



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Associate Area Counsel (LMSB:DAL:2)

FROM: Charles P. Besecky
Branch Chief CC:INTL:BR4

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated June 7, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Parent =
Sub1 =
Sub2 =
Sub3 =
FSub1 =
FSub2 =
FSub3 =
Sub4 =
Holding =
Business A =
Business B =
County A =
Country B =
Country C =
Country D =
Country E =
Country F =

Year X =
 Year X+1 =
 Year X+2 =

Date 1 =
 Date 2 =
 Date 3 =

a =
b =
c =

SUMMARY OF CONCLUSIONS

1. Section 269 can be applied to disallow foreign tax credits and deductions that result from the Year X Reorganization if the principal purpose of such transactions is to secure tax benefits.
2. If the principal purpose of the Year X Reorganization were tax avoidance, the Service can apply section 482 principles to limit the amount of foreign tax deductions or credits that are available.
3. If the principal purpose of the Stapling Reorganization were tax avoidance, the Service can apply the sham transaction doctrine to limit the amount of tax benefits that are available.
4. The Holding Reorganization may fail to qualify for nonrecognition treatment under section 368(a)(1)(B) or section 351 if the transaction lacks a sufficient business purpose and was done for tax avoidance purposes. The Service also may be able to apply section 269 to deny nonrecognition treatment to the Holding Reorganization, or apply the sham transaction doctrine to the Holding Reorganization, in which case the Holding Reorganization would be ignored for income tax purposes.
5. To the extent that foreign tax credits claimed relate to foreign income taxes paid with respect to foreign oil and gas extraction income, the Service can apply section 907(a) to limit the amount of credits available.

FACTS

A. General Background

Parent, a domestic corporation, is the parent corporation of an affiliated group of corporations that files a consolidated Federal income tax return (the "Parent Group"). Parent and its direct and indirect subsidiaries engage in two principal

business activities: (1) Business A throughout the world; and (2) Business B in several countries.

Parent wholly owns Sub1, a domestic corporation, that in turn wholly owns Sub2, also a domestic corporation. Sub2 in turn wholly owns Sub3, a domestic corporation. Sub3 is a holding company for more than 100 of Parent's foreign subsidiaries that engage in Business A. Sub3 provides administrative and technical services to its subsidiaries and allocates the costs of providing such administrative and technical services among its subsidiaries. Prior to Date 2, Year X, Sub3, in addition to owning other subsidiaries, wholly owned Sub4, a domestic corporation, and wholly owned FSub1, FSub2, and FSub3, which are controlled foreign corporations within the meaning of section 957. FSub1, a Country A corporation, engages in Business A in Country B; FSub2, a Country A corporation, engages in Business A in Country C; and FSub3, which was a Country D corporation, engages in Business A in Country F. Prior to Date 2, Year X, Sub3 was the U.S. shareholder of FSub1, FSub2, and FSub3 within the meaning of section 951(b). FSub1, FSub2, and FSub3 each owns lower-tier foreign corporations that are also controlled foreign corporations within the meaning of section 957, and prior to Date 2, Year X, Sub3 was also the U.S. shareholder within the meaning of section 951(b) of such lower-tier foreign corporations. FSub1, FSub2, and FSub3 and their lower-tier foreign corporations will collectively be referred to as the "Sub3 CFCs."

Sub1, Sub2, Sub3, and Sub4 are members of the Parent Group for purposes of filing Federal income tax returns.

B. The Year X Reorganization

On Date 1, Year X, Sub3 formed Holding, as a newly-formed Country A corporation. Pursuant to an agreement and plan of reorganization among Sub3, the Sub3 CFCs, and Holding (the "Holding Reorganization Agreement"), Sub3 transferred the stock of the Sub3 CFCs to Holding on Date 2, Year X, in transactions intended to qualify as reorganizations under section 368(a)(1)(B) (collectively the "Holding Reorganization"). Sub3 had a total tax basis of \$c in the stock of the Sub3 CFCs at the time of the transfers. The Parent Group did not conduct a contemporaneous appraisal to determine the fair market value of the stock of the Sub3 CFCs. Also, on Date 2, Year X, FSub3, changed its domicile from Country D to Country E in a transaction intended to qualify as a section 368(a)(1)(F) reorganization.

On Date 3, Year X, the stock of Holding was "stapled" to the stock of Sub4, and the stock of Sub4 was stapled to the stock of Holding (the "Stapling Reorganization"). In particular, the organizational documents of Sub4 were amended on Date 3, Year X to provide as follows:

No shares of the common stock of Sub4 are to be transferred to any transferee unless a number of shares of common stock of Holding, a foreign corporation, equal to the percentage of ownership of Sub4

shares of common stock to be transferred, are at the same time to be transferred to the same transferee.

Similarly, the organizational documents of Holding were amended on Date 3, Year X to provide as follows:

No shares of Holding are to be transferred to any transferee unless a number of shares of common stock of Sub4, a domestic corporation, equal to the percentage of ownership of Holding shares to be transferred, are at the same time to be transferred to the same transferee.

The formation of Holding, the Holding Reorganization, and the Stapling Reorganization will collectively be referred to as “the Year X Reorganization.” The Holding Reorganization Agreement noted that the purpose of the Holding Reorganization was to facilitate efficient financing and cash management for Sub3, the Sub3 CFCs, and Holding. However, the Year X through Year X+2 financial information that Parent provided to the Service for Sub3, Holding, and the Sub3 CFCs shows substantial shareholder equity and an absence of debt with third party lenders.

For tax years prior to the Year X tax year, the Parent Group sustained substantial overall foreign losses (as defined in section 904(f)(2)). At the time of the Year X Reorganization, a number of lower-tier subsidiaries of the Parent Group, including the Sub3 CFCs, were generating income and distributing dividends to Sub3 and other members of the Parent Group, that would, in the absence of the Parent Group’s overall foreign losses, constitute foreign source income eligible to be sheltered from U.S. tax by direct foreign taxes paid and by foreign taxes deemed paid under sections 902 and 960. Because of prior overall foreign losses, however, the overall foreign loss recapture rules would have recharacterized a portion of the foreign source income as U.S. source income, making it disadvantageous for the Parent Group to claim foreign tax credits. On its Year X tax return, as in prior years, the Parent Group took a deduction for foreign taxes paid. Although Sub4 continued to be included as a member of the Parent Group for the Year X tax year, Holding was not included as a member of the Parent Group for the Year X tax year.

Holding filed a separate short year Federal income tax return for its Year X tax year, and on it, Holding reported interest and dividend income received from the Sub3 CFCs and included subpart F income arising from the Sub3 CFCs. Under section 901, Holding claimed foreign tax credits in the amount of \$a for foreign taxes deemed paid under sections 902 and 960 with respect to distributions and deemed inclusions from the Sub3 CFCs. In subsequent years, Holding claimed substantially larger amounts of foreign tax credits for deemed-paid taxes related to the Sub3 CFCs.

A Service Examination Team estimates that from Year X through Year X+2, the Year X Reorganization generated \$b of Federal income tax savings for the controlled group that includes Holding and the Parent Group. Although the Service has requested information about the business and tax purposes for the Year X Reorganization, Parent has not provided any information in response to such requests. Moreover, the documents the Service has reviewed do not contain any specific information supporting how the Holding Reorganization was intended to facilitate efficient financing and cash management for Sub3, the Sub3 CFCs, and Holding (as was stated in the Holding Reorganization Agreement).

C. Parent's Position on the Effect of the Year X Reorganization

Neither the Parent Group nor Holding has provided the Service with information about its reasons for excluding Holding as a member of the Parent Group. We can infer from the manner in which the Parent Group and Holding filed their separate Year X income tax returns, that the Parent Group and Holding believe that the stock of Holding is validly stapled to the stock of Sub4 under section 269B, and that Holding is generally treated as a domestic corporation.

Finally, the Service has reason to believe that transactions similar to the Year X Reorganization were marketed to taxpayers as tax manipulation strategies. In particular, by forming Holding and moving the ownership of the Sub3 CFCs outside the Parent Group, the Parent Group appears to have the circumvention of the controlled group's overall foreign loss limitations under section 904(f) as the primary purpose of the Year X Reorganization.

D. Assumptions

Parent, Sub1, Sub2, Sub3, Sub4, Holding, and the Sub3 CFCs are related taxpayers and are part of a controlled group of taxpayers. Consequently, this memorandum will refer to Parent, Sub1, Sub2, Sub3, Sub4, Holding, and the Sub3 CFCs as controlled taxpayers, controlled group, or group of controlled taxpayers.¹

For purposes of the analysis provided below, we have assumed that Sub4 and Holding are properly stapled under section 269B. We note, however, that there may be grounds for challenging the Stapling Reorganization under state law.

Finally, we assume that to the extent the Holding Reorganization and the Stapling Reorganization were valid nonrecognition events within the provisions of section 368(a)(1) or section 351, the transfers are not taxable under the sections 367(a) and (b) provisions and the Parent Group has satisfied all

¹We use section 482 definitions as a tool for describing controlled group concepts. See generally Treas. Reg. §§ 1.482-1(i)(1) - (8).

appropriate reporting requirements. This memorandum does not otherwise address these issues or consider the validity of these assumptions. As provided below, however, we believe that the Service may have several ways of challenging both the Holding Reorganization and the Stapling Reorganization as valid nonrecognition events or as events that should otherwise be respected for tax purposes.

LAW AND ANALYSIS

A. Overview

In essence, we have been asked whether the Year X Reorganization, if viewed as a tax avoidance or tax distortion transaction, may result in different tax consequences to the Parent Group or Holding. We believe that the Examination Team can take various approaches with respect to the parts of the Year X Reorganization, *i.e.*, the Holding Reorganization and the Stapling Reorganization, which will result in different tax consequences. For example, if the Examination Team determines that either under section 269 or section 482, that the principal purpose of the Year X Reorganization was tax avoidance, the Service may reallocate or disallow certain income, credits, or deductions of the Parent Group or Holding. On the other hand, if the Examination Team determines that the Holding Reorganization does not have a business purpose, the Holding Reorganization will be a taxable event under section 1001. Also, for example, if the Examination Team determines that based on the sham transaction doctrine, the Stapling Reorganization should be disregarded for tax purposes, then Holding will be treated as a foreign corporation, and the dividends and interest paid to it will be subpart F income to Sub3 (Holding's U.S. shareholder).

B. Background of International Code Provisions

1. General Rules Related to Foreign Tax Credits and Deductions

Section 164(a)(3) allows a taxpayer to deduct foreign income, war profits, and excess profits taxes ("foreign income taxes") paid or accrued during a taxable year. Section 901(a), on the other hand, allows a taxpayer to elect to credit foreign income taxes paid or accrued (or deemed paid) during a taxable year. If for any taxable year, a taxpayer to any extent chooses to claim a credit for foreign income taxes under section 901, the taxpayer must apply the choice to all foreign income taxes paid or accrued during the year and the taxpayer may deduct no portion of such taxes in such taxable year or any succeeding taxable year. I.R.C. §§ 275(a)(4)(A) and 905(a); Treas. Reg. § 1.901-1(c).

The common parent of a consolidated group may elect to claim foreign tax credits for the year on behalf of the group. Treas. Reg. § 1.1502-4(a). If an election is made, the common parent determines the foreign tax credit computations, including the section 904 computations (described below), on a consolidated basis. Treas. Reg. § 1.1502-4. Also, if the election is made, no deduction may be taken on the

consolidated return for foreign income taxes paid or accrued by any member of the group. Treas. Reg. § 1.1502-4(a). See also Treas. Reg. § 1.1502-9 (which sets forth the section 904(f) overall foreign loss rules for corporations filing consolidated returns). Under Treas. Reg. § 1.904(i)-1, all “affiliates” must consistently either elect under section 901(a) to claim a credit for foreign income taxes paid or accrued or deemed paid, or to deduct foreign income taxes paid or accrued under section 164, and must combine their foreign source taxable income or loss in determining their foreign tax credit limitations.

If a domestic corporate shareholder that owns at least 10 percent of the voting stock in a foreign corporation (a “ten-percent shareholder”) receives dividends from the foreign corporation, then under section 902, the domestic corporation is deemed to have paid a percentage of the foreign corporation’s foreign income taxes and may claim a tax credit for the taxes that it is deemed to have paid. I.R.C. §§ 901(a) and 902(a). Similarly, a deemed-paid tax credit is available to a domestic corporate shareholder owning the requisite amount of voting stock of certain lower-tier foreign corporations that pay foreign income taxes and distribute their earnings to the domestic corporation through the first-tier foreign corporation. I.R.C. § 902(a) & (b). Also, under section 960, a ten-percent shareholder that includes subpart F income in gross income under section 951(a) may claim a foreign tax credit for foreign income taxes paid or accrued or deemed paid by the controlled foreign corporation. See I.R.C. §§ 901(a) and 960(a)(1).

The Code imposes several limits on the amount of foreign tax credits a taxpayer may claim, including the foreign tax credit limitation under section 904(a). Section 904(a) limits the amount of foreign income taxes that a taxpayer may claim as a credit during a taxable year to the amount of the taxpayer’s pre-credit U.S. tax on the taxpayer’s foreign source taxable income for the year. The taxpayer computes the limitation by multiplying its pre-credit U.S. tax liability by the ratio of its foreign source taxable income to its worldwide taxable income. A taxpayer is required to calculate foreign tax credit limitations separately for different categories of income. See I.R.C. § 904(d).

Under section 904(f), a taxpayer’s ability to claim foreign tax credits is limited by the taxpayer’s overall foreign losses from prior years. In determining foreign source taxable income for foreign tax credit limitation purposes, section 904(f) generally requires a taxpayer to treat 50 percent of its otherwise foreign source taxable income as U.S. source income to the extent that the taxpayer has overall foreign losses from prior years that are attributable to the same separate category as the foreign source taxable income. I.R.C. § 904(f)(1); Treas. Reg. § 1.904(f)-2(a). Section 904(f)(2) describes overall foreign losses as the amount by which foreign source gross income is exceeded by the sum of the expenses, losses, and other deductions properly allocated or apportioned to the foreign source income. I.R.C. § 904(f)(2); Treas. Reg. § 1.904(f)-1(c)(3). The recharacterization of the taxpayer’s foreign source taxable income as U.S. source income reduces the taxpayer’s foreign tax credit limitation.

2. Purpose of Section 904(i) – Limitation on Use of Deconsolidation to Avoid Foreign Tax Credit Limitations

Congress enacted section 904(i) to prevent a consolidated group of corporations from using techniques to disaffiliate a subsidiary with foreign losses to manipulate the controlled group's foreign tax credit limitation. See P.L. 101-239, the Omnibus Budget Reconciliation Act of 1989. The Senate Finance Committee Print provides the following reasons for the enactment of section 904(i):

The committee believes that techniques for avoiding or lessening the impact of the foreign tax credit limitation and related rules have been eliminated over the past years, in particular in the 1986 Act and the regulations issued thereunder, and believes that it would be inappropriate to allow taxpayers to negate the effects of the 1986 Act and prior [A]cts merely by using the expedient of interposing entities other than includible corporations into the chain of ownership of includible corporations. To permit the use of such techniques might reward diligent tax planning, but promotes no arguably important policy objective, in the committee's view. * * * *

For example, where an includible corporation indirectly controls another includible corporation through an entity that is not an includible corporation, the Treasury is authorized to recharacterize by regulation foreign source income of the includible corporations as U.S. source income, so that the aggregate U.S. tax liability of those corporations is no less than the tax that would be imposed if, for foreign tax credit purposes, the includible corporations had joined in filing a consolidated return. In addition, the bill authorizes the Secretary to prescribe regulations preventing the avoidance (through disaffiliation) of other provisions relating to the proper calculation of the foreign tax credit, such as the limitation imposed under section 907 with respect to certain oil and gas extraction taxes. Senate Finance Committee Print, P.L. 101-239, Omnibus Budget Reconciliation Act of 1989.

Congress intended that under the authority of section 904(i), the Service may resource income or disallow incremental tax credits or deductions that result from a deconsolidation where the purpose of the deconsolidation was to avoid the foreign tax credit limitations. Senate Finance Committee Print, P.L. 101-239, Omnibus Budget Reconciliation Act of 1989. It appears that Congress was concerned with transactions similar to the Year X Reorganization. In particular, the Senate Finance Committee Print to the legislation provides insight into the tax avoidance issues for which Congress was concerned:

As an example of a case that the regulations contemplated by the committee would reach, assume that a domestic parent corporation owns indirectly (through entities that are not includible corporations) 80

percent or more of the stock of two domestic subsidiary corporations. One such domestic subsidiary corporation has \$200 of U.S. source income and \$100 of foreign source loss. The second has \$100 of pre-tax foreign source taxable income, and has paid \$34 of foreign income taxes. Assume that all income of the above domestic corporations is subject to U.S. tax at the 34 percent rate. Under the bill Treasury is authorized to recharacterize the income of the second domestic subsidiary corporation as U.S. source income, resulting in an aggregate U.S. tax liability of the two corporations of \$68, which would be their tax liability if the parent corporation had owned the stock of the two subsidiaries directly and the three corporations had been required to file a consolidated return. (Under this example, the bill also eliminates the need to resource as domestic, under section 904(f), any foreign source income earned by the first domestic subsidiary corporation in a later year to account for its overall foreign loss described above.)

As another example, assume that in the above case the first domestic subsidiary corporation has \$200 of U.S. source income, \$100 of foreign source loss from operations in one foreign country, and \$100 of pre-tax foreign source income from operations in another foreign country, on which the corporation has paid \$34 in foreign income tax. As in the above example, assume that the second domestic subsidiary corporation has \$100 of pre-tax foreign income, and has paid \$34 of foreign income taxes. Were the first subsidiary corporation permitted to separately elect to deduct its foreign income taxes while the second corporation took the credit, the combined U.S. tax liabilities of the two would be \$56.44, or 34 percent of \$166 (the U.S. tax liability of the first corporation) plus zero (the U.S. tax liability of the second corporation). By contrast, if both corporations were required to jointly elect either to deduct or credit foreign taxes, then their combined current year U.S. tax liabilities would be \$78.88 (using the deduction), or \$68 (using the credit). Under the bill, the Treasury is authorized to preclude either domestic subsidiary corporation in such a situation from electing to deduct its foreign taxes at the same time that the other domestic subsidiary corporation takes the benefit of the foreign tax credit provisions. Senate Finance Committee Print, P.L. 101-239, Omnibus Budget Reconciliation Act of 1989.

In 1995, the Service and the Treasury issued Treas. Reg. § 1.904(i)-1 pursuant to the authority granted under section 904(i). Treas. Reg. § 1.904(i)-1 applies to “includible corporations” that are “affiliates,” and requires that all such affiliates consistently choose either to claim a credit for foreign income taxes paid or accrued (or deemed paid) under section 901(a) or to deduct foreign taxes paid or accrued under section 164. Treas. Reg. § 1.904(i)-1(a)-(d). Also, Treas. Reg. § 1.904(i)-1

requires affiliates to combine their foreign source taxable income (or loss) for purposes of calculating each of the affiliate's foreign tax credit limitations.

3. Purpose of Section 269B -- Stapled Entities

Congress enacted section 269B as a means to prevent taxpayers from avoiding or evading tax through the use of stapled entities. As a means to prevent tax avoidance or evasion, Congress provided that as a general rule, if a domestic corporation and a foreign corporation are stapled entities, the foreign corporation will be treated as a domestic corporation and therefore subject to tax on its worldwide income. See I.R.C. § 269B(a)(1). Congress also indicated that in furtherance of preventing tax avoidance or evasion, a foreign corporation that is stapled to a domestic corporation generally will not be eligible to file a consolidated return with the U.S. corporate group. See House Committee Report, P.L. 98-369, Deficit Reduction Act of 1984.

Section 269B(c)(2) defines the term "stapled entities" as any group of two or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consists of stapled interests. Section 269B(c)(3) defines the term "stapled interests" as two or more interests that by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of one of such entities, the other of such entities are required to be transferred. For these purposes the term "entities" includes corporations, partnerships, trusts, associations, estates, and any other forms of carrying on a business or activity. I.R.C. § 269B(c)(1). Thus, in general, two entities are stapled entities if more than 50 percent in value of their beneficial ownership consists of stapled interests.

In Rev. Rul. 89-103, the Service noted that because a foreign corporation that is stapled to a domestic corporation generally will be treated as a domestic corporation under section 269B(a)(1), the foreign corporation will be deemed to convert to a domestic corporation through a reorganization that qualifies under section 368(a)(1)(F). 1989-2 C.B. 65; see also Notice 89-94, 1989-2 C.B. 416. As a way of preventing stapled foreign corporations from importing losses to offset income of members of a consolidated group, Notice 89-94 provides that although a stapled foreign corporation is generally treated as a domestic corporation under section 269B(a)(1), a stapled foreign corporation will be treated as a foreign corporation for purposes of the definition of an includible corporation under section 1504(b). 1989-2 C.B. 416.

C. The Service May Be Able to Apply Section 269 to Disallow Sub3 and the Parent Group or Holding the Benefits of Certain Foreign Tax Credits or Deductions if the Principal Purpose of the Year X Reorganization Were to Secure Tax Benefits

1. General Background of Section 269

Section 269(a) provides as follows:

In general. – If –

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

There are two threshold conditions for the application of section 269(a) to the formation of Holding by Sub3 and the Holding Reorganization, namely: (1) a person or persons must have acquired, directly or indirectly, control of a corporation, or a corporation must have acquired directly or indirectly property of another corporation, not controlled directly or indirectly immediately before such acquisition by the acquiring corporation or its stockholders, with the property having a carryover basis from the transferor corporation; and (2) the principal purpose for the acquisition must have been to evade or avoid Federal income tax by securing the benefit of a deduction, credit, or other allowance that such person would not otherwise enjoy.

2. Acquisition Requirement of Section 269

Sub3's formation of Holding and its transfers of the Sub3 CFCs to Holding in the Holding Reorganization constitute the requisite acquisition of control under section 269(a), as the formation of a new corporation can constitute the requisite acquisition of control for section 269(a)(1) purposes. See Treas. Reg. § 1.269-1(c) and Treas. Reg. § 1.269-3(b); see also Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968); Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957).

Thus, the Service can apply section 269 to disallow any tax benefits of a deduction, credit, or other allowance claimed by Sub3 or the Parent Group if the principal purpose of forming Holding and the Holding Reorganization were tax avoidance. In particular, although Holding has directly claimed a foreign tax credit on its tax return, Sub3 and Parent will be considered to have secured a tax benefit within the meaning of section 269 as a result of the Holding Reorganization. See Treas. Reg. § 1.269-3(a) (which provides that an acquiring person or corporation can secure the benefit of a deduction, credit, or other allowance within the meaning of section 269(a) even though it is the acquired corporation that is entitled to such benefit). See also Treas. Reg. § 1.269-1(c) (which provides that the parent of the wholly-owned corporation acquiring control will also be considered to acquire control).

Holding's acquisition of 100 percent of the stock of the Sub3 CFCs from Sub3 through the Holding Reorganization also constitutes the requisite acquisition of control under section 269(a)(1). In addition, if the Holding Reorganization qualifies as tax free transactions under section 368(a)(1)(B) or section 351, then Holding's acquisition of the stock of the Sub3 CFCs may also satisfy the "acquisition of property" requirement of section 269(a)(2). See Coastal Oil Storage, 242 F.2d 396; but c.f. Brick Milling Company v. Commissioner, T.C. Memo 1963-305 (which held in part that section 269(a)(2) was inapplicable where a brother corporation acquired a sister corporation one year later and then liquidated the sister corporation, as the two corporations were commonly controlled for a full year prior to the transactions).

3. Principal Purpose Requirement of Section 269

If the principal purpose of an acquisition is tax avoidance, section 269 can be applied to deny tax benefits claimed by either an acquiring person or an acquired corporation. See, e.g., Treas. Reg. § 1.269-3(a); Coastal Oil Storage, 242 F.2d 396; and James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960). Moreover, if the purpose to evade or avoid Federal income tax exceeds in importance any other purpose for an acquisition, then such purpose is the principal purpose for the acquisition:

In either instance the principal purpose for which the acquisition was made must have been the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such other person, or persons, or corporation, would not otherwise enjoy. If this requirement is satisfied, it is immaterial by what method or by what conjunction of events the benefit was sought. Thus, an acquiring person or corporation can secure the benefit of a deduction, credit, or other allowance within the meaning of section 269 even though it is the acquired corporation that is entitled to such deduction, credit, or other allowance in the determination of its tax. If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. Treas. Reg. § 1.269-3(a).

Under this standard, the purpose which is relevant is the purpose which existed at the time of the formation of Holding and the Holding Reorganization, although facts occurring prior to and following the Holding Reorganization may be considered to the extent that they tend to support or negate the forbidden purpose. Hawaiian Trust Co. v. United States, 291 F.2d 761 (9th Cir. 1961).

Parent has not provided specific information about the business purposes of the Holding Reorganization. The Holding Reorganization Agreement states that the business purpose for the Holding Reorganization was to facilitate efficient financing and cash management for Sub3, Holding, and the Sub3 CFCs. This stated purpose appears to be unsubstantiated, however, as the Year X through Year X+2 financial information provided to the Service related to Sub3, Holding, and the Sub3 CFCs shows substantial shareholder equity and an absence of debt with third-party lenders. Consequently, based on the information developed to date, it appears that the only purpose of the Holding Reorganization is to avoid the overall foreign loss recapture rules that would limit the benefits to the Parent Group of the deemed-paid foreign tax credits under sections 902 and 960 related to the Sub3 CFCs. Section 269's application in such an instance is appropriate:

Under the Code, an amount otherwise constituting a deduction, credit, or other allowance becomes unavailable as such under certain circumstances. Characteristic of such circumstances are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowances was designed by the Congress to effectuate. The distortion may be evidenced, for example, by the fact that the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer, by the unreal nature of the transaction such as its sham character, or by the unreal or unreasonable relation which the deduction, credit, or other allowance bears to the transaction (emphasis added). Treas. Reg. § 1.269-2(b).

Although the Holding Reorganization appears to have been undertaken for tax avoidance purposes, the Examination Team should continue to work with the Parent Group to determine the business purposes for the Holding Reorganization. Even if Sub3 and the Parent Group or Holding eventually produces further evidence in support of the business purposes of the Holding Reorganization, the strength of the evidence and underlying business purposes must be weighed against the significant tax savings produced by the transaction. J.T. Slocumb v. Commissioner, 334 F.2d 269 (2d Cir. 1964); Coastal Oil Storage, 242 F.2d 396.

4. Burden of Proof

Because there is evidence that the Holding Reorganization was tax motivated, the Examination Team should closely scrutinize the business purposes of the Holding Reorganization. Note that the question of whether a transaction had tax avoidance as its principal purpose is a question of fact, for which the Sub3 and the Parent Group or Holding has the burden of persuading the trier of fact. Slocomb, 334 F.2d 269. Under Treas. Reg. § 1.269-3(a), if the purpose to evade or avoid Federal income tax exceeds in importance any other purpose for the Holding Reorganization, it is the principal purpose. Also, the Service can apply section 269 to disallow tax benefits from transactions related to an acquisition of control of a corporation even if the transaction in which control is acquired does not create tax benefits in and of itself. Treas. Reg. § 1.269-3(a). Consequently, the fact that the tax benefits obtained by Holding or Sub3 and the Parent Group are not derived solely from the Holding Reorganization, but result from the combined effects of the Holding Reorganization and the Stapling Reorganization, does not bar the application of section 269. See, e.g., Treas. Reg. § 1.269-3(a) (which provides that, if the principal purpose test is met with respect to an acquisition giving rise to a tax benefit, then “it is immaterial by what method or by what conjunction of events the benefit was sought”); see also Slocomb, 334 F.2d 269; Borge, 405 F.2d 673.

5. Permissible Disallowances under Section 269

If the Examination Team determines that the principal purpose of the Holding Reorganization, including the formation of Holding, were the evasion or avoidance of Federal income taxes, the Service can apply section 269(a) to disallow the tax benefits, such as foreign tax credits or deductions, secured through the Year X Reorganization. Consequently, we believe that pursuant to Treas. Reg. § 1.269-4, and upon a determination that the principal purpose of Sub3's formation of Holding and the Year X Reorganization was the evasion or avoidance of tax, the Examination Team could, for example, apply section 269 to Holding's acquisition of 100 percent of the stock of each of the Sub3 CFCs in the Holding Reorganization and disallow the entire foreign tax credit claimed by Holding. Similarly, the Examination Team could apply section 269 to Sub3's formation of Holding and the Holding Reorganization and either disallow the entire foreign tax credit claimed by Holding, a portion of the tax credit claimed by Holding², or reallocate from Holding

²Treas. Reg. § 1.269-4 provides:

The district director is authorized by section 269(b) to allow a part of the amount disallowed by section 269(a), but he may allow such part only if and to the extent that he determines that the amount allowed will not result in the evasion or avoidance of Federal income tax for which the acquisition was made. The district director is also authorized to use other methods to give effect to part of the amount disallowed under section 269(a), but only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was

to Sub3 the income arising from the Sub3 CFCs along with the related direct and deemed paid foreign taxes. If the Examination Team reallocates the income to Sub3, it could then determine the appropriate amount of foreign tax credit or deduction available to the Parent Group and reallocate back to Holding the Sub3 CFCs' income, along with the appropriate amount of foreign tax credit or deduction. In the case of the reallocation of income, the Examination Team should make adjustments against both the Parent Group and Holding. The Service also may be able to apply section 269 to disallow any collateral tax benefits, in addition to the direct tax benefits, that Holding or Sub3 and the Parent Group enjoy as a result of the Holding Reorganization. Treas. Reg. § 1.269-4, and see, e.g., Slocomb, 334 F.2d 269.

We also note that while post-Year X tax years are not presently at issue, to the extent that the Service establishes that tax benefits are available to Sub3 and the Parent Group or Holding as a result of the Holding Reorganization, the Service also can apply section 269 to disallow those tax benefits and to reallocate income, deductions and credits, or disallow foreign tax credits for those years as well. See, e.g., Hall Paving Co. v. United States, 74-1 U.S.T.C. (CCH) 9397 (D. Ga. 1974) (which held that operating losses of acquired companies that occurred in years after the acquisitions could not be deducted where the original transactions were motivated principally by a tax-avoidance purpose).

D. The Service May Be Able to Apply Section 482 to the Year X Reorganization to Reallocate Income and Adjust Foreign Tax Credits and Deductions

The Service may be able to apply section 482 to the Year X Reorganization to reallocate income between the Parent Group and Holding and make adjustments in foreign tax credits and deductions claimed to reflect their true taxable income or to prevent Parent and the controlled group from evading or avoiding tax. Section 482 provides in relevant part:

In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such

made. Whenever appropriate to give proper effect to the deduction, credit, or other allowance, or such part of it which may be allowed, this authority includes the distribution, apportionment, or allocation of both the gross income and the deductions, credits, or other allowances the benefit of which was sought, between or among the corporations, or properties, or parts thereof, involved, and includes the disallowance of any such deduction, credit, or other allowance to any of the taxpayers involved.

distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

To justify an allocation of income pursuant to section 482, the Service must find: (1) that there are two or more trades, businesses or organizations; (2) that such trades, businesses, or organizations are owned or controlled by the same interests; and (3) that it is necessary to allocate gross income, deductions, credits, or allowances among such businesses to prevent evasion of taxes or to reflect income clearly. B. Forman Co. v. Commissioner, 453 F.2d 1144 (2d Cir. 1972), cert. denied, 407 U.S. 934 (1972). For purposes of section 482, the term "evasion of taxes" is synonymous with "tax avoidance." Foster v. Commissioner, 80 T.C. 34 (1983).

Because Sub3, Sub4, and Holding are all indirectly owned by Parent, it is clear that Sub3, Sub4, and Holding are two or more trades, businesses, or organizations that are controlled by the same taxpayer. See generally Treas. Reg. §§ 1.482-1(i)(1)-(8). The next question is whether as a result of the Year X Reorganization there was tax avoidance or evasion or a distortion of income for which the Service may reallocate income, credits, or allowances between Holding and Sub3 and the Parent Group so that income will be clearly reflected. I.R.C. § 482; Treas. Reg. § 1.482-1(a)(1)-(2).

In determining the true taxable income of a controlled taxpayer, the Service is not restricted to cases of improper accounting, cases of fraudulent, colorable, or sham transactions, or cases involving devices designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. See Treas. Reg. § 1.482-1(f)(1); Forman, 453 F.2d 1144. Instead, the Service's authority to determine true taxable income extends to any case in which, either by inadvertence or design, the taxable income of a controlled taxpayer is other than it would have been had the taxpayer in the conduct of its affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. See Treas. Reg. § 1.482-1(f)(1); Forman, 453 F.2d 1144.

Treas. Reg. § 1.482-1(f)(1)(iii) specifically provides that the Service may apply section 482 in circumstances described in the Code providing for nonrecognition of gain or loss as necessary to prevent the avoidance of taxes or to reflect income clearly. See also National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943), aff'g 46 B.T.A. 562 (1942) cert. denied, 320 U.S. 794 (1943); General Electric Co. v. United States, 3 Cl. Ct. 289 (1983); Ruddick Corp. v. United States, 226 Ct. Cl. 426, 643 F.2d 747 (1981), on remand 3 Cl. Ct. 61 (1983), aff'd without published opinion 732 F.2d 168 (Fed. Cir. 1984); G.D. Searle and Co. v. Commissioner, 88 T.C. 252 (1987). Moreover, the Service may exercise its authority under section 482 where the taxpayer employs a nonrecognition provision to achieve an overall result that is abusive of another provision of the Code and conflicts with the logic of applicable provisions of the Code or where the transaction

results in an income distortion not implicitly sanctioned by Congress as an integral aspect of a nonrecognition transaction. General Electric, 3 Cl. Ct. 289, 291. See also G.D. Searle, 88 T.C. 252. The courts have also construed section 482 liberally to achieve the declared purpose of Congress under other provisions of the Code. See Forman, 453 F.2d 1144. Courts have also allowed the Service to use the clear reflection of income test to justify an allocation where the challenged transaction has shifted income earned by one party to a related party.

Importantly, as previously noted, based on the information developed to date, the Holding Reorganization appears to have been motivated by a tax avoidance purpose. Similarly, concerning the Stapling Reorganization, we can discern no business purpose, apart from tax benefits, that the Parent Group and Holding would realize from amending the organizational documents of Sub4 and Holding to require the concurrent transfer of interests in Sub4 and Holding. Neither the Parent Group nor Holding has provided us any information about the business purposes for the Stapling Reorganization. In fact, the Parent Group and Holding appear to have implemented the Stapling Reorganization to use foreign tax credits not otherwise available. The Examination Team should continue to work with the Parent Group and Holding, however, to determine the reasons for the Holding Reorganization and the Year X Reorganization generally.

We believe that pursuant to Treas. Reg. § 1.482-1(a)(2), if the Examination Team determines that the Year X Reorganization results in (1) tax avoidance, or (2) income distortion not implicitly sanctioned by Congress as an integral aspect of a nonrecognition transaction, the Service should reallocate the income related to the Sub3 CFCs from Holding to Sub3, and then make appropriate collateral and conforming adjustments under Treas. Reg. §§ 1.482-1(g)(2) and 1.482-1(g)(3). In addition, the Service may be able to apply section 482 to disallow any collateral incremental tax benefits to Holding or Sub3 and the Parent Group (i.e., the group of controlled taxpayers) that these entities obtain as a result of the Year X Reorganization. But see Eli Lilly, 84 T.C. 996, at 1124-1125.³

E. The Service May Be Able to Disregard the Stapling Reorganization Under the Sham Transaction Doctrine

³Eli Lilly “[does] not imply that [the Service’s] authority to invoke section 482 is limited to within a one year period.” 84 T.C. at 1125 n. 63. However, for purposes of determining whether a mismatching of income and expenses gave rise to a distortion of income properly addressed under section 482, the Tax Court determined that the expenditures to develop the transferred intangibles were too remote in time to be matched with the income earned from the intangibles during the years in issue. Similar considerations may also be relevant to the section 482 allocations proposed in the present case.

As indicated above, a stapling generally results from a requirement in organizational documents that more than 50 percent in value of the beneficial ownership of two or more entities consists of stapled interests. I.R.C. § 269B(c)(2). Two or more interests generally are stapled if organizational documents require that in connection with the transfer of one of such interests, the other interests are also required to be transferred. I.R.C. § 269B(c)(3). Holding would be deemed to convert to a domestic corporation through a reorganization qualifying under section 368(a)(1)(F) as a result of a valid stapling transaction of Holding and Sub4. See Rev. Rul. 89-103 and Notice 89-94 (which provides for the tax treatment of a foreign corporation upon stapling to a domestic corporation).

Under the economic substance doctrine, sometimes called the sham transaction doctrine, a transaction will not merit tax respect when it has no significant economic effects other than the creation of tax benefits. Frank Lyon Co. v. United States, 435 U.S. 561 (1978). As a general rule, whether a taxpayer's characterization of a transaction is respected depends upon whether the characterization represents and is supported by a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities, and not shaped solely or primarily by tax avoidance features that have meaningless labels attached. Gregory, 293 U.S. 465; Nicole Rose, 117 T.C. No. 27; Frank Lyon, 435 U.S. 561. The sham transaction doctrine generally prevents taxpayers from claiming the purportedly sanctioned tax benefits of transactions which, although they may fit within the language of the Code, are not the type of transactions Congress intended to favor. See Gregory, 293 U.S. 465; Winn-Dixie Stores Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001) (per curiam), aff'g 113 T.C. 254 (1999).

Courts have articulated various applications of two principal tests for determining whether a transaction is a sham: (1) that the taxpayer was motivated by no significant business purpose other than obtaining tax benefits in entering the transaction, and (2) that the transaction has no economic substance because no reasonable possibility of profit exists. United Parcel Service of America, Inc. v. Commissioner, 254 F.3d 1014 (11th Cir. 2001); Kirchman v. Commissioner, 862 F.2d 1486 (11th Cir. 1989); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985) (note that some courts require that both prongs of the test be satisfied for a transaction to be a sham, while other courts require either that the transaction lacks a significant business purpose or that the transaction lacks economic substance for the transaction to be considered a sham). Because the sham transaction doctrine was developed as part of the broader tax concept that substance should prevail over form, regardless of how the sham transaction doctrine is applied to the Stapling Reorganization, we believe that a court would not permit the "true nature of the transaction be disguised by mere formalisms, which exist solely to alter tax liabilities." See Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517 (10th Cir. 1991); True v. United States, 190 F.3d 1165 (10th Cir. 1999). Consequently, we analyze the Stapling Reorganization under the sham transaction doctrine based on a common sense approach.

First, we analyze the Stapling Reorganization under the subjective business purpose test. Under this test, the Service should respect the Stapling Reorganization if the transaction were engaged in for a significant business purpose other than tax avoidance. As we have previously noted, based on the information provided to date, we can discern no non-tax business purpose for the Stapling Reorganization, and in fact, the stapling of Sub4 and Holding appears to be solely for the purpose of achieving tax benefits. Nonetheless, the Examination Team should continue to work with the Parent Group and Holding to determine the non-tax reasons for implementing the Stapling Reorganization. Because the Year X Reorganization appears to result in tax benefits not intended by Congress, however, the Service should scrutinize the Stapling Reorganization. See Senate Finance Committee Print, P.L. 101-239, the Omnibus Budget Reconciliation Act of 1989; Gregory, 293 U.S. 465; Winn-Dixie Stores, 254 F.3d 1313.

Next we analyze the Stapling Reorganization under the objective economic substance test. The Service should respect the Stapling Reorganization under this test if from an objective standpoint the transaction were likely to produce economic benefits aside from tax reduction. Casebeer, 909 F.2d 1360; Bail Bonds by Marvin Nelson, Inc. v. Commissioner, 820 F.2d 1543 (9th Cir. 1987). Neither the Parent Group nor Holding has provided any information about the economic benefits resulting from the Stapling Reorganization. In addition, based on the information developed to date, we fail to discern any economic benefit that Holding, Sub4, or Sub3 and the Parent Group would realize from the Stapling Reorganization. Again, although the Examination Team should continue to work with the Parent Group and Holding to determine the economic benefits from the Stapling Reorganization, the Service may question the genuineness of a transaction where persons who are not dealing at arm's length enter into a transaction that gives them tremendous tax savings. True, 190 F.3d 1165; Bail Bonds, 820 F.2d 1543.

If the Stapling Reorganization is disregarded for tax purposes under the sham transaction doctrine, Holding will not be considered a domestic corporation under section 269B, and the dividends and interest paid to it would be subpart F income to Sub3 (Holding's U.S. shareholder). This would have the effect of denying the Parent Group and Holding the benefit sought by entering into the Stapling Reorganization.

F. Qualification of the Holding Reorganization for Nonrecognition Treatment

Sub3's transfer of the Sub3 CFCs stock to Holding is a transaction intended to qualify as a reorganization under section 368(a)(1)(B). One of the requirements of a section 368(a) reorganization is that the transaction be motivated by a valid business purpose. Treas. Reg. § 1.368-1(c) states that the nonrecognition provisions governing reorganizations are inapplicable unless there is a "plan of reorganization." This section further provides:

A scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization.

In explaining the term “plan of reorganization,” Treas. Reg. § 1.368-2(g) provides as follows:

Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 368(a), but the readjustments involved in the exchanges or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization.

As a general rule, a transaction has a business purpose if a taxpayer engages in the transaction for economic, commercial, or legal and regulatory reasons and not solely or primarily for tax avoidance reasons. Wortham Machinery Co. v. United States, 375 F.Supp. 835, 838 (D. Wyo. 1974), aff'd 521 F.2d 160 (10th Cir. 1975); Gregory, 293 U.S. 465, 469. A transaction will lack business purpose if the taxpayer engages in the transaction principally or solely to obtain tax benefits. See Wortham Machinery, 375 F.Supp. 835 (citing Gregory, and holding that a reorganization intended to qualify under section 368(a)(1)(C) failed because the business purposes for the transaction were inadequate).

Because the Parent Group and Holding have not provided any information to demonstrate that the Holding Reorganization has a sufficient non-tax business purpose, it cannot be determined whether the Holding Reorganization qualifies for nonrecognition treatment because the transfers qualify under section 368(a)(1)(B) or section 351. Therefore, the Examination Team should attempt to obtain information about the business purposes (including tax purposes) for the Holding Reorganization. Based on the information developed to date, however, it appears that the only obvious purpose of the Holding Reorganization is to avoid the overall foreign loss credit recapture rules that would limit the benefits to the Parent Group of the deemed-paid foreign tax credits under sections 902 and 960 related to the Sub3 CFCs. Even if the Parent Group or Holding eventually provides additional business purposes or factual support for the stated business purpose, the strength of the underlying business purposes for the Holding Reorganization must be weighed against the substantial tax savings produced by the Holding Reorganization. See Wortham Machinery, 375 F.Supp. 835. In general, the taxpayer bears a heavier burden in securing nonrecognition treatment if the dominant purpose for the transaction is tax savings. Id.

If the stated business purpose for the Holding Reorganization is insufficient for purposes of section 368(a)(1)(B), the Holding Reorganization may fail to qualify as tax-free transfers to controlled corporations under section 351. See Caruth v. United States, 688 F.Supp. 1129, 1138 -1141 (N.D. Tex. 1987), aff'd on other grounds, 865 F.2d 644 (5th Cir. 1989) (citing Gregory, and stating that the business purpose requirement for reorganizations is also applicable to section 351 incorporations). See also Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935). In such cases, the Holding Reorganization would be treated as taxable exchanges under section 1001, and section 1248 would apply.

It is important to note that the Holding Reorganization may also be challenged under the sham transaction doctrine or under section 269. If the sham transaction doctrine is applied to the Holding Reorganization, the Service may be able to ignore the transfers of the stock of the Sub3 CFCs for tax purposes. On the other hand, if the Service applies section 269 to the Holding Reorganization, the transfers of the stock of the Sub3 CFCs could be denied the benefit of nonrecognition treatment as a result of being treated as transfers under section 368(a)(1)(B) or section 351. See generally this Memorandum, Law and Analysis, Section E above for general principles related to the sham transaction doctrine. Note the Service can apply section 269 to deny the Holding Reorganization nonrecognition treatment, because when the requirements of section 269(a) are satisfied, the Service can disallow any deduction, credit, or other allowance resulting from an acquisition. Treas. Reg. § 1.269-1(a) defines an “allowance” as anything in the Code that has the effect of diminishing tax liability. The nonrecognition treatment provided as a result of the transfers being treated as transfers under sections 368 and 351 is therefore an allowance. But see Cherry v. United States, 264 F.Supp 969 (C.D. Cal. 1967) and Bijou Park Properties, Inc. v. Commissioner, 47 T.C. 207 (1966), acq. in result, 1967 AOD Lexis 41 (Oct. 27, 1967) (in both cases the courts determined that section 269 does not deal with nonrecognition concepts); and compare Cherry, Ray K., 1969 AOD Lexis 324 (Nov. 20, 1969) (the Service disagrees with the determinations in Cherry and Bijou Park Properties). If section 269 is applied to prevent nonrecognition treatment to the Holding Reorganization, the transactions would be treated as taxable exchanges under section 1001, and section 1248 would also apply.

G. The Service May Be Able to Apply Section 907 to Limit Tax Credits Claimed by Holding

Section 907(a) limits the amount of foreign tax credits that may be claimed during a taxable year for foreign income taxes paid with respect to foreign oil and gas extraction income (“FOGEI”). In the case of a corporation, the limit is determined by multiplying a taxpayer’s FOGEI for the taxable year by 35 percent. I.R.C. § 907(a). Oil and gas extraction taxes in excess of the limit may be carried over to other taxable years. I.R.C. § 907(f).

If the Sub3 CFCs are engaged in oil and gas extraction and production activities, a portion of their income would likely be FOGEI. If such were the case, a portion of the dividend income received by Holding from the Sub3 CFCs would also likely be treated as FOGEI, and deemed-paid taxes of Holding attributable to the FOGEI would be subject to the section 907(a) limitation. I.R.C. § 907(c)(3). Consequently, the deemed-paid taxes would not be creditable in Year X to the extent they exceed 35 percent of Holding's FOGEI for the year, and any foreign tax credits claimed by Holding for deemed-paid taxes in excess of the section 907(a) limitation could be disallowed by the Service under section 907(a). Any deemed-paid taxes for which credit is disallowed, however, will be eligible to be carried over to other years under section 907(f).

Foreign tax credits claimed by Holding with respect to the deemed-paid taxes may also be subject to disallowance under section 907(b) if the income of the Sub3 CFCs qualifies as "foreign oil related income." See I.R.C. §§ 907(b) and 907(c)(3).

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