

# Outbound Asset Transfers

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## Code Sec. 367(a) Transfers by Partnerships to Foreign Corporations: Who Is the Transferor?



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In AM 2008-006 (the “AM”), the IRS addressed the issue of who is required to file Form 926 when a partnership makes a transfer described in Code Sec. 367(a) and such partnership is owned by other entities, such as partnerships, C corporations, S corporations, or trusts or estates. These types of transactions occur quite frequently, and, as discussed in detail below, highlight the nuances relating to such transfers and a possible trap for the unwary. The question raised in these transactions is whether the partnership, the partners in the partnership or the partners/shareholders/beneficiaries of a partner are required to file Form 926.

The answer to this question revolves around the interaction of Code Secs. 367(a) and 6038B and the regulations under those sections, which provide rules relating to transfers by partnerships and other entities to foreign corporations in transactions covered by Code Sec. 367(a). Determining the person that must file the Form 926 is highly relevant given the possible penalties (lesser of 10 percent of the fair market value of the property transferred or \$100,000) that the IRS could impose (subject to reasonable cause relief) on a person who fails to file such form.<sup>1</sup>

After analyzing two Code Sec. 367(a) transfers by a partnership to a foreign corporation, the IRS concludes in the AM that the partners (and not the partnership) are required to file Form 926. The AM further provides that if a partner is itself a partnership, its partners generally will be required to file Form 926, with corporations, trusts (except grantor trusts) and estates



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generally being required to file Form 926 instead of shareholders and beneficiaries. Finally, the AM sheds some light on how the penalty provisions operate in such cases.

## Fact Pattern

The following fact patterns were the subject of the AM and were designed to illustrate how the reporting rules operate. In the first fact pattern, Partnership 2, a domestic partnership, transferred \$1 million (cash) to a foreign corporation in exchange for stock in the foreign corporation in a transaction meeting the requirements of Code Sec. 351. In the second fact pattern, Partnership 2 transferred tangible property with a fair market value of \$1 million to a foreign corporation in exchange for stock also meeting the requirements of Code Sec. 351. In this situation, the tangible property will be used in the active conduct of a trade or business in a foreign country.

Partnership 2 had the following partners: an individual, a trust, a domestic partnership (Partnership 1) and an S corporation. Partnership 1's partners included domestic corporations. An individual and a trust hold the shares of the S corporation.

## Analysis

The IRS's analysis begins with Code Sec. 6038B(a), which generally provides that each U.S. person who transfers property to a foreign corporation in a Code Sec. 351 exchange (among other exchanges) is required to furnish to the Secretary such information regarding the exchange as the Secretary may require in regulations. The time and manner for providing the information shall be prescribed by the Secretary in said regulations. To give teeth to the provision, Code Sec. 6038B(c) provides a penalty in the amount of 10 percent of the fair market value of the property transferred at the time of the exchange for failure to furnish the information required by Code Sec. 6038B(a). The penalty is limited to \$100,000, unless the penalty was due to intentional disregard of the filing requirement. As with most penalties, there is a reasonable cause exception. More specifically, the

penalty does not apply if the U.S. person shows the failure to furnish the required information is due to reasonable cause, and not to willful neglect.

Reg. §1.6038B-1(b) provides that generally Form 926 must be used for reporting transfer pursuant to Code Sec. 6038B. In addition, a special rule for transfers of cash is included in Reg. §1.6038B-1(b) (3). Under this regulation, a U.S. person that transfers cash to a foreign corporation in a transfer described in Code Sec. 6038B(a)(1)(A) (which includes an exchange under Code Sec. 351) must report the transfer if the amount of cash transferred by such person or related persons (determined under Code Sec.

267(b)(1) through (3) and (10) through (12)) in the 12-month period ending on the date of the transfer exceeds \$100,000. Moreover, it also requires reporting if a U.S. person transfers cash to a foreign corporation in a transfer described in Code Sec. 6038B(a)(1)(A) if immediately after the transfer such person holds directly, indirectly or by attribution (determined under the rules of Code Sec. 318(a), as modified by Code Sec. 6038(e)(2)), at least 10 percent of the total voting power or the total value of the foreign corporation.<sup>2</sup>

If one were to stop the analysis at this point, it would appear that a domestic partnership (Partnership 2 in the facts above) would be required to file Form 926. This would be the case because Code Sec. 7701(a)(30) provides that a U.S. person includes a domestic partnership. Therefore, absent a special rule, a domestic partnership that makes a Code Sec. 367(a)(1) transfer to a foreign corporation would be treated as the transferor and the person with the reporting obligation under the entity theory of partnership taxation. Furthermore, a transfer by a foreign partnership, which is not included in the definition of a U.S. person as provided in Code Secs. 7701(a) (5) and (a)(30),<sup>3</sup> would not appear to be a transfer triggering Code Sec. 6038B reporting.

The regulations under Code Sec. 6038B, however, provide for a different result. The regulations under Code Sec. 6038B cross-reference the Code Sec. 367(a) regulations for purposes of determining whether there has been a transfer by a U.S. person. More specifically, Reg. §1.6038B-1(b) states that for purposes of determining if a U.S. transferor is subject

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to Code Sec. 6038B, the rules of Reg. §§1.367(a)-1T(c) and 1.367(a)-3(d) apply with respect to a transfer described in Code Sec. 367(a).<sup>4</sup>

Reg. §1.367(a)-1T(d)(1) provides that the term “U.S. person” includes those persons described in Code Sec. 7701(a)(30). It further provides that the term includes a citizen or resident of the United States, a domestic partnership, a domestic corporation, and any estate or trust other than a foreign estate or trust.<sup>5</sup> However, Reg. §1.367(a)-1T(c)(3) provides that if a partnership (whether foreign or domestic) transfers property to a foreign corporation in an exchange described in Code Sec. 367(a)(1) (e.g., an exchange under Code Sec. 351), then a U.S. person that is a partner in the partnership shall be treated as having transferred a proportionate share of the property in an exchange described in Code Sec. 367(a)(1).<sup>6</sup> A U.S. person’s proportionate share of partnership property shall be determined under the rules and principles of Code Secs. 701 through 761 and the regulations thereunder.<sup>7</sup>

Therefore, under this regulation, U.S. persons that are partners in a foreign partnership that transfer property to a foreign corporation in a Code Sec. 367(a) exchange are subject to the rules under Code Sec. 367(a), even though the transaction otherwise is a foreign-to-foreign transfer. This rule prevents a U.S. person that is a partner in a foreign partnership from avoiding the possible application of Code Sec. 367(a) on transfers by a foreign partnership to a foreign corporation.

Before discussing the issue of who should file the Form 926 further, it is worth noting that Code Sec. 367(a)(1) uses the term “U.S. person” when describing the type of person that is subject to the Code Sec. 367(a) rules.<sup>8</sup> The statute contains a specific rule reflecting the use of an aggregate approach when a U.S. person transfers a partnership interest to a foreign corporation in a Code Sec. 367(a) exchange.<sup>9</sup> Code Sec. 367(a) does not, however, contain a specific statutory rule dealing with transfers by partnerships (domestic or foreign) to foreign corporations in exchanges described in Code Sec. 367(a)(1). Nevertheless, the regulations under Code Sec. 367(a) do address these types of transfers. They provide for an aggregate approach presumably relying on the general authority of subchapter K to apply the aggregate or entity approach to certain Code sections outside subchapter K depending on a section’s purpose, and the underlying policies of Code Sec. 367(a).<sup>10</sup>

The Code Sec. 367 regulations also contain specific rules relating to transfers by trusts and estates

and, generally speaking, provide an entity approach. Reg. §1.367(a)-1T(c)(4) provides that, for purposes of Code Sec. 367(a), a transfer of property by an estate or trust is treated as a transfer by the entity itself, and not as an indirect transfer by its beneficiaries. Thus, a transfer of property by a foreign trust or estate (as defined in Code Sec. 7701(a)(31)) is not described in Code Sec. 367(a), regardless of whether the beneficiaries of the trust or estate are U.S. persons. Similarly, a transfer of property by a domestic trust or estate may be described in Code Sec. 367(a)(1), regardless of whether the beneficiaries of the trust or estate are foreign persons.<sup>11</sup>

However, there is a special rule for grantor trusts that, not surprisingly, provides a look through approach. Specifically, Reg. §1.367(a)-1T(c)(4)(ii) provides that, in the case of a grantor trust, the transfer of a portion of or all the assets of a trust is considered to be a transfer by any U.S. person who is treated as the owner of any such portion or all of the assets of the trust under Code Secs. 671 through 679.

## Application of Analysis to Fact Pattern

The IRS applied the above analysis to Partnership 2’s transfer of cash in excess of \$100,000 (or, alternatively, its transfer of tangible property) to a foreign corporation in exchange for stock in a transaction qualifying for nonrecognition treatment under Code Sec. 351.

It first noted that, for purposes of Code Sec. 367(a), Reg. §1.367(a)-1T(c)(3) treats a transfer of property by a partnership in a Code Sec. 367(a) exchange as a transfer by the partners of their proportionate share of the property. Accordingly, it concluded that the partners of Partnership 2 are treated as having transferred their proportionate share of the cash, or alternatively, the tangible property, which was transferred by Partnership 2. To the extent the partners of Partnership 2 are U.S. persons, Code Sec. 367(a) applies.

The IRS next noted that Code Sec. 6038B and the regulations thereunder generally require a U.S. person to give notice to the IRS of a transfer subject to Code Sec. 367(a) through filing Form 926. The regulations under Code Sec. 6038B apply the rules of the regulations under Code Sec. 367(a) in determining if the U.S. transferor is subject to the reporting requirements of Code Sec. 6038B. In this manner, the same party that ultimately transfers the property under Code Sec. 367(a) must report the transfer under Code Sec. 6038B. As a result, Partnership 2 is not required to file Form 926.

The IRS next specifically discussed the following U.S. persons and the filing requirement under Code Sec. 6038B (Form 926):

- **The S corporation.** Because an S corporation is included in the definition of U.S. person, and there is no provision in Reg. §1.367(a)-1T (or any other regulation) removing the filing requirement from it and imposing the filing requirement on its shareholders, the corporation is required to file the Form 926. This would be consistent with the general treatment of an S corporation as a corporation for purposes of the subchapter C provisions.
- **The trust.** Based on Reg. §1.367(a)-1T(c)(4)(i), unless the trust is a grantor trust, it is required to file the Form 926. Therefore, under Reg. §1.6038B-1(b)(1)(i), which applies the rules of Reg. §1.367(a)-1T(c) for purposes of determining if the U.S. transferor is subject to Code Sec. 6038B, the trust, rather than its beneficiaries, may be required to file Form 926. The AM noted that this rule applies to all trusts (*i.e.*, simple and complex trusts) other than grantor trusts. In the case of a grantor trust, the parties that are treated as owning the assets of the trust may be required to file, as regards the transfer of those assets.
- **A domestic C corporation that is one of Partnership 1's partners.** In analyzing the transfer by Partnership 2, the IRS first cited to Reg. §§1.6038B-1(b) and 1.367(a)-1T(c)(3), which together impose the filing requirement on the partners of the transferring partnership (Partnership 2). With respect to Partnership 1, the IRS concluded that Partnership 1 is not required to file under Code Sec. 6038B because Reg. §1.367(a)-1T(c)(3) must be applied to the Code Sec. 367(a) transfer that Partnership 1, as a partner in Partnership 2, is treated as having made. Consequently, Partnership 1's partners are treated as having transferred their proportionate share of the cash, or, alternatively, the tangible property, which Partnership 1 is treated as having transferred to the foreign corporation under Reg. §1.367(a)-1T(c)(3). Partnership 1's partners, as a result of the above analysis, may be required to file Form 926, assuming the partners are U.S. persons and are not partnerships. In discussing a domestic C corporation that is a partner in Partnership 1, the IRS concludes that the filing requirement is imposed on such domestic C corporation because it is included in the definition of U.S. person, and

there is no provision in Reg. §1.367(a)-1T (or any other regulation) removing the filing requirement from it, and imposing the filing requirement on its shareholders.

Additionally, the issue of status as a general or limited partner and the requisite filing obligations were addressed. The IRS stated that the requirement of Reg. §1.367(a)-1T(c)(3) applies to both general and limited partners of the transferring partnership (or of a partnership that is treated as being the transferor, because it is a partner in the transferring partnership). Reg. §1.6038B-1(b) then imposes a filing requirement on the same partners.

The analysis next turned to penalties. Specifically, the question posed in the AM was whether the penalty for failure to comply with the filing requirements was limited to \$100,000 for each partner of Partnership 2 that failed to comply or limited to \$100,000 in total. It concluded that the penalty for failure to comply with Code Sec. 6038B and the regulations thereunder is imposed on each partner that failed to comply and that the amount of the penalty would be 10 percent of the partner's proportionate share of the transferred property. The penalty on each partner that failed to comply with Code Sec. 6038B and the regulations thereunder is limited to \$100,000, unless the failure to comply was due to intentional disregard of Code Sec. 6038B. Further, the IRS concluded that this result is not changed if either Partnership 1 or 2 is a TEFRA partnership (as the term is defined in Code Sec. 6231(a)(1)). It noted that Reg. §1.367(a)-1T(c)(3) applies any time a partnership (whether domestic or foreign) transfers property to a foreign corporation. It applies to all partnerships. Presumably, if the taxpayer can show reasonable cause for failing to file, such penalty would be abated.

## Issues Not Addressed

One issue that the AM apparently assumed but did not specifically state was that each partner analyzed above either was treated as transferring the requisite amount of cash (over \$100,000 in the 12-month period ending of the date of the transfer)<sup>12</sup> or having the requisite 10-percent interest, as provided in Reg. §1.6038B-1(b)(3), in applying the Code Sec. 6038B rules to situation 1 (*i.e.*, the situation involving the cash transfer by Partnership 2). The AM does not supply that relevant information but, given the aggregate theory for reporting purposes, this would appear to have been the case.<sup>13</sup> If this is the case (and it should

be), there may be situations in which a partnership transfers a large amount of cash (e.g., in excess of \$100,000) but its U.S. partners (or other U.S. persons that are treated as having made a transfer applying the analysis of this AM) that are treated as having made the transfer are not required to report the transfer because the thresholds of Reg. §1.6038B-1(b)(3) are not triggered.

The AM also highlights another issue regarding a possible opportunity for the IRS to reduce the administrative burden with respect to the filing requirements under Code Sec. 6038B for transfers to foreign corporations. Application of the aggregate theory in the AM appears to be appropriate from a policy perspective. However, requiring each domestic partner (or other U.S. persons required to report as discussed in the AM) to comply with the filing obligation may prove unduly harsh especially in situations in which the domestic partner (or other U.S. persons required to report as discussed in the AM) does not have a controlling interest and may not even be aware that the partnership has transferred property to a foreign corporation which would trigger a reporting obligation. Thus, it may be more appropriate in certain situations to allow a partnership (or, at least a domestic partnership) to comply with the filing requirements on behalf of its domestic partners (or other U.S. persons required to report as discussed in the AM) in certain instances (e.g., transfers of cash by a partnership to a foreign corporation).<sup>14</sup>

Such a rule exists under Reg. §1.6038B-2(a)(2) with respect to Code Sec. 721 transfers by a domestic partnership to a foreign partnership. As a general matter, Reg. §1.6038B-2(a)(1) provides the situations in which a U.S. person who transfers property to a foreign partnership in a Code Sec. 721 contribution

(including Code Sec. 721(b)) must file a Form 8865.<sup>15</sup> Reg. §1.6038B-2(a)(2) generally applies an aggregate approach when a domestic partnership makes a Code Sec. 721 transfer to a foreign partnership. As a result, the domestic partners of the domestic partnership are deemed to have transferred their proportionate share of the partnership assets to the foreign partnership and they may have a reporting obligation under the regulations. However, Reg. §1.6038B-2(a)(2) provides an important exception to this general aggregate approach. Specifically, if the domestic partnership properly reports the transfer, no partner of the transferor partnership, whether direct or indirect (through tiers of partnerships), is required to report the transfer.<sup>16</sup> Thus, under this exception, the domestic partners are relieved of their filing requirements.<sup>17</sup> A similar approach should be considered for certain Code Sec. 367(a) transfers of property by a partnership to a foreign corporation.

## Conclusion

This AM provides a good analysis of how the Code Sec. 6038B rules and the corresponding penalty provisions apply in the case of transfers of property (including cash) by a partnership to a foreign corporation in a Code Sec. 367(a) exchange. The approach of the AM is not surprising given the general aggregate approach of the Code Sec. 367(a) regulations to partnership transfers to foreign corporations and provides useful insight into the application of the rules in a tiered partnership structure. Although the rules make sense, from an administrative standpoint, it is hoped that the IRS will consider possible ways to relieve some of the burdens of this reporting and perhaps look to the rules under Reg. §1.6038B-2(a)(2) for possible guidance.

## ENDNOTES

<sup>1</sup> Code Sec. 6038B(c) (the \$100,000 limit does not apply to situations in which there was intentional disregard of the reporting requirements). The period of limitations for assessment of tax upon the transfer of that property is extended to the date that is three years after the date on which the information required to be reported is provided. For further details, see Form 926 and the instructions thereto.

<sup>2</sup> The reporting requirement relating to 10-percent interests in the foreign corporation was not discussed in the AM but nevertheless can trigger a reporting requirement.

<sup>3</sup> Code Sec. 7701(a)(5) provides that the term

“foreign” when applied to a corporation or partnership means a corporation or partnership that is not domestic.

<sup>4</sup> The regulation also provides that the rules of Reg. §1.367(a)-1T(c)(3) apply with respect to a transfer described in Code Sec. 367(d). For further details and special rules regarding transfers that may trigger Code Sec. 6038B reporting, including special rules relating to transfers of stock or securities, see generally, Reg. §1.6038B-1(b). See also Form 926 and the instructions thereto.

<sup>5</sup> The regulation also provides that “[f]or purposes of this section, an individual with respect to whom an election has been made

under Code Sec. 6013(g) or (h) is considered to be a resident of the United States while such election is in effect. A nonresident alien or a foreign corporation will not be considered a United States person because of its actual or deemed conduct of a trade or business within the United States during a taxable year”; see also Reg. §1.6038B-1T(b)(4)(iv).

<sup>6</sup> The regulations include the following example illustrating this general rule:

**Example.** P is a partnership having five equal general partners, two of whom are United States persons. P transfers property to F, a foreign corporation, in connection with an exchange

ENDNOTES

described in Code Sec. 351. The exchange includes an indirect transfer of property by the partners to F. The transfers of property attributable to those partners who are United States persons, that is, 40 percent of each asset transferred to F, are transfers described in Code Sec. 367(a)(1). The gain (if any) recognized on the transfer of 40 percent of each asset to F is attributable to the two partners who are United States persons. Reg. §1.367(a)-1T(c)(3)(i)(A), Example.

- <sup>7</sup> The regulations also provide for special adjustments to be made as a result of treating U.S. persons that are partners in the partnership as the transferors. Specifically, Reg. §1.367(a)-1T(c)(3)(i)(B) provides that, if a U.S. person is treated under Reg. §1.367(a)-1T(c)(3)(i) as having transferred a proportionate share of the property of a partnership in an exchange described in Code Sec. 367(a), and is therefore required to recognize gain upon the transfer, then (1) the U.S. person's basis in the partnership shall be increased by the amount of gain recognized by him; (2) solely for purposes of determining the basis of the partnership in the stock of the transferee foreign corporation, the U.S. person shall be treated as having newly acquired an interest in the partnership (for an amount equal to the gain recognized), permitting the partnership to make an optional adjustment to basis pursuant to Code Secs. 743 and 754; and (3) the transferee foreign corporation's basis in the property acquired from the partnership shall be increased by the amount of gain recognized by U.S. persons under this paragraph (c)(3)(i).
- <sup>8</sup> Specifically, Code Sec. 367(a)(1) provides that "if, in connection with any exchange described in Code Secs. 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation." The statute and regulations provide a number of exceptions to this general gain recognition rule.
- <sup>9</sup> Specifically, Code Sec. 367(a)(4) provides that, except as provided by regulations, a transfer by a U.S. person of an interest in a partnership to a foreign corporation in an

exchange described in Code Sec. 367(a)(1) shall, for purposes of Code Sec. 367(a), be treated as a transfer to such corporation of such person's *pro rata* share of the assets of the partnership. For regulations addressing such exchanges as well as rules relating to satisfying Reg. §1.367(a)-2T, special basis adjustments, and the exclusion from this general aggregate approach to partnership taxation certain transfers of limited partnership interests that are regularly traded on an established securities market, see Reg. §1.367(a)-1T(c)(3)(ii).

- <sup>10</sup> The legislative history of subchapter K provides that for purposes of interpreting Code Secs. outside of subchapter K, either the entity or aggregate approach can be used, depending on which characterization is more appropriate to carry out the provisions of the particular Code section at issue. See H.R. CONF. REP. NO. 2543, 83 Cong. 2d. Sess. 50 (1954). The IRS relied on this legislative history when it issued the *Brown Group* regulations. See, e.g., T.D. 9008. Certain international regulations have employed an aggregate theory relying on this legislative history. See, e.g., Reg. §1.1248-1(a)(4) (providing that (1) for purposes of Code Sec. 1248(a), if a foreign partnership sells or exchanges stock of a corporation, the partners in such foreign partnership shall be treated as selling or exchanging their proportionate share of the stock of such corporation, and (2) stock which is considered to have been sold or exchanged by a partner by reason of the application of paragraph (a)(4) shall for purposes of applying such sentence be treated as actually sold or exchanged by such partner). See also T.D. 9345 and REG-135866-02. The partnership regulations also contain an anti-abuse regulation that was added as a final regulation in 1994 permitting the Commissioner to employ the aggregate approach. See T.D. 8588 and Reg. §1.701-2(e)(1) (providing that the Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or the regulations promulgated thereunder, subject to an exception in (e)(2) when entity treatment is clearly contemplated).
- <sup>11</sup> Reg. §1.367(a)-1T(c)(4).
- <sup>12</sup> Prior cash transfers during the 12-month pe-

riod and transfers by related persons would need to be considered. See Reg. §1.6038B-1(b)(3).

- <sup>13</sup> Some information that would have been helpful would include each partner's proportionate share of the cash transferred under the rules and principles of Code Secs. 701 through 761 and the regulations thereunder, whether any related parties made any transfers that must be considered with respect to each partner (assuming the above does not already trigger a reporting obligation), whether prior cash transfers were made during the 12-month period (assuming reporting is not already required), each partner's interest in the partnership after the transfer for purposes of the requisite 10-percent interest test under Reg. §1.6038B-1(b)(3) taking into account the attribution rules of the regulation (assuming reporting is not already required).
- <sup>14</sup> For this to apply in situations involving transfers of stock or securities, other adjustments to the regulations would be necessary as transfers of stock sometimes involve a gain recognition agreement.
- <sup>15</sup> Specifically, Reg. §1.6038B-2(a)(1) provides that a U.S. person that transfers property to a foreign partnership in a contribution described in Code Sec. 721 (including Code Sec. 721(b)) must report that transfer on Form 8865, *Information Return of U.S. Persons With Respect to Certain Foreign Partnerships*, pursuant to Code Sec. 6038B and the rules of this section, if (1) immediately after the transfer, the U.S. person owns, directly, indirectly or by attribution, at least a 10-percent interest in the partnership, as defined in Code Sec. 6038(e)(3)(C) and the regulations thereunder; or (2) the value of the property transferred, when added to the value of any other property transferred in a Code Sec. 721 contribution by such person (or any related person) to such partnership during the 12-month period ending on the date of the transfer, exceeds \$100,000. For other rules relating to reporting involving partnerships, see Form 8865 and the instructions thereto.
- <sup>16</sup> For examples of these rules, see Reg. §1.6038B-(a)(7), Examples 4 and 5.
- <sup>17</sup> The regulations reserve on indirect transfers through a foreign partnership. Reg. §1.6038B-2(a)(3).

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