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A World of Taxpayers? Not A Small World After All

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OUTLINE

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I. INTRODUCTION

The U.S. Internal Revenue Code ("Code") is an expansive document containing over 1,100 pages and 7 million words.[1] It reaches almost every facet of our economic lives, making tax considerations ubiquitous in American society. Few significant business decisions are undertaken in the United States without giving close consideration to the relevant tax implications. While U.S. persons have become accustomed to the omnipresent nature of our tax laws,[2] their potential relevance to foreigners is often overlooked.

It is well settled that, at least in certain limited areas, the reach of the U.S. tax law extends to foreign persons.[3] To what extent must foreign persons pay the same close attention to the Code as U.S. persons do? When the world was less mobile and most businesses operated in defined geographic areas, there was little need for foreigners to consider any U.S. tax implications of their actions. Only those foreign persons actually extending their businesses into the United States, or individuals becoming U.S. residents, had any cause to seriously consider the reach of the U.S. tax laws and the potential consequences of their past actions. However, today we operate in a thriving global economy with America serving as a crucial central player. To compete effectively, even small foreign businesses need to consider engaging in U.S. activities. Similarly, many foreign individuals, especially high-tech professionals, live and work in the United States. Consequently, more and more foreign persons must consider whether the Code had any application to them prior to their developing a U.S. connection.

The potential consequences of economic connections with the United States can be far reaching. For instance, if a French corporation was subject to all the rules of the Code prior to its opening of a U.S. branch, then the taxation of the U.S. branch could be adversely affected by the French company's failure to have made timely U.S. tax elections in the past (perhaps at a time when a future U.S. branch was not even contemplated). Conversely, even if the Code only becomes applicable to a foreign corporation after the opening of a U.S. branch, all future decisions of the foreign entity regarding its operations—even its foreign-only operations—still require a review of the Code for potential adverse consequences.

For example, assume a diversified French company operates one line of business solely in France and a completely different business activity solely in

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[1] *See generally* I.R.C. (2001).

[2] Will Rogers once quipped, "By the time you die, you should be so used to paying taxes that it would be almost second nature to you."

[3] For instance, when Francesca, an Italian national with no U.S. connection, buys her first house in Milan for a half-billion lira, the U.S. tax laws tell her she has a tax basis in that house of $250,000 (*i.e.*, a basis equal to her cost stated in dollars, assuming a 2000 Lira to 1 U.S. dollar exchange rate on the date of purchase). *See infra* Part II.A. for a detailed discussion of these basis rules. Of course, unless Francesca becomes a U.S. resident, or transfers her home to a U.S. person in a carryover basis transaction, she has little reason to pay attention to the technical application of the Code to her in this particular instance.

the United States. Due to the existence of a U.S. branch, the Code's provisions and elections may become applicable to the French-only business activity. Consequently, if the U.S. branch subsequently expands into the previously French-only line of business, its tax situation may be impacted by the prior activities and decisions of the French-only line of business. Similarly, the taxation of the U.S. branch, and the portions of the Code applicable to it, may be impacted by the nature of the global activities carried on by the foreign person worldwide.

The United States has a legitimate interest in taxing economic activity occurring within its borders. The relevant question is how far the Code should reach in prescribing rules applicable to a foreign person's activities outside the United States and how much of a U.S. nexus, if any, is required before specific provisions of the Code are so extended. It is often stated that, when relevant for U.S. tax purposes, a foreign person's tax history is recreated "as if" she had always been a U.S. person.[4] Consequently, all the rules of the Code would become applicable to her prior transactions and activities, regardless of the fact that she would have had no reason to ever consider such rules (or any associated elections) at the time of undertaking those transactions. Such a wholesale exportation of the Code to all past transactions is both unfair and unadministrable. Such a universal extension of the Code would require foreign persons without any significant U.S. activities to study and comply with U.S. tax rules, maintain duplicate sets of records, and often adjust the form of major transactions merely on the chance that a relevant U.S. connection might arise in

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[4] *See, e.g.*, Dep't of the Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals* 205-207 (Feb. 2000) [hereinafter "2001 Administration Proposals"] ("Under current law, a taxpayer that becomes subject to U.S. taxation may take the position that it determines its beginning bases in its assets under U.S. tax principles *as if* the taxpayer had historically been subject to U.S. taxation.") (emphasis added); *see also* Tech. Adv. Mem. 87-28-002 (Oct. 29, 1986) ("[I]n order to determine the application of the installment method rules to the contract payments in 1983 and 1984, *it must be determined what the U.S. tax treatment would have been in 1981 if taxpayer had been a resident at the time of the sale.*") (emphasis added); HUGH J. AULT, COMPARATIVE INCOME TAXATION: A COMPARATIVE ANALYSIS 373 (1997) (stating that in order to establish the tax history of a new subject it is necessary "to reconstruct past events *as if* they had taken place while the taxpayer was subject to the taxing system.") (emphasis added); Jeffery Colon, *Changing U.S. Tax Jurisdiction: Expatriates, Immigrants, and the Need for a Coherent Tax Policy*, 34 SAN DIEGO L. REV. 1, 74 ("[The] tax history [of a foreign asset brought into the U.S.] must be *recreated under U.S. tax principles* using U.S. dollars. Although it is possible to recreate the basis of property in simple cases, there is no guidance on how to take into account, for example, elections to deduct or capitalize certain expenses."); Keith E. Engel, *Importing Assets into Domestic Taxing Jurisdictions: Learning from Canada*, 52 TAX LAW. 275, 315 (1999) (noting that applying the U.S. basis adjustment provisions to assets brought into the U.S. is "a logical extension of a pure historic basis entry system that views entering assets *as if* they had always been within the U.S. taxing jurisdiction.").

In contrast, this article takes the position that such statements are misperceptions of the relevant law and that U.S. principles are not applied wholesale in these situations. Rather, the language of the Code and Congressional intent combine to indicate which provisions of U.S. law have relevance to foreign persons and which do not.

the future. In a practical sense such an extension of the Code would result in an entire world of U.S. taxpayers.[5]

Such generalizations regarding the universal scope of the Code are overbroad. However, in some situations provisions of the Code have been applied with worldwide scope irrespective of any U.S. nexus.[6] How is one to rationally determine whether, or when, any particular rule has a broad international application?

This article analyzes the relevant authorities on which generalizations regarding the supposed universal nature of the Code are typically based. The examination reveals that while certain limited aspects of the Code were intended to, and in fact do, apply universally to all persons on this planet (or presumably on any other),[7] a uniform application of the entire Code to all foreign persons is both unwarranted and unsupported by the language and structure of the Code. Instead, the proper paradigm for determining the scope of particular Code provisions is to review the language of the provision, its underlying policy objectives, and the relevant Congressional intent regarding its scope. Consequently, a key factor in determining the proper reach of any Code section should be whether the provision is specifically limited in scope by its very language.

This paper takes the position that the use of the term "taxpayer" in various sections of the Code serves this limiting function and prevents the application of such Code provisions to foreign persons unless they are directly liable for the particular type of tax governed by such provisions. Thus, the term "taxpayer" is not merely a generality whose use in a particular provision can be ignored. Conversely, the term "taxpayer" is also not monolithic in nature such that a foreigner paying one particular type of tax would force the conclusion that such person is also a taxpayer for purposes of every other provision in the Code.[8]

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[5] Indeed, some commentators have taken the position that the Code's definition of "taxpayer" in fact does include all persons in the world. *See* Harvey P. Dale, *Tax Accounting For Foreign Persons*, 37 TAX L. REV. 275, 277 (1982) ("The Code defines taxpayer to be 'any person subject to any internal revenue tax.' The definition of taxpayer has been interpreted in an expansive way: it includes any person who might have been subject to tax liability if he had received income from within the United States. As thus interpreted, there are more than four billion individual 'taxpayers' in the world!") (footnotes omitted).

[6] For example, the basis determination provisions of the Code apply to all persons regardless of their nexus with the United States. *See* Part II, *infra* (discussing these basis rules and certain other specific areas of intended universality under the Code).

[7] The Star Wars saga provides an analogous example of extending tax rules in a galaxy far, far away. *See* STAR WARS EPISODE I: THE PHANTOM MENACE (Lucas Films 1999) (illustrating how the Galactic Republic's taxation of trade routes with outlying star systems resulted in an escalating conflict with the planet Naboo, ultimately requiring the intervention of Jedi Knights (the guardians of peace and justice in the galaxy)).

[8] *See supra* note 3. Suppose Francesca (Italian homeowner) also happens to own some shares of IBM stock. Ignoring any tax treaty reductions, when IBM pays dividends on those shares it is required to withhold 30% of the dividend amount in U.S. taxes. I.R.C. § 871(a)(2001). Because Francesca has paid taxes to the U.S. through this withholding, she is presumably a taxpayer for withholding tax purposes. However, this paper takes the position that she would not be a taxpayer within the meaning of that term as used elsewhere in the Code. Indeed, taken to its extreme, a

Instead, each instance where the term "taxpayer" appears must be analyzed contextually to determine those persons (generally those persons actually liable for that particular type of tax) intended to be covered.

Part II of this article examines the primary authorities used to support a universal interpretation of the Code and demonstrates that these authorities merely represent instances where Congress has consciously chosen not to limit the reach of the Code. Part III analyzes the term "taxpayer" as used in the Code and concludes that the scope of the term is limited and its meaning must be interpreted in a contextual manner. Part IV examines certain authorities indicating that the term "taxpayer" has a broader, more universal meaning, and distinguishes or otherwise reconciles them with the more narrow contextual approach advocated in Part III. Part V makes some generalizations regarding the types of Code provisions that are limited in their reach and those that were intended to have broader application. Part VI examines special problems related to branch operations of foreign entities in interpreting the scope of the Code, using the taxpayer analysis developed in earlier sections. Part VII concludes that based on the history, language and structure of the Code, relying on the term "taxpayer" as a primary indication of a provision's scope is proper and correct.

II. GENESIS OF THE UNIVERSALITY CONCEPT

The generalization that the entire Code should apply universally and retroactively to any foreign person when relevant to a U.S. tax determination is derived primarily from three distinct lines of authority. The first is a series of rulings and cases dealing with the determination of the U.S. tax basis of a foreigner's property upon entry into the United States.[9] These cases generally hold that a foreign person's U.S. tax basis in property is its original cost translated into U.S. dollars, with certain adjustments for subsequent events and sustained depreciation.[10] The rule enunciated in these authorities comes directly from the fact that the relevant Code provisions purport to reach all property without stating any restriction regarding its location or the residency of its owner.[11] Consequently, these cases can be explained as a specific example of Congressional intent to broadly apply a specific U.S. tax rule, and do not demonstrate a broader universality concept applicable to the Code as a whole.

The second line of authority arises from the calculation of a foreign corporation's earnings and profits. Determining whether a distribution from a

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contrary position would require a foreign person paying even $1.00 of U.S. excise tax to be treated as a taxpayer for every purpose under the Code!

[9] *See* Rev. Rul. 55-62, 1955-1 C.B. 212; Gen. Couns. Mem. 34,572 (Aug. 3, 1971); Gutwirth v. Comm'r, 40 T.C. 666 (1963); Reisner v. Comm'r, 34 T.C. 1122 (1960); Feiks v. Comm'r, 17 T.C.M. (CCH) 642 (1958); Elek v. Comm'r, 30 T.C. 731 (1958); Slots v. Comm'r, 19 T.C. 183 (1952); Schnur v. Comm'r, 10 T.C. 208 (1948); Abraham v. Comm'r, 9 T.C. 222 (1947); Heckett v. Comm'r, 8 T.C. 841 (1947); Houdry v. Comm'r, 7 T.C. 666 (1946).

[10] *Id.*

[11] I.R.C. § 1012 (1986) ("The basis of property shall be the cost of such property. . . ."). Unless otherwise stated all section references are to the Internal Revenue Code of 1986 as amended and the relevant regulations thereunder.

corporation is classified as a dividend for U.S. tax purposes depends upon whether the distribution is made from the company's current or accumulated earnings and profits.[12] The Code's provisions dealing with corporate dividends makes no distinction between domestic and foreign corporations.[13] Consequently, when U.S. persons receive distributions (potentially representing taxable dividends) from foreign corporations, it is necessary to determine whether the foreign corporation had current or accumulated earning and profits at the time of the distribution.[14]

This second line of authority recognizes that the Code intended dividends and earnings and profits to be universal concepts.[15] These concepts must be determined under U.S. principles to effectuate Congress' understanding of the term's meaning rather than based on analogous foreign law concepts.[16] This authority is therefore consistent with a narrow application of the Code, except in areas where the Code's provisions were specifically intended to have broader application. Subsequently, Congress revisited this area and mandated the creation of more specific rules for calculating a foreign corporation's earnings and profits in certain situations.[17] However, these provisions implicitly indicate that the scope of the Code is generally limited to domestic application except where a specific, more universal impact is intended.

A third source of support for a universal application of U.S. tax principles is the Supreme Court's decision in *Biddle v. Commissioner*.[18] This case stands for the proposition that in determining the meaning of statutory language, terms should be presumed to have been used by Congress in the context of their generally accepted domestic meaning, absent a clear indication that a foreign law concept was intended.[19]

A. U.S. Tax Basis Rules

1. War Loss Cases

The determination of the U.S. tax basis of property owned by a non-U.S. person when that property becomes subject to U.S. net income tax has long been established. Under current law, the United States uses the historic cost basis of the property, rather than the fair market value at the time of the change in status.[20] This rule of law is grounded on a literal application of section 1012 of

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[12] I.R.C. § 316(a) (2001).
[13] I.R.C. §§ 301(a), 316(a), (2001).
[14] Utermeyer v. Comm'r, 59 F.2d 1004 (2nd Cir. 1932).
[15] *Id.*; I.R.C. §§ 312(k)(4), 964 (2001).
[16] *Untermeyer*, 59 F.2d at 1004; Biddle v. Comm'r, 302 U.S. 573 (1938).
[17] I.R.C. §§ 312(k)(4), 964 (2001).
[18] 302 U.S. 573 (1938).
[19] *See* Philip R. West, *Foreign Law in U.S. International Taxation: The Search for Standards*, 3 FLA. TAX REV. 147 (1996) (discussing *Biddle* and its proper implications for applying foreign law to U.S. tax questions).
[20] Colon, *supra* note 4, at 62. In 2000, the Clinton Administration proposed that property brought into the United States be given a fair market value basis on entry—that is, that its tax basis be

the Code that mandates the basis of property (wherever situated or however owned) is the cost of such property, and on the general proposition that a mere change in the property's status with respect to the U.S. taxing jurisdiction is not a sale or exchange that triggers the recognition of the inherent gain or loss in the asset.[21] The concept that property takes a cost basis is a universal one based on the statute's language. Additionally, in the absence of a statutory definition, the term "cost" must be interpreted based on Congress's understanding of the term's meaning in a domestic context. Consequently, it is irrelevant whether a foreign jurisdiction would treat any particular expense as an element of "cost." This represents a longstanding interpretation of the relevant provisions.

In 1955, the Internal Revenue Service ("Service") ruled that a nonresident alien who becomes a resident must recognize the full amount of gain inherent in his property if the property is subsequently sold, despite the fact that a portion of such gain accrued prior to his obtaining residency.[22] Although this ruling established the basic principle that assets entering the United States retain their historic basis rather than taking a fair market value basis at the time of entry, it did not explicitly state its rationale or explain how basis was to be determined.[23] In 1971, the Service had occasion to further examine the rules for determining asset basis for foreign persons becoming U.S. residents.[24] The Service further examined whether different rules should apply depending on a person's resident or nonresident status or the source of the income derived.[25] In holding that the normal basis provisions of the Code should apply to determine the basis of property outside the United States even if held by nonresident aliens, the Service stated:

> We believe that the general statutory basis provisions set forth in sections 1001 and 1011 of the Code are applicable in determining the amount of gain or loss under the circumstances about which you have inquired. In this connection, we think that there is no authority for distinguishing between treatment of resident and nonresident aliens, or between treatment of U.S. source and foreign source income.[26]

The Service based its conclusion on the fact that under the Code, gross income includes gains from property dispositions without making any attempt to limit the reach of either this provision or the related basis determination provisions.[27] Thus, assets coming into the United States take an historic basis determined under the relevant provisions of the Code, which by their terms mandate universally applicable basis calculations.

"marked-to-market." However, Congress never adopted this proposed change. *See* 2001 Administration Proposals, *supra* note 4.

[21] I.R.C. § 1012 (2000).

[22] Rev. Rul. 55-62, 1955-1 C.B. 212.

[23] See id.

[24] Gen. Couns. Mem. 34,572 (Aug. 3, 1971).

[25] Id.

[26] *Id.*

[27] Id.

These principles were first applied in a series of cases dealing with persons who became U.S. citizens or resident aliens as a result of fleeing Nazi oppression in the 1930s and 40s.[28] Such taxpayers often owned property in Europe, which was either damaged or confiscated as a result of the war.[29] These taxpayers would attempt to claim a loss for U.S. tax purposes as a result of such damage or confiscation.[30] Such claims were often based on section 127 of the Internal Revenue Code of 1939 ("1939 Code") dealing with certain World War II losses.[31] Alternatively, sometimes the confiscated or lost property was later recovered by the taxpayer only to be subsequently destroyed or damaged at a later point in the war. In such circumstances, section 127 of the 1939 Code provided a special basis provision giving the property a basis equal to its fair market value at the time of recovery.[32] However, the taxpayer could affirmatively elect to have such fair market value (and thus the post-recovery tax basis) deemed to be equal to her adjusted basis in the property at the time of confiscation.[33] This basis could then be used in claiming a casualty loss or subsequent depreciation on the property to the extent allowable under the Code.[34]

A representative case in this genre is *Gutwirth v. Commissioner*.[35] In *Gutwirth*, a foreign individual owned and operated a diamond-cutting factory in Belgium that was ultimately confiscated by the German government.[36] The individual then relocated to the United States and restarted his business.[37] The taxpayer ultimately recovered his Belgian diamond-cutting factory in 1944, but it was subsequently destroyed as a result of later German bombing.[38] The court determined that the property was recovered in 1944.[39] Therefore, the taxpayer's election to take a U.S. tax basis equal to the property's tax basis at the time it was originally confiscated, rather than its fair market value upon recovery, was permissible in determining his ultimate tax loss.[40]

The court then determined the basis at the time of confiscation under U.S. tax principles (despite the foreign status of the taxpayer at all times prior to the confiscation) by (1) adding certain capital expenditures to the property's original cost despite the fact that these amounts had been deducted for foreign tax

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[28] *See* Gutwirth v. Comm'r, 40 T.C. 666 (1963); Reisner v. Comm'r, 34 T.C. 1122 (1960); Feiks v. Comm'r, 17 T.C. M. (CCH) 642 (1958); Elek v. Comm'r, 30 T.C. 731 (1958); Slots v. Comm'r, 19 T.C. 183 (1952); Schnur v. Comm'r, 10 T.C. 208 (1948); Abraham v. Comm'r, 9 T.C. 222 (1947); Heckett v. Comm'r, 8 T.C. 841 (1947); Houdry v. Comm'r, 7 T.C. 666 (1946).
[29] *Id.*
[30] *Id.*
[31] Analogous provisions also appeared in subsequent versions of the Code until their ultimate repeal as deadwood. *See* I.R.C. §§ 1331 – 1337 (1939) (repealed 1976).
[32] I.R.C. § 127 (1939).
[33] Id.
[34] Id.
[35] 40 T.C. 666 (1963).
[36] *Id.* at 667-69.
[37] *Id.* at 668-70.
[38] *Id.* at 671-72.
[39] Id.
[40] *Gutwirth*, 40 T.C. at 677-78.

purposes and (2) by reducing that amount by the estimated depreciation on the factory.[41] The court stated:

> The Government has argued that there should not be any upward revisions to the original basis on account of subsequent capital additions, since these additions were treated as expenses in Belgium. We cannot accept that position. Regardless of how these additions were treated in Belgium years ago, they in fact represented capital expenditures, and the basis of the property must be adjusted to reflect such capital items. On the other hand, we reject the petitioners' contention that there would be no downward adjustments to basis in respect of depreciation. We have always required that basis be adjusted to reflect depreciation in circumstances such as these. *See, e.g.*, Abraham v. Commissioner, 9 T.C. 222, 227 (1947). *The contrary view would discriminate in favor of nonresident aliens owning property abroad as against resident taxpayers in identical situations. In the absence of a clear statutory command to that effect, we cannot assume that Congress intended any such discrimination.*[42]

The emphasized language indicates that while the court viewed the basis provisions of the Code as applying generally to all persons whether citizens or aliens, it recognized that Congress could direct otherwise by appropriate language. Thus, Congress can designate certain Code provisions as not applicable to foreign activities and persons, despite the fact that other provisions may be intended to have a universal scope, such as the basis rules. In determining whether Congress intended particular Code provisions to be universal or more limited, it is relevant to examine the purpose of the provision and the policy implications arising from applying the provision broadly or narrowly.

The other war loss cases are similar to *Gutwirth* but contain even less in terms of analysis regarding the method or rationale for adjusting basis for depreciation.[43] *Gutwirth* and the other war loss cases indicate that historic basis determinations are to be made using the dollar exchange rate existing at the time the foreign person acquired the property.[44]

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[41] *Id.* at 678. During the period under consideration in *Gutwirth*, the relevant statutory provisions regarding depreciation adjustments did not explicitly require downward basis adjustments for foreign owned property. This statutory gap was remedied in 1954 with the addition of section 1016(a)(3) to the Code. However, even absent a specific statutory requirement, the court was correct in requiring depreciation adjustments in light of previously established U.S. tax common law principles that basis should be adjusted for depreciation sustained even during periods a property was not subject to U.S. taxation (*e.g.*, in periods prior to the enactment of the U.S. income tax in 1913). The development of the statutory depreciation adjustment provisions and the relevance of section 1016(a)(3) is discussed below. *See infra* Part II. A-B.

[42] *Gutwirth*, 40 T.C. at 678-79 (emphasis added).

[43] *See* Reisner v. Comm'r, 34 T.C. 1122 (1960); Feiks v. Comm'r, 17 T.C.M. (CCH) 642 (1958); Elek v. Comm'r, 30 T.C. 731 (1958); Slot v. Comm'r, 19 T.C. 183 (1952); Schnur v. Comm'r, 10 T.C. 208 (1948); Abraham v. Comm'r, 9 T.C. 222 (1947); Heckett v. Comm'r, 8 T.C. 841 (1947); Houdry v. Comm'r, 7 T.C. 666 (1946).

[44] *See* Freudmann v. Comm'r, 10 T.C. 775 (1948) (using exchange rate at the time of acquisition to determine the U.S. dollar basis of diamonds a nonresident alien acquired with Belgian francs.);

2. Foreign Depreciation Adjustments

The conclusion reached in *Gutwirth* and the war loss cases is premised on the universality of the language in the basis provisions of the Code.[45] Indeed, the fact that those particular provisions were generally intended to have universal application was further confirmed in 1954 by the adoption of section 1016(a)(3)(A), a specific rule regarding the depreciation adjustments to be made in the basis of property owned by persons not subject to U.S. income taxation.[46] The legal history of requiring basis adjustments for depreciation generally, and of section 1016(a)(3)(B) in particular, is useful in understanding the war loss cases as well as serving as an illustration of the Code specifying different rules for persons subject and not subject to U.S. taxation.

Section 1012 of the Code provides that property takes a cost basis for U.S. tax purposes.[47] Section 1011 further provides that the original basis of property must be adjusted to reflect the items specified in section 1016.[48] Section 1016(a)(1) provides that capital expenditures in respect of property must be added to basis unless such amounts were actually taken as deductions in determining U.S. taxable income.[49] All of these provisions apply to "property" generally, without limitation as to its situs or the nature of the owner. Thus, the war loss cases and other authorities have interpreted the provisions, based on their history and Congressional intent, as applying universally to all persons and property. However, the specific provisions of section 1016, dealing with depreciation adjustments, provide rules that clearly differentiate between persons based on whether they are in fact subject to U.S. net income taxation.[50]

The provisions of section 1016 dealing with downward adjustments in the basis of property for "exhaustion, wear and tear, obsolescence, amortization, and depletion" (referred to herein as "depreciation") are somewhat involved.[51]

Heckett v. Comm'r, 8 T.C. 841 (1947) (denying war losses where taxpayer could not show cost of items using acquisition date exchange rates.). Using historic conversion rates preserves any gain or loss that may have occurred based on the fluctuations in currency exchange rates. Although sections 985-989 of the Code now provide detailed rules regarding the tax treatment of foreign currency exchange gains and losses, their impact on the use of historic exchange rates in these situations is somewhat unclear. *See infra* Part VI.

[45] *See* Gutwirth v. Comm'r, 40 T.C. 666 (1963); Reisner v. Comm'r, 34 T.C. 1122 (1960); Feiks v. Comm'r, 17 T.C. M. (CCH) 642 (1958); Elek v. Comm'r, 30 T.C. 731 (1958); Slots v. Comm'r, 19 T.C. 183 (1952); Schnur v. Comm'r, 10 T.C. 208 (1948); Abraham v. Comm'r, 9 T.C. 222 (1947); Heckett v. Comm'r, 8 T.C. 841 (1947); Houdry v. Comm'r, 7 T.C. 666 (1946).

[46] I.R.C. § 1016(a)(3)(A) (2001).

[47] *See* I.R.C. § 1012 (2001).

[48] *See* I.R.C. § 1011 (2001).

[49] I.R.C. § 1016 (a)(1) (2001). In the context of *Gutwirth*, (discussed above) this principle was applied to permit the cost of improvements to a factory by a nonresident alien (which amounts constituting capital expenditures under U.S. tax principles) to be added to the cost basis of the property despite the fact that such amounts were in fact deducted for Belgian tax purposes. Thus, the scope and application of the adjustments required under section 1016(a)(1) are relatively clear from the statutory language and their application is well settled. *Gutwirth*, 40 T.C. at 666.

[50] I.R.C. § 1016(a) (2001).

[51] *Id.* § 1016(a)(2).

Section 1016(a)(2) provides that the basis of property acquired after February 28, 1913 is decreased by the amount actually allowed as a deduction in computing a person's U.S. tax liability, but not less than the amount allowable under the Code.[52] Section 1016(a)(3)(A) provides that the basis of property acquired before March 1, 1913 is adjusted for depreciation actually "sustained."[53] Similarly, section 1016(a)(3)(B) provides that the basis of property is also adjusted for depreciation "sustained" in periods after February 28, 1913 during which the property "was held by a person or an organization not subject to [U.S.] income taxation."[54]

The relevant regulations indicate that the amount of depreciation actually "sustained" is the amount charged off on the books of the taxpayer where such amount is considered by the Commissioner to be reasonable, and in other cases would equal the amount that would have been allowable as a deduction if the person had been subject to income tax during the relevant period but using a straight line method of depreciation.[55]

Based on this statutory scheme it would appear that a foreign person, not subject to income taxation, would adjust basis to reflect "sustained" depreciation pursuant to section 1016(a)(3)(B) rather than calculate the depreciation adjustments under section 1016(a)(2) "as if" he were a U.S. taxpayer. This approach comports with the general rule that the basis provisions were intended to apply universally except to the extent specifically provided. Nevertheless, certain Service pronouncements have taken conflicting positions as to which provision applies in the foreign context.[56] However, before discussing the merits of the conflicting Service positions regarding the applicability of section 1016(a)(3)(B), a review of the evolution of the current provisions is required.[57]

As originally enacted in 1913, the U.S. income tax provisions provided no rule regarding basis determinations. In 1916, Congress added a provision specifying that the basis (for purposes of determining gain or loss) of property acquired before March 1, 1913 was equal to the fair market value of the property on that date.[58] This rule was expanded in 1921 to require the same basis to be used for purposes of calculating depreciation.[59] The 1921 changes also limited the basis for determining loss to the lower of original cost or the value of the property on March 1, 1913.[60] Although no statutory provision existed prior to

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[52] *Id.*.
[53] *Id.* § 1016(a)(3)(A).
[54] *Id.* § 1016(a)(3)(B).
[55] Treas. Reg. § 1.1016-4(b) (as amended in 1963).
[56] Tech. Adv. Mem. 87-49-008 (Aug. 18, 1987); Prop. Treas. Reg. §§ 1.016-3, 1.1016-4; 49 Fed. Reg. 5940 (Feb. 16, 1984); Gen. Couns. Mem. 39,291 (Sept. 24, 1984); Priv. Ltr. Rul. 84-38-058 (June 20, 1984); Mary Voce, *Basis of Foreign Property That Becomes Subject to U.S. Taxation*, 49 TAX LAW. 341 (1996) (discussing the depreciation reduction rules for foreign assets and the conflicting Service authorities).
[57] *See* Mary Voce, *Basis of Foreign Property That Becomes Subject to U.S. Taxation*, 49 TAX LAW. 341 (1996) (providing a detailed description of the relevant statutory changes).
[58] Revenue Act of 1916, ch. 463, § 2(c), 39 Stat. 756, 758 (1916).
[59] Revenue Act of 1921, ch. 136, §§ 214(a)(8), 234(a)(7), 42 Stat. 227, 240, 255 (1921).
[60] *Id.* § 202(b)(1)-(3), 42 Stat. at 229-30.

1924 for adjusting basis downward for depreciation, the courts uniformly held that even in the absence of a statute mandating adjustments to basis for depreciation, downward adjustments were required in every case.[61] That is, under general tax principles, downward adjustments to basis were required in the cost basis of property, even for periods prior to 1913, without any specific statutory directive in this regard.[62]

In 1924, Congress again revised the basis provisions to create a uniform rule that for purposes of gain, loss, and depreciation, the basis of property acquired before March 1, 1913 would equal the *greater* of the property's original cost or its March 1, 1913 value.[63] The 1924 enactment for the first time included a specific provision that basis, once determined, should be reduced for depreciation "previously allowed."[64] This phrasing created confusion regarding whether the proper adjustment was for amounts actually claimed or for amounts which could have been claimed and whether any adjustment was still appropriate for depreciation in periods prior to 1913 as the courts had previously required.

In 1926, Congress clarified the law by requiring that for periods after March 1, 1913 basis be adjusted by the greater of the amount allowed or the amount allowable, thereby keying literal statutory adjustment to persons actually liable for U.S. income taxes after 1913.[65] However, Congress also adopted a specific provision confirming that the basis of property must also be adjusted for depreciation "sustained" prior to March 1, 1913 in accordance with the rule established by prior case law.[66] The relevant legislative history stated:

> Owing to the fact that there was no income tax prior to March 1, 1913, in cases where property was acquired prior to that date no depreciation had been "allowed," and the taxpayer may receive too large a basis for determining gain or loss. The amendment proposed provides that the deductions for depreciation, etc., to be made in such cases shall be such deductions as were actually sustained with respect to such property,

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[61] *See generally*, Koepfli v. Comm'r, 13 B.T.A 784 (1928), *aff'd*, 41 F.2d 606 (9th Cir. 1930); Title Ins. & Trust Co. v. Comm'r, 11 B.T.A. 288 (1928); Noaker Ice Cream Co. v. Comm'r, 9 B.T.A. 1100 (1928); *In re* Even Realty Co., 1 B.T.A. 355 (1925).

[62] The existence of this common law, requiring depreciation during periods when an asset was not subject to U.S. taxation, is directly applicable to the conclusions the courts reached in the war loss cases. Even though the statutory provisions in existence during the periods covered by those decisions explicitly provided for depreciation adjustments only for persons subject to U.S. taxation, these common law principles support the courts' conclusion that depreciation adjustments were in fact required. Thus, it is not necessary to read the war loss cases as applying the relevant Code provisions existing at that time regarding depreciation adjustments "as if" the foreigner was a U.S. person in order to justify the result reached by those courts. Indeed, *Gutwirth* and many of the war loss cases fail to make any explicit reference to the then existing statutory provisions requiring depreciation adjustments. *See Gutwirth*, 40 T.C. at 666.

[63] Revenue Act of 1924, ch. 234, §§ 204(b)-(c), 43 Stat. 253, 259-60 (1924).

[64] *Id.* § 202(b), 43 Stat. at 255.

[65] Revenue Act of 1926, ch. 27, § 202(b)(2), 44 Stat. 9, 12 (1926).

[66] *Id.*

> which would include such depreciation as had occurred prior to that date.[67]

Thus, after 1926, the predecessor rules to sections 1016(a)(2) and (a)(3)(A) were in place. However, no specific rules existed in the Code for the determination of post-1913 depreciation adjustments for persons not subject to U.S. income taxation until the adoption of section 1016(a)(3)(B) in 1954. In this regard, it is relevant to note that even in the absence of a specific statutory requirement, the Service and the courts in the war loss cases took the position that a nonresident was required to adjust his basis for depreciation prior to becoming subject to U.S. taxation.[68] However, the relevant case law was somewhat unclear as to whether the predecessor to section 1016(a)(2) was being applied or whether the result was reached under analogous principles of U.S. tax law akin to those used to provide for pre-1913 depreciation adjustments prior to the adoption of the predecessor to section 1016(a)(3)(A). Similarly, prior to 1954, the Service took the position that a tax-exempt entity was required to adjust the basis of its assets to reflect depreciation sustained during periods it was not subject to income taxation due to its tax-exempt status.[69]

In response to a 1950 statutory change resulting in a number of previously tax-exempt entities becoming subject to taxation, Congress adopted section 1016(a)(3)(B) in 1954. Congress did so to affirm and codify the Service's historic interpretation of the proper manner to tax account for depreciation upon the conversion of a tax-exempt domestic entity into a taxable one.[70] The relevant legislative history provided:

> Where a tax-exempt organization which has held a property for a number of years becomes taxable (as in the case of the application of the unrelated business income tax since the Revenue Act of 1950) questions have been raised as to what basis the property should have for purposes of computing depreciation for income tax purposes. The alternatives available are the original cost of the property, its fair market value at the time the organization becomes taxable, or its cost less depreciation and obsolescence which has taken place during the interval prior to the time when the organization becomes taxable. *The present code does not deal specifically with this problem.* The rule presently followed by [the Service] is the third alternative described above. The House and your committee have endorsed the position taken by the Service by specifically providing in the new code that the basis of the property, for purposes of computing taxable income, is reduced for exhaustion, wear, tear, obsolescence, amortization, and

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[67] S. Rep. No. 69-52, at 16 (1926).

[68] *See* Gutwirth v. Comm'r, 40 T.C. 666 (1963); Reisner v. Comm'r, 34 T.C. 1122 (1960); Feiks v. Comm'r, 17 T.C. M. (CCH) 642 (1958); Elek v. Comm'r, 30 T.C. 731 (1958); Slots v. Comm'r, 19 T.C. 183 (1952); Schnur v. Comm'r, 10 T.C. 208 (1948); Abraham v. Comm'r, 9 T.C. 222 (1947); Heckett v. Comm'r, 8 T.C. 841 (1947); Houdry v. Comm'r, 7 T.C. 666 (1946).

[69] *See* Gen. Couns. Mem. 27,491 (1952); Treas. Reg. § 29.423-3(a)(2) (1952); Rev. Rul. 54-381, 1954-2 C.B. 163, *declared obsolete by* Rev. Rul. 70-594, 1970-2 C.B. 301.

[70] S. Rep. No. 83-1622, at 108 (1954).

> depletion to the extent sustained during any period since 1913 when the property was held by an organization not subject to income taxation.[71]

Although the legislative history does not specifically indicate that the provision was intended to apply to foreign persons, nothing in the legislative history prohibits this interpretation and the literal words of the statute are sufficiently broad to encompass all persons not subject to U.S. taxation. Additionally, a consistent application of depreciation adjustments for periods when an asset was not subject to taxation (either because the income tax did not exist, the owner was a tax-exempt entity, or the owner was a foreign person not subject to U.S. tax) would seem to mandate this approach in the context of a foreign person.

Finally, the pre-1954 depreciation reductions required by the Service for domestic tax-exempt entities were also endorsed by the Service and the courts in respect of nonresident aliens not subject to U.S. income taxation as evidenced in the war loss cases discussed previously.[72] Consequently, the statutory language of section 1016(a)(3)(B) should provide the relevant rules for adjusting the basis of a foreign person or entity during periods it is not subject to U.S. income taxation.

However, despite the statutory language, the Service has taken inconsistent positions as to whether sections 1016(a)(2) or (3)(B) apply to the importation of foreign assets into the United States.[73] In a 1987 technical advice memorandum, the Service addressed a foreign corporation, which was not a controlled foreign corporation, that had used an offshore drilling rig outside the U.S. from 1967 to 1975.[74] The memorandum discussed the relevant basis for depreciation when the rig was subsequently brought into U.S. waters in 1975 (and the foreign corporation began a U.S. trade or business for the first time) and applied section 1016(a)(2).[75] The Service determined the pre-U.S. depreciation adjustment for the period 1967 to 1975 based on the depreciation that would have been allowable under the Code to a domestic taxpayer.[76] Thus, the Service applied a ten-year double declining balance method.[77] The Service did not discuss how the corporation treated the drilling rig on their books, nor did the Service explain why section 1016(a)(3)(B) was inapplicable.[78] Indeed, the ruling primarily relies on *Gutwirth.*[79] *Gutwirth* does not stand for the proposition that the Code always applies on an "as if they were U.S. persons" basis to foreigners and makes no

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[71] *Id.* (emphasis added).
[72] *See* Gutwirth v. Comm'r, 40 T.C. 666(1963); Reisner v. Comm'r, 34 T.C. 1122 (1960); Feiks v. Comm'r, 17 T.C. M. (CCH) 642 (1958); Elek v. Comm'r, 30 T.C. 731 (1958); Slots v. Comm'r, 19 T.C. 183 (1952); Schnur v. Comm'r, 10 T.C. 208 (1948); Abraham v. Comm'r, 9 T.C. 222 (1947); Heckett v. Comm'r, 8 T.C. 841 (1947); Houdry v. Comm'r, 7 T.C. 666 (1946).
[73] *See* I.R.C. § 1016(a)(2), (3)(B) (2001).
[74] Tech. Adv. Mem. 87-49-008 (Aug. 18, 1987).
[75] *Id.*
[76] *Id.*
[77] *Id.*
[78] *Id.*
[79] *See* Tech. Adv. Mem. 87-49-008 (Aug. 18, 1987).

explicit reference to section 1016(a)(2).[80] Similarly, in proposed regulations dealing with an accelerated depreciation system, the Service appears to apply section 1016(a)(2) to determine the basis of foreign persons rather than section 1016(a)(3)(B).[81]

These authorities exemplify a lack of clarity and attention to the exact statutory provisions relevant to such situations. In particular, these authorities reflect a misunderstanding of the difference in meaning of depreciation "allowable" (*i.e.*, depreciation adjustments for property subject to U.S. net income tax) and depreciation "sustained" (*i.e.*, depreciation adjustments for property not subject to U.S. net income tax) under the Code and a failure to fully understand the import of *Gutwirth*. It is relevant to note that even after the proposed accelerated depreciation regulations were published in February of 1984, the Service applied the rules of section 1016(a)(3)(B) in determining a foreign corporation's basis for depreciation in calculating its earnings and profits.[82]

In light of the foregoing, the fairest reading of the relevant Code provisions in sections 1012, 1011, and 1016 is that the Code applies to determine the basis of a foreign person by adjusting the cost basis of the asset for depreciation sustained during the period the asset is not subject to U.S. income taxation. In other words, depreciation adjustments provide an example of where the Code applies differently depending on whether persons are subject to U.S. tax. The adjustments thus confirm the general proposition that while in certain areas U.S. tax principles may be made generally applicable to determine the U.S. implications of foreign transactions, Congressional intent and statutory language can and do limit the Code's reach.

B. U.S. Earnings and Profits Rules

Another area of U.S. tax law that is sometimes used to support the universal application of the Code is in the realm of determining a foreign corporation's earnings and profits. However, examination reveals that this extension of U.S. tax principles to foreign entities again derives from the language and intent of the relevant Code provisions and not from a general principle of universality inherent in the entire Code. More specifically, section 316 generally provides that a "dividend" is any distribution to shareholders made by a corporation (whether or not subject to U.S. tax) out of current or accumulated "earnings and profits."[83] Although the Code does not specifically define the meaning of the phrase "earnings and profits," section 312 provides a number of specific adjustments

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[80] *See* Gutwirth v. Comm'r, 40 T.C. 666 (1963).

[81] *See* Prop. Treas. Reg. §§ 1.016-3, 1.1016–4; 49 Fed. Reg. 5940 (Feb. 16, 1984).

[82] *See* Gen. Couns. Mem. 39,291 (Sept. 24, 1984); *see also* Priv. Ltr. Rul. 84-38-058 (June 20, 1984); Mary Voce, *Basis of Foreign Property That Becomes Subject to U.S. Taxation*, 49 TAX LAW. 341 (1996) (discussing the depreciation reduction rules for foreign assets and the conflicting Service authorities).

[83] I.R.C. § 316(a)(2) (2001).

required to be made in arriving at a corporation's earnings and profits.[84] By their terms, these provisions, and therefore the phrase "earnings and profits," apply to all "corporations" without distinction as to whether the corporation is domestic or foreign.

The concept that sections 316 and 312 were intended to apply universally and that U.S. principles generally apply to determine the meaning of the phrase "earnings and profits" is found very early in the relevant case law. For instance, in *Untermyer v. Commissioner*[85] it was necessary to determine the earnings and profits of a Canadian company to know whether a distribution received by a U.S. shareholder was a dividend under the analogous provision to current section 316.[86] The court ruled that Canadian law was irrelevant to determining earnings and profits for U.S. purposes, particularly to the appropriate allowances for natural resource depletion.[87] Instead, the court held that U.S. tax principles must be used to determine the appropriate depletion amounts on foreign mines in determining earnings and profits.[88]

The interplay of sections 312(k)(1) and (4) also demonstrate the operation of specific Congressional intent in this area to have the concept of earnings and profits apply universally, except in specific enumerated circumstances. Section 312(k)(1) provides that for calculating earnings and profits, depreciation deductions must be calculated using the straight-line method, even if an accelerated method were otherwise used.[89] However, section 312(k)(4) specifically provides that this limitation does not apply to a foreign corporation if less than 20% of its gross income is derived from U.S. sources.[90] This demonstrates an example of the Code specifying when provisions are universal and when they have limited scope.

Further, in section 964, Congress also explicitly recognized that while all foreign corporations are required to determine their earnings and profits for U.S. purposes in accordance with the rules of sections 316 and 312 and general U.S. tax principles, limitations on the nature of the concept were required to make the provisions of Subpart F administrable.[91] Although universally people recognized the earnings and profits concept prior to the adoption of Subpart F, people were uncertain as to the mechanics of its application. This uncertainty was compounded by the fact that the concept of "earnings and profits" was an amorphous one even in the domestic context since no specific definition was contained in the Code. However, in the domestic context, people generally accepted that the starting point for calculating earnings and profits was a corporation's taxable income. The proper starting point for a foreign

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[84] *Id.* § 312(a).
[85] 59 F.2d 1004 (2d Cir. 1932).
[86] *Id.*
[87] *Id.* at 1005.
[88] *Id.*
[89] I.R.C. § 312(k)(1) (2001).
[90] *Id.* § 312(k)(4).
[91] I.R.C. § 964(a) (2001).

corporation, especially one without any U.S. source income, was therefore unclear. One commentator at that time noted that:

> As a practical matter, the common practice is to determine both the total profits of the foreign affiliate and its accumulated profits by reference to the income reflected in the accounts of the foreign affiliate rather than in the tax returns of the foreign affiliate or by reference to the technical provisions for determining earnings and profits for United States income tax purposes.[92]

In effect, requiring a foreign corporation or a U.S. shareholder of a foreign corporation to determine its earnings and profits exactly as if it were a domestic corporation was a practical impossibility for most foreign companies. As another commentator noted:

> [Computing earnings and profits exactly as if a foreign corporation were a domestic entity] would require in effect that the accounts of the foreign corporation be recast in accordance with [U.S. tax and accounting] standards. Either the corporation would have to maintain another set of books, or the shareholders would have to make adjustments in its financial statements to achieve the same result. Recasting the accounts of a foreign entity is likely to be a costly and time-consuming procedure. To keep another set of books probably would entail the use of additional bookkeeping personnel. Since foreign employees usually are not familiar with United States tax and accounting practices, it also may necessitate a substantial training effort or the substitution of United States employees. The latter course in particular may adversely affect relations between the enterprise and the foreign government. On the other hand, reconstructing the records of the foreign company through adjustments to its financial statements could well prove unduly burdensome, requiring as it does the elimination of even the most minor and insignificant differences between United States and foreign practices.[93]

As a reflection of the practical difficulties in applying the earnings and profits concept universally to foreign corporations, Congress consciously decided to limit the reach of that concept in the context of Subpart F by enacting section 964.[94] In relevant part, section 964 provides that for purposes of Subpart F of the Code the earnings and profits of a foreign corporation "shall be determined according to rules *substantially similar* to those applicable to domestic corporations, under regulations prescribed by the Secretary."[95] Thus, section 964

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[92] Albert H. Cohen, *Tax Accounting Problems in International Operations*, 18 N.Y.U. TAX INST. 293, 312-13 (1960).

[93] Stanley Weiss, Application of American Accounting Methods to Foreign Operations: Government Objectives in Setting up Accounting Requirements, 23 N.Y.U. TAX INST. 981, 985 (1965).

[94] Although the reach of section 964 subsequently has been expanded beyond Subpart F to include determinations of earnings and profits under sections 1248 and 902, its limiting impact on the otherwise universal phrasing of sections 316 and 312 is still operative.

[95] I.R.C. § 964(a) (2001) (emphasis added).

provided the Service with regulatory authority to create more administrable rules for determining earnings and profits while still generally reaching results in line with those that would have been reached by a full application of U.S. tax and accounting rules. In consultation with experts on international accounting principles, the Service eventually promulgated regulations aimed at achieving this goal. In this regard the current regulations:

> [S]trike a balance between computing earnings and profits solely as though the foreign corporation was a U.S. corporation on the one hand and complete acceptance of foreign accounting concepts on the other. By so doing, the regulations prevent such problems as requiring the foreign corporation to keep a second set of books or to recast its accounts on an item-by-item basis. In addition, by striking such a balance, the difference in procedures utilized in various countries is no longer significant. Accordingly, under the regulations' approach, foreign profit or loss is used as the starting point of the computation, but adjustments are made to eliminate any material differences from the treatment required under U.S. tax and accounting procedures.[96]

Consequently, the adoption of section 964 represents yet another example of Congress specifically limiting the scope of Code provisions in a manner consonant with the intended purpose of the relevant provisions.[97] As such, section 964 does not stand for the proposition that foreign corporations are always treated "as if" they were U.S. persons, but rather represents an explicit Congressional limitation on the application of the general earnings and profits concepts, which by their terms otherwise would apply to all corporations universally. In the case of section 964, Congress apparently found that it needed to cut back on a rule that itself purports to apply universally (*i.e.*, the determination of "earnings and profits" of any corporation) because such a universal rule was essentially unadministrable once it had any widespread practical application. This was the case with the creation of the Subpart F regime.[98]

Indeed, the enactment of section 964 shows that it would be inappropriate to adopt a general rule of statutory interpretation providing that the Code should be viewed as applying to all persons at all times.[99] Such an approach would likely result in unadministrable tax laws because it would demand a recreation of a person's tax history based on U.S. principles that were not relevant at an earlier time. This approach to interpreting the Code may also demand unrealistic production of records and dedication of resources to create U.S. tax records. Further, this approach, if adopted by other jurisdictions, would effectively submit a person (or transaction) to every potential taxing jurisdiction (including U.S. tax

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[96] Lorraine S. Rothenberg & Lowell D. Yoder, *Subpart F-Sections 959-964, 1248 and Related Provisions*, 930 TAX MGMT. PORT. (BNA) A-50 (1999).
[97] I.R.C. § 964 (2001).
[98] In the case of basis determination, such a rule is administratable because original cost is a single determination that is likely to have been made in any event.
[99] *See* I.R.C. § 964 (2001).

jurisdiction) at a time when those taxes are not relevant. The approach would further create an untenable tax planning burden. The Code by its own terms can and does limit its reach in many circumstances. Such limitation reflects rational policy and should be respected when particular Code provisions with these limitations are being interpreted.

C. The Biddle Case

Another case often cited for the proposition that U.S. tax rules apply universally is *Biddle v. Commissioner*.[100] An examination of the case indicates that it is significantly more narrow. In *Biddle*, the Court had to determine whether a U.S. person owning stock in a British corporation could claim a credit for foreign taxes paid directly by that corporation.[101] The Court held that the only way to determine whether the taxes paid by the British corporation should be treated as taxes paid by its U.S. shareholders within the meaning of the U.S. tax provisions was by using U.S. law.[102] The Court deemed irrelevant the fact that under the British tax laws such taxes were deemed paid by the corporation's shareholders.[103] Thus, the context of the case did not involve the question of whether U.S. tax provisions or concepts were applicable to a foreign person.[104] Instead, the issue was merely what Congress intended when it used specific statutory language in the relevant U.S. tax provision.[105] In this light, the conclusion that, absent a clear contrary intent, Congress should be presumed to have been speaking in terms of U.S. principles when it employed particular language in a tax statute hardly seems controversial.

Although courts have cited *Biddle* for the broad proposition that U.S. tax principles apply to foreign entities "as if" they were U.S. taxpayers, the actual statement of the relevant legal standard in the case indicates that the Court was observing that U.S. tax terms and principles can apply universally when intended by Congress.[106] However, they may not be so universally applied if a contrary interpretation is indicated by the language of the Code or Congressional intent and purpose.[107] In this regard the *Biddle* court commented:

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[100] 302 U.S. 573 (1938).
[101] *Id.* at 575-77.
[102] *Id.* Although the literal holding in *Biddle* was subsequently changed by treaty, the logic of the case has survived. *See, e.g.*, United States v. Goodyear Tire & Rubber Co., 493 U.S. 132, 145 (1989) ("Lastly, we find support for the Government's position in the statutory canon adopted in *Biddle v. Commissioner*, 302 U.S. 573, 578 (1938), that tax provisions should generally be read to incorporate domestic tax concepts absent a clear congressional expression that foreign concepts control. This canon has particularly strong application here where a contrary interpretation would leave an important statutory goal regarding equal tax treatment of foreign subsidiaries and foreign branches to the varying tax policies of foreign tax authorities.").
[103] *Biddle*, 302 U.S. at 582.
[104] *Id.*
[105] *Id.* at 578.
[106] *Id.*
[107] *Id.*

> At the outset it is to be observed that decision must turn on the precise meaning of the words in the statute which grants to the citizen taxpayer a credit for foreign "income taxes paid." The power to tax and to grant the credit resides in Congress, and it is the will of Congress which controls the application of the provisions for credit. The expression of its will in legislation must be taken to conform to its own criteria unless the statute, by express language or necessary implication, makes the meaning of the phrase "paid or accrued," and hence the operation of the statute in which it occurs, depend upon its characterization by the foreign statutes and by decisions under them.[108]

III. THE NARROW AND CONTEXTUAL MEANING OF TAXPAYER

The foregoing analysis demonstrates that, despite occasional statements by commentators and the Service that U.S. tax principles apply to foreign persons "as if" they were subject to U.S. taxation, the authorities cited for this proposition merely demonstrate that the Code and U.S. tax principles apply to foreign persons and transactions only to the extent Congress has indicated that they apply by not limiting their scope. Consequently, if specific Code provisions are circumscribed to persons subject to U.S. taxation, then those provisions are irrelevant to foreign persons not so subject. In the specific context of determining U.S. tax basis, the relevant Code provisions providing for a cost basis are not so limited and thus apply to any property wherever located regardless of ownership by a person not subject to tax. However, while the provisions of section 1016 generally provide that all persons must adjust their original basis for various items,[109] the specific rules for determining the amount of depreciation adjustments vary depending on whether or not the person owning the property is subject to U.S. income taxation.[110]

Consequently, Code provisions specifically limited in their reach to persons actually subject to U.S. taxation should be inapplicable to foreign persons. A primary method the Code uses to designate such limited provisions is by circumscribing their application to "taxpayers." The following sections will demonstrate that the term "taxpayer" serves as a substantive limitation on the scope of numerous Code provisions. However, the extent of the limitation that Congress intends by using the term "taxpayer" in a particular provision also depends on the context in which the term arises. The authorities discussed below support the conclusion that the term "taxpayer" requires a person to have some actual liability (as opposed to a mere hypothetical possibility of liability) for a U.S. tax, and that the term "taxpayer" does not have a single uniform meaning throughout the Code, but instead must be interpreted contextually in light of the purpose of the relevant statute, Congressional intent and the specific tax involved.

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[108] *Id.*
[109] I.R.C. § 1016(2)(1) (2001).
[110] *Id.* § 1016(a)(3).

A. Definition of "Taxpayer"

"Taxpayer" is defined in section 7701(a)(14) as "any person subject to any internal revenue tax."[111] The Code also provides that "person" is "construed to mean and include an individual, a trust, estate, partnership, association, company or corporation."[112] Further, both definitions apply to all provisions of the Code "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof."[113] Consequently, a "person" is intended to be a universal concept encompassing all persons and entities wherever located.[114] By contrast, the Code identifies a subset of this universal concept in Section 7701(a)(14) by defining a "taxpayer" to mean "any person subject to any internal revenue tax."[115] The terms "person" and "taxpayer" are not synonymous, and the term "taxpayer" is more limited in scope than the term "person."

There are two potential ambiguities regarding how limited the Code's definition of "taxpayer" is meant to be. First, what was intended by the phrase "subject to?"[116] That is, does this phrase include any person who could potentially become (or hypothetically be) liable to pay a tax to the U.S. government or is it limited to persons who are in fact actually paying or actually liable for U.S. taxes? In the former case, there would be little difference between "person" and "taxpayer," contrary to how the Code defines the two terms.

The second ambiguity is whether the reference to "any internal revenue tax" means that once a person becomes "subject to" any particular tax then that person is a "taxpayer" for all purposes under the Code notwithstanding that such person may not be "subject to" any other U.S. tax? In other words, is the definition of taxpayer effectively uniform throughout the Code, irrespective of the various policy considerations relevant to different types of taxes, such that finding a person liable for one particular type of tax automatically requires the substantive provisions of every other type of U.S. tax to become relevant to that person. As discussed below, the authorities support the conclusion that "taxpayer" has a limited and contextual meaning intended only to identify a person who is *actually* liable for the *relevant* tax. While certain authorities contain contradictory dicta, upon a close examination even those authorities serve to confirm the foregoing interpretation of the meaning of "taxpayer."

B. Meaning of "Subject To"

There are several reasons that the phrase "subject to" means actual liability for (or actual payment of) a U.S. tax, rather than hypothetical or potential liability for a U.S. tax. First, the phrase "subject to" as well as the term "taxpayer" are generally defined as involving actual liability.[117] Second, the U.S. Supreme

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[111] I.R.C. § 7701(a)(14) (2001).
[112] *Id.* § 7701(a)(1).
[113] *Id.* § 7701(a).
[114] *Id.* § 7701(a)(1).
[115] *Id.* § 7701(a)(14).
[116] *Id.*
[117] *See* I.R.C. § 7701 (2001).

Court has specifically held that a taxpayer is one who is liable for or pays the subject tax.[118] Third, any broader reading of "subject to" would make the terms "person" and "taxpayer" synonymous when "person" is intended to be broader than "taxpayer." Fourth, certain regulations implementing the net income tax provisions recognize that a person not paying (or liable for) the relevant tax is not within the scope of the relevant regulations.[119] Lastly, the view that any person who might hypothetically be liable for a U.S. tax qualifies as a taxpayer is simply not supported by the weight of existing authority.

In common parlance, the dictionary definition of "subject to" when used as an adjective is "liable."[120] Thus, the plain meaning of "subject to" as used in section 7701(a)(14) would be a person liable for a U.S. tax.[121] A foreign person should therefore only become a taxpayer if she is in fact liable for a tax.

Likewise, the Supreme Court in *U.S. v. Williams*[122] indicated that actual payment or actual liability is required for a person to be a "taxpayer" under section 7701(a)(14).[123] In *Williams,* the Service assessed a tax against a husband and placed a levy on all of his property, including his interest in a home owned jointly with his then wife.[124] Before the lien was recorded, the husband transferred his share of the home to his wife in contemplation of divorce.[125] Although the wife was not personally liable for the tax assessed against her husband, she paid the tax under protest in order to have the lien removed from the home prior to its sale to a third party.[126] The wife then sued for a refund of the taxes as erroneously collected.[127] The Service maintained that a refund suit could not be brought since the filing of such a suit requires that a "taxpayer" exhaust her administrative remedies prior to bringing suit, and the wife was not a "taxpayer" for this purpose pursuant to section 7701(a)(14) since the tax she paid was never assessed against her.[128] In the Service's view, even the fact that she actually paid the tax liability was insufficient to give her standing to get a refund of that payment since she would only be a "taxpayer" "subject to" the tax if she was the person directly liable for that tax as a legal matter. In dismissing the argument of the Service and finding that the wife could indeed bring a suit for refund, the Court stated:

> From the statute's use of the term "taxpayer," rather than "person who paid the tax," the Government concludes that only a "taxpayer" may file for administrative relief under section 7422, and thereafter pursue a refund action under 28 U.S.C. § 1346(a)(1). Then, to show

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[118] United States v. Williams, 514 U.S. 527 (1995).
[119] *See infra* Part III.C.3.
[120] BLACK'S LAW DICTIONARY 1438 (7th ed. 1999); WEBSTER'S DICTIONARY 1813 (2d ed. 1978).
[121] *See* I.R.C. § 7701(a)(14) (2001).
[122] 514 U.S. 527 (1995).
[123] *Id.*
[124] *Id.* at 529-30.
[125] *Id.* at 530.
[126] *Id.*
[127] *Williams,* 514 U.S. at 530.
[128] *Id.* at 532-33.

> that Williams is not a "taxpayer," the Government relies on 26 U.S.C. § 7701(a)(14), which defines "taxpayer" as "any person subject to any internal revenue tax." *According to the Government, a party who pays a tax is not "subject to" it unless she is the one assessed.*
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> The Government's argument fails at both statutory junctures. First, the word "taxpayer" in § 6511(a)—the provision governing administrative claims—cannot bear the weight the Government puts on it. This provision's plain terms provide only a deadline for filing for administrative relief, not a limit on who may file. To read the term "taxpayer" as implicitly limiting administrative relief to the party assessed is inconsistent with other provisions of the refund scheme, which expressly contemplate refunds to parties other than the one assessed. . . .
>
> Further, even if, as the Government contends, only "taxpayers" could seek administrative relief under § 6511, the Government's claim that Williams is not at this point a "taxpayer" is unpersuasive. Section 7701(a)(14), defining "taxpayer," informs us that "[w]hen used in [the Internal Revenue Code], where not otherwise distinctly expressed or manifestly incompatible with the intent thereof, . . . [t]he term 'taxpayer' means any person subject to any internal revenue tax." That definition does not exclude Williams. The Government reads the definition as if it said "any person who is assessed any internal revenue tax," but these are not Congress' words. The general phrase "subject to" is broader than the specific phrase "assessed" and, *in the tax collection context before us, we think it is broad enough to include Williams. In placing a lien on her home and then accepting her tax payment under protest, the Government surely subjected Williams to a tax, even though she was not the assessed party.* [129]

Williams indicates that the term "taxpayer" applies to a person when the tax has an actual (not hypothetical) impact on the person.

Although the Court rejected a narrow definition of "subject to" as meaning only assessment, its expansion was merely to the extent necessary to cover an actual collection by the Service extracted to release a Government lien as included in the meaning of "subject to."[130] Conversely, the Court did not summarily dismiss the Government's argument on the theory that "subject to" means anyone potentially liable for any U.S. tax.[131] That is, the Court did not find the wife was a taxpayer for these purposes based on an expansive reading of "subject to" as encompassing anyone who might potentially be liable for any U.S. tax, despite the fact that the wife as a U.S. citizen had other U.S. tax liabilities.[132] Thus, the opinion supports the concept that "subject to" requires some actual liability for or actual payment of a U.S. tax before taxpayer status can be found.

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[129] *Id.* at 533-35 (footnotes omitted) (emphasis added).
[130] *Id.*
[131] *Id.*
[132] *Williams*, 514 U.S. at 533-35.

In this regard, the Supreme Court's emphasis on actual payment is not only consistent with the structure of the word "taxpayer" and its dictionary definition, but is also required by the fact that the Code treats "taxpayer" as a more narrow concept than "person." Limiting the reach of the "subject to" language in the definition of "taxpayer" is necessary to differentiate the term "taxpayer" from the term "person" as defined in section 7701(a)(1).[133] If "subject to" means any person who could potentially become liable for a U.S. tax, then the definition of "taxpayer" would arguably include every person and entity on the planet and would be completely coextensive with the definition of "person."

Similarly, the Service has taken the position that a foreign person is not automatically a "taxpayer," but only becomes one if she actually becomes "subject to" U.S. taxation.[134] The most notable area in this regard is the Service's position regarding the election of taxable years by foreign corporations and nonresident alien individuals. After the adoption of the controlled foreign corporation provisions in 1962, there was a flurry of activity by foreign corporations to try to elect fiscal years that would postpone the effective date of those provisions.[135] To address the issue of when and how a foreign corporation could elect a fiscal year for purposes of sections 951 to 972, the Service issued Revenue Procedure 63-7.[136] That procedure provided in part that:

> [T]he taxable year of the foreign corporation shall be determined under section 441 of the Code, and the regulations thereunder, and by *treating a foreign corporation which is not subject to United States income tax as though it were a taxpayer within the meaning of section 7701(a)(14) of the Code.*"[137]

Similarly, the current regulations under section 442 provide that a "controlled foreign corporation or a foreign corporation that meets the stock ownership requirements of a foreign personal holding company not subject to United States income tax shall be treated for the purposes of this section as a taxpayer within the meaning of section 7701(a)(14)."[138] Finally, Revenue Ruling 80-352 states the Service's position that a nonresident alien is not a U.S. taxpayer if he has "never been required by any provision of internal revenue laws or regulations to file a return or any equivalent document with the Service."[139]

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[133] *See* I.R.C. § 7701(a)(1) (2001).

[134] *See, e.g.*, Rev. Proc. 63-7, 1963-1 C.B. 485, *clarified by* Rev. Proc. 75-54, 1975-2 C.B. 594, *amplified by* Rev. Proc. 76-35, 1976-2 C.B. 648; Treas. Reg. § 1.442-1(c)(5) (as amended in 1987); Rev. Rul. 80-352, 1980-2 C.B. 160.

[135] The Controlled Foreign Corporation provisions (I.R.C. §§ 951-64 (2001)) generally require certain U.S. shareholders of foreign corporations to currently report as income certain types of income earned by such foreign corporations prior to any distribution of such income to the shareholder. The provisions apply even to U.S. shareholders of foreign corporations having no operations in or nexus with the United States.

[136] Rev. Proc. 63-7, 1963-1 C.B. 485, *clarified by* Rev. Proc. 75-54, 1975-2 C.B. 594, *amplified by* Rev. Proc. 76-35, 1976-2 C.B. 658.

[137] Rev. Proc. 63-7, 1963-1 C.B. 485, 486 (emphasis added).

[138] Treas. Reg. § 1.442-1(c)(5) (as amended in 1987).

[139] Rev. Rul. 80-352, 1980-2 C.B. 160, 161.

However, despite the above authorities some commentators have stated that a more expansive reading of "subject to" arguably applies based on certain older authorities.[140] For example, the view that the term "taxpayer" potentially means any person that theoretically could be liable for a U.S. tax is this statement:

> At first blush, the rules [regarding taxable year elections] might seem to be inapplicable to foreign persons because they apply only to "taxpayers." Foreign persons usually pay no U.S. taxes. Unfortunately, that observation does not end the issue. The Code defines taxpayer to be "any person subject to any internal revenue tax." *The definition of taxpayer has been interpreted in an expansive way: it includes any person who might have been subject to tax liability if he had received income from within the United States.* As thus interpreted, there are more than four billion individual "taxpayers" in the world![141]

Support for this broad interpretation of the "subject to" language arguably derives from a series of cases from the mid-70s, holding that a dual resident does not have short taxable year in the year she obtains or terminates her U.S. residency, thus the portion of her 12-month taxable year during which she was a nonresident must still be included in her return for federal income tax purposes.[142] This can have the consequence of denying aliens the benefits of

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[140] *See* Colon, *supra* note 4, at n.199; Dale, *supra* note 5, at 277-78.

[141] Dale, *supra* note 5, at 277 (footnotes omitted) (emphasis added).

[142] *See, e.g.,* More v. Comm'r, 66 T.C. 27 (1976), *aff'd without opinion*, 562 F.2d 38 (2d Cir. 1977) (concluding that petitioners were not eligible to elect income averaging because the first "taxable year" of base period held to cover a full 12 month period rather than a short year based on date of residence change and therefore included a period of time for which taxpayer was still a nonresident alien); Nico v. Comm'r, 67 T.C. 647, *aff'd in part and rev'd in part*, 565 F.2d 1234 (2d Cir. 1977) (denying joint filing status and standard deduction for taxable year of residence change since the taxable year was a 12 month period including both nonresident and resident portions of the year. However, the court explicitly noted that the taxpayers could have achieved their goal by adopting a fiscal year beginning with the date of residency.); Simenon v. Comm'r, 44 T.C. 820 (1965) (holding a long time resident alien who abandoned his U.S. resident status during a taxable year was forced to report income from entire 12 month period since no provision permitted terminating his taxable year on the date of residence change). *See also* Treas. Reg. § 1.871-13 (as amended in 1980) (holding that residency change results in single taxable year for purposes of applying graduated U.S. rates even though foreign source non-resident alien income is not subject to U.S. tax. Generally, a Form 1040 is filed for the entire year with a Form 1040NR attached as a supporting schedule).

All of these cases are distinguishable because they are based on the fact that a taxable year, once established, covers the entire 12 month period defined by that first taxable year, and a return must be filed showing the entire dual residency period, as long as the taxpayer was in existence for the entire period. Thus, a short taxable year is not created merely by the change in residency. That is, the persons involved were taxpayers during their period of residence and therefore were forced to file returns for the entire year containing the residence change, since under the Code's definitions, there was no provision for dividing the 12 month period defining their first or last "taxable year" into two short periods based on the date of residency change. As such, these cases do not stand for the proposition that a non-U.S. person is indeed a "taxpayer" during the nonresident portion of a single taxable year. Interpreting the dicta in these cases more broadly would lead to the arbitrary result that any person alive (in existence) is a taxpayer for U.S. purposes.

income averaging, joint filing, and claiming the standard deduction. Yet, these authorities merely hold that once a person's status as "taxpayer" is established (*i.e.*, a nonresident alien individual has become a resident alien), the initial tax year spans the entire calendar year.[143] As such these precedents have little relevance to the definition of "taxpayer" since they involve persons who were U.S. residents for a portion of their taxable year and thus deal only with the question of whether the definition of "taxable year" could be read to exclude the portion of the year in which they were nonresidents. Such authorities should not create any inference that a nonresident alien is generally a "taxpayer" during his period of nonresidency. Any broader reading ignores the meaning of "subject to," the Code's distinction between "person" and "taxpayer," the Supreme Court's emphasis on actual payment in *Williams*,[144] and such authorities as *Freudmann*,[145] Revenue Procedure 63-7[146] and Revenue Ruling 80-352.[147]

Similarly, the Tax Court case of *Dougherty v. Commissioner*[148] is cited for the proposition that "a foreign corporation has a taxable year even if it has no income subject to U.S. taxation."[149] *Dougherty* dealt with determining the taxable year of a wholly owned controlled foreign corporation ("CFC") for purposes of applying Subpart F of the Code.[150] The court rejected the U.S. shareholder's initial argument that the Subpart F provisions could not be applied because a CFC without U.S. income was not a taxpayer and therefore could not have a taxable year that would trigger a Subpart F inclusion.[151] The taxpayer's argument was specious, as the controlled foreign corporation provisions require Subpart F inclusion for actual U.S. taxpayers.[152] The inclusions cannot properly occur without some definitive accounting period for the CFC, regardless of whether the CFC is itself a U.S. taxpayer.

Notably, the Tax Court in *Dougherty* relied in part on Revenue Procedure 63-7 and on the case of *Forrest City Production Credit Ass'n v. U.S.*[153] Revenue Procedure 63-7 is based on the assumption that for purposes of implementing the Subpart F provisions a CFC is treated as a "taxpayer" for taxable year elections. The *Forrest City* case held that a domestic tax-exempt entity was a "taxpayer"

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[143] *Id.*
[144] 574 U.S. 527 (1995).
[145] 10 T.C. 775 (1948).
[146] Rev. Proc. 63-7, 1963-1 C.B. 485.
[147] Rev. Rule 80-352, 1980-2 C.B. 160 (holding that a foreign person not previously liable for U.S. tax is not a U.S. taxpayer.).
[148] 60 T.C. 917 (1973).
[149] Dale, *supra* note 5, at 281.
[150] *Dougherty*, 60 T.C. at 931.
[151] *Id.*; I.R.C. § 951(a)(1) (2001). In this regard section 951(a)(1) provides that a U.S. shareholder of a CFC includes his pro rata share of the CFC's earnings and profits in his gross income "for his taxable year in which or with which such *taxable year of the corporation ends*." *Id.* (emphasis added).
[152] *Id.*
[153] *Id.* (quoting *Forrest City*, 300 F. Supp. 609 (D.C. Ark. 1969)).

that had established a taxable year.[154] While the *Forrest City* case is discussed in more detail below,[155] it is distinguishable because in that context Congress presumably specifically intended to have the term "taxpayer" apply more broadly. Consequently, despite the broad phrasing of the holding in *Dougherty*, the case should be viewed as based on the clear Congressional intent in enacting Subpart F that CFC's be treated as if they are taxpayers for the purposes relevant to implementing the provisions of Subpart F (including the election of a taxable year).

This weight of authority supports the conclusion that the phrase "subject to," as used in section 7701(a)(14), should not be interpreted as encompassing all persons. Instead, it should be read to refer to persons that are actually liable for or that actually pay taxes to the United States.[156]

C. Any Internal Revenue Tax

The second question in determining how the term "taxpayer" should be interpreted is whether a person's liability for one tax under the Code means that a person is a taxpayer for purposes of all provisions of the Code. While the literal language of section 7701(a)(14) could be read as mandating this result by its reference to "any" internal revenue tax, the history of the Code refutes such a literal interpretation.[157] Indeed, the nature of the Code as simply a codification of many substantively unrelated taxes indicates that the meaning of the term "taxpayer" must be determined based on the context in which the phrase is used. Section 7701(a)(14) should not be interpreted as linking the internal revenue laws in a way that causes one tax (*e.g.*, an excise tax) to become a substantive modifier for an unrelated tax (*e.g.*, the income tax). If section 7701(a)(14) is interpreted to mean that a taxpayer for purposes of one internal revenue tax is always a taxpayer for all other tax provisions, then substantive legal outcomes under one tax would likely be determined by outcomes derived under unrelated and substantively distinct taxes. Interpreting the definition of taxpayer in a manner that forces such meaningless linkages between unrelated taxes and tax policies would be contrary to the Congressional intent underlying those distinct substantive provisions and the purpose for creating a codification of the tax laws.

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[154] Forrest City Prod. Credit Ass'n v. U.S., 300 F. Supp. 609, 614-15 (D.C. Ark. 1969) *aff'd per curiam*, 426 F.2d 819 (8th Cir. 1970).

[155] *See infra* Part IV.B.

[156] A regulatory example of the use of the term "subject to" can be found in the regulations under section 338. In certain circumstances, these regulations permit a foreign corporation to delay making a section 338 election until after becoming "subject to" U.S. tax. Treas. Reg. § 1.338-2(e)(1) (2001). As a general matter, the regulation defines being subject to U.S. tax as engaging in a U.S. trade or business or qualifying as a CFC, QEF, FIC or FPHC. *Id.* § 1.338-2(e)(1)(v). Receipt of U.S. source income subject to withholding tax is not considered subject to U.S. tax as long as the withholding fully satisfies the U.S. tax liability. *Id.* The regulation is consistent with the view that merely a potential liability for U.S. tax is not enough to cause a foreign corporation to be a taxpayer. Further, the regulation distinguishes net income tax from withholding tax at the source.

[157] *See* I.R.C. § 7701(a)(14) (2001).

Requiring the term taxpayer to be limited by its contextual surroundings is also supported by a number of court cases and Service regulations. For example, the Supreme Court in *Williams* indicated that the term "taxpayer" must be interpreted in light of the particular context in which the term is used.[158] Similarly, in several cases the Tax Court has specifically rejected the argument that if a person is a taxpayer for one tax that person is also a taxpayer for all taxes imposed by the Code.[159]

1. Nature of the Code as a Codification

To understand the intended meaning of the term taxpayer as used in the Code, it is necessary to reflect on the nature of the current Code as merely a definitive legislatively enacted codification of numerous distinct taxes enacted in the past. The internal revenue laws were first codified in 1939.[160] Prior to the enactment of a single code in 1939, the hundred or so different U.S. tax impositions were spread throughout many volumes of the Statutes at Large. As a consequence, determining the definitive law in any particular case required an extensive amount of legal double-checking. Additionally, even within the income tax laws themselves, confusion reigned due to the fact that the pre-1939 Revenue Acts often restated the law in almost identical language to that used in prior acts without reference to the prior acts and without expressing any intention regarding whether the prior laws were in fact amended or repealed. It is significant to note that many of these distinct taxes used the term "taxpayer" and often defined it as a person subject to the tax imposed by that particular enactment.[161] Although the term "taxpayer" was used in such separate and substantively distinct laws, the term was specific and distinct to each law.[162] Prior to codification there would have been no question but that qualifying as a taxpayer for purposes of an excise tax imposition would not have caused such a person to qualify as a taxpayer for purposes of the income tax laws, or vice versa. When Congress adopted the codification of these disparate laws, it placed certain common definitions in a separate section for ease of reference. Thus, the multiple substantively specific definitions of taxpayer were eliminated and a single definition of taxpayer was inserted using language nearly identical to current

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[158] *See Williams*, 514 U.S. at 527.

[159] *See, e.g.,* Sam Goldberger, Inc. v. Comm'r, 88 T.C. 1532 (1987); Rollercade, Inc. v. Comm'r, 97 T.C. 113 (1991).

[160] Although the various tax impositions of the federal government (consisting primarily of liquor and tobacco taxes) were also codified in 1874, the first codification to include income taxes occurred in 1939. *See* 26 U.S.C. § 1 (1939).

[161] For instance, the income tax provisions enacted in the Revenue Act of 1938 contained the following definition "(a) When used in this Act – (14) The term "taxpayer" means any person subject to a tax imposed by this Act." Revenue Act of 1938, ch. 289, § 901, 52 Stat. 447, 583-84 (1938).

[162] *Id.*; I.R.C. § 3797 (1939).

section 7701(a)(14).[163] By adopting this common definition Congress did not intend to alter the specific contextual meanings that taxpayer had had under the various independent tax statutes existing before the codification. Indeed the first point made by the various congressional reports regarding the codification was always that the codification "makes no changes in existing law."[164] As a result, the history of the Code and the simplifying purpose of creating a central definitional section indicate that Congress intended the term "taxpayer" to take a contextual meaning based on the particular type of tax involved, rather than create a single monolithic definition that would apply invariably in all contexts. The introductory language to section 7701(a) also indicates that a contextual approach to applying the definitional provisions of the Code is appropriate by stating that the definitions do not apply where a contrary intent is distinctly expressed or the definition is manifestly incompatible with the intent of the statute.[165]

In understanding the role of the taxpayer definition within the codification, it is also instructive to examine why Congress saw fit to specifically modify the definition of taxpayer in section 1313.[166] The Code contains certain mitigation provisions applicable in instances where an error in a prior year is unable to be corrected due to the expiration of the statute of limitations or other applicable rules of law.[167] In appropriate circumstances adjustments can be made in an open taxable year to mitigate the harshness of barring a correction in the actual year containing the error.[168] These mitigation provisions only apply with respect to U.S. income taxes.[169]

Section 1313(b) specifically provides that "[n]otwithstanding section 7701(a)(14), the term "taxpayer" means any person subject to a tax under the applicable revenue law."[170] Given this definition, one might initially conclude that the general definition of taxpayer in section 7701(a)(14) is in fact an invariable one, since if the definition varied contextually there would be no need for a special definition in section 1313(b), which apparently intended to limit the term to net income taxes (*i.e.*, the "applicable revenue law").[171] However, this conclusion rests on the assumption that the purpose of the special definition is to indicate that the mitigation provisions only apply to income tax errors. In reality, the history of section 1313 and the mitigation provisions demonstrates that the purpose of a special taxpayer definition in this context was to expand the reach of the definition to include persons who paid income taxes in periods not covered

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[163] "When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof . . . [t]he term 'taxpayer' means any person subject to a tax imposed by this title." I.R.C. § 3797(a)(14) (1939).
[164] S. REP. NO. 76-20, at 1 (1939).
[165] I.R.C. § 7701(a) (2001).
[166] *Id.* § 1313(b).
[167] *Id.* § 1311-1314.
[168] *Id.* § 1311(b)(2).
[169] *Id.*
[170] I.R.C. § 1313(b) (2001).
[171] *Id.* §§ 7701(a)(14), 1313(b).

by the current enactment of the Code.[172] More specifically, the definition of taxpayer in section 7701(a)(14) applies for purposes of "this title" (*i.e.*, the current Code) to persons subject to "any internal revenue *tax*" (*i.e.*, a *tax* imposed by the *current* Code).[173] Section 1313(b) is intended to clarify that the term "taxpayer," as used in the context of mitigating the application of the statute of limitations to years covered by prior enactments of the Code, covers any person "subject to a *tax* under the *applicable revenue law*" (*i.e.*, a *tax* imposed under either the current Code or under a *prior enactment of the Code* applicable to a closed year) despite the more *narrow* definition of "taxpayer" in section 7701(a)(14).[174]

This reading of section 1313(b) is confirmed by an examination of the legislative history surrounding the original enactment of the mitigation provisions.[175] The mitigation provisions first came into the tax law in 1938 primarily to ensure that neither taxpayers nor the Service could inappropriately benefit by taking a position inconsistent with a position taken in a prior year now closed by the statute of limitations.[176] As discussed above, prior to the enactment of the 1939 Code the various income tax laws were often reenacted with slight modifications each year.[177] Consequently, the income tax mitigation provisions needed to cover mitigating inconsistencies and errors even in situations where the two years in question were covered by different enactments of the internal revenue laws. To address this the Conference Committee reconciling the Revenue Act of 1938 inserted a special definition of the term "taxpayer" for purposes of the mitigation rules.[178] This definition provided that notwithstanding the general definition of taxpayer applicable to all the provisions of the Revenue Act of 1938, in the mitigation provisions the term "taxpayer" meant "any person subject to a tax under the applicable Revenue Act."[179] That is, taxpayers were persons subject to tax under the Revenue Acts enacted prior to 1938 and applicable to those prior years.

The 1939 codification of the internal revenue laws did nothing to alter the need for a special definition in the mitigation provisions since the codification applied only prospectively and did not alter the relevance of prior laws to periods before 1939.[180] The 1939 codification was stated to only be prospective in application and therefore the income tax provisions of the Revenue Act of 1938

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[172] *See infra* notes 175-82 and accompanying text.
[173] *Id.* § 7701(a)(14).
[174] I.R.C. §§ 1313(b), 7701(a)(14) (2001).
[175] *See generally* S. Rep. No. 1567, 75th Cong., 3d Sess. (1938); H.R. No. 2330, 75th Cong., 3d Sess. (1938); H.R. No. 6, 76th Cong., 1st Sess. (1939); S. Rep. No. 20, 76th Cong., 1st Sess. (1939).
[176] S. Rep. No. 1567, 75th Cong., 3d Sess. (1938), *reprinted in* 1939-1 (Part 2) C.B. 779, 814-17; H.R. No. 2330, 75th Cong., 3d Sess. (1938), *reprinted in* 1939-1 (Part 2) C.B. 817, 835-37.
[177] S. Rep. No. 20, 76th Cong., 1st Sess. (1939) at 4.
[178] H.R. No. 2330, 75th Cong., 3d Sess. (1938), *reprinted in* 1939-1 (Part 2) C.B. 817, 836.
[179] *See* Revenue Act of 1938 § 820(a)(2).
[180] H.R. No. 6, 76th Cong., 1st Sess. (1939) at 1-4; S. Rep. No. 20, 76th Cong., 1st Sess. (1939) at 1-4.

and all prior Revenue Acts continued to exist and apply to years prior to 1939.[181] Thus, even after the internal revenue laws were codified in 1939, two definitions of taxpayer were still required: one to apply generally throughout the codification, and a special definition in the mitigation provisions to refer to persons subject to tax under pre-codification laws.[182] Sections 1313(b) and 7701(a)(14) represent a continuation of this necessary dichotomy in the Code. Consequently, the existence of section 1313(b) does not create an inference that section 7701(a)(14) was intended to apply monolithically to all provisions of the Code.

2. Case Law Support

The position that the definition of a taxpayer should vary based on the contextual context in which it occurs also finds support in a number of court cases.[183] For instance, the Supreme Court, in interpreting the definition of "taxpayer" in *Williams*, took the view that the meaning of taxpayer must be determined by reference to the context in which it is used.[184] In this regard two aspects of the Court's decision should be noted. First, in examining the appropriate scope for the definition of taxpayer the Court found it relevant to examine the statutory context and intent of the provision in which the term arose.[185] Thus the Court stated:

> [T]he word "taxpayer" in section 6511(a)—the provision governing administrative claims—cannot bear the weight the Government puts on it. This provision's plain terms provide only a deadline for filing for administrative relief, not a limit on who may file. To read the term "taxpayer" as implicitly limiting administrative relief to the party assessed is inconsistent with other provisions of the refund scheme, which expressly contemplate refunds to parties other than the one assessed.[186]

The second relevant point is that if "taxpayer" literally means any person subject to *any* internal revenue tax, then the Court could have summarily dispensed with the Service's arguments by noting that the wife (a U.S. citizen) paid U.S. taxes in her own right and therefore was a "taxpayer" who paid a tax even though she was not liable for the particular tax paid.[187] That is, if the term "taxpayer" is really to be read so broadly that the payment of any U.S. tax makes a person a taxpayer for all other purposes, then there was no need for the Court to even examine whether the "subject to" language required specific assessment or

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[181] *Id.*
[182] *See* I.R.C. § 3797(a)(14) (1939) (providing a global definition of "taxpayer" very close to that now contained in § 7701(a)(14)); I.R.C. § 3801(a)(2) (1939) (defining taxpayer in the mitigation rules as "any person subject to a tax under the applicable Revenue Act.").
[183] *See, e.g., Williams*, 514 U.S. at 533-34.
[184] *Id.*
[185] *Id.* at 534.
[186] U.S. v. Williams, 514 U.S. 527, 534 (1995) (footnotes omitted) (emphasis added).
[187] *Id.*

just payment of a tax.[188] Such a broad reading would lead to anomalous results and the Court was wise not to entertain such a broad reading of the definition.

Likewise, a number of other cases indicate that the term "taxpayer" must be reviewed in the context of the particular tax involved in resolving the scope of particular statutory provisions limited to "taxpayers." For instance, in the case of *Sam Goldberger, Inc. v. Commissioner,*[189] a domestic corporation (SG Inc.) owned all of the stock of SG International.[190] SG International elected to be treated as a domestic international sales corporation (DISC).[191] The Service mailed a notice of deficiency to SG Inc. with respect to International's activities.[192] Since Tax Court jurisdiction requires a validly issued notice of deficiency, the court examined whether the Service had properly issued the deficiency notice to SG Inc. rather than issuing it to SG International.[193] That determination in turn hinged on which entity was the "taxpayer" for purposes of these procedural matters.[194] In concluding that SG Inc. should be treated as the "taxpayer" in this context the court stated:

> Sections 6212(a) and 6213(a) and (c) require that notice be given to the "taxpayer" of the determined deficiency in taxes imposed by subtitle A (income tax) or B (estate and gift tax) or other miscellaneous chapters as a prerequisite, except under exceptional circumstances, to the assessment of a deficiency. However, section 991 provides that a DISC shall not be subject to the taxes imposed by subtitle A except for the taxes imposed by chapter 5 (sections 1491 through 1494) on certain transfers to avoid tax. A DISC still remains liable for other taxes, for

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[188] *See id.* In this regard it should be noted that the literal statutory language in section 6511 being construed by the Court reads as follows: "Claim for credit or refund of an overpayment of any tax imposed by this title *in respect of which tax the taxpayer is required to file a return* shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, *or if no return was filed by the taxpayer*, within 2 years from the time the tax was paid." I.R.C. § 6511(a) (emphasis added). Although it could be argued that even though the wife was a "taxpayer" in her own right due to payment of her own income tax liability, that fact is irrelevant to section 6511 since it requires the refund claim to be made by the *specific* taxpayer obligated to file the tax return associated with the tax. However, if this is indeed the requirement of the statute, then even under the Court's logic the wife should not have been allowed to sue for a refund. That is, the Court finds that the wife is a "taxpayer" because payment of the tax constitutes being "subject to" the tax, but it does not follow that mere payment of the tax would cause the wife to be "required" under the law to file a tax return in respect of the tax paid. Instead the position of the Court seems to be that the second emphasized portion of the statute applies to the wife here (*i.e.*, the statute of limitations relevant when no return is filed). Consequently, under a broad reading of the term taxpayer, the wife could still be a "taxpayer" in her own right who paid a tax and could sue for a refund even if the Court accepted the Service's position that literal assessment is required to satisfy the "subject to" portion of the taxpayer definition.

[189] 88 T.C. 1532 (1987).

[190] *Id.*

[191] *Id.*

[192] *Id.*

[193] *Id.*

[194] *Sam Goldberger*, 88 T.C. at 1540.

> example, social security taxes payable with respect to its employees under section 3111. Sec. 1.991-1(a), Income Tax Regs.
>
> Sections 6212(a) and 6213(a) and (c) do not define the term "taxpayer." Section 7701(a)(14) provides that, unless "otherwise distinctly expressed or manifestly incompatible with the intent thereof * * * 'taxpayer' means any person subject to any internal revenue tax." *Were we to apply literally the definition of taxpayer in section 7701(a)(14) to sections 6212(a) and 6213(a) and (c), without regard to the purpose Congress intended them to serve, it would follow that International was a "taxpayer," since its DISC status did not exempt it from every "internal revenue tax."*
>
> By virtue of the DISC status of International, Goldberger, Inc., became liable for the taxes on the income of International. Sec. 995(a). As such, Goldberger, Inc., was a taxpayer in its own right with respect to the income of International. *International was not subject to the taxes imposed by the notice of deficiency and, therefore, was not the "taxpayer" within the meaning of the relevant Code sections. The purpose of the statutory requirements is directly to inform a taxpayer of a claim against him for additional taxes due from him. . . .* We emphasize that we are not dealing with income for a taxable year in which International was determined not to qualify as a DISC. In view of the foregoing, we conclude that the notice of deficiency was properly sent to Goldberger, Inc. [195]

Thus, the court rejected a literal interpretation of the term taxpayer.[196] They did so in light of the context of the provisions and the fact that, while SG International was subject to some U.S. taxes (and therefore was a "taxpayer" for those purposes), it was not appropriately treated as a taxpayer for purposes of applying the procedural rules of the Code to taxes for which a DISC was not in fact actually subject to.[197]

Similarly, in determining against whom a penalty for instituting a proceeding primarily for purposes of delay under section 6673(a) could be assessed, the Tax Court in *Rollercade, Inc. v. Commissioner*[198] stated:

> Section 6673(a) provides that "the Tax Court, in its decision, may require the taxpayer to pay to the United States a penalty not in excess of $25,000." A "taxpayer," as defined by section 7701(a)(14), is "any person subject to any internal revenue tax."
>
> In the circumstances of this case, Rollercade, an S corporation, is a "pass-thru" entity not subject to tax. Sec. 1363(a). Thus, Rollercade is not a "taxpayer" within the meaning of section 7701(a)(14). However, each of Rollercade's shareholders for the taxable year ended September 30, 1986, is a "taxpayer" within the meaning of section 7701(a)(14) because corporate-level adjustments determined by this proceeding

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[195] *Id.* (emphasis added) (footnotes omitted) (citations omitted).
[196] *Id.*
[197] *Id.*
[198] 97 T.C. 113 (1991).

> cannot be litigated in a personal income tax case, and respondent may determine the additional tax liability of the shareholders with respect to these adjustments by computational adjustment. [199]

3. Regulatory Support

The concept that the term "taxpayer" is to be interpreted in view of the relevant statutory provisions where it occurs is also demonstrated by the Service's implementation of several income tax regulations. These examples demonstrate that the meaning of "taxpayer" cannot be one single mechanical definition, otherwise the regulations would yield arbitrary results.[200] For instance, Treasury Regulation section 301.7701(b)-6(a) provides that an "alien individual who has not established a fiscal year as his or her taxable year prior to the period that the individual is *subject to United States income tax* as a resident or a nonresident shall adopt the calendar year as his or her taxable year."[201] If such a person qualified as a "taxpayer" under section 7701(a)(14) because of the payment of a non-income tax, then the normal taxable year provisions of sections 441 and 442 would be applicable and the special rule for nonresident aliens should not permit those persons to elect a non-calendar year.[202] That is, if a broad reading of taxpayer is correct, the above quoted regulation should only refer to individuals who establish a fiscal year prior to becoming subject to "any internal revenue tax" rather than being limited to income taxes.[203]

Similarly, the general regulations regarding changing taxable years under section 442 provide that a "controlled foreign corporation or a foreign corporation that meets the stock ownership requirements of a foreign personal holding company *that is not subject to United States income tax* shall be treated for the purposes of this section as a taxpayer within the meaning of section 7701(a)(14)."[204] The direct implication is that only a CFC that is actually subject to U.S. *income* taxes would normally qualify as a "taxpayer" required to elect a taxable year. Again, if a foreign corporation was considered a "taxpayer" for income tax purposes merely due to the payment of an excise tax or some other U.S. tax, then the regulation would merely need to create a deemed taxpayer when the CFC is not subject to "any internal revenue tax."

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[199] *Id.* at 118-19 (1991) (footnotes omitted) (citations omitted).
[200] Treas. Reg. § 301.7701(b)-6(a) (1992); Rev. Rul. 80-352, 1980-2 C.B. 160.
[201] Treas. Reg. § 301.7701(b)-6(a) (1992) (emphasis added).
[202] I.R.C. §§ 7701(a)(14), 441-42 (2001).
[203] Rev. Rul. 80-352, 1980-2 C.B. 160 (basing its conclusion that a nonresident alien individual is not a taxpayer based only on the statement that the nonresident "had never been required by any provision of internal revenue laws or regulations to file a return or any equivalent document with the Service" prior to his beginning a U.S. trade or business. If a nonresident could become a "taxpayer" for U.S. income tax purposes solely by the payment of an excise or other non-income tax to the United States, then the factual statement in the ruling would be insufficient to support the Service's conclusion (without the additional statement that no such other taxes had ever been paid)).
[204] Treas. Reg. § 1.442-1(c)(5) (as amended in 1987) (emphasis added).

It should be noted that it is not entirely clear whether the reference to "United States income tax" in the above regulations was intended only to cover foreign persons with taxable income which is effectively connected with the conduct of a trade or business within the United States under sections 871(b) and 882, or whether such term includes persons subject to the 30% gross basis tax on investment income from U.S. sources under sections 871(a) and 881.[205] However, in this regard it is relevant to note that the examples given in Treasury Regulation section 301.7701(b)-6 all concern persons subject to net basis taxation under section 871(b).[206] Additionally, at least one commentator has noted that applying such provisions to persons whose only U.S. connection is having U.S. investment income would yield anomalous results:

> A literal reading of the [section 301.7701(b)-6] regulations would seem to suggest that "U.S. income tax" includes both taxes imposed under sections 871(a) and [871](b), but such a reading leads to strange results. For example, assume that a calendar year nonresident alien buys one share of stock of IBM and receives a dividend in 1980 and is subject to tax under section 871(a) on the dividend, but otherwise has no contact with the United States. Assume that the individual changes her taxable year in 1982 to a fiscal year and continues to use a fiscal year when she moves to the United States in 1996. A literal reading of the regulations would seem to require that she use a calendar year taxable year because she had not established a fiscal year as her taxable year prior to being subject to U.S. income tax [in 1980].[207]

Support for the position that U.S. income tax provisions aimed at "taxpayers" should only be applied to foreign persons with effectively connected income subject to tax under sections 871(b) and 881(a) can be found in the proposed accelerated depreciation regulations.[208] In Proposed Treasury Regulation section 1.168-5(e)(5), special rules are provided regarding the making of certain elections by foreign persons.[209] A CFC is required to make elections pursuant to the regulations under section 964.[210] In the case of a foreign person not covered by section 964, the relevant elections are to be made in the same manner as a domestic person makes the elections except that "the election shall be made on the taxpayer's income tax return for the later of the taxable year in which the property is placed in service as recovery property by the taxpayer or *the first taxable year in which the taxpayer is subject to United States tax.*"[211] The proposed regulation then goes on to specifically define "subject to United States tax" as meaning only income taxes under subtitle A of the Code "other than sections 871(a)(1) and 881 thereof."[212] Thus, for purposes of making

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[205] I.R.C. § 871(b), 882 (2001).
[206] *See* I.R.C. § 871(b); Treas. Reg. § 301.7701(b)-6 (1992).
[207] Colon, *supra* note 4, at n.200.
[208] *See* Treas. Reg. § 1.168-5, 49 Fed. Reg. 5940, 5968 (Feb. 16, 1984).
[209] *Id.*
[210] *Id.*
[211] *Id.* (emphasis added).
[212] *Id.*

depreciation elections by a non-CFC, the Service was willing to limit the relevance of "taxpayer" elections under section 168 to nonresident foreign persons having taxable income effectively connected with a U.S. trade or business.[213]

The proposed regulations under section 168 indicate that the Service believed it was inappropriate to interpret the term "taxpayer" in the context of calculating accelerated depreciation deductions to include persons not actually subject to net basis income taxation (or deemed subject for earnings and profits purposes pursuant to the regulations under section 964). This result is directly in line with the contextual approach taken by the authorities generally discussed above. Just as it creates anomalous results to treat a person paying only excise or employment taxes as governed by all the other divergent substantive tax provisions of the Code referring to taxpayers, it reaches arbitrary and inconsistent results to apply all the substantive net basis income tax provisions to a foreign person merely because they have portfolio income subject to gross basis taxation by the United States. Thus, the ultimate U.S. taxable year of a nonresident alien should not be dictated by the fact that the alien had one dollar of dividend income from a U.S. company ten years before coming to the United States. Such a result would be contradictory to the purpose of the statute and an efficient and logically administrable rule of law. Consequently, the contextual approach of *Williams* ultimately dictates that Code provisions relating to the substance of net basis income taxation should not be interpreted as applying to persons whose U.S. activities or nexus does not actually subject them U.S. income taxation on a net basis.

D. Additional Illustrations Acknowledging Limited and Contextual Interpretation

1. Installment Sale Provisions

The installment sale provisions of the Code represent a specific area where Congress intended, and the Service has interpreted, the Code to have only limited application based in part on the use of the term taxpayer within such provisions.

The function of the installment method of reporting is to permit the spreading of a person's U.S. income tax liability over the period that installment payments are actually received and thereby alleviate possible liquidity problems which might arise if the full gain was taxed in a year where only a portion of the sales proceeds have been actually received.[214] When the seller of property is a

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[213] Prop. Treas. Reg. § 1.168-5, 49 Fed. Reg. 5940, 5968 (Feb. 16, 1984). However, a potential ambiguity exists in the fact that the proposed regulations only cover elections by "foreign taxpayers." While the context of this term indicates that it was intended to effectively designate all foreign persons (whether or not qualifying as CFCs), the fact that the actual definition provided in the regulations is itself based on the term "taxpayer" creates some internal ambiguity. In relevant part the definition reads: ""Foreign taxpayer" means a taxpayer that is not a United States person as defined in section 7701(a)(30)." *Id.*

[214] S. Rep. No. 1000, 96th Cong., 2d Sess. (1980) at 7.

nonresident alien or a foreign corporation not subject to U.S. tax on the disposition, there is no need for this ameliorative type of provision to apply.[215] Indeed, under the pre-1980 version of the installment sale provisions the Service explicitly ruled that a nonresident alien was not subject to the installment sale provisions prior to a residency change precisely because he was not subject to U.S. tax during that period (*i.e.*, he was not a "taxpayer").[216]

Prior to 1980, reporting gains from installment sales under the installment method of section 453 was elective.[217] That is, any gain would be reported in full in the year of sale unless the seller specifically elected to be taxed as the installments were received.[218] This elective treatment was available for persons who regularly sold personal property on an installment plan (*i.e.*, a dealer in personal property).[219] However, once a dealer in personal property made an election to report gain on the installment method then all installment payments received after the election would be subjected to taxation even if the subject property had been sold in a year prior to the election and the full gain was recognized in that earlier year.[220] However, to prevent double taxation, the tax for the year of the installment payment was reduced to reflect the tax paid in an earlier year.[221] While this mechanic worked for persons whose original gain had been subjected to U.S. tax, it would have yielded unfair results if applied to a foreign person just becoming subject to U.S. taxation.

In a 1978 Private Letter Ruling, the Service addressed this exact issue and concluded that if a newly resident dealer in personal property elected to use the installment method, the receipt of installment payments relating to sales prior to obtaining U.S. residency would not be includable in his income.[222] The Service reached its conclusion based on a close reading of the relevant statutory provision requiring inclusion of all post-election receipts since that provision literally applied to "taxpayers" whose accounting method was changed as a result of electing into the installment method of reporting.[223] Additionally, the ruling noted that the regulations interpreting the installment sale provisions also stated that the term "sale on the installment plan" referred to a sale of personal property "by a taxpayer."[224] Thus the Service reasoned that the installment sale provisions were only applicable to "taxpayers."[225] The Service concluded that since the new resident was not subject to U.S. income tax while he was a nonresident, he was not a "taxpayer" and as such the election of the installment method on his first

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[215] I.R.C. § 865(a)(2) (2001) (gains from personal property sales generally do not create U.S. source income).
[216] Priv. Let. Rul. 78-17-060 (Jan. 26, 1978).
[217] S. Rep. No. 1000, 96th Cong., 2d Sess. (1980) at 11.
[218] *Id.*
[219] I.R.C. § 453(a) (1980) (prior to 1980 amendments).
[220] I.R.C. § 453(c) (1980) (prior to 1980 amendments).
[221] *Id.*
[222] Priv. Let. Rul. 78-17-060 (Jan. 26, 1978).
[223] I.R.C. § 453(c) (1980) (prior to 1980 amendments); Priv. Let. Rul. 7817060 (Jan. 26, 1978).
[224] Treas. Reg. § 1.453-2(c) (1976) (prior to repeal, repealed 1989).
[225] Priv. Let. Rul. 7817060 (Jan. 26, 1978).

U.S. tax return did not represent a change in accounting method requiring reporting of the pre-residency gains upon the receipt of post-residency installments.[226] Effectively, when he became a resident he became a new taxpayer and could make an installment sale election covering only his post-residency installment transactions.[227] The ruling demonstrates that the term "taxpayer" represents a substantive limitation on the scope of Code provisions in which it is used.

In 1980, Congress modified the installment sale provisions by reversing the election mechanic in non-dealer situations.[228] That is, after 1980 a person was treated as reporting installment sales on the installment method unless she specifically elected out of the installment method (*e.g.*, by reporting the full gain on her tax return for the year of sale).[229] The purpose of this change was not intended as a substantive change to the law, but rather was primarily intended to eliminate a trap for the unwary by making the presumptive treatment the one most often favorable to taxpayers and thereby minimize the risk of taxpayers making elections which might ultimately be found invalid due to a technical deficiency.[230] Switching the operation of the election also eliminated potential whipsaw problems for the Service.

Although this change simplified matters for persons subject to U.S. taxation and was intended as a non-substantive change, if the section applied to foreign persons not subject to U.S. taxation it would have presented a major reversal of the treatment of installment payments received after such persons became subject to U.S. taxation. More specifically, prior to 1980 the Service indicated that the installment sale provisions did not apply to foreign persons not subject to U.S. income tax since they were not taxpayers.[231] Consequently, when such persons became subject to U.S. tax subsequent to consummating an installment sale transaction, payments received after entry into the U.S. would be non-taxable returns of capital since the full gain would have been realized and recognized at the time of the pre-residency sale as the installment method was simply inapplicable to such nonresidents. Conversely, if the revised installment sale provisions applied to an installment sale by such a foreign person after the 1980 changes, then installments received after becoming subject to U.S. taxation would presumably trigger taxable income in the United States since no election out of the installment method was made at the time of the original foreign sale. Such a conclusion might follow from the language of revised section 453 that

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[226] *Id.*
[227] *Id.*
[228] *See* I.R.C. § 453(a) (2001).
[229] *Id.*
[230] S. Rep. No. 1000, 96th Cong., 2d Sess. (1980) at 11-12.
[231] *See id.* In any event, no foreign person not subject to U.S. taxation would have had reason to consider making such an election or would have found the election advisable as an economic matter even if considered.

purports to apply to any "disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs."[232]

Congress, however, was aware of this potential interpretation of its 1980 amendments and indicated in the legislative history that it did not in fact intend to alter current law treatment of persons becoming U.S. residents and citizens after having made a foreign installment sale.[233] In this regard the legislative history provided that:

> Under the installment method rules of present law, these gains do not become taxable as payments are received after the seller becomes a resident or citizen subject to U.S. income tax for a taxable year subsequent to the year in which the sale was made. It is intended that the election regulations will continue this treatment in appropriate cases. Further, it is intended that similar treatment will be provided for a deferred payment sale made by a tax-exempt organization which later receives payments after losing its tax-exempt status.[234]

This legislative history indicated that despite any possible contrary interpretations of the post-1980 language of section 453, Congress did not intend the provision to apply to persons not subject to U.S. income taxation (whether they be foreigners or tax-exempt entities).[235] Thus the history of section 453 supports the proposition that Code provisions are only applicable universally when appropriate to their purpose and such interpretation properly reflects Congressional intent.[236] Additionally, these materials indicate that the scope of a section often is limited by reference to persons actually subject to U.S. taxation and that term "taxpayer" is relevant in identifying such provisions.[237]

While the "election out" regulations under section 453 have never specifically implemented Congress' 1980 directive, in a Technical Advice Memorandum (TAM) the Service examined a situation where a nonresident alien sold property in 1981 on the installment method and then became a U.S. resident.[238]

The taxpayer did not report any gain from the receipt of installment payments during his period of residency despite the fact that he never made any election out of the installment method.[239] The Service found that in light of the legislative history to the 1980 installment sale provisions, the taxpayer should not have to report income under the installment method for the years of his residency

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[232] I.R.C. § 453(b)(1) (2001). However, a strong argument exists that the overall language of the statute supports the position that it was still intended to not apply to foreign persons not subject to U.S. taxation. This argument is based on references in the statute to "the taxable year in which the disposition occurs" and the fact that the provision permitting elections out of installment sale reporting are specifically to be made by "taxpayers." *Id.*

[233] S. Rep. No. 96-1000 (1980).

[234] S. REP. NO. 96-1000, at 12 (1980).

[235] *Id.*

[236] See id.

[237] See id.

[238] Tech. Adv. Mem. 87-08-002 (Oct. 29, 1986).

[239] *Id.*

despite not having elected out of the installment method.[240] Consequently the Service ruled that the taxpayer was "deemed" to have elected out of the installment method.[241]

Finally, despite the conclusion of the TAM (that the installment sale provisions of the Code would not be applied to a nonresident), in discussing the relevant law the TAM summarized the applicable rule of law more broadly than appears warranted by the cited authorities.[242] More specifically, the TAM stated:

> In the application of U.S. income tax laws, the concepts established by that body of law are controlling despite the fact that a particular transaction under consideration may have had its origin in a foreign country and, to that extent, may have been affected by a foreign income tax law. See Mary Duke Biddle v. Commissioner, 302 U.S. 573, Ct. D. 1303, C.B. 1938-1, 309; Edward D. Utermeyer v. Commissioner, 59 Fed. 2nd 1004, Ct. D. 644, C.B. XII-1, 157 (1933), affirming 24 B.T.A. 906 (1931), cert. denied, 287 U.S. 647 (1932). Based on this principle, in order to determine the application of the installment method rules to the contract payments in 1983 and 1984, *it must be determined what the U.S. tax treatment would have been in 1981 if taxpayer had been a resident at the time of the sale.* The treatment of this transaction under the tax laws of Country X is not relevant in determining U.S. tax law consequences.[243]

Although the italicized portion of the ruling appears contrary to the thesis of this article that the Code does not apply universally to foreign persons, the broad formulation of the legal standard in this ruling is not supported by the cases cited or even by the explanation of relevant law in the TAM itself.[244] Thus, the statement is best viewed as an inexact shorthand method for determining the reach of the Code provisions when no limiting Congressional intent exists. The cited authorities suggest that while the provisions of the Code are generally presumed to apply based on U.S. tax laws and principles when relevant to determining U.S. tax consequences, if the language or purpose of a statutory provision is clearly limited or a contrary Congressional intent is evident, then U.S. principles will not govern the characterization of the transaction. Consequently, the existence of such a presumption regarding the applicability of U.S. principles in appropriate cases does not support the broad position that a foreign person not otherwise subject to U.S. taxation is always treated "as if" he were a U.S. person for purposes of applying the Code since the general rule stated above recognizes that Congress can and does act to limit the reach of particular Code provisions.[245] Indeed, in the situation discussed in the ruling this was in fact the case since Congress had specifically noted in the legislative

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[240] *Id.*
[241] *Id.*
[242] Tech. Adv. Mem. 87-28-002 (Oct. 29, 1986).
[243] *Id.* (emphasis added).
[244] *See supra* Part II.C. (discussing *Biddle*).
[245] *Id.*

history to the 1981 change that the provision was not to apply to foreign persons.[246]

2. Taxable Year Election Provisions

Another example of the Service accepting both the general rule that Code provisions can be limited in their scope, and the fact that the term "taxpayer" often serves as the indication that Congress intended such limited treatment, is found in the Code provisions governing the determination of a person's taxable year. More specifically, the issue is whether the relevant statutory provisions permit a foreign person without prior U.S. contacts to adopt a fiscal year at the time that he becomes subject to U.S. taxation or whether the prior approval of the Service is required. The resolution of this question hinges on whether such a foreign person is treated as having a "taxable year" during the period he is not subject to U.S. taxation such that using a fiscal year after his change in status represents a change in his taxable year.

Section 441(a) provides that "taxable income shall be computed on the basis of the taxpayer's taxable year."[247] Section 441(b) defines "taxable year" as (1) the taxpayer's annual accounting period, used in regularly computing income and keeping his books, or (2) the calendar year if no books are kept or no annual accounting period exists.[248] Generally, section 442 provides that a taxpayer cannot change its taxable year without the consent of the Service.[249] However, Treasury Regulation Section 1.441-1(b)(3) provides that a "new taxpayer" may adopt any permissible taxable year on its first tax return without prior approval from the Service.[250] Thus, by their literal terms all these provisions purport to only apply to "taxpayers."[251]

In Revenue Ruling 80-352[252] the Service considered this specific issue. They ruled that a nonresident alien could, on his first federal income tax return elect a fiscal year as his U.S. taxable year, despite the fact that the individual had used a calendar year for foreign tax purposes.[253] In reaching this conclusion, the Service relied on the fact that the taxable year provisions of the Code were limited in scope and had no bearing on a person not subject to U.S. taxation.[254] In so finding, the Service relied on the term "taxpayer" as a substantive limitation on the scope of the relevant statutory provisions, stating:

> Prior to the commencement of A's trade or business in the United States, A had never been required by any provision of internal revenue laws or regulations to file a return or any equivalent document with the

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[246] S. Rep. No. 96-1000 (1980).
[247] I.R.C. § 441(a) (2001).
[248] I.R.C. § 441(b) (2001).
[249] *Id.* § 442.
[250] Treas. Reg. § 1.441-1(b)(3).
[251] *See* I.R.C. § 441(a) (2001); Treas. Reg. § 1.441-1(b)(3).
[252] 1980-2 C.B. 160.
[253] *Id.*
[254] *Id.*

> Service. *Therefore, although A was in existence, A was not a United States taxpayer.* When A began A's trade or business in the United States, A was required to file a federal income tax return for the first time and was, therefore, a new taxpayer within the meaning of sections 1.441-1(b)(3) and 1.442-1(a)(2) of the regulations.[255]

It should be noted that the Deficit Reduction Act of 1984 addition of section 7701(b)(9) to the Code altered the narrow holding of Revenue Ruling 80-352.[256] This change and the relevant implementing regulations now provide that for an alien individual to adopt a fiscal year upon becoming subject to U.S. income taxation, he must show that he used a fiscal year and maintained appropriate books prior to becoming subject to U.S. income taxation.[257] That is, a consistency requirement is imposed between the pre- and post-U.S. taxation periods for determining the individual's accounting period. Thus, the use of the calendar year for foreign tax purposes by the nonresident alien in Revenue Ruling 80-352 would have forced the use of the calendar year as the taxable year for U.S. tax purposes.[258] However, Congress' adoption of a specific consistency rule in this regard should not be viewed as abrogating the logic of the revenue ruling that the taxable year provisions of sections 441 and 442 only apply to specified persons (*i.e.*, taxpayers). Indeed, the modification indicates that such a consistency limitation only applies because Congress specifically acted to cause the Code to base its taxable year determination on the prior foreign practices of the otherwise new taxpayer.

Further confirmation of the Service's understanding of the scope of the limiting purpose of the term "taxpayer" as used in the taxable year provisions is demonstrated by the regulations under section 442, relating to the need for IRS approval to change a taxable year.[259] Those regulatory provisions, in the context of a foreign corporation which is not subject to U.S. taxation, but which qualifies

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[255] *Id.* at 161 (emphasis added). This ruling is in accord with the Tax Court's view of the law as stated in dicta in Freudmann v. Comm'r, 10 T.C. 775 (1948) (stating that a new resident could adopt a taxable year under the relevant statutory provisions but nevertheless requiring application of a calendar year based on a lack of adequate books and records supporting the claimed fiscal taxable year.). Although the statements in *Freudmann* constitute dicta, in an earlier memorandum decision the Tax Court allowed a new resident to adopt a fiscal year without Service approval. *See* Colon, *supra* note 4, at 61-70; Dale, *supra* note 5, at 277-78; Godson v. Comm'r, 5 T.C.M. (CCH) 648 (1946). The revenue ruling apparently overturns the conclusion reached in an earlier private letter ruling where the Service stated that since a nonresident alien was "in existence" (that is, alive) prior to becoming a resident, he could not be a "new taxpayer." *See* Priv. Ltr. Rul. 78-44-042 (Apr. 25, 1978). For commentary on this topic see generally Richard L. Goldman & Peter J. Connors, *IRS Puts Tough Limits on Election of Fiscal Year by Foreign Individuals*, 53 J. TAX'N. 172 (1980); Goldman & Connors, *Aliens May File Fiscal-Year Returns: What Are the Implications of the Service's New Position?*, 54 J. TAX'N. 294 (1981). For a further discussion of the meaning of taxpayer in the context of selecting a taxable year on behalf of tax-exempt entities, see *infra* Part IV.B.

[256] *Compare supra* note 255 and accompanying text *with* I.R.C. § 7701(b)(9) *and* Treas. Reg. § 301.7707-6(a) (1992).

[257] *See* Treas. Reg. § 301.7701-6(a) (1992).

[258] *See id.*

[259] *See id.* (as amended in 1987).

as a controlled foreign corporation, and therefore was intended by Congress to have a taxable year for purposes implementing the Subpart F provisions of the Code, provide that a "controlled foreign corporation or a foreign corporation that meets the stock ownership requirements of a foreign personal holding company that is not subject to United States income tax *shall be treated for the purposes of this section as a taxpayer* within the meaning of section 7701(a)(14)."[260]

The above discussion demonstrates that the term "taxpayer" generally exerts a substantive limitation on the scope of Code provisions wherein it appears. These authorities also confirm the general rule that the Code does not automatically reach all persons in all situations, but only has universal application when specifically intended by Congress.

IV. ARGUABLY CONTRADICTORY INTERPRETATIONS OF THE TERM TAXPAYER

A number of other authorities contain dicta arguably contrary to the foregoing discussion.[261] That is, such authorities could be viewed as indicating that the definition of taxpayer in section 7701(a)(14) must be applied uniformly and that a person's liability for *any* U.S. tax makes the person a "taxpayer" for all purposes under the Code. Yet even in these cases the actual holdings generally demonstrate that a person's status as a taxpayer for a particular U.S. tax (usually the income tax provisions) ultimately turns on an analysis of the wording, policy and structure of the relevant tax, and indicate that the person's status as a taxpayer under a different, unrelated tax does not provide any meaningful guidance regarding her status under the tax in question.[262]

A. Partnership Authorities

A partnership is a "pass-through" entity for federal income tax purposes. Because the entity itself is not subject to U.S. income taxation, one would expect that a partnership would not qualify as a taxpayer, at least for income tax purposes. This view seems to be confirmed by the Code itself.[263] Section 706(b)(1)(A) states that "[t]he taxable year of a partnership shall be determined *as though* the partnership were a taxpayer."[264] The implication is that a partnership generally is not a taxpayer for income tax purposes. On the other hand, in determining how the partners of a partnership are taxed on the income from the partnership, it is necessary to apply most of the substantive income tax provisions of the Code at the partnership level. Further, to create uniformity in the treatment of items among partners it is desirable to have elections made in a consistent manner for all partners. These two goals are achieved by Section 703. Section 703(a) provides that the taxable income of a partnership shall be

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[260] Treas. Reg. § 1.442-1(c)(5) (as amended in 1987) (emphasis added).
[261] *See infra* Part IV.A-C (discussing such contrary authorities).
[262] *See* Demirjian v. Comm'r, 457 F.2d 1 (3d Cir. 1972).
[263] I.R.C. § 706(b)(1)(A) (2001).
[264] *Id.* (emphasis added); *see also* Treas. Reg. § 1.706-1(b)(1)(i) (as amended in 1987).

computed in the same manner as in the case of an individual.[265] Section 703(b) provides that, with limited exceptions, any election affecting the computation of taxable income derived from a partnership shall be made by the partnership.[266]

Reading section 703 in conjunction with section 706 leads to the conclusion that a partnership is not a taxpayer for income tax purposes under section 7701(a)(14) (a conclusion consistent with the view that a person must be liable for the particular type of U.S. tax involved to qualify as a taxpayer in the context of such statutory provision). Instead, the partnership is the vehicle for determining the taxable income or loss of the relevant taxpayers (*i.e.*, the partners).[267] Nevertheless, Congress intended that a partnership would be treated as if it were a taxpayer for any purpose bearing on the computation of taxable income or elections of the actual taxpayers (*i.e.*, the partners). Consequently, the authorities holding that partnerships do qualify as taxpayers for income tax purposes can be justified based on Congress' overriding intent to have the income tax provisions (other than the actual imposition of tax) applied on an entity level to partnerships, despite the fact that a partnership would not normally qualify as a taxpayer for income tax purposes under section 7701(a)(14). Indeed, this logic has been specifically applied by the Third Circuit in analyzing whether a partnership could properly make an election without being a section 7701(a)(14) taxpayer.[268]

The Service has also explicitly considered the interplay between the section 7701(a)(14) definition of taxpayer and Congress' overriding intent to have partnerships generally treated as entities for income tax purposes.[269] In General Counsel Memorandum (GCM) 36550, the General Counsel's Office considered whether the surviving partnership in a merger could continue to use accelerated depreciation methods for assets acquired from the merged partnerships.[270] If the partners, rather than the partnership, were considered the "taxpayer" owning the assets, then no transfer of the property would have occurred and accelerated depreciation could be continued.[271] However, if the partnership were considered the taxpayer on an entity basis, then the benefits of accelerated depreciation would be lost on the transfer of the assets.[272] In analyzing whether the merged partnerships should be considered transferring taxpayers, the GCM stated:

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[265] I.R.C. § 703(a) (2001).
[266] *Id.* § 703(b).
[267] H.R. No. 1337, 83rd Cong, 2d Sess. (1954) at A222-23; S. Rep. No. 1622, 83rd Cong., 2d Sess. (1954) at 378.
[268] Demirjian v. Comm'r, 457 F.2d 1, 6 n.23 (3rd Cir. 1972) ("Petitioners contend that since a partnership is not a "taxpayer", 26 U.S.C. §7701(a)(14), it cannot make an election under Section 1033, which provides that an election must be made by a taxpayer. It seems clear that in adopting the entity approach to reporting income, Congress intended that a partnership be considered a taxpayer for purposes of computing and reporting income.")
[269] *See* Gen. Couns. Mem. 36,550 (Jan. 13, 1976).
[270] *Id.*
[271] *Id.*
[272] *Id.*

> [The relevant accelerated depreciation provisions] look to original use commencing with "the taxpayer." Code § 7701(a)(14) defines "taxpayer" as a person subject to any internal revenue tax. Code § 701 provides that partners and not partnerships shall be liable for taxes imposed by the Code. On the basis of Code §§ 701 and 7701(a)(14), it can be argued the aggregate theory should be adopted for purposes of Code § 167. But, other provisions suggest that reliance on Code § 7701 is not appropriate. For example, Code §§ 703(a) refers to a partnership's "taxable years;" the fact that partnerships have "taxable years" implies that they are, at least in some aspects, "taxpayers." . . . There exists no exclusive rule as to when a partnership will be viewed as an entity or an aggregate. The resolution is generally dependent upon the question to be resolved.[273]

The discussion in the GCM reflects the view that a partnership would not generally be a taxpayer under the definition in section 7701(a)(14), but notes that the intent of the Code in respect of the particular question at hand could indicate that Congress intended entity concepts to override the general definition.[274] The ultimate revenue ruling published on this question[275] held that the merged partnership could not continue to use the accelerated depreciation methods of its predecessors, an entity approach.[276]

Despite the foregoing authorities (which indicate that while a partnership may be treated as a taxpayer due to overriding entity policies, it is not literally a taxpayer for income tax purposes within the meaning of section 7701(a)(14)), a series of private letter rulings under section 29 of the Code and a recent Tax Court decision take the position that a partnership is a taxpayer for income tax purposes as long as the partnership can be shown to be liable for *any* other U.S. tax, regardless of amount or type.[277] As a practical matter under this approach every partnership will qualify as a taxpayer.

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[273] *Id.*

[274] Gen. Couns. Mem. 36,550 (Jan. 13, 1976).

[275] Rev. Rul. 77-458, 1977-2 C.B. 220, *clarified by*, Rev. Rul. 90-17, 1990-1 C.B. 119.

[276] *Id.* While the General Counsel Memoranda reached the opposite conclusion (*i.e.*, that the relevant policy considerations did not require an entity approach so the partners would be the relevant "taxpayers"), its logic remains relevant irrespective of differing conclusions regarding the strength of Congress' desire for entity treatment of partnerships for depreciation purposes.

[277] *See, e.g.*, Hayden v. Comm'r, 112 T.C. 115, 120 (1999), *aff'd*, 204 F.3d 772 (7th Cir. 2000); Priv. Ltr. Rul. 1999-43-046 (July 29, 1999); Priv. Ltr. Rul. 1999-06-028 (Nov. 18, 1998); Priv. Ltr. Rul. 1999-04-027 (Nov. 3, 1998); Priv. Ltr. Rul. 1999-05-024 (Oct. 21, 1998); Priv. Ltr. Rul. 98-41-013 (June 29, 1998); Priv. Ltr. Rul. 98-39-022 (June 26, 1998); Priv. Ltr. Rul. 98-37-028 (June 12, 1998); Priv. Ltr. Rul. 98-36-031 (June 10, 1998); Priv. Ltr. Rul. 98-32-011 (May 7, 1998); Priv. Ltr. Rul. 98-32-014 (May 7, 1998); Priv. Ltr. Rul. 98-32-017 (May 7, 1998); Priv. Ltr. Rul. 98-32-021 (May 7, 1998); Priv. Ltr. Rul. 98-31-010 (Apr. 29, 1998); Priv. Ltr. Rul. 98-31-006 (Apr. 23, 1998); Priv. Ltr. Rul. 97-52-006 (Sept. 19, 1997); Priv. Ltr. Rul. 97-01-041 (Oct. 4, 1996); Priv. Ltr. Rul. 96-31-006 (Apr. 6, 1996); Priv. Ltr. Rul. 95-29-019 (Apr. 24, 1995); Priv. Ltr. Rul. 94-42-009 (July 14, 1994); Priv. Ltr. Rul. 89-42-068 (July 26, 1989); Priv. Ltr. Rul. 87-38-085 (June 29, 1987); Priv. Ltr. Rul. 84-43-084 (July 25, 1984).

Section 29 (formerly section 44D) provides a taxpayer an income tax credit for production of nonconventional fuels if they are sold to an unrelated person.[278] It is common for several businesses to jointly create a partnership to produce such fuel and sell part of the production to its partners. Consequently, if the partnership were the relevant taxpayer, a sale to a less than 50 percent partner would still qualify for the credit as a sale to an unrelated person. However, if the credit applies at the partner level then a portion of the sales would be to itself and no credit would obtain. In a series of private letter rulings, the Service has taken the position that a partnership is a taxpayer for section 29 purposes and cited section 7701(a)(14) as authority.[279] While most of the rulings do not go into detail regarding their analysis, at least one contains the following explanation:

> To determine whether Partnership M is a taxpayer under section 44D(a)(2)(A) of the Code we note that this term is not defined in section 44D, therefore, the definition in section 7701(a)(14) is to be used, i.e., any person subject to any internal revenue tax. By reason of section 7701(a)(1), Partnership M is a "person". Although a partnership is not subject to income tax it is subject to other internal revenue taxes such as federal unemployment tax (section 3301) and old-age survivors and disability insurance tax (section 3111), hence we conclude that Partnership M is a "taxpayer."[280]

While the reasoning of the ruling is contrary to the interpretation of section 7701(a)(14) in Part III above, its conclusion is not. That is, based on the entity concept of section 703 and Congress' desire to promote investments in nonconventional fuel technologies, it seems correct to treat a partnership in this context as a taxpayer, based on reasoning wholly unrelated to whether the partnership is (or might be) liable for employment taxes. Consequently, since the same result would be reached irrespective of how section 7701(a)(14) applies, the highly abbreviated explanation contained in certain of these rulings should not be seen as representing the proper interpretation of section 7701(a)(14). Additionally, the relatively narrow applicability of section 29 and the fact that the interpretation is contained in private letter rulings indicate that the stated explanation should be given less weight.

In *Hayden v. Commissioner*[281] the Tax Court had to determine whether a "taxpayer" election to currently expense the cost of depreciable business assets under section 179 and certain limits on the amount deductible should be applied to each partner or whether the Service was correct in applying the election and limitations at the partnership level.[282] In finding for the Service the court

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[278] I.R.C. § 29 (2001).

[279] *Id.* While the General Counsel Memoranda reached the opposite conclusion (*i.e.*, that the relevant policy considerations did not require an entity approach so the partners would be the relevant "taxpayers"), its logic remains relevant irrespective of differing conclusions regarding the strength of Congress' desire for entity treatment of partnerships for depreciation purposes.

[280] Priv. Ltr. Rul. 84-43-084 (July 25, 1984).

[281] 112 T.C. at 117.

[282] *Id.*

primarily relied on the entity policies of section 703 to conclude that the partnership was the taxpayer for purposes of section 179.[283] However, the court also commented on the scope of section 7701(a)(14):

> The gravamen of petitioners' argument is that a partnership is not a taxpayer under the definition contained in section 7701(a)(14). It should be noted initially that this is literally incorrect. A taxpayer is defined as "any person subject to any internal revenue tax." Sec. 7701(a)(14). In turn, a person "shall be construed to mean and include * * * [inter alia] a * * * partnership". Sec. 7701(a)(1). Under section 701 a partnership generally is not "subject to the income tax", rather the partners are "liable for income tax only in their separate or individual capacities." But, a partnership may be subject to a variety of internal revenue taxes, including, e.g., employment taxes under section 3111(a) (United States v. Hays, 877 F.2d 843 (10th Cir. 1989)) or other excise taxes (Young v. Riddell, 283 F.2d 909 (9th Cir. 1960)).[284]

Although the court's statement gives a broad interpretation to the "any internal revenue tax" portion of the definition, this statement is at worst an alternative rationale for the court's decision and is better seen as dicta that does not address the fact that a partnership's liability for excise or employment tax provides no meaningful guidance to the specific income tax issue raised in the case. That is, if perchance the partnership could be shown never to have been liable for any other tax, it is unlikely that the court would have found that fact to be a dispositive factor and ruled the other way. This is especially true since in this context the same result should have been achieved regardless of whether section 7701(a)(14)'s definition was broadly or narrowly interpreted. Consequently, the court's statements regarding the scope of section 7701(a)(14) are ultimately unpersuasive.

Finally, it should be noted that a leading partnership treatise makes the following statement in respect of whether a partnership is a taxpayer:

> Most of the elections to be made by the partnership are elections which the particular provision in the Code requires to be made by the "taxpayer." Section 7701(a)(14) defines a taxpayer as "any person subject to any internal revenue tax." Section 701 states expressly that a partnership "shall not be subject to the income tax imposed by this chapter." Section 706(b)(1) provides that the taxable year of a partnership shall be determined "as though the partnership were a taxpayer," implying that it is not. *However, a partnership still should qualify as a taxpayer since it is subject to other internal revenue taxes (e.g., social security taxes).*[285]

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[283] *Id.* at 119-20.
[284] *Id.*
[285] ARTHUR B. WILLIS, JOHN S. PENNELL & PHILLIP F. POSTLEWAITE, *Partnership Taxation*, ¶ 9.04[1], at 9-102 (6th ed. 1997) (footnote omitted) (emphasis added).

Although this statement takes a broad literal approach to the meaning of section 7701(a)(14), the only authority cited for the sweeping interpretation in the emphasized sentence is the case of *Southern v. Commissioner*.[286]

Southern dealt with the question of whether the investment tax credit provisions should be applied at a partner or partnership level.[287] In ruling that a partnership was a taxpayer for these purposes, the court stressed the application of the entity approach in informing its interpretation of the statutory term, but then also commented in a footnote that partnerships are taxpayers generally under section 7701(a)(14):

> The amounts computed under section 38 are distributable partnership items. While the investment credit provisions do not refer to partnerships, in the context of section 48(c)(1), relating to the purchase of used section 38 property, we have recognized that an entity rather than an aggregate approach should be used in determining whether the property was used by the same person who used the property prior to purchase. Moradian v. Commissioner, 53 T.C. 207, 211-212 (1969). Although the operative term used when determining the amount of investment credit is "taxpayer" and not "person"; *see e.g.*, section 46(c)(1); it is clear that an entity rather than an aggregate approach is contemplated. As in *Moradian* the operative term includes a partnership. Sec. 7701(a)(14). /5/ It is the partnership which places the property in service under section 46(c)(1). Therefore, the focus of the investment credit provisions is initially on the partnership as an entity, and the investment credit is a partnership item for which each partner must report a distributable share.
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> /5/ Sec. 7701(a)(14) provides that a "taxpayer" is any person subject to any internal revenue tax. Sec. 701 specifically exempts a partnership from income tax liability but does not exempt a partnership from other taxes imposed by the Internal Revenue Code. Thus, a partnership is a taxpayer for purposes of sec. 7701(a)(14). *See* 1 A. Willis, J. Pennell & P. Postlewaite, Partnership Taxation, sec. 72.01, at 72-3 (3d ed. 1981).[288]

Once again, the comment of the court regarding the scope of section 7701(a)(14) was gratuitous since the same result should have been reached based on the strong entity preference evidenced by Congress in subchapter K in any event. Additionally, the court's reliance on an earlier version of the Willis treatise, which itself made this bald assertion without analysis or citation, should not be given much weight.

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[286] 87 T.C. 49 (1986). In this regard the Willis treatise does not even cite the section 29 private letter rulings discussed above. *Cf.*, WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 9.01[10], at 9-42 (3d ed. 1997) ("Finally, a partnership is *apparently* a "taxpayer" within the meaning of § 7701(a)(14)" *citing* Priv. Ltr. Rul. 84-43-084 (July 25, 1984) (emphasis added)).

[287] *Southern*, 87 T.C. at 55.

[288] *Id.* at 55 (certain footnotes omitted).

Consequently, when viewed in their entirety, the partnership materials discussed above strongly support the conclusion that the question of whether a partnership is a taxpayer (*i.e.*, an entity) for income tax purposes should be based solely on the context of the income tax provisions and Congressional intent regarding the integration of Subchapter K with those provisions. A partnership's status as a taxpayer for purposes of other unrelated taxes should have no bearing on the analysis. Indeed, any reliance on the fact that a partnership was a taxpayer for purposes of unrelated taxes (like excise or employment taxes) would create wholly arbitrary results since the policy choice between entity and aggregate status for purposes of such taxes would have no logical relation to the proper choice in the income tax context. Additionally, such a rule would arguably result in different tax consequences for similarly situated partnerships based on whether or not they were subject to completely unrelated U.S. taxes.

Fundamentally, the dicta, which suggests that section 7701(a)(14) means that a taxpayer for one internal revenue tax is a taxpayer for purposes of all internal revenue taxes, would cause section 7701(a)(14) to act as a substantive link among many unrelated and independent taxes, causing one tax to affect the legal outcome of another.[289] This cannot be a proper reading of section 7701(a)(14). The partnership cases demonstrate that the status of a partnership as a taxpayer for purposes of the income tax is a complex issue that depends on factors uniquely related to the income tax, and a partnership's status as a taxpayer under such unrelated taxes as excise or employment, does not provide meaningful guidance for purposes of the income tax.

B. Tax-Exempt Entity Authorities

In Revenue Ruling 67-173, 1967-1 C.B. 101, the Service considered whether a domestic entity exempt from U.S. income tax under section 501 ("tax-exempt entity") must ask permission to change its taxable year if it looses its tax-exempt status. In the ruling, two tax-exempt entities lost their tax-exempt status and attempted to adopt a fiscal year in their first income tax returns as tax paying entities.[290] One of the entities had been required to file annual information returns showing its income under section 6033 and the other had not been required to file such returns.[291] In finding that the entities could not adopt a taxable year different from the period they had used to maintain their books when they were tax-exempt, the ruling stated:

> Although both *X* and *Y* as a result of being held to be taxable organizations are required for the first time to file Form 1120 returns of income subject to the taxes imposed under subtitle A of the Code, neither is a "new taxpayer" within the meaning of the regulations. In order for a corporation to qualify as a 'new taxpayer' within the meaning of section 1.442-1 of the regulations, the *requirements of section 441 of the Code must be met, and these requirements cannot be*

[289] *See Hayden*, 112 T.C. at 119-20.
[290] Rev. Rul. 67-173, 1967-1 C.B. 101
[291] *Id.*

> *met if the taxpayer was in existence*, even though exempt from taxation, for a period of time preceding that for which it must file its first return of income subject to taxation under subtitle A of the Code. *If a taxpayer was in existence prior to such time and has an established annual accounting period on the basis of which its books and records are kept, then under section 441(c) of the Code such period is its "annual accounting period" and under section 441(b) of the Code this is its "taxable year."* If such a taxpayer fails to maintain books and records, its "taxable year" is the calendar year under section 441(g) of the Code.[292]

It is significant to note that while the ruling is discussing the term "new taxpayer" it never refers to section 7701(a)(14).[293] The real focus of the ruling is that a person who was in existence prior to becoming a taxable entity, has already established an accounting method for keeping its books.[294] Under the logic of the ruling, if such an established accounting method exists on the first day that the tax-exempt entity becomes taxable, then the requirement of section 441 that any fiscal year must be the same as is used to by a person to "regularly compute his income in keeping his books" can never be satisfied.[295] As such, the ruling does not depend at all on the scope of section 7701(a)(14)'s definition of taxpayer, and indeed that section is not even cited in the ruling.

Nevertheless, in examining the same issue the district court in *Forrest City Production Credit Ass'n v. United States*[296] justified reaching the same conclusion (*i.e.*, that upon becoming subject to income taxation a former tax-exempt entity must continue using its historic "taxable year" unless the Service consents to the change) in part by arguing that a tax-exempt entity is a "taxpayer" if it pays FICA or other excise taxes.[297] In *Forrest City,* the tax-exempt entity had claimed that it qualified as a "new taxpayer" eligible to adopt a new fiscal year without the approval of the Service since it was not a "taxpayer" prior to losing its tax-exempt status.[298] The district court rejected this argument in harsh terms stating:

> There is no merit to plaintiff's contention that through December 31, 1960, it was never a "taxpayer"; that, therefore, as of January 1, 1961, when it lost its exemption, it became a new taxpayer; that the return filed for the period January 1, 1961, through September 30, 1961, was the first return of a new taxpayer; and that, therefore, it came within the provisions of Section 1.442-1(a) . . . . Contrary to plaintiff's position is Rev. Rul. 67-173 [wherein the Service found that a similarly situated tax-exempt entity did not qualify as a "new taxpayer".] . . . . Moreover, Section 501(a) exempts qualifying

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[292] *Id.* at 103 (emphasis added).
[293] *See id.*
[294] Rev. Rul. 67-173, 1967-1 C.B. 101, 103.
[295] *Id.* at 101.
[296] 300 F. Supp. 609 (E.D Ark. 1969), *aff'd*, 426 F.2d 819 (8th Cir. 1970) (per curiam).
[297] *Id.* at 613.
[298] *Id.* at 611.

> organizations from income taxes only. The fact that plaintiff may have derived its exemption under Section 501(a) does not mean that it was not a "taxpayer" as defined in the Code. The term "taxpayer" is broadly defined by the Code itself. Section 7701(a)(14) in pertinent part, provides that the "term 'taxpayer' means any person subject to any internal revenue tax." .... Thus, if through December 31, 1960, taxpayer's exemption from taxation did in fact stem from Section 501, it is an exemption from income taxes only. Therefore, since plaintiff was not exempted from F.I.C.A. taxes, it was a "taxpayer" prior to January 1, 1961, and cannot thus be said to be a "new taxpayer" as of that date.[299]

It should be noted that the Service's rationale as enunciated in Revenue Ruling 67-173 would reach consistent results among all tax-exempt entities losing their tax-exempt status, but the logic of the court in *Forrest City* would create potentially disparate treatment for an entity that could show it never paid any employee salaries subject to FICA taxes (albeit a somewhat unlikely situation). Additionally, an alternative rationale could well justify the result reached in *Forrest City* without giving the term taxpayer an overly broad reading. That argument goes as follows: Even though a tax-exempt entity is not taxpayer for income tax purposes under section 7701(a)(14), the fact that Congress directed such entities to generally file annual information returns reporting their income "for the purposes of carrying out the internal revenue laws" indicates a strong Congressional intent to treat domestic tax-exempt entities as taxpayers for purposes of determining their "taxable year" in the context of such annual information returns.[300] Indeed, the court in *Forrest City* took notice of this language as another basis supporting its conclusion.[301]

Consequently, despite language to the contrary by the district court in *Forrest City*, it appears that requiring former tax-exempt entities to seek Service approval before changing their historic bookkeeping and information return reporting period does not mandate that the term taxpayer be interpreted broadly.

C. FIRPTA Authorities

Under section 897 of the Code any gain or loss recognized by a nonresident alien individual or a foreign corporation upon the disposition of a United States real property interest is subjected to U.S. income taxation "as if *the taxpayer* were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business."[302] Although this section explicitly refers to foreign corporations and nonresident aliens as "taxpayers," this usage should not be viewed as indicating

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[299] *Id.* at 612-613 (footnotes omitted).
[300] *See* I.R.C. § 6033 (2001).
[301] *Forrest City*, 300 F. Supp. at 614. Additionally, the correlation between section 6033 and income taxes was even closer at the time of the Forrest City case since at that time section 6033 referred to the "provisions of Subtitle A" rather than to "the internal revenue laws." I.R.C. § 6033 (1969).
[302] I.R.C. § 897(a)(1)(B) (2001) (emphasis added).

that all foreign persons were intended to automatically qualify as "taxpayers." Rather, the statute merely indicates that foreign persons who actually have gains or losses on the disposition of U.S. real property are indeed actually subject to taxation under that provision and therefore are "taxpayers" in that context for purposes of section 897 as a result of their disposition.[303]

V. THE LOGIC OF THE CODE'S USE OF THE TERM TAXPAYER

While there are certain authorities containing contrary dicta, the definition of taxpayer in section 7701(a)(14) is generally applied contextually and is highly influenced by Congressional intent surrounding the intended scope of the term in the particular Code provisions where it is utilized. Such a contextual approach to interpreting the definitional sections of the Code appropriately implements their intended purpose in facilitating the codification of a wide array of distinct and disparate taxes into a single easily accessed body of law. A circumscribed contextual meaning also avoids creating arbitrary differences in the U.S. tax treatment of similarly situated persons merely based on whether they have ever been subject to completely unrelated excise or other U.S. taxes in the past. The fact that the term taxpayer generally indicates a section of the Code limited in scope can also be seen by an examination of the parts of the Code in which that term most frequently appears. The term is used most often in the income tax provisions of the Code dealing with deductions, accounting methods, characterization of income and procedural matters. Conversely, the term is only used sparingly in connection with the non-recognition provisions of the Code and the estate, gift and excise tax provisions. That is, provisions having a strong focus on property transfers, where Congress' intended scope is more likely to extend to foreign persons, use the term taxpayer only rarely.

A. Provisions Supporting Basis, E&P and Common Law Rules

The authorities discussed in Part II of this article demonstrate that the basis and earnings and profits provisions of the Code were intended to apply broadly to all property and persons wherever located. Similarly, other sections of the Code that impact basis determinations (non-recognition provisions) or the treatment of corporate entities are also structured in a manner that applies universally. This way the integrity of the Code's basis and earnings and profits regimes are bolstered. It is not necessary to apply every provision of the Code to all persons to obtain the desired result and Congress has not done so.

For instance, almost all the provisions of Subchapter C of the Code (dealing with corporate distributions and adjustments) apply to "corporations" without specifying either their status as domestic or foreign or whether they are subject to any U.S. tax. Consequently, the provisions of Subchapter C apply universally by their terms based on the implementing language that Congress has chosen for

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[303] *Id.*

these rules. While the term taxpayer does appear in several sections of Subchapter C, the term is never used to define the scope of a significant operative rule.[304] Rather, the term appears in sections explaining the correlative consequences of an operative provision applying.[305] That is, once an uncircumscribed provision becomes applicable, these sections sometimes refer to any person determining the consequences of such application as a taxpayer.[306] While this may be inartful drafting, the context and intended coherence of the system make it inescapable that the term taxpayer is being used with a specific contextual meaning in these provisions. Various other non-recognition provisions are also phrased in terms that are broadly applicable to all persons to indicate their intended universality.[307]

It should also be noted that under the logic of the *Biddle* decision, common law U.S. legal principles and doctrines also often have a more universal application. For instance, to the extent relevant for U.S. tax purposes, whether a particular instrument is classified as debt or equity would generally be determined under U.S. principles. Similarly, in determining the relevant transaction for U.S. tax purposes, the common law doctrines of substance over form, step transaction and business purpose are generally employed.

B. Provisions Applying Narrowly

Contrary to the manner in which the term "taxpayer" is used in most of the non-recognition sections of the Code, when the term taxpayer is used to define the scope of an operative provision, it indicates Congressional intent to limit the scope of that provision to persons actually liable for the type of tax involved. Consequently, provisions dealing with the allowance of deductions under the Code are limited in their application to persons actually liable for income taxes either by use of the term taxpayer or by their other terms and context.[308]

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[304] *See* I.R.C. §§ 307, 312, 332, 355, 357-58, 362, 367 (2001).

[305] *See e.g.*, I.R.C. § 358 (2001) (providing rules of determining the basis of property received in a tax-free reorganization or incorporation and using the term taxpayer in defining what items figure into the basis of property received in the tax-free transaction). However, section 358's application is limited to those transactions already determined to qualify under section 351 or the various reorganization provisions. By their terms, all these pre-requisite provisions are unlimited in their application. Consequently, the better view is that the term taxpayer as used in section 358 should be interpreted as a shorthand reference to persons covered by the pre-requisite operative provisions, rather than as an indirect indication that Congress intended such operative provisions to be limited in scope only to taxpayers in a broader sense.).

[306] *See id.*

[307] *See e.g.*, I.R.C. §§ 1031-32, 1035-37 (2001). However, similar to section 358, these provisions contain a provision that adjusts basis to reflect money or property received by "the taxpayer." Again, this reference to taxpayer in the correlative provision is best understood in the context of indicating the person to whom the nonrecognition provision applies generally. *Id.*

[308] *See e.g.*, I.R.C. §§ 63, 151-52, 162-65, 263 (2001). The limited nature of such provisions is often created indirectly by referring to deductions arising in a "taxable year." Taxable year is itself a concept that only has relevance to a taxpayer. *See* I.R.C. § 441(b) (2001) (defining taxable year only by reference to certain periods of a "taxpayer"). *See also supra* Part III.D.2. (discussing how a foreign person generally has no taxable year prior to actually becoming subject to U.S. income taxation).

Similarly, provisions excluding certain amounts from income or disallowing certain losses are often specifically limited in their scope to taxpayers since such provisions would have no relevance to a person not subject to U.S. taxation.[309]

Similarly, the concept of characterizing income as capital or ordinary has no relevance for a person not actually subject to U.S. taxation on their income. Consequently, the Code's definition of a capital asset is specifically limited to property held by a taxpayer.[310] As a consequence, the provisions of Subchapter P of the Code (dealing with capital gains and losses) are generally inapplicable to foreign persons having no U.S. nexus. In recognition of this fact, many of the provisions of Subchapter P are explicitly limited to taxpayers or by a taxable year reference.[311]

VI. SPECIAL PROBLEMS REGARDING FOREIGN ENTITIES WITH U.S. BRANCHES

As an overlay to the foregoing discussion, the fact that a foreign person may operate in the United States through a branch can create additional areas of uncertainty regarding the proper application of various Code provisions.

A. QBU Basis Determinations Under the Functional Currency Rules

Historically, the Code has been interpreted as requiring that the dollar basis of foreign owned property be determined at the time of acquisition or capital improvement using the currency exchange rates then in effect.[312] In 1986, Congress adopted a complicated set of rules to account for the existence of foreign currency fluctuations in applying the provisions of the Code.[313] Some commentators have suggested that, at least in certain circumstances, these rules may override the historic method for determining the basis of foreign assets.[314]

More specifically, section 985(a) provides that all income tax determinations are to be made in a taxpayer's functional currency.[315] Section 987 goes on to provide that if a taxpayer has business units (*e.g.*, branches) with functional currencies other than the dollar, then the taxpayer's taxable income is determined by (1) determining income or loss separately for each business unit using its own functional currency, (2) translating that income or loss into dollars at the

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[309] *See e.g.*, I.R.C. § 121 (2001) (allowing exclusion of gain on sale of a personal residence), I.R.C. § 108 (2001) (exclusion of discharge of indebtedness income for insolvent taxpayers), I.R.C. § 1091 (2001) (disallowing of wash sale losses), and I.R.C. § 1092 (2001) (deferral of losses from certain offsetting positions in property).

[310] I.R.C. § 1221 (2001).

[311] Only nine sections in Subchapter P lack a reference to the terms taxpayer or taxable year. *See* I.R.C. §§ 1236, 1241, 1243, 1249, 1255, 1273, 1286-88 (2001).

[312] *See supra* Part II.A.

[313] I.R.C. § 985-989 (2001).

[314] *See* Colon, *supra* note 4, at 75-79; Clifford E. Muller & G. Garner Prillaman, *Tax Aspects of Foreign Currency*, 921 TAX MGMT. PORTFOLIO (BNA) A-19; Voce, *supra* note 30, at 379.

[315] I.R.C. § 985(b) (2001). A taxpayer's functional currency is generally "the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used by such unit in keeping its books and records." *Id.*

appropriate exchange rate and (3) making adjustments for transfers of property between business units with different functional currencies.[316] Covered business units are referred to as Qualified Business Units ("QBUs").[317]

The implementing regulations under these two provisions contain several rules for determining the basis of property transferred to a QBU. Treasury Regulation Section 1.985-5 provides rules regarding a QBU that changes its functional currency.[318] Among these rules is a provision that requires the QBU to restate the basis of its assets in its new functional currency using the spot exchange rate between the old and new currencies in existence at the end of the taxable year preceding the currency change.[319] Consequently, applying this rule to a newly created U.S. QBU of a foreign corporation would apparently require the QBU to record its asset basis using recent currency exchange rates rather than the historical rates traditionally applicable to such situations.

For several reasons, this regulation should not apply to the creation of a U.S. QBU by a foreign corporation. First, the provision by its terms is only applicable to taxpayers. A foreign corporation creating a U.S. QBU would generally not have been subject to U.S. taxation prior to the QBU's creation and therefore should not be covered by section 985.[320] Second, the regulation only appears to cover changes in a QBU's functional currency and the creation of a U.S. QBU represents an initial adoption of a functional currency, not a change in currencies. Third, the legislative history of sections 985 and 987 indicates that they were aimed at abuses caused by U.S. persons creating foreign QBUs.[321] Viewed in the context of an ultimate U.S. owner, the requirement that basis translations for QBU's be based on roughly contemporaneous exchange rates makes policy sense. However, extending such rules to U.S. QBU's of foreign persons serves no policy purpose furthering the intent of these provisions. Fourth, the relevant legislative history contains no indication that Congress intended to alter the traditional basis rule that had been applied to assets transferred into the U.S. (*i.e.*, using historic currency exchange rates).[322] In light of the ambiguous language, without a clear expression of Congressional intent to alter this longstanding rule, the statute and regulation should not be interpreted as requiring the use of recent spot exchange rates when a foreign corporation transfers assets into a new U.S. QBU.

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[316] I.R.C. § 987 (2001).

[317] A QBU is defined as "any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained." Treas. Reg. 1.989(a)-1(b)(1) (1990).

[318] Treas. Reg. § 1.985-5(c) (as amended in 1998).

[319] *Id.*

[320] *See infra* Part VI.B. (discussing whether the operation of a U.S. branch can be sufficient to make an entire foreign entity a taxpayer under the Code).

[321] *See generally*, H.R. No. 99-426, 99th Cong., 2d Sess. (1985) at 449-81; S. Rep. No. 99-313, 99th Cong., 2d Sess. (1986) at 433-74; H.R. No. 99-841, 99th Cong., 2d Sess. (1986) at II-659-78.

[322] *Id.*

The proposed regulations under section 987 also contain similar basis translation rules using contemporaneous spot exchange rates.[323] Proposed Treasury Regulation Section 1.987-2 provides that basis calculations for property transferred between a U.S. person and a foreign QBU branch (or among the U.S. taxpayer's foreign QBU branches) is determined by multiplying the transferor's basis by the relevant exchange rate on the date of transfer.[324] While this proposed regulation is only applicable to foreign QBUs of U.S. persons, it is unclear whether the Service would attempt to apply a similar spot exchange rate on transfers to U.S. QBUs of foreign persons. In this regard the preamble to the proposed section 987 regulations states: "The treatment under section 987 of United States QBU branches of foreign taxpayers is reserved. However, it is anticipated that these rules will be substantially similar to the rules for foreign QBU branches."[325]

For the same reasons discussed above in connection with section 985, it would be inappropriate for the Service to interpret section 987 as altering the historic basis and currency exchange rate determinations that have traditionally been applied to assets entering the U.S. This is especially true since the purpose of section 987 was to ensure that U.S. persons are taxed on remittances from foreign branches. To apply the rules in the reverse situation in a manner that eliminates the currency exchange history of a foreign person's assets entering the U.S. was not intended or even contemplated by Congress.

B. Taxpayer as a Unitary Concept When U.S. Branches Involved

Another issue with respect to the application of the term taxpayer in the Code is whether the term can ever be applied narrowly to a segment of a person's activities, or whether it mandates a unitary application to all of a person's activities once taxpayer status has been acknowledged for a particular activity. For instance, if a foreign corporation desires to expand its business and establishes a U.S. QBU branch to operate a U.S. business, there is no question but that the U.S. operations conducted through the branch are subject to U.S. taxation and at least in this respect the foreign corporation is a "taxpayer." Indeed such a conclusion would seem to follow directly from the fact that branches or divisions of corporations are generally not respected as separate taxable entities for U.S. purposes. The definition of taxpayer in section 7701(a)(14) also comports with this approach by referring to any "person" subject to any internal revenue tax.[326] However, in some situations applying U.S. tax rules to all of a foreign person's operations, despite the fact that only a fraction of those activities are attributable to a U.S. business, would be irrelevant, fruitless and costly. To what extent then can the contextual nature of the term taxpayer be extended to ameliorate such situations?

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[323] Prop. Treas. Reg. § 1.987-2, 56 Fed. Reg. 48459 (Sept. 24, 1991).
[324] *Id.*
[325] Prop. Treas. Reg. INTL-965-86, 56 Fed. Reg. 48457, 48459 (Sept. 24, 1991).
[326] I.R.C. § 7701(a)(14) (2001).

In a recent private letter ruling the Service partially examined this issue in the context of section 475.[327] That section provides that a dealer in securities must periodically account for unrealized gains and losses in its dealer assets (i.e., mark its assets to current market value).[328] In the ruling, a foreign bank was engaged in dealer activity with respect to notional principal contracts (NPCs) in its foreign jurisdiction because it regularly entered into transactions with customers.[329] While the bank's U.S. branch regularly entered into NPCs as hedges or as part of its proprietary trading, it only "rarely" entered into NPCs with customers.[330] In general, section 475 only applies to a "taxpayer" who "regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business."[331] Consequently, if the dealer determination were made solely by reference to the activities of the U.S. branch, then section 475's mark to market regime might not apply to such transactions.[332] On the other hand, if the reference to taxpayer required inclusion of all the foreign activities of the bank, then dealer status existed.

The Service determined that the Bank's activities must be viewed as a whole to determine whether as an entity it regularly entered into NPCs with customers.[333] It based its conclusion on the fact that a corporation is generally viewed as a single entity that cannot enter into transactions with itself, and the fact that section 864 of the Code has been interpreted to judge dealer status based on an entity's worldwide (not just U.S.) operations.[334]

The ruling leaves open the question of whether once dealer status is determined based on worldwide operations, all the bank's foreign assets must be marked to market under section 475. While the resolution of this question is unclear, and substantial arguments could be made for both approaches, the ultimate resolution should depend largely on whether extending the reach of this section to foreign assets would further the Congressional intent underlying section 475. This article has demonstrated that the term taxpayer can vary in meaning based on Congressional intent, and it seems logical to extend this contextual application of the term to the branch context in appropriate situations, despite the fact that branches are often not respected as separate entities.[335]

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[327] Priv. Ltr. Rul. 97-43-013 (July 23, 1997).
[328] I.R.C. § 475 (2001).
[329] Priv. Ltr. Rul. 97-43-013 (July 23, 1997).
[330] *Id.*
[331] *Id.*
[332] The ruling is unclear regarding whether the "rare" customer transactions of the U.S. branch alone would themselves have been enough to find the bank to be a dealer in securities.
[333] Priv. Ltr. Rul. 97-43-013 (July 23, 1997).
[334] *Id.*
[335] In this regard, certain taxpayers may be able to garner additional support for a branch only interpretation of the term taxpayer depending on the language of any tax treaty between the U.S. and their country of origin. Certain treaties contain language requiring the U.S. to treat branches as separate entities for certain purposes. *See e.g.*, Nat'l Westminster Bank PLC v. U.S., 44 Fed. Cl. 120 (1999) (invalidating Service regulation disregarding interest expense between foreign company and its U.S. branch based on relevant tax treaty provisions).

VII. CONCLUSION

The foregoing discussion has demonstrated that the Code should never be applied wholesale to determine the tax history of a foreign person. Instead, the history and structure of the Code indicate that only certain provisions of the Code and U.S. tax law (generally those relating to basis, earnings and profits, non-recognition transactions and characterizing the nature of an instrument or transaction) have universal application. Attempting to extend the reach of all provisions of the Code to all persons throughout the world would be both unworkable and unnecessary. One of the primary indications regarding the scope of any particular Code provision is its use of the term "taxpayer." However, such term itself must be contextually construed to understand the intended reach of the subject section. By recognizing the proper importance of a contextual interpretation of the provisions of the Code, it is possible to rationalize the extension of U.S. tax principles in certain areas without having to conclude that the entire Code is always applicable to everyone in the entire world. It may be a small world after all, but thankfully it is not yet a world of taxpayers!