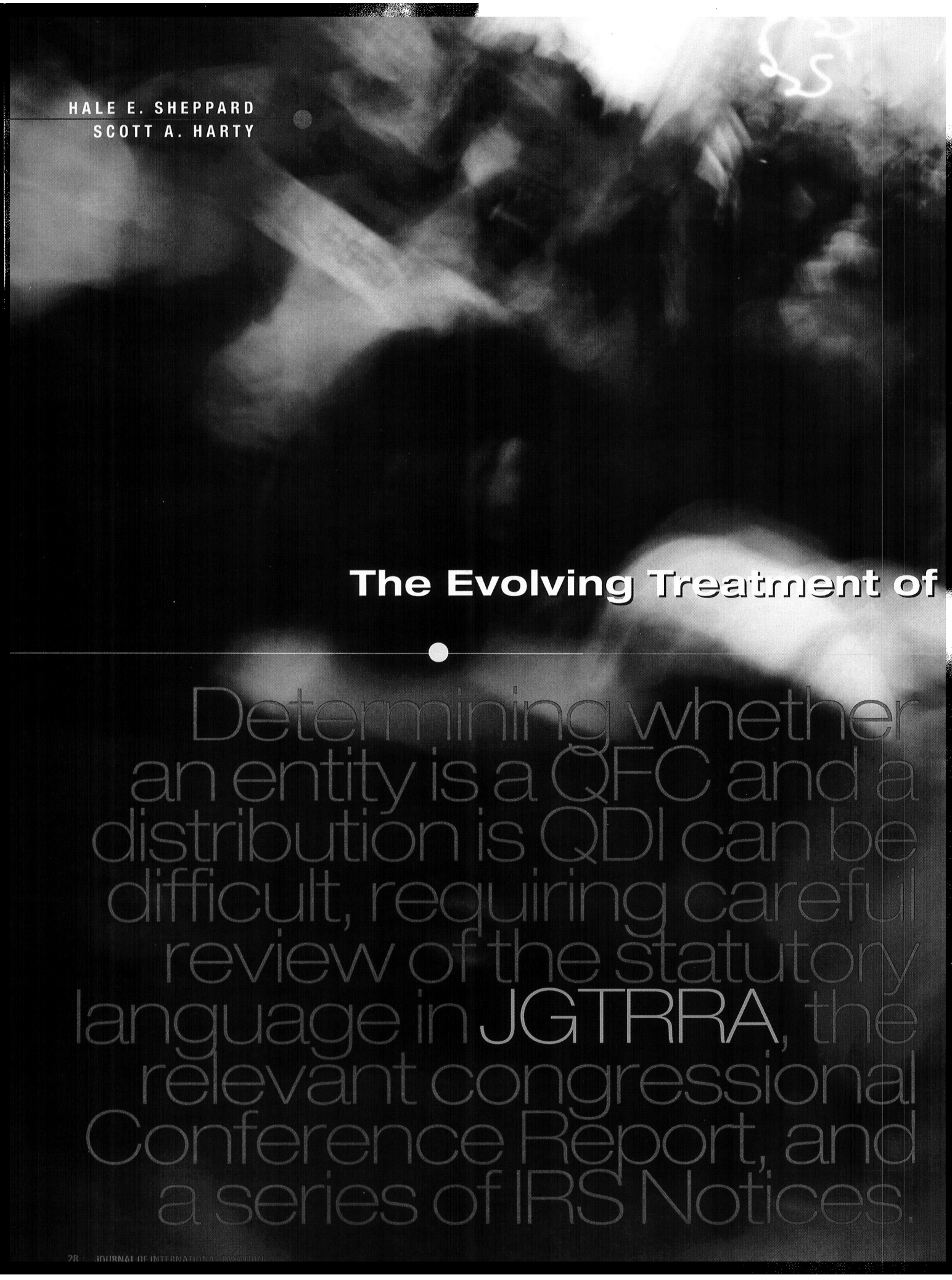


HALE E. SHEPPARD
SCOTT A. HARTY

# The Evolving Treatment of

Determining whether an entity is a QFC and a distribution is QDI can be difficult, requiring careful review of the statutory language in JGTRRA, the relevant congressional Conference Report, and a series of IRS Notices.

# The Jobs and Growth Tax Relief Reconciliation Act (P.L. 108-27, May 28, 2003) (JGTRRA) was an effort to stimulate the sluggish domestic economy.[1] While the legislation altered U.S. tax law in numerous ways, those in the international tax, business, and investment communities have been particularly interested in the JGTRRA provisions that substantially lower the tax imposed on dividends from certain foreign corporations.[2]

The Code generally provides that a taxpayer's "net capital gain" for any year will be subject to a maximum tax rate of 15%.[3] JGTRRA added Section 1(h)(11), which provides that "net capital gain" also includes any qualified dividend income (QDI).[4] A dividend must meet several conditions to be considered QDI. Importantly, the dividend must be distributed by either a domestic corporation or a qualified foreign corporation (QFC).[5]

Determining whether an entity is a "domestic corporation" is relatively simple since the Code provides that a corporation is considered domestic if it is formed in the United States, under U.S. law, or under the laws of any state.[6] On the other hand, ascertaining whether a foreign corporation is a QFC may be quite difficult. In making this determination, several sources must be consulted, including the Code, the legislative history, and a series of administrative Notices.

Guidance from the IRS regarding QDI and QFCs has come in the form of various pronouncements since May 2003 in response to scores of public comments. The IRS's efforts in this regard are laudable, particularly considering the complexity of the new law, the amount of revenue at stake, the time pressures involved, and conflicting external influences. Nonetheless, many practitioners still have unanswered questions about QDI and QFCs, and struggle with applying these new rules to various fact patterns.

In an attempt to provide some much needed clarity on the subject, this article examines the evolution of seven tests applicable to the QDI provisions: the Possessions Test, Treaty Test, Market Test, Foreign Investment Company Exclusion Test, Holding Period Test, Equity Test, and the Earnings and Profits (E&P) Test. This article then identifies several open issues regarding QDI and QFCs. In doing so, it will become apparent that from the initial confusion has come (some) clarity.[7]

*HALE E. SHEPPARD is an attorney with Chamberlain, Hrdlicka, White, Williams & Martin specializing in tax controversies and international tax. SCOTT A. HARTY is an attorney in the tax practice of Smith, Gambrell & Russell, LLP, in Atlanta, Georgia. They wrote previously for* THE JOURNAL *on JGTRRA in the October 2004 and July 2004 issues.*

## Possessions Test

JGTRRA provides that a corporation will be considered a QFC if it is established in a U.S. possession including Puerto Rico, Guam, American Samoa, and the Virgin Islands ("Possessions Test").[8] Unlike some of its counterparts, the Possessions Test is notably straightforward. Consequently, virtually no public comments on this topic have been published, and the IRS has issued no additional guidance.

## Treaty Test

Certainly for closely held companies, the Treaty Test presents the most likely method by which foreign corporations will qualify as QFCs. An entity will be considered a QFC under the Treaty Test if:

1. It is eligible for the benefits in a comprehensive income tax treaty with the United States.

2. The U.S. Treasury Department (Treasury) determines that the treaty is satisfactory for purposes of JGTRRA.
3. The treaty includes an exchange-of-information program.[9]

With respect to the first prong of the Treaty Test, the Conference Report explains that a foreign corporation would be considered eligible for the benefits in a comprehensive income tax treaty if it would qualify for such benefits with respect to "substantially all" of its income during the year in which the dividend in question is paid.[10] Unfortunately, to date there has been no clarification of what it means to qualify for the benefits of a treaty with respect to "substantially all" of a foreign corporation's income.

Regarding the second prong, the Conference Report provides that the current (1984) U.S.-Barbados income tax treaty is not satisfactory to Treasury since it "may operate to provide benefits that are intended for the purpose of mitigating or eliminating double taxation to corporations that are not at risk of double taxation." Aside from the Barbados treaty, the Conference Report indicates that, until Treasury formally identifies the particular tax treaties that it finds acceptable for purposes of JGTRRA, *all* foreign corporations established in nations having comprehensive income tax treaties with the U.S. that include an exchange-of-information program will be considered QFCs.[11]

With regard to the third prong of the Treaty Test, the U.S. has signed tax information exchange agreements (TIEAs) with numerous countries, including the Cayman Islands, Barbados, Bermuda, Costa Rica, Dominica, Dominican Republic, Peru, St. Lucia, and Trinidad and Tobago. Although these TIEAs are helpful in thwarting tax evasion, they are not tantamount to "comprehensive income tax treaties." Accordingly, despite a notable degree of cooperation with the U.S. under the TIEAs, foreign corporations in these countries would not satisfy the Treaty Test.[12]

**Initial ambiguities.** After reviewing JGTRRA and the Conference Report, several groups raised issues regarding the Treaty Test. These concerns fell into several main categories.

Some organizations argued that it is implausible, if not outright impossible, for individual U.S. shareholders to determine if a particular foreign corporation satisfies the Treaty Test. They explained that no U.S. treaty imposes such an obligation on shareholders; rather, the corporation itself has the task of making this determination and then conveying it to the shareholders.[13]

Reversing the obligation such that individual shareholders (instead of the corporations) must determine treaty eligibility would pose an extremely arduous challenge for investors for at least two reasons. First, deciding whether a corporation is a "resident" of a particular nation for purposes of a treaty is a complex legal and factual issue. Second, even if an individual shareholder somehow manages to accurately determine that a foreign corporation meets the definition of "resident," the limitation-on-benefits (LOB) provision of the treaty ordinarily denies

# Unless and until Treasury updates Notice 2003-69 to include the income tax treaty with Barbados, corporations organized in Barbados remain ineligible for QFC status

treaty benefits to the corporation unless it also meets one of three very complicated tests: the publicly traded test, the ownership and base erosion test, or the competent authority test.

Accordingly, it was suggested that the IRS issue rules stating that a dividend paid by a foreign corporation should be considered QDI if (1) the foreign corporation is resident in a treaty country; (2) the shares of stock on which the corporation paid the dividend are publicly traded on a recognized stock exchange; and (3) the shareholder does not have actual knowledge that the corporation is not eligible for the benefits of the treaty with respect to substantially all of its income.[14]

Other groups supported this argument, but suggested that the IRS take a different approach to solving the problem. They recommended, in particular, that the Service issue guidance to the effect that individual U.S. investors may rely on several external indicators in determining whether a foreign corporation satisfies the Treaty Test. Among the potential external indicators are how long the corporation has been in existence, the nature of its business, how many employees that it has, its size, the composition of its assets, whether it is known within its industry, and whether its common stock is traded on a home-country stock exchange.[15]

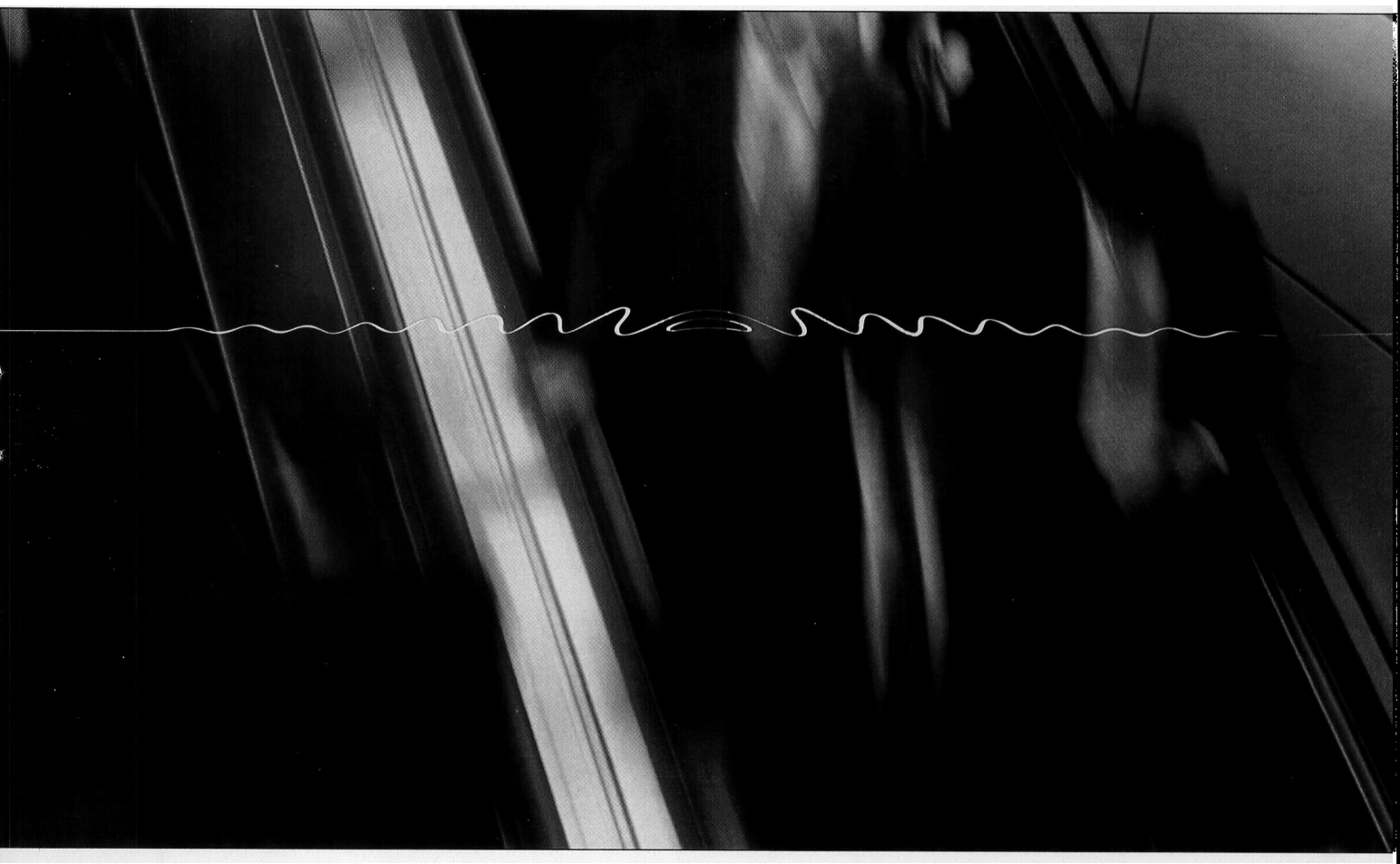
Another major concern focused on the first prong of the Treaty Test, i.e., that a foreign corporation will be eligible for the benefits in a comprehensive income tax treaty only if it would qualify for such benefits with respect to "substantially all" of its income during the year in which the dividend in question is paid.[16] One source of uneasiness for commentators was the murky source of the "substantially all" language: it did not appear in JGTRRA itself, it was not debated in Congress, and it simply appeared in the Conference Report.[17] Other international tax practitioners leery of the "substantially all" language contended that this phrase is unclear and will lead to dangerous speculation. For instance, does this phrase mean substantially all of the foreign corporation's income in general or does it mean that a foreign corporation must qualify for treaty benefits with respect to substantially all of its income that is within the purview of the treaty? [18]

The last major concern regarding the Treaty Test centered on its second prong, that a treaty must be "satisfactory" to Treasury. As explained above, the Conference Report expressly declared the U.S.-Barbados income tax treaty unsatisfactory, yet failed to make any additional findings in this regard. The Conference Report simply created a presumption that all foreign corporations established in countries that have comprehensive income tax treaties with the U.S. that include an exchange-of-information program will be temporarily considered QFCs until Treasury formally identifies the particular treaties that is finds "satisfactory."[19] Not surprisingly, several commentators urged the government to quickly identify the "satisfactory" treaties, to eliminate current confusion and facilitate long-term tax planning.[20]

**IRS Notices responding to taxpayer concerns.** The IRS has issued three pieces of guidance with information applicable to the Treaty Test: Notice 2003-69, 2003-42 IRB 851; Notice 2003-79, 2003-50 IRB 1206; and Notice 2004-71, 2004-45 IRB 793.

Notice 2003-69 identified the countries that either satisfy or fail the Treaty Test.[21] The list of countries that satisfy the Treaty Test is extensive, and it is hoped that it will be updated, while the list of countries that fail was relatively short. In that regard, the U.S. treaties with Bermuda and the Netherlands Antilles are unacceptable because they are not considered "comprehensive income tax treaties." The treaty with the former U.S.S.R. is also objectionable, not because of its lack of comprehensiveness, but rather because it is devoid of an exchange-of-information provision. Finally, as discussed in the Conference Report, the U.S.-Barbados treaty is inadequate because it purportedly grants tax benefits designed to mitigate or eliminate double taxation where there is no risk of such double taxation.

Notice 2003-79 acknowledges that analyzing whether a particular foreign corporation is eligible for benefits under a certain treaty is a "fact-intensive determination," but maintains that a foreign corporation generally will have all of the pertinent information to apply the Treaty Test.[22] The Notice then proceeds to explain a simplified procedure to



determine whether a foreign corporation meets the Treaty Test for those persons required under Section 6042 to file Forms 1099-DIV. For this purpose, the Treaty Test is satisfied if (1) the foreign corporation is organized in a country whose income tax treaty with the U.S. is listed in Notice 2003-69; and (2) if the relevant treaty contains a LOB provision, the foreign corporation's common or ordinary stock is listed on an exchange covered by the publicly traded test in that LOB provision.

Notice 2004-71 generally extends the simplified procedures and other rules in Notice 2003-79 to the 2004 tax year. Notice 2004-71 concludes by stating that the IRS will waive penalties for the 2004 tax year where a person makes a "good faith effort" to comply.[23]

**Are corporations organized in Barbados eligible for QFC status?** Despite JGTRRA, the Conference Report, and the three IRS Notices, it is uncertain which nations will satisfy the Treaty Test in the future. Notice 2003-69 explains that Treasury and the IRS intend to update the list of countries that satisfy the Treaty Test either when new treaties are executed or existing treaties are renegotiated. Notice 2003-69 further announces that the U.S. government will continue to study the operations of income tax treaties to ensure that each of them accomplishes its proposed objectives, thereby maintaining their "satisfactory" status for JGTRRA purposes.

Taken together, it is clear that the guidance in Notice 2003-69 regarding the Treaty Test is subject to change. This reality was not lost on some commentators, who warned that "taxpayers and practitioners should be careful to monitor changes to the treaties deemed to be satisfactory to the [IRS]."[24] Barbados provides an example of this uncertainty. As discussed in the Conference Report, the U.S.-Barbados treaty is not "satisfactory" because it allegedly provides tax benefits designed to mitigate or eliminate double taxation where there is no risk of such double taxation.[25] Displeased with its omission from the Treaty Test, Barbados took action. In particular, treaty negotiators from the U.S. and Barbados met in October 2003 to discuss a revision of the treaty first signed in 1984 and amended by protocol in 1991.[26]

Various Washington-based tax attorneys speculated that one of the principal purposes for the renewed negotiations was to ensure that this bilateral tax pact meets the Treaty Test.[27] While this may have been partially true, the motivation for the negotiations was more likely Treasury's desire to stop American corporations from using Barbados as a jurisdiction for inversion transactions.

The Protocol to the U.S.-Barbados Treaty, which was signed on July 14, 2004, includes a total revision of the LOB provision and a new exchange-of-information provision.[28] Since the adoption of this new protocol, neither Treasury nor the IRS has announced whether corporations established in Barbados can now satisfy the Treaty Test, lending support to the theory that corporate inversions drove the negotiations. Accordingly, unless and until Treasury updates Notice 2003-69 to include the

Amounts treated as "dividends" under Section 1248(a) on the sale of stock in a CFC are generally QDI. However, Subpart F "inclusions" will not be considered QDI

income tax treaty with Barbados, corporations organized in Barbados remain ineligible for QFC status.[29]

**Guidance on reporting requirements.** Notice 2003-79 states that Treasury and the IRS intend to issue Regulations setting forth procedures for a foreign corporation to certify that it is a QFC, which would apply to tax years after 2003. Although no specific details were offered, Notice 2003-79 explained that the future Regulations will generally allow persons who are required under Section 6042 to file Forms 1099-DIV to report dividends as QDI if the foreign corporation makes an "appropriate certification under penalties of perjury" that the seven tests are met. Notice 2004-71 explains that Treasury and the IRS continue to develop detailed procedures for implementing the certification process described in Notice 2003-79; however, to date no such procedures have been promulgated.

## Foreign Investment Company Exclusion Test

JGTRRA identifies three types of foreign entities that will *not* be considered QFCs. In particular, individual shareholders of foreign personal holding companies (FPHCs), foreign investment companies (FICs), and passive foreign investment companies (PFICs) are prohibited from enjoying the tax advantages offered by JGTRRA ("Foreign Investment Company Exclusion Test").[30] U.S. investors generally use these three vehicles to defer the payment of taxes by placing funds outside the reach of the IRS. Provided that none of the numerous anti-deferral mechanisms in the Code are triggered, the U.S. investor essentially enjoys a tax-free, non-interest-bearing loan from the IRS until these offshore funds are transferred back to the U.S. investor and taxed accordingly.[31] The purpose of the Foreign Investment Company Exclusion Test, therefore, is to limit the benefits of tax deferral by taxing distributions by these entities at the top rates, even though they may otherwise satisfy JGTRRA.[32]

**Initial ambiguities.** Much has been written about the Foreign Investment Company Exclusion Test; however, there initially appeareed to be six main areas of uncertainty.

**#1: Subpart F inclusions from CFCs.** Various tax practitioners questioned the proper treatment of "inclusions" from controlled foreign corporations (CFCs).[33] Generally, if a foreign corporation is a CFC for a specified period, every U.S. shareholder (i.e., a person who owns at least 10% of the total voting stock of the CFC) must include in gross income his share of the Subpart F income and the average amounts of U.S. property held by the CFC (Section 951(a)(1)). Commentators pointed out that such inclusions are essentially constructive dividends, and arguably should be so treated for JGTRRA purposes. This conclusion finds support from various sources. For instance, income "inclusions" under Subpart F are based on E&P, which is the primary consideration in determining whether a corporate distribution constitutes a "dividend" (Section 316).

**#2: Absence of CFCs from prohibited list.** As noted above, the Foreign Investment Company Exclusion Test identifies three specific types of entities that will not be considered QFCs—FPHCs, FICs, and PFICs (Section 1(h)(11)(C)(iii)). Conspicuously absent from this list is another type of foreign entity ordinarily used for tax-deferral purposes—the CFC. As a result, it may be concluded that *actual dividend* distributions from CFCs qualify for reduced tax rates under JGTRRA. This conclusion, however, was not clarified in JGTRRA.[34]

**#3: Overlap of CFC and PFIC rules.** Ambiguity initially existed because of the potential overlap of the Code provisions relevant to CFCs and PFICs. Section 1297(e)(1) provides that a corporation will not be treated with respect to a shareholder as a PFIC dur-

1 P.L. 108-27, May 28, 2003.

2 This interest has only been heightened with the enactment of new Section 965 as part of the American Jobs Creation Act of 2004 (P.L. 108-357, October 22, 2004) ("JOBS Act"), which permits corporations to claim a dividends received deduction, under certain circumstances, with respect to dividends from foreign corporations. See Rollinson, Mundaca, and Murillo, "American Jobs Creation Act of 2004: Extraordinary Repatriation Incentive," 16 JOIT 18 (January 2005) 0110.

3 Section 1(h)(1)(C). This rate is reduced to 5% percent or 0% in some situations. See Section 1(h)(1)(B).

4 For a brief overview of Section 1(h)(11) and the entire JGTRRA, see U.S. Joint Committee on Taxation, "Summary of Conference Agreement on H.R. 2, The 'Jobs and Growth Tax Relief Reconciliation Act of 2003'" (JCX-54-03, May 22, 2003), at http://www.house.gov/jct/x-54-03.pdf

5 Section 1(h)(11)(B)(i).

6 Sections 7701(a)(3), (4); Temp. Reg. 301.7701-5T(a). See also TD 9153 (August 12, 2004) on dual chartered entities.

7 This article is the third in a series following Sheppard, "Reduced Tax Rates on Foreign Dividends Under JGTRRA: Ambiguities and Opportunities," 15 JOIT 14 (July 2004) 0710, and Sheppard and Harty, "Tax Treatment of Foreign Dividends Under JGTRRA: Further Ambiguities, Remaining Opportunities," 15 JOIT 20 (October 2004) 1010.

8 Section 1(h)(11)(C)(i)(I).

9 Section 1(h)(11)(C)(i)(II).

10 H. Rep't No. 108-126, 108th Cong., 1st Sess. 42 (May 22, 2003) (Conference Report), page 42.

11 *Id.*

12 *Complete Analysis of the Jobs and Growth Tax Relief Reconciliation Act of 2003* (RIA), para. 107.

13 Lawson, "ICI Discusses Application of New Qualified Dividend Income Rules to RICs," 2003 Tax Notes Today (TNT) 147-54 (July 31, 2003).

14 id.

15 Berg. "Dividends Provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003," 2003 TNT 199-34 (October 15, 2003). See also Berg. "NYSBA Comments on Dividend Provisions of Tax Act," 2003 TNT 172-14 (September 5, 2003).

16 Conference Report, page 42.

17 Merrill. "PwC Forwards Dividend Tax Paper to Treasury in Preparation for Upcoming Meeting," 2003 TNT 172-31 (September 5, 2003).

18 Tolin, "Dividend Rate Reduction Under U.S. Jobs and Growth Act of 2003," 14 JOIT 22 (December 2003) at 25. 1208

19 Conference Report, page 42.

20 Nelson. "Banking Group Comments on Effect of Jobs and Growth Tax Relief Act," 2003 TNT 157-31 (August 14, 2003); Tolin, *supra* note 18.

21 Notice 2003-69, 2003-42 IRB 851, Appendix. Notice 2003-69 specifically requires that a foreign corporation be a "resident" in one of the selected countries within the meaning of "resident" under the relevant treaty and satisfy all

# Shareholders of foreign corporations that were PFICs prior to January 1, 1998, and who did not make elections to purge the PFIC taint do not appear to be eligible to receive QDI from the foreign corporation

ing the "qualified portion" of the shareholder's holding period with respect to such stock. Under Section 1297(e)(2), "qualified portion" means the portion of the shareholder's holding period that is after December 31, 1997, and during which the shareholder is a U.S. shareholder (i.e., he owns 10% or more of the voting stock) of the corporation and the corporation is a CFC. In other words, the general rule is that in cases of dual application, the CFC provisions trump the PFIC provisions. As a result, practitioners questioned whether a PFIC distribution (which is not eligible for reduced tax rates under JGTRRA) may be converted into a dividend from a CFC (which is eligible for reduced tax rates under JGTRRA).[35]

**#4: Once a PFIC, always a PFIC.** Practitioners also questioned the effect of the "once a PFIC, always a PFIC" rule. Under Section 1298(b)(1), once a foreign corporation is a PFIC, it remains a PFIC unless a shareholder makes an election to recognize gain as of the last day of the last tax year during which the entity was a PFIC (also referred to as a purging election). The question, therefore, was whether actual dividend distributions from a CFC that was also a PFIC before enactment of Section 1297(e) (the "CFC rules trump the PFIC rules" provision) was enacted and whose shareholders did not elect to purge the PFIC status under Section 1298(b)(1) will qualify as QDI.[36]

**#5: Application of QDI rules to Section 1248 stock sales.** Commentators identified uncertainty with regard to the applicability of JGTRRA when stock in a CFC is sold. Section 1248(a) generally requires that gain from the sale of CFC stock be included in the seller's gross income as a "dividend" to the extent of the CFC's E&P that are attributable to the stock sold. While the income is included as a dividend, no actual distribution of property from the CFC occurs. Therefore, it was unclear whether a dividend inclusion pursuant to Section 1248 would be QDI.[37]

**#6: Determining PFIC status.** Commentators underscored the difficulty for individual investors, brokers, and foreign corporations of determining whether a particular foreign corporation is one of the tainted entities described in the Foreign Investment Company Exclusion Test. One group warned that it will be difficult for an individual investor to assess whether a foreign corporation is a PFIC because "it is not always easy for a foreign corporation to make that determination itself since U.S. tax principles must be applied to non-U.S. income and assets." This group also cautioned that it will be equally, if not more, difficult for brokers. The revised Form 1099-DIV obligates securities brokers and others to identify which dividends paid to U.S. individual investors are QDI. Brokers generally have more sophistication and better resources than the majority of individual investors; nonetheless, their ability to accurately determine whether a foreign corporation is an unacceptable entity (such as a PFIC) is "not materially greater."[38]

Consequently, commentators urged the IRS to draft Regulations permitting a foreign corporation to certify that it was not, should not have been, or more likely than not was not a PFIC, FIC, or FPHC during the preceding tax year, and that it does not anticipate becoming any of these types of entities in the current tax year. They also suggested that the Regulations allow publicly traded foreign corporations to rely primarily on their audited financial statements and available

other requirements of the relevant treaty, including the LOB provision.

22 Notice 2003-79, 2003-50 IRB 1206.

23 Notice 2004-71, 2004-45 IRB 793; U.S. Treasury Department, "Treasury and IRS Issue Guidance on Information Reporting of Dividends from Foreign Corporations" (JS-2051, October 22, 2004); "IRS Provides Guidance on Foreign Dividend Reporting," 2004 TNT 206-7 (October 25, 2004).

24 Lady, "Qualified Foreign Corporations: Taxing Foreign Corporation Dividends at Net Capital Gain Rates," 33 Tax Mgmt. Int'l J. (TMIJ) 349 (June 11, 2004).

25 Conference Report, page 42; Notice 2003-69.

26 Bell, "U.S., Barbados Step Up Tax Treaty Negotiations," 2003 TNT 208-3 (October 28, 2003).

27 id.

28 Remarks by Treasury Secretary John W. Snow at the Signing Ceremony for the U.S.-Barbados Income Tax Protocol (JS-1786, July 14, 2004); see Zive, Bristol, Fiernandes, and Payne," New Protocol to U.S.-Barbados Income Tax Treaty May Mean Restructuring for Some Foreign Multinationals," 16 JOIT xx (April 2005).

29 See also Joint Committee on Taxation Explanation of the proposed Protocol (JCX-55-04, September 16, 2004), page 25: "The Committee may wish to ask the Treasury Department whether it intends to amend its list of qualifiying treaties to include the U.S.-Barbados treaty, once the modifications made by the proposed protocol enter into force."

30 Section 1(h)(11)(C)(iii). These entities are defined in Sections 552, 1246, and 1297, respectively.

31 On tax deferral possibilities with FPHCs, FICs, and PFICs, see Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts* (WG&L/RIA), paras. 70.1, 70-2, 70-3.

32 Lawson, *supra* note 13.

33 Sheppard and Harty, *supra note 7*; Kahen, "A Year's Experience with the Taxation of Qualified Dividend Income at Capital Gains Rates," 45 Tax Mgmt. Memo. (April 5, 2004), pages 113-114; Lady, *supra* note 24, pages 353-354.

34 See Sheppard and Harty, *supra* note 7; Tolin, *supra* note 18 at 29.

35 Lady, *supra* note 24, pages 352-353; Boggs. "Qualified Dividend Income Under the 2003 Tax Act," Florida Bar J. (November 2004), page 51; Carlisle. "Attorney Urges Consistent Treatment for Shareholders of U.S. PFICs," 2004 Worldwide Tax Daily (WTD) 66-22 (April 6, 2004).

36 Sheppard and Harty, *supra* note 7.

37 id.; Kahen, *supra* note 32, page 114.

38 Berg, *supra* note 15.

39 Borisky, "Attorney Addresses Qualified Foreign Corporation Status," 2004 TNT 61-22 (March 30, 2004).

40 Notice 2004-70, 2004-44 IRB 724.

41 This reasoning would arguably not apply to inclusions under Section 962(d) which are not included "as a dividend" but are effectively treated as dividends for purposes of that section.

# The benefits of the QDI provisions will expire within the next four years absent additional action, which raises the issue of whether the Bush Administration will be able to extend or otherwise make permanent Section 1(h)(11)

market and shareholder data in making this determination.[39]

**IRS Notices responding to taxpayer concerns.** The IRS has issued three Notices regarding the Foreign Investment Company Exclusion Test: Notice 2003-79 and 2004-71 (discussed above) and Notice 2004-70, 2004-44 IRB 724. In response to concerns regarding the ability to assess a foreign corporation's characterization, Notice 2003-79 explains that foreign corporations will generally have all of the information necessary to determine whether they are one of the three tainted entities described in the Foreign Investment Company Exclusion Test, especially since many of these foreign entities are publicly traded in the U.S. and thus required to make and disclose this determination annually to the SEC. Notice 2003-79 nevertheless recognizes that not all foreign companies are publicly traded on U.S. markets and that not all foreign corporations that are so traded make an annual determination of their status. As a result, Notice 2003-79 sets forth a simplified reporting procedure for the 2003 tax year based on the knowledge of those persons required to file Form 1099-DIV. In particular, Notice 2003-79 provides that a person will treat a foreign corporation as not being one of the three tainted foreign entities, unless the person knows or has reason to know that the corporation is or expects to be a FPHC, FIC, or PFIC.

**Subpart F income dilemma.** Notice 2004-70 provides extensive guidance concerning the issues related to the Foreign Investment Company Exclusion Test.[40] With regard to CFCs, Notice 2004-70 says that, since JGTRRA does not expressly exclude CFCs from the definition of QFC, any "actual dividends" distributed by a CFC from its non-previously taxed E&P to an individual shareholder will generally be considered QDI. Likewise, Notice 2004-70 provides that amounts treated as "dividends" under Section 1248(a) on the sale of stock in a CFC are generally QDI. However, Subpart F "inclusions" will not be considered QDI.

In support of its position regarding Subpart F income, the IRS raises two points. First, neither Section 951(a)(1) nor the corresponding Treasury Regulations characterize an "inclusion" as a "dividend."[41] Second, unlike the CFC rules, the deemed inclusions under the FPHC and PFIC rules are consistently characterized as "dividends."

**FPHCs and FICs.** Regarding FPHCs, Notice 2004-70 provides that the following are not QDI: actual dividend distributions from a FPHC and undistributed FPHC income that is treated as distributed to individual U.S. shareholders as a dividend. Moreover, Notice 2004-70 states that a dividend from a foreign corporation that is not currently a FPHC, but that was a FPHC during the preceding tax year, is not QDI. Finally, when an entity is both a FPHC and a CFC, Notice 2004-70 states that since the entity continues to be a FPHC pursuant to the rules regarding overlapping provisions, any dividends (either actual or amounts treated as dividends) are not QDI.

Notice 2004-70 excludes from QDI many items related to FICs. In particular, the Notice provides that the following are not QDI:

1. Actual dividends received by an individual U.S. shareholder of an FIC.
2. A shareholder's portion of an FIC's post-1962 E&P after the sale of FIC stock.
3. Amounts distributed as ordinary income by an FIC that has made an election under Section 1247 to be subject to a tax regime resembling that for domestic mutual funds.
4. A dividend from a foreign corporation that is not currently an FIC, but that was an FIC during the preceding tax year.
5. Any dividends or other distributions from a foreign corporation that is both an FIC and a CFC.

As noted below, the FPHC and FIC rules have only temporary relevance due to recent changes in the law.

**Clarity on treatment of PFICs.** Notice 2004-70 contains three major rules regarding PFICs. First, QDI does not include dividends (including an "excess distribution") from an entity that is a PFIC during the current tax year or was a PFIC in the preceding tax year;

amounts included in a shareholder's gross income under Section 1293(a) (when a shareholder that has made a qualified electing fund (QEF) election), and amounts included in a shareholder's gross income under Section 1296 (when a shareholder that has made a mark-to-market election).

Second, with respect to determining PFIC status, Notice 2004-70 recognizes that some of the rules for determining whether an entity is a PFIC operate shareholder by shareholder. Accordingly, a particular foreign corporation may be treated as a PFIC with respect to some shareholders but not others. Expanding on this issue, Notice 2004-70 obliquely explains that this shareholder-by-shareholder analysis is important for some shareholders whose holding period may include a year in which the foreign corporation was a PFIC because of the "once a PFIC always a PFIC" rule in Section 1298(b)(1), while the holding period for other shareholders may not include a year during which the foreign corporation is treated as a PFIC and therefore Section 1298(b)(1) does not apply to them.

Third, with respect to PFICs that are also CFCs, Notice 2004-70 provides the general rule that, unless Section 1297(e) applies to a shareholder (i.e., the CFC rules take precedence over the PFIC rules), amounts received by a shareholder from such a corporation are not QDI. If a foreign corporation would be a PFIC with respect to a particular shareholder but for Section 1297(e), any distributions, inclusions, or amounts received by such shareholder must undergo the same analysis applicable to CFCs. Therefore, any distributions by a CFC (that would have also been a PFIC were it not for Section 1297(e)) from its non-previously taxed E&P to an individual shareholder will be considered QDI, provided that the other relevant JGTRRA tests are met, while Subpart F inclusions would not be considered QDI.

Notice 2004-70 also makes a very significant comment regarding the application of Section 1297(e). It says that a foreign corporation is not treated as a PFIC with respect to a shareholder during the "qualified portion" of the shareholder's holding period even if the foreign corporation would otherwise constitute a PFIC. The qualified portion is the portion of the shareholder's holding period after December 31, 1997 and during which the shareholder is a U.S. shareholder and the foreign corporation is a CFC. Notice 2004-70 then states that:

> [t]his overlap elimination rule does not apply if the foreign corporation otherwise is treated as a PFIC under section 1298(b)(1) because there is a portion of the shareholder's holding period prior to the application of this rule when the foreign corporation was a PFIC.

In other words, shareholders of foreign corporations that were PFICs prior to January 1, 1998, and who did not make elections to purge the PFIC taint do not appear to be eligible to receive QDI from the foreign corporation.

**Permanent certification procedure.** Notice 2004-71 confirms the intention of Treasury and *(Continued on page 56)*

*(Continued from page 37)* the IRS to develop a permanent certification procedure to assist those persons required to issue Forms 1099-DIV. Until this procedure is finalized, persons may rely on Notice 2003-79, which provides that a person will treat a foreign corporation as not being one of the three tainted foreign entities, unless the person knows or has reason to know that the foreign corporation is or expects to be a FPHC, FIC, or PFIC.

**Open issue—FPHC and FIC repeal.** The American Jobs Creation Act of 2004 (P.L. 108-357, October 22, 2004) ("JOBS Act") repealed the FPHC and FIC rules for tax years of foreign corporations beginning after December 31, 2004.[42] The QDI rules as added by JGTRRA are generally effective for tax years beginning after December 31, 2002. As a result, concerns related to FPHCs and FICs should be limited to the 2003 and 2004 tax years.

Further, Notice 2004-70 provides that Regulations to be issued relating to guidance in the Notice will be effective for amounts included in income on or after October 8, 2004. It can be expected that any such Regulations would either not elaborate on the explanations of the FPHC and FIC rules in Notice 2004-70 or provide limited guidance for the two years during which these rules would be relevant for QDI purposes.

**Open issue—guidance on other constructive dividend provisions.** IRS has left open the issues related to inclusions pursuant to Section 304 and Section 306(a)(2).[43] Presumably, future guidance will indicate that such inclusions are eligible for QDI treatment to the extent that they are treated as distributions to which Section 301 applies (i.e., dividends). However, such a presumption would be premature given that the language in each section does not specifically state that the income is included "as a dividend" but rather as distributions to which Section 301 applies.

## Market Test

JGTRAA provides that an entity will be treated as a QFC if its dividend-paying stock is readily tradable on an established U.S. securities market ("Market Test") (Code Section 1(h)(11)(C)(ii)). According to the Conference Report, stock will be treated as "readily tradable" if an American Depository Receipt (ADR) backed by such stock is readily tradable.[44] Shares of foreign corporations are not ordinarily traded on U.S. securities markets. Instead, the foreign corporations list their securities by using the ADR system, whereby they issue shares to U.S. depository banks, which, in turn, issue to U.S. investors ADRs representing the underlying shares. Since these ADRs are traded like normal shares, "[f]or practical purposes, the U.S. holders of ADRs are in essentially the same economic position as direct shareholders."[45]

**Initial ambiguities.** Several organizations and tax practitioners have lobbied for a liberal interpretation of JGTRRA with respect to ADRs. While the particulars vary somewhat, the gist of their arguments was that if stock is in the same class as the stock traded on an established U.S. securities market through an ADR program, dividends on any share in that class should constitute QDI, irrespective of where the stock in question is acquired.[46] For instance, if a Chilean corporation's shares are traded on the *Bolsa de Comercio* (Chilean securities exchange) and are also traded on a U.S. securities market through ADRs, shares of that class of stock purchased on the *Bolsa de Comercio* should be treated as "readily tradable." With respect to the meaning of "an established securities market," several groups have suggested that this phrase should include national securities markets, the OTC Bulletin Board, and electronic pink sheets.[47]

**IRS Notices.** The IRS has issued Notice 2003-71, 2003-43 IRB 922, Notice 2003-79, and Notice 2004-71 (the last two discussed above) to address uncertainties surrounding the Market Test. Notice 2003-71 states that, for purposes of JGTRRA, common or ordinary stock, as well as an ADR in respect of such stock, will be considered "readily tradable on an established securities market in the United States" if it is listed on a national securities exchange that is registered under the Securities Exchange Act of 1934 (i.e., the American Stock Exchange, Boston Stock Exchange, Cincinnati Stock Exchange, Chicago Stock Exchange, New York Stock Exchange, Philadelphia Stock Exchange, and Pacific Exchange) or is listed on NASDAQ.[48]

Notice 2003-79 had two main purposes—to provide guidance to those persons required under Section 6042 to file a Form 1099-DIV and to describe when a preferred stock or its corresponding ADR issued by a foreign corporation fulfills the Market Test. With regard to the former, Notice 2003-79 states that Form 1099-DIV and the corresponding instructions have been revised to reflect the changes introduced by JGTRRA. In particular, persons filing Form 1099-DIV must enter in Box 1a the total amount of ordinary dividends paid during the year and in Box 1b the portion of these dividends that are QDI. Regarding the latter,

42 JOBS Act, section 413(a).

43 Notice 2004-70, fn. 4.

44 Conference Report, page 42, fn. 41.

45 Tolin, *supra* note 18, at 27.

46 Lawson, *supra* note 13; Merrill, *supra* note 17; Tolin, *supra* note 18; Berg, *supra* note 15 (2003 TNT 199-34; Dixon. "Qualified Dividend Income and Foreign Corporation Shares: A Few Areas of Uncertainty," 17 J. of Financial Institutions 26 (September/October 2003); Paul, "Qualified Dividend Income: Issues, Problems, and Opportunities," 21 J. Tax'n of Investments 19 (Winter 2004).

47 Peterson, "Bank of New York Expresses Concern Over ADR Dividend Status," 2003 TNT 181-37 (September 18, 2003); Merrill, *supra* note 17; Berg, *supra* note 15 (2003 TNT 199-34).

48 Notice 2003-71, 2003-43 IRB 922; "Treasury and IRS Issue Guidance on Qualification for New Reduced Tax Rate on Dividends" (JS-778, October 3, 2003).

49 Section 1(h)(11)(B)(iii) referring to Section 246(c).

50 Notice 2003-79, 2003-50 IRB 1206.

51 "IRS Gives Investors the Benefit of Pending Technical Corrections on Qualified Dividends" (IR-2004-22, February 19, 2004); Gary. "Treasury, IRS to Let Taxpayers Reap Dividend Tax Cut Benefits Early," 2004 TNT 34-2 (February 20, 2004).

52 Ann. 2004-11, 2004-10 IRB 581.

53 Berg, *supra* note 15.

54 Paul, *supra* note 45.

55 id.

56 id.

57 Lady, *supra* note 24, page 346.

58 Tolin, *supra* note 18.

59 P.L. 108-27, section 303.

60 Conference Report, page 42.

61 Lady, *supra* note 24, pages 354-355; Tillinghast. "Computing Foreign Tax Credits for Taxes on Qualifying Foreign Dividends," 33 TMIJ (September 10, 2004), pages 529-530.

Notice 2003-79 explains that for the 2003 tax year, preferred stock or an ADR in respect of such stock issued by a foreign corporation will satisfy the Market Test if it is listed on a national securities exchange that is registered under the Securities Exchange Act of 1934 or is listed on NASDAQ.

Notice 2004-71 states that Treasury and the IRS decided to extend to the 2004 tax year the procedures and other rules in Notice 2003-79. Thus, a security or ADR in respect of such security (including common or preferred stock) issued by a foreign corporation will meet the Market Test if it is listed on a national securities exchange that is registered under the Securities Exchange Act of 1934 or is listed on NASDAQ.

**Open issues.** Notice 2003-71 states that Treasury and the IRS are currently analyzing the proper tax treatment of dividends distributed with respect to stock that is not listed on the New York Stock Exchange, NASDAQ, etc. In particular, the government is considering whether or to what extent other stock (e.g., stock listed on the OTC Bulletin Board or on electronic pink sheets) should be able to satisfy the Market Test based on factors such as trading volume, minimum number of market makers, maintenance and publication of historical trade or quotation data, and issuer reporting requirements. Until this issue is resolved, determining which corporations are considered QFCs under the Market Test will be problematic.

In addition, various uncertainties regarding the Market Test still exist. As discussed above, Treasury and the IRS announced in both Notice 2003-79 and Notice 2004-71 that they intend to develop a permanent certification procedure to assist those persons required to issue Forms 1099-DIV. Until this certification procedure is finalized, doubts will persist.

## Holding Period Test

JGTRRA provides that "QDI" does not include dividends paid on stock that a shareholder has held for 60 days or less during a period of 120 days, which period begins 60 days before the stock becomes ex-dividend ("Holding Period Test"). Stated another way, for a dividend to be considered QDI, the shareholder must have held the relevant stock for 61 days or more during the 120-day holding period, which starts 60 days before the ex-dividend date. "Ex-dividend" means the first day on which a share of stock on which a dividend has been declared may be sold without the purchaser being entitled to receive the previously declared dividend.[49]

The IRS intended to clarify issues related to the Holding Period Test by issuing Notice 2003-79.[50] According to the Notice, if a person who is obligated to file Form 1099-DIV either determines that a particular shareholder has satisfied the Holding Period Test or concludes that it is impractical to make this decision, the person may presume that the shareholder has indeed met the Holding Period Test.

The IRS announced in February 2004 that the Tax Technical Corrections Act of 2003 ("Act"), which had not yet been passed, would change the Holding Period Test. Under the Act, for a dividend to be considered QDI, the shareholder must have held the stock in question for at least 61 days (instead of 60) during the 121-day period (instead of 120) beginning 60 days before the ex-dividend date. The IRS further stated that stock purchased on the last day before the ex-dividend date can still meet the Holding Period Test because there would be 61 days remaining in the 121-day period. Likewise, stock sold on the ex-dividend date can meet the new Holding Period Test since that is the 61st day in the period. In addition to slightly modifying the relevant days in the Holding Period Test, the IRS pronouncement also expressly created a legal fiction. In particular, it stated that "[t]o reduce the burden of requiring amended [Forms 1099-DIV] to investors, who might then have to amend their tax returns, the Treasury Department and the IRS have agreed to let all taxpayers apply the technical corrections in Section 2 of the Act as if the legislation were already enacted."51 This decision was seconded shortly thereafter by additional IRS statements.52

**Open issues.** Like many aspects of JGTRRA, commentators have suggested that the apparent straightforwardness of the Holding Period Test may be misleading. They argue that complications surrounding this rule include the following: the holding period must be tested for *each* dividend; the 61-day period may be satisfied by combining days before and after the ex-dividend date; and the entire idea of the "ex-dividend" date is unfamiliar to many individual investors.[53]

**Split holding periods.** Tax practitioners have raised other issues, including the impact of split holding periods. If a shareholder buys stock and holds it for 31 days, including the ex-dividend date, and enters into a short sale for a week, which is closed by the delivery of newly acquired stock, Section 246(c)(4)(A) provides that the shareholder cannot accrue the holding period during the time that the short sale was outstanding. Nevertheless, the shareholder did continue to hold the same shares of stock and JGTRRA seems to indicate that the shareholder can combine the holding periods both before and after the short sale to satisfy the Holding Period Test. The IRS has not yet addressed this split holding-period issue in the context of JGTRRA.[54]

**Margin stock, stock futures, carryover basis transactions.** Practitioners have also questioned the effect of margin stock loaned out by a broker. Assume that a shareholder buys stock and does not enter into any transactions. The shareholder's broker borrows the stock (which was held in a margin account) for one week, which is generally allowed under brokerage agreements. Provided that the stock was not lent out on the record date, the shareholder would be considered to have received the dividend. For purposes of the Holding Period Test, does the shareholder's holding period for the stock include the time during which the broker had loaned out the stock?[55]

Stock futures are also an area of concern. If a taxpayer enters into a futures contract to obtain stock and acquires the stock by settling the futures contract before the ex-dividend date, the unresolved issue is whether the time during which the taxpayer held the futures contract is considered part of the taxpayer's holding period for purposes of the Holding Period Test.[56]

A final issue raised by practitioners is the potential applicability of Section

1223(1) when stock in one QFC is exchanged for stock in another QFC in a carryover-basis transaction. Practitioners believe that it is "likely" that an individual shareholder that receives stock in a new QFC in a carryover basis transaction should receive the benefit of the tacked-holding period for purposes of the Holding Period Test, but this issue remains unresolved.[57]

## Equity Test

Under general corporate taxation rules, for a corporate distribution to be treated as a "dividend," it must, among other things, be made to a shareholder "with respect to its stock" (Sections 301(a) and 316(a)). This principle was not addressed in JGTRRA or the Conference Report. However, Notice 2003-79 explained that for a corporate distribution to be considered QDI, it must have been made with respect to equity, such as stock, rather than with respect to debt, such as bonds or loans ("Equity Test").

This characterization as "equity" or "debt" is based on both the instrument in question and all of the surrounding facts and circumstances. Notice 2003-79 explains that common or ordinary stock is generally treated as "equity" for U.S. tax purposes, but when a foreign corporation has preferred stock, a person required to file a Form 1099-DIV may not possess all of the information necessary to determine whether such preferred stock is better categorized as "equity" or "debt." Notice 2003-79 provides that, for purposes of filing Forms 1099-DIV for dividends issued during the 2003 tax year, a person filing Form 1099-DIV will treat the security as satisfying the Equity Test if it is a common or ordinary stock. If the security is *not* common or ordinary stock, the person will treat the security as satisfying the Equity Test if the foreign corporation has a public statement filed with the SEC confirming that the security "will be, should be, or more likely than not will be" properly classified as "equity" rather than as "debt." Pursuant to Notice 2004-71, these same rules apply to distributions during the 2004 tax year.

**Open issues.** Determining whether the Equity Test has been satisfied has proven difficult for many foreign corporations. As proof thereof, a recent survey of U.S. tax and securities filings reveals that some foreign entities say that they will qualify for the reduced tax rate, others say that they believe they will qualify, while still others simply acknowledge that the question is unclear and refer U.S. holders to their own tax advisors.[58] Notice 2003-79 states that the IRS intends to issue Regulations outlining a certification procedure under which foreign corporations will publicly announce whether a distribution meets the Equity Test. For publicly traded companies, this certification will likely be made in a public SEC filing (such as in a Form 20-F). As evidenced by Notice 2004-71, finalizing this certification procedure may not occur in the near future. Until that time, reservations regarding the Equity Test will remain.

## E&P Test

General corporate tax rules provide that a corporate distribution will not be treated as a "dividend" unless it represents a distribution of property to its shareholders out of its E&P ("E&P Test") (Section 316(a)). Logically, a distribution cannot be considered QDI unless it is first considered a "dividend." Neither JGTRRA nor the Conference Report addressed this topic. Notice 2003-79 recognizes that a person filing a Form 1099-DIV may not know in some cases whether a distribution meets the E&P Test. Therefore, when a person is unable to determine *what portion* of a particular corporate distribution is a dividend, the person must treat the *entire distribution* as a dividend.

As mentioned several times above, Notice 2004-71 confirms the intention of Treasury and IRS to develop a permanent certification procedure to assist those persons required to issue Forms 1099-DIV. Persons are entitled to rely during the 2004 tax year on the simplified procedures in Notice 2003-79, which include the presumption that an entire distribution is a "dividend" in some situations. However, uncertainty will exist until the certification procedure is final.

## Other Open Issues

JGTRRA contained numerous "sunset" provisions to satisfy the budgetary requirements associated with tax cuts. The QDI provisions were no exception. Specifically, Section 1(h)(11) will not apply to tax years beginning after December 31, 2008.[59] The benefits of the QDI provisions will therefore expire within the next four years absent additional action. This raises the issue of whether the Bush Administration will be able to extend or otherwise make permanent Section 1(h)(11). In his State of the Union address on February 2, 2005, President Bush mentioned that the budget that he sends to Congress will include provisions to make the tax cuts permanent. It is hoped that an answer to this question will come in the next few months.

The Conference Report provides that special rules will apply for QDI with respect to foreign tax credits. In particular, rules similar to those in Section 904(b)(2)(B), which address adjustments to the foreign tax credit limitation to reflect any capital gain rate differential, will apply to any QDI. The Conference Report further indicates that Congress anticipates that Regulations promulgated under Section 904 will coordinate the rules that apply to both capital gains and QDI.[60] Tax practitioners have raised many issues relating to foreign tax credits, all of which remain unanswered since neither Regulations under Section 904 nor IRS Notices have been issued on this topic yet.[61]

## Conclusion

This article demonstrates that ascertaining whether an entity is a QFC and a distribution is QDI can be a difficult exercise, one requiring a careful review of the statutory language in JGTRRA, the relevant congressional Conference Report, and a series of IRS Notices. It also necessitates a solid understanding of seven tests—Possessions Test, Treaty Test, Market Test, Foreign Investment Company Exclusion Test, Holding Period Test, Equity Test, and E&P Test. Thanks to the commendable efforts thus far by Congress, Treasury, and IRS, much of the initial confusion surrounding JGTRRA has been clarified. As this article shows, however, additional guidance is still needed. ●