(6). The U.S. taxpayer thus earned a mix of U.S. and foreign source income from its sales of inventory.

At the same time, members of the U.S. consolidated group ran trading desks for internal hedging purposes and executed commodities hedging contracts to manage the group's price risk on manufacture and sale of inventory. The contracts executed as part of the hedging program qualified for Code Sec. 1221(b)(2) treatment, so that gains and losses on the contracts produced ordinary income and ordinary deductions.

From a source of income perspective, however, the taxpayer faced a potential whipsaw. The sales of inventory property would generate a mix of foreign source and U.S. source income, as noted above. By contrast, the commodities hedging contracts could give rise to gains and losses from the sale of personal property under Code Sec. 1234A in case of the forward contracts or other contract

terminations. Moreover, even if the contracts did not give rise to sales or exchanges of property under the general rules of the Code, one might also analogize the gains and losses from hedging contracts to property sales for sourcing purposes. Applying Code Sec. 865(a)'s residency of the taxpayer rule would distort the taxpayer's source of income result, as the U.S. source gains and losses on the contracts did not match the underlying foreign and U.S. source income from the inventory sales.

In the LTR, the IRS concluded that Code Sec. 865(a) does not directly apply to source gains and losses from derivatives transactions. Code Sec. 865(j)(2) authorizes regulations to address sourcing gains and losses from derivatives transactions, but no regulations have been issued. The LTR also cited a provision in Reg. §1.865-1 for sourcing losses from sales of property which excludes losses on certain derivatives transactions from the normal Code Sec. 865 rules.

Instead, the IRS looked to Code Sec. 1221 for the definition of "inventory" for purposes of the source rules, since Code Sec. 865 incorporates this definition. Under Code Sec. 1221(a)(1), prior to the enactment of Code Sec. 1221(b) to address hedging transactions, the case law had interpreted "inventory" to include gains and losses from hedging transactions with respect to the taxpayer's inventory.[2] Although the Supreme Court significantly limited the holding of *Corn Products* in *Arkansas Best*,[3] and Congress's enactment of Code Sec. 1221(b)(2) largely rendered the *Corn Products* doctrine moot, the IRS in this LTR found the 1955 case to still have vitality in providing a common law definition of "inventory" to include hedges of inventory. Accordingly, for sourcing purposes, the gains and losses from the hedging contracts were property sourced under the rules for sale of inventory property.

In summary, the recent trend of the IRS and Treasury has been to include specific hedging definitions in regulations.[4] However, in cases where specific regulations do not exist, the *Corn Products* case continues to be a relevant and potentially important authority.

LTR 202141005—Is Every Public Acquisition a Code Sec. 304 Transaction?

The second LTR covers a lurking issue in any taxable acquisition of a publicly traded corporation—potential treatment of such an acquisition as a Code Sec. 304 deemed dividend transaction due to the overlapping shareholders between the Buyer and the Seller. The taxpayer requesting the ruling was a U.S. multinational company that acquired the stock of a publicly traded foreign corporation for a mix of stock and cash. Although its reason for requesting the ruling is unstated, the taxpayer presumably wanted to make a Code Sec. 338(g) election which would have been precluded if Code Sec. 304 had applied to the transaction.[5] In addition, depending on the extent to which any particular shareholder's ownership was reduced and whether it met the Code Sec. 302 standards, Code Sec. 304 treatment could have resulted in the purchase consideration being a deemed dividend by the U.S. acquirer subject to FDAP withholding.

Code Sec. 304(a)(1) applies to so-called "brother-sister transactions." Where it applies, Code Sec. 304 deems the purchase of stock of the target (*i.e.*, the "issuing corporation") to be recast into two steps: first, a deemed Code Sec. 351 transfer of Target's stock to the Acquiring corporation for fictional Acquiring corporation shares, and second, a Code Sec. 302 redemption of those deemed issued shares by Acquiring for the stock purchase consideration. Notably, even if the result of the Code Sec. 304 recast is a redemption treated as a sale of stock under Code Sec. 302(a), rather than a deemed dividend, Code Sec. 304 still technically causes the Target's stock to be acquired in a Code Sec. 351 exchange.

Under the Code Sec. 304 recast, the Buyer would be deemed to acquire the Target shares in a Code Sec. 351 transaction, rather than a Code Sec. 1001 taxable stock purchase. Even though such a recast would not affect the Sellers (to the extent that the Code Sec. 302(a) redemption were not to be equivalent to a dividend), the Buyer would be viewed as acquiring the stock of Target in a tax-free Code Sec. 351 exchange. Buyer would no longer receive a cost basis in Target's stock, and moreover, such stock would not be considered to have been "purchased" under Code Sec. 338(h)(3). Without a "purchase" of the Foreign Target's shares, Buyer would be precluded from making an election under Code Sec. 338(g) to obtain a stepped-up basis in the asset of the foreign Target and other benefits from the election.

Normally, Code Sec. 304 is encountered in sales of stock among brother-sister companies in a multinational group. However, the statute is not so limited. Code Sec. 304(a)(1) applies to any transaction in which "one or more persons" are in control of both corporations. Control is defined as 50% or more of the stock by vote or value. There is no requirement that the shareholders in the so-called control group own any minimum threshold of stock. Therefore, two publicly traded corporations could be viewed as commonly controlled by virtue solely of 50% or more overlapping ownership by the same mutual funds, institutional holders or even individual investors. Ruling out this possibility raised tricky questions of proof and substantiation that were resolved in this LTR.[6]

In the LTR, the IRS reviewed and approved a set of diligence procedures undertaken by the Taxpayer to establish that Taxpayer and Target lacked sufficient cross-ownership to cause Code Sec. 304 to apply. There are no regulations or other published guidance on the taxpayer's manner of proof.[7] As described in the LTR, the Taxpayer took the following steps to establish that Target was not under common control with the Taxpayer for purposes of Code Sec. 304:

- Review of SEC filings, including Schedules 13F and 13G to identify all 5% shareholders for SEC reporting purposes as of the period before the closing. In many cases, however, the listed 5% shareholder was a fund manager, and not itself the beneficial owner of the stock.
- Review of datasets containing shareholder analysis from certain "Subscription Services" that identified the total number of Target shares outstanding and the number of shares owned by each mutual fund. The Subscription Service allowed the Taxpayer to look behind the reported owner on Schedule 13 to the underlying mutual funds that beneficially owned the stock.
- To the extent that the beneficial ownership of shares was not disclosed by the Subscription Services (what the ruling terms "Undisclosed Shares"), the Taxpayer contacted the Target's Transfer Agent to attempt identify the ownership of such Undisclosed Shares.
- Review the manner in which the Subscription Services identified relevant shareholders.

Even after undertaking all of this diligence, the taxpayer still was not able to identify all of the beneficial owners of the stock of Taxpayer and Target. However, apparently the taxpayer was able to identify enough owners of stock to satisfy the IRS that there was no 50% overlap of controlling shareholders.

Pending further regulations or official guidance, it will be interesting to see if other taxpayers pursue a private letter ruling to obtain certainty on availability of Code Sec. 338(g) in a public company acquisition or attempt to independently obtain comfort that a given level of diligence is sufficient to substantiate the position that Code Sec. 304 does not apply.

LTR 202114002—Preliminary Liquidation to Manage the Active Business Gross Receipts Test of Code Sec. 165(g)(3)

In the third ruling, LTR 202140002 ruled that for purposes of computing the "more than 90% gross receipts" test under Code Sec. 165(g)(3)(B), a CFC could take into account the historic gross receipts of a lower-tier CFC that liquidated in a Code Sec. 332. Effectively, the IRS blessed the preliminary liquidation as a planning technique to obtain ordinary treatment under Code Sec. 165(g)(3) for a liquidation of an insolvent CFC holding company that lacked the necessary history of active gross receipts. While similar private rulings have been granted in the past,[8] this is the first ruling on this point in several years.

Where the stock of a subsidiary becomes worthless, Code Sec. 165(g)(3) provides for ordinary loss treatment, provided that certain requirements are met. Relevant here, the taxpayer must establish that at least 90% of the subsidiary's gross receipts for its entire existence are from sources other than certain passive sources, such as interest, dividends, rents, or royalties.[9] In the case of a foreign subsidiary that, in turn, owns other lower-tier CFCs, neither the Code nor the Regulations provide for the aggregation of the gross receipts of the lower-tier CFC with those of the first-tier CFC as to which a worthless stock loss was claimed. This led the Taxpayer to employ self-help by liquidating one of the lower-tier operating CFCs into the Foreign HoldCo effective prior to the date of worthlessness of the Holding Company.

In the LTR, the Taxpayer formed Foreign Sub 1 in Year 1 and Foreign Sub 2 in Year 2 to facilitate the development and exploitation of Product. In Year 3, Taxpayer contributed the two foreign subsidiaries to foreign Holding Company. No check-the-box elections were made.

Later, in the time period addressed in the LTR, the taxpayer began to wind down its operations relating to Product, eliminated Foreign Sub 2's workforce, and disposed of substantially all Foreign Sub 2's assets. Foreign Sub 2, which apparently housed all of the operations associated with exploiting the Product, became insolvent. At the same time, a third-party appraiser determined that the equity interests in the CFC Holding Company were also worthless. The Holding Company itself lacked any gross receipts throughout its life since the date of its incorporation.

As noted above, Code Sec. 165(g)(3) provides that the general rule in Code Sec. 165(g)(1) treating worthless stock losses as capital losses does not apply to shares of an affiliated corporation that satisfies an active gross receipts test. Holding Company, however, had no gross receipts.

To cause HoldCo to satisfy the gross receipts test of Code Sec. 165(g)(3)(B), the Taxpayer made a check-the-box election with respect to Foreign Sub 2 to cause it to liquidate into the Holding Company effective prior to the Holding Company's deemed worthlessness. Foreign Sub 2's liquidation was also effective before Foreign Sub 2's stock became worthless, so that the liquidation of Foreign Sub 2 into

the Holding Company was governed by Code Sec. 332. Through this synchronized timing, the Holding Company became the successor under Code Sec. 381 to Foreign Sub 2's tax attributes. As held by the LTR, Foreign Sub 2's active gross receipts history for Code Sec. 165(g)(3)(B) was among the tax attributes that carried over to HoldCo.[10] The Holding Company could, therefore, meet the requirement of Code Sec. 165(g)(3)(B) that at least 90% of its gross receipts were derived from sources other than those seen as generating passive income.

Interestingly, the taxpayer represented to the IRS that Foreign Sub 1, which did not liquidate into the Holding Company, did not have any historical gross receipts, and that the Holding Company did not have any other subsidiaries besides Foreign Sub 1 and Foreign Sub 2. Perhaps there was a concern at the IRS with the selective use of this technique to cause the Holding Company to inherit the gross receipts of an active subsidiary without inheriting the gross receipts of another subsidiary with passive income.

CCA 202132009—Treatment of a Non-Deductible Expense in Transfer Pricing Analysis

CCA 202132009 concerned liability among members of a foreign-parented multinational group for fees imposed on branded prescription drug sales (the "BPD Fee") in an a transfer pricing arrangement where the U.S. corporation paid the BPD Fee on behalf of a foreign related party.[11] In the CCA, the taxpayer group develops, manufactures, and distributes medical care products, including branded prescription drugs.[12] The foreign members of the group manufactured the branded prescription drugs and owned all the intellectual property (IP) rights. Their U.S. affiliate distributed the branded prescription drugs in the United States as a limited risk distributor.

Under the ACA, controlled groups are treated as a single entity for purposes of the BPD Fee, with all members of the controlled group jointly and severally liable for the BPD Fee. In the intercompany distribution agreement, the U.S. distributor remitted the BPD Fee on behalf of the group, with the foreign manufacturer reimbursing the U.S. distributor for the entire BPD Fee. In the fact pattern addressed in the CCA, the U.S. distributor excluded the amount reimbursed from its gross income under the reimbursement doctrine. The CCA, by contrast, held that the BPD Fee was an expense of the U.S. distributor, which, despite being non-deductible, factored into the calculation of its transfer pricing margin.

In the CCA, the IRS did not directly address which entity was liable for BPD Fee under the ACA, but ruled that joint and several liability of the members of the group does not result in a *per se* exclusion of the reimbursement from the U.S. distributor's gross income. Rather, the CCA analyzed the issue of whether the reimbursement was includible in gross income (*i.e.*, whose expense is the fee) under an evaluation of several factors.[13]

According to the CCA, a taxpayer does not have gross income when it is reimbursed for an expense paid by the taxpayer as an agent or conduit on behalf of the reimbursing party.[14] Moreover, the CCA noted that when a person reimburses the expenses of the taxpayer to advance its own interests, the payments are not included in the taxpayer's gross income, notwithstanding any incidental or indirect economic benefit to the taxpayer.[15] Under the view expressed in the CCA, reimbursement will not be income to the taxpayer only when the expense is undertaken for the reimbursing party's own benefit and not for the benefit of the reimbursed party. According to the IRS, the fact that the manufacturer also was legally liable for the fee was insufficient to show that the manufacturer was able to make a non-taxable reimbursement.

The IRS's cramped interpretation of the reimbursement doctrine is relevant not only for the BPD Fee at issue in the case, but also for transfer pricing and BEAT issues more generally. The reimbursement doctrine and similar principles have been garnering additional attention from the IRS.[16] Unless and until BEAT is replaced by a different statutory provision, it would appear that these common law doctrines are here to stay.[17]

Late Election Relief Granted in LTR 202135006 to Mitigate Adverse Effects Under the Code Sec. 245A Temporary Regulations

In LTR 202135006, the IRS granted a U.S. corporation late filing relief to make an entity classification election on Form 8832 to treat its controlled foreign corporation (CFC) as a disregarded entity. The late Form 8832 election was allowed by the IRS prior to a contribution of assets so that the taxpayer could avoid adverse consequences under Code Sec. 245A temporary regulations that were released with retroactive applicability.[18]

In the ruling, U.S. parent, a publicly traded corporation, owned several CFCs including FSub, treated as a corporation for U.S. federal tax purposes. FSub wholly owned X, a foreign company also treated as a corporation

for U.S. federal tax purposes. On Date 3, FSub contributed assets to X in exchange for newly issued shares of X, with FSub recognizing gain in the transaction. Subsequent to the contribution, Code Sec. 245A regulations were released with retroactive applicability to a date prior to Date 3.

The Code Sec. 245A regulations at issue would cause future distributions made by FSub out of E&P from the gain recognized in the contribution to be taxable in part as distributions made out of "extraordinary disposition" E&P. In light of these regulations, it would have been beneficial for the U.S. parented group to have made a check-the-box application prior to the contribution, so that the contribution would have also been disregarded for U.S. federal tax purposes and no gain would have been recognized by FSub. Accordingly, the U.S. group sought Reg. §301.9100-3 relief in order to obtain a retroactive check-the-box application prior to Date 3.

In granting the taxpayer's requested relief for a late Form 8832 entity classification election, the IRS emphasized that X failed to make the election because (after exercising reasonable diligence) it was unaware of the negative tax consequences that could result if an election was not made. Moreover, the IRS noted there was no hindsight used by X in requesting relief, because the Code Sec. 245A regulations were issued after contribution on Date 3 with retroactive to a date prior to the effective date of X's proposed check-the-box application.[19] The ruling also focused on the fact that X was not informed in all material respects of the election and consequences because "its tax advisors did not advise them of the negative tax consequences that could result if an election was not made."

ENDNOTES

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1 *Corn Products Refining Co*, SCt, 55-2 USTC ¶9746, 350 US 46, 76 SCt 20.

2 *See Corn Products*, *supra*, note 1.

3 *Arkansas Best Corp*, SCt, 88-1 USTC ¶9210, 485 US 212, 108 SCt 971.

4 *See*, *e.g.*, Reg. §1.250(b)-4(f).

5 Since the acquisition was effected *via* a stock purchase, but for application of Code Sec. 304, it would have constituted a taxable stock purchase rather than a B reorganization.

6 The New York State Bar Association recently issued a report requesting guidance on application of Code Sec. 304 to public company acquisitions due to shareholder overlap. *See* Report No. 1445 (Nov. 29, 2020). As other commentators have noted, it is not uncommon for institutional investors to own shares in both parties to an M&A transaction, for example, because both companies are included in the same industry sector that the fund focuses on. *See* Willens, *Overlapping Ownership Rule Comes to the Company's Rescue*, 173 Tax Notes Federal 361 (Oct. 18, 2021).

7 *Compare* Reg. §1.382-3(j)(5) (standards of knowledge for identifying 5% shareholders for Code Sec. 382 purposes) and Reg. §§1.367(a)-3(c)(2) and 1.367(a)-3(c)(6) (presumptions of U.S. person status and manner of rebuttal).

8 *See, e.g.*, LTR 200710004, LTR 200932018; *see also, e.g.*, LTR 201006003 (Oct. 28, 2009) (ruling that Code Sec. 332 liquidation of consolidated subsidiaries caused the subsidiaries' gross receipts history to be imputed to the shareholder entity for purposes of its gross receipts history).

9 *See* Code Sec. 165(g)(3)(B).

10 *See also Dover Corp.*, 122 TC 324, Dec. 55,630 (2004) (holding that subsidiary's active business history carried over for purposes of determining exception to subpart F foreign personal holding company income); Rev. Ruls. 75-223 and 77-376 (same for purposes of determining the active conduct of a business requirement of a partial liquidation).

11 Implemented under the Patient Protection and Affordable Care Act (the ACA), P.L. 111-148 (2010), the BPD Fee is imposed on entities that manufacture or import branded prescription drugs for sale to specified government programs. Under §9008(f)(2) of the ACA, and Reg. §51.9(d), the BPD Fee is treated as a nondeductible excise tax under Code Sec. 275(a)(6).

12 In a similar ruling, LTR 201904004 also addressed an arrangement regarding payment of the BPD amongst related party entities.

13 The CCA noted that whether reimbursement of the BPD Fee would be includible in the taxpayer's income depends on multiple factors, and to what extent the taxpayer is the beneficiary of payment of the fee. Relevant factors include: (1) whether the parties intended that Foreign will bear the economic burden of the fee; (2) whether Taxpayer has an unconditional obligation to remit the amount received by Foreign as payment of the BPD Fee; (3) whether Taxpayer profits, gains, or benefits from the amount received and remitted; (4) whether Taxpayer claims the amount received as its own; and (5) whether the amount is received by Taxpayer in exchange for services provided by it.

14 *See, e.g.*, *Seven-Up Co.*, 14 TC 965, Dec. 17,656 (1950) (soda manufacturer-taxpayer did not realize income upon receipt of funds from bottlers for use in a national advertising campaign when the manufacturer agreed to collect the money and spend it on the national campaign, but did not profit or maintain discretion in how to use the funds); *Affiliated Foods, Inc.*, CA-5, 98-2 USTC ¶50,750, 154 F3d 527 (operator of a food purchasing cooperative did not realize income upon receipt of funds from vendors for use in advertising, where vendors had ultimate control over when and where to release the funds for advertising).

15 *Gotcher*, CA-5, 68-2 USTC ¶9546, 401 F2d 118. (European manufacturer paid expenses of taxpayer-dealer for dealer's trip to Germany to tour facilities as required by the manufacturer. The manufacturer's payments were not included in gross income because the costs were primarily for the manufacturer's benefit.)

16 *See*, *e.g.*, LTR 202138001 (Aug. 23, 2021) (refusing S corporation's requested LTR that it could exclude reimbursements by clients for certain expenses mandated by a government agency under the reimbursement doctrine).

17 For a discussion of reimbursement doctrine in the context of BEAT, please *see* William Skinner, *The BEAT Proposed Regulations: Use of Common Law Doctrines*, Int'l Tax J, May-June 2019.

18 *See* T.D. 9909 (Aug. 27, 2020).

19 Nonautomatic relief under Reg. §301.9100-3 is granted on a case-by-case basis and will only be granted if it can be shown that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government.