Case No. 12-60533

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

UNITED STATES OF AMERICA,

OSVALDO RODRIGUEZ AND ANA M. RODRIGUEZ,
PETITIONERS - APPELLANTS

VS.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT - APPELLEE

ON APPEAL FROM THE UNITED STATES TAX COURT

BRIEF FOR APPELLANT

ATTORNEY FOR APPELLANT
Patrick R. Gordon,
GORDON DAVIS JOHNSON & SHANE P.C.
4695 N. Mesa St.
El Paso, Texas 79912
Telephone: (915) 545-1133
Fax: (915) 545-4433

CERTIFICATE OF INTERESTED PERSONS

OSVALDO RODRIGUEZ AND ANA M. RODRIGUEZ,
PETITIONERS - APPELLANTS

VS. **No. 12-60533**

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT - APPELLEE

The undersigned counsel of record certifies that the following listed persons have an interest in the outcome of this case. These representations are made in order that the judges of this Court may evaluate possible disqualification or recusal.

1. Osvaldo Rodriguez.
2. Ana M. Rodriguez.
3. Commissioner of Internal Revenue.

Patrick R. Gordon,
GORDON DAVIS JOHNSON & SHANE P.C.
4695 N. Mesa St.
El Paso, Texas 79912
Telephone: (915) 545-1133

REQUEST FOR ORAL ARGUMENT

The Appellants, Osvaldo Rodriguez and Ana M. Rodriguez respectfully request oral argument. This appeal presents to the court the issue of whether inclusions under Section 951(a)(1) of the Internal Revenue Code of 1986, as amended (the "Code"), are considered dividends for purposes of qualified dividend treatment under Section 1(h)(11) of the Code. Oral discussion of the facts and the applicable precedent would benefit the Court. *See* Fed. R. App. P. 34(a)(3).

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

Internal Revenue Service Notice

Internal Revenue Manual

Internal Revenue Service Rulings

General Counsel Memoranda

Private Letter Rulings

Rules and Regulations

Treaty

Treasury Forms

Treasury Decisions

Other Federal Statutes

Legislative History

Other Sources

STATEMENT OF JURISDICTION

Jurisdiction of this Court is invoked under Section 1291, Title 28, United States Code, as an appeal from a final judgment in the United States Tax Court. Notice of appeal was timely filed in accordance with Rule 4(b) of the Federal Rules of Appellate Procedure.

STATEMENT OF THE ISSUE

Issue 1:

Whether the Section 951 (a) income inclusion amounts of $1,585,527.00 in 2003 and $1,478,202.00 in 2004 (the "Inclusion Amounts") are deemed dividends or should be treated as ordinary income?

Issue 2:

If the Inclusion Amounts are treated as dividends, are such dividends "qualified dividends" as defined in Section 1(h) (11) and subject to the preferential tax rate of fifteen percent (15%) under Section 1(h) (1) (c) ?

STATEMENT OF THE CASE

The amount in controversy is a deficiency determined by the Internal Revenue Service ("IRS") of $316,950.00 for 2003 and $295,530.00 for 2004, based on the Appellant's characterization of Appellee's qualified dividends under Section 1(h)(11) in 2003 and 2004, respectively, to that of ordinary income. Appellants and the Appellee have stipulated that for the years in question, Editora

was eligible for benefits under the US-Mexico Tax Treaty[1] and that Editora was not a "foreign personal holding company" ("FPHC") under Section 552 of the Internal Revenue Code of 1986[2], as amended from time to time.[3] Thus, the CFC at bar is a "controlled foreign corporation" (CFC) as such term is defined in Section 1 (h) (11).[4] The Tax Court ruled in a favor of the Appellee, characterizing section 951(a) income inclusions as ordinary income. The Tax Court's ruling as discussed below is flawed and goes against long standing international tax principals and original intentions of Congress in enacting the Subpart F regime.

SUMMARY OF THE FACTS

Appellants, Osvaldo Rodriguez and Ana M. Rodriguez, citizens of Mexico and permanent residents of the United States, were the sole shareholders of Editora Paso del Norte S.A. de C.V. ("Editora"). (USCA5 ROA Vol. 2 Doc. 19 p. 1-2, 4). Editora is incorporated under the laws of Mexico. (Doc. 19 p. 4). In 2001, it had established a branch in the United States under the name Editora Paso del Norte, S.A. de C.V., Inc. (Doc. 19 p. 6).

[1] Convention between the Government of the United States of America and the Government of the United Mexican States for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income which entered into force on December 28, 1993, as amended by protocols signed Sept. 8, 1994 and Nov. 26, 2002.
[2] I.R.C. § 522.
[3] All references to "IRC," "Code" and "Section," shall mean the Internal Revenue Code of 1986, as amended and the treasury regulations promulgated thereunder.
[4] I.R.C. § 1 (h) (11).

Pursuant to Section 951(a)(1)(B), for the years 2003 and 2004, Appellants included in their gross income $1,585, 527 and $1,478, 202 amounts of Editora's earnings that were invested in U.S. Property (as defined by Subpart F). (Doc. 19 p. 3). Appellant characterized these inclusions as qualified dividend income subject to a preferential income tax rates under section 1(h)(11)(B), the rate of fifteen percent (15%). (Doc. 19 p. 4). The Appellee re-characterized the amounts invested as ordinary income subject to higher ordinary income rates rather than a qualified dividend income. (Doc. 19 p. 3). After Appellee sent a deficiency notice for a total of $612,480.00, the Appellant served on the Appellee a letter of protest and proceeded through administrative appeals until filing a petition in the Tax Court. (Doc. 19 p. 4). The Tax Court ruled in favor of the Appellee, characterizing section 951(a) inclusion as ordinary income. Appellants appeal from that judgment in its entirety.

SUMMARY OF THE ARGUMENT

Editora's Section 951 income inclusions should be taxed at a rate of fifteen (15%) under Section 1(h)(11) because (i) Section 951 income inclusions are substantively dividends and should be treated as such and (ii) Editora is a "qualified foreign corporation" as such term is used therein.

The re-characterization of the qualified dividend income pursuant to Notice 2004 issued by the Commissioner on November 1, 2004 (the "Notice") conflicts

with Congressional intent indicating such income inclusions are dividends.[5] The 2003 Job Growth and Reconciliation Tax Act of 2003 ("2003 Act") does not directly address whether Section 951 income inclusions qualify as "qualified dividend income,"[6] so prior Congressional intent, indicating that such income inclusions are dividends, and Editora's status as a "qualified foreign corporation" should be the controlling factor in determining that such income inclusions are "qualified dividend income."

ARGUMENT

As a "qualified foreign corporation," Editora is eligible for qualified dividend tax treatment and as such was not deficient for the years 2003 and 2004. Section 1(h)(11), enacted as part of the Jobs and Growth Tax Relief Reconciliation (the "2003 Act"), provides for reduced rates of federal income tax on qualified income dividends for taxable years beginning after December 31, 2002.[7] Qualified dividend income includes dividends received from a qualified foreign corporation. The maximum rate of tax on qualified dividend income is currently 15 percent (15%).[8]

A. The Section 951 Inclusions Should be Treated as Deemed Dividends Under the Code Because the True Nature of the Transaction is that of a Dividend

[5] Notice 2004-70, 2004-44 IRB 724 (Nov. 1, 2004).
[6] Job and Growth Reconciliation Tax Act of 2003, P.L. 108-27, 117 Stat. 752 (May 28, 2003).
[7] *Id.*
[8] Pub. L. No. 111-312, 111th Cong., 2d Sess., 102(a) (2010).

Section 951, which is part of Subpart F works as an anti-deferral mechanism by taxing directly on the controlled foreign corporation's ("CFC") earnings that are invested in certain types of assets in the United States.[9] Section 951(a) requires a United States shareholder of a CFC to "include in [its] gross income" its pro rata share of the CFC's Subpart F income and certain investments in U.S. property.[10]

1. Section 951 Inclusion Should be Characterized as a Dividend Because the General Purpose of Subpart F is to Tax CFC's Earnings as if They Were Distributed as Dividends

When interpreting Section 951, Subpart F's general purpose and mechanics should govern the analysis.[11] While Subpart F does not expressly label an inclusion as a dividend or as an ordinary income, Subpart F treats the amount included in the U.S. shareholder's gross income essentially like a dividend.

The mechanics of the Section 951 income inclusion are almost identical to the mechanics of a Section 316 "dividend." Thus, Section 951 income inclusions should be treated as dividends. Section 316(a) defines a dividend as follows:

> any distribution of property made by a corporation to its shareholders:
> (1) out of its **earnings and profits** (emphasis added) accumulated after February 28, 1913, or
> (2) out of its **earnings and profits** of the taxable year […], without regard to the amount of the earnings and profits at the time the distribution was made.[…][12]

[9] I.R.C. § 951.
[10] *Id.*
[11] *SEC v. Joiner*, 320 U.S. 344, 350-51(1943) (stating that courts will construe the details of an act in conformity with its dominating general purpose).
[12] I.R.C. § 316.

Pursuant to Section 316(a), a distribution made out of a corporation's earning and profits ("E&P") generally must be treated as a dividend unless otherwise provided in the applicable statute.[13] The amount of an inclusion under Section 951 is directly linked to the **earnings and profits** of a CFC, same as a dividend, and is treated like a dividend for foreign tax purposes.[14] Pursuant to Section 951, U.S. shareholders are deemed to have received dividends from CFC's attributable to the receipt of Subpart F income, as defined in Section 952(a), or to the increase in earnings invested in U.S. property, as defined in Section 956.[15] Under Section 952(c), the earnings and profits of the CFC set a maximum limit on the computation of Subpart F income of the CFC.[16] Section 956 limits the increase in earnings invested in U.S. property to amounts which would have been dividends if they had been distributed, thus necessitating a determination of the CFC's earnings and profits.[17]

Sections 951 and 956 required Editora to declare a deemed distribution to Appellants.[18] Consequently, for tax purposes, the substance of a direct investment in the United States, such as in the present case, is identical to paying out actual dividends to the shareholders who then make an investment in the United States.

[13] *Id*.
[14] *See* I.R.C §§ 316, 951.
[15] I.R.C §§ 951, 956.
[16] I.R.C. § 952.
[17] I.R.C. § 956.
[18] I.R.C §§ 951, 956.

The Tax Court erred in characterizing the Section 951(a) income inclusion as an ordinary income. The Tax Court emphasized the structural differences between a dividend and a Section 951(a) income inclusion stating that to be considered a dividend it *must involve a change in form of ownership*.[19] However, such analysis overlooks the Appellants' characterization as a deemed dividend not an actual dividend and contradicts other provisions in Subpart F and the Code. For example, Section 1248 provides that a gain from exchange of stock should be characterized as dividend notwithstanding that *no change in ownership* has occurred.[20] Additionally, characterizing an inclusion as a dividend when the statute does not specifically uses the term "dividend" is not a novel concept. Analogous to the concept of deemed dividend, courts have recognized the concept of a constructive dividend which does not involve a change in form of ownership.[21]

2. Pursuant to the Substance Over Form Doctrine, Section 951 Inclusions Should be Treated as Dividends

A general rule for taxation provides that the incident of taxation depends on the substance rather than the form of the transaction.[22] In *Commissioner v. Court Holding Co.*, the court explained that the incidence of taxation depends upon the

[19] USCA5 ROA Vol. 1 Doc. 40 p. 5-6.
[20] *See also* I.R.C. § 367.
[21] *See e.g.*, *United States v. Smith*, 418 F.2d 589, 596 (5th Cir. 1969).
[22] *Gregory* v. *Helvering*, 293 U.S. 465 (1935); *see also True* v. *U.S.*, 190 F.3d 1165, 1174 (10th Cir. 1999); *Weiss v. Stearn*, 265 U.S. 242 (1924) ("[W]hen applying … income tax laws … we must regard matters of substance and not mere form.")

substance of a transaction, and that mere formalism cannot alter tax liabilities to impair Congress' tax policies.[23]

The Appellee claims that the "substance over form doctrine is probably not available to a taxpayer."[24] While the Appellee correctly notes that the doctrine is not as readily available to a taxpayer as it is to IRS, the Fifth Circuit has held that this doctrine is available when necessary to prevent an unjust result.[25] Here, the substance of the transaction governs over the form in order to prevent an absurd, harsh, and unjust result. IRS is seeking to tax the income inclusion at a rate of thirty five percent (35%), while the dividend rate is only fifteen percent (15%). Appellant argues that imposing a twenty percent (20%) increase in tax merely because the Appellants have not first declared a dividend (i.e. form) and then invest the said monies in United States or as the Tax Court described it, changing the form of ownership is utterly harsh and unjust. There is nothing magical or extraordinary about declaring a dividend as to warrant such a large tax difference. The Appellant has not derived any tangible benefit by choosing a direct investment rather than an incorporating an extra step of declaring a dividend.

Moreover, this is not the first and only time Appellants may be subject to taxation related to the transactions at issue here. Editora may also be subject to

[23] 324 U.S. 331 (1945)
[24] USCA5 ROA Vol. 1 Doc. 36 p. 11.
[25] *Spector v. Comm'r*, 641 F.2d 376 (5th Cir. 1981) cert. denied, 454 U.S. 868, 102 S.Ct. 334, 70 L.Ed.2d 171; *Adobe Res. Corp. v. United States*, 967 F.2d 152 (5th Cir. 1992) ("[T]he taxpayers cannot argue substance over form except when necessary to prevent unjust results.").

U.S. taxation with respect to income derived from its activities in the U.S. in connection with its ownership of the U.S. real estate and personal property located in the United States as income attributable to a U.S. permanent establishment. So the property that caused the Section 951(a) income inclusion could also result in income subject to U.S. taxation at the corporate level.

Appellants argue that any Section 951 inclusion should always be treated as a dividend. However, the Appellants also take the position that if the court elects not to make such broad finding, that the court restrict its holding to the case at bar on the basis that the IRS interpretation leads to an absurd and unjust result to the Appellant.

B. Legislative History, Case law, and IRS's Own Policies Support Treatment of Section 951 Inclusions as a Deemed Dividends.

Section 951(a)(1)(A)(i) inclusions constitute deemed dividends for U.S. federal income tax purposes. This position is supported by (1) the legislative history of Section 1(h)(11) when read together with the legislative history of the Revenue Act of 1962 (enacting Subpart F of the Code), (2) case law, (3) official and unofficial pronouncements from the IRS, and (4) IRS internal policy as set forth in the Code.

1. Legislative History Supports Treatment of Section 951 Inclusion as Deemed Dividends

When interpreting a statute, if the meaning is uncertain the courts look at the enabling act's legislative history and "the statements by those in charge of it during its consideration by the Congress" to determine a statute's purpose and origin.[26] Thus, the legislative history aids in interpreting Section 951(a). In the alternative, if the court finds that pursuant to a plain reading of the statute, Section 951(a) inclusion refers to an inclusion as ordinary income, such an interpretation would produce an absurd result and thus, the court should still resort to legislative history.[27] Legislative intent and history provide that Section 951(a)(1) income inclusions were intended to be characterized as dividends.

During the legislative debates for the enactment of Section 1(h)(11), Congress was concerned about the double taxation of earnings and intended for U.S. corporations and foreign corporations to be treated "fairly and equally."[28] Section 1(h)(11) legislative history indicates that Congress intended to include Section 951(a)(1) dividends as deemed dividends.[29]

a. Pursuant to The Revenue Act of 1962 Undistributed Income From Controlled Foreign Corporations Should Constitute Deemed Dividends

---

[26] *Nat'l Muffler Dealers Ass'n. Inc.*, v. *U.S.*, 440 U.S. 472, 477 (1979); *see also United States v. Great N. Ry.*, 287 U.S. 144 (1932) (stating that "[i]n aid of the process of construction [courts] are at liberty, if the meaning be uncertain, to have recourse to the legislative history of the measure and the statements by those in charge of it during its consideration by the Congress."[26]

[27] *See e.g., United States v. Granderson*, 511 U.S. 39, 47 n.5 (1994) (dismissing an interpretation said to lead to an absurd result).

[28] Pub. L. No. 87-834, 76 Stat. 960 (1962).

[28] *Id*.

[29] *Id*.

The Revenue Act of 1962 supports the view that Subpart F inclusions are deemed dividends for purposes of Section 1(h) (11). The Section 951(a)(1) income inclusion was initially proposed by President Kennedy's Tax Message to the Congress of 1962.[30] The President's proposal was aimed at curtailing tax manipulations by taxing domestic corporations who through a foreign subsidiary would avoid paying taxes on its accumulated earnings.[31] President Kennedy's Tax Message States:

> …Under the recommendation, deferral would be eliminated, and the annual undistributed profits of any controlled foreign corporation […] would be **deemed distributed as a dividend** to American shareholders. Double taxation would be avoided through the allowance of a credit, to the extent permitted under existing law, for the foreign taxes paid.[32]

One of the earlier drafts of Section 951 is very similar to the current version of the Section 951and provided as follows: "the undistributed tax haven profits of a CFC shall be included in the gross income of U.S. persons owning a direct or indirect interest in such corporation in the manner and to the extent set forth in this

[30] Message from the President of United States, H.R. Doc. No.140, 87th Cong., 1st Sess., 1 Legislative History of H.R. 10650, at 135, 146-48, 194 (1967) [hereinafter cited as Legislative History of H.R. 10650].
[31] *Id*.
[32] Detailed Explanation of the President's Recommendation Contained in His Message on Taxation (Submitted by Secretary of the Treasury Dillion in connection with the Hearings before the Committee on Ways and Means, House of Representatives, May 3, 1961).

subpart."[33] At the time the draft was proposed Treasury representatives were aware of the executive intent that Subpart F inclusions would be deemed distributions to American shareholders. The fact that the language did not change substantially with respect to the method of taxing undistributed income supports the view that the original intent to treat Subpart F inclusions as dividends did not change. Moreover, nothing in the legislative history of the Revenue Act of 1962 indicates that the original intent to treat Subpart F inclusions as dividends changed during the legislative process.

b. Statements from the House of Representatives and Senate Finance Committee Support Characterization of Section Inclusions as Deemed Dividends

The Report issued by the House of Representatives concerning the new Subpart F regime reaffirms the original intent of treating inclusions under Subpart F as a dividend. The House of Ways & Means Committee Report stated, "[t]his Subpart F income under the bill is attributed to 10-percent of the U.S. shareholders and taxed to them in largely the **same manner as a dividend**." Further, the same Report Bill provides as follows:

> …certain undistributed income of controlled foreign corporations is to be included in the income of U.S. shareholders in the year the income is earned by the foreign corporation, whether or not it is distributed. In

[33] Treasury Department Press Release D-186, July 28, 1961, reprinted in [1961] 7 Stand. Fed. Tax. Rep. (CCH) 6479.

> these cases, the shareholders are permitted foreign tax credits to the same extent as if **actual distributions** had been made.[34]

The inclusion of the second sentence further strengthens the Appellant position that deemed distributions should be treated exactly like actual distributions. Congress contemplated that for purposes of Section 951 the inclusion be treated as a dividend, notwithstanding the fact that no actual distribution has been made, or as the Tax Court described it—*no change in form* occurred.

Additionally, a subsequent House Floor Debate emphasized that the bill **would tax U.S. shareholders'** income derived from a foreign subsidiary as if it had been distributed by the subsidiary **as a dividend**. [35] Similarly, a Senate Finance Committee Report stated that:

> undistributed earnings of U.S. shareholders from CFC's are permitted to take foreign tax credits to the **same extent as if actual distributions** have been made the bill also provides that earnings invested in U.S. property (property located in the U.S. or having a situs in the U.S.) are to be taxed to the U.S shareholders as subpart F income (to the extent that subpart F income is taxed to U.S. shareholders the income of the corporation will not again be taxed to the U.S. shareholders because of investments in U.S. property). [36]

2. Case Law Supports Treatment of Section 951 Inclusions as Deemed Dividends.

The treatment of Section 951 inclusions as deemed dividend is also supported by case law. In *Koehring* v. *United States*, the court stated (emphasis

[34] H. Rep. No. 87-1447, 1 Legislative History of H.R. 10650, at pp. 1192-93.
[35] House Floor Debate, 2 Legislative History of H.R. 10650, at p. 1583 (Emphasis added).
[36] *Id*. at 2439.

added) that "[if] the corporation in question is [a] CFC , Section 951 of the Code provides that a U.S. shareholder's pro rata share of the Subpart F income of that U.S. shareholder as a deemed dividend paid in money on the last day of the taxable…."[37] In *Stamn* v. *Commissioner*, the IRS entered into a settlement agreement with a taxpayer. The settlement agreement required the taxpayer to treat a Section 951 inclusion as a dividend.[38] Consequently, pursuant to existing case law the Section 951 Inclusion should be treated as a dividend.

3. General Counsel Memoranda from Internal Revenue Code Support Treatment of Section 951 Inclusions as Deemed Dividends

Further strengthening the Appellants' position is the fact that the IRS on a number of occasions through General Counsel Memoranda (GCM) and private letters rulings has described Subpart F inclusions as deemed dividends. The Chief Counsel's analysis is sound and "helpful in interpreting the Tax Court when 'faced with an almost total absence of case law'."[39] Although there are few cases that referred to Section 951 inclusion as a deemed dividend, there is no case law interpreting Section 951 in light of the recent 2004-70 Notice published by the IRS. Consequently, the court should look for guidance at pertinent General Counsel Memoranda. In *Morganbesser* v. *United States*, the Second Circuit Court

[37] 433 F.Supp. 929, 932(E.D. Wis. 1977, aff'd, 583 F.2d 313(7th Cir. 1978).
[38] 90 T.C. 315, 317 (1988).
[39] *Container Corp.* v. *Comm'r,* 134 T.C. 122, 134 n. 12 (2010).

of Appeals provided that "G.C.M.'s are helpful in interpreting the Tax Code when faced with an almost total absence of case law."[40] G.C.M. 39153 provides that "amounts described in sections 951(a)(1)(B) and 951(a)(1)(A) are included in gross income of U.S. shareholders as **deemed dividends**."[41] Similarly, in GCM 36965 the IRS states, "under Code §951 U.S. shareholders are **deemed to have received dividends** from CFC attributable to the receipt of Subpart F income, as defined in Code §952(a), or to the increase in earnings invested in U.S. property, as defined in Code §956."[42] Thus, IRS understood that for purposes of Section 951, Congress did not intend to impose a "change of form" requirement.

In 1984, the Office of the IRS Chief Counsel conducted an analysis of the interrelationship between Sections 951(a)(1)(A)(i), 959, 301, and 316. This analysis, summarized in G.C.M. 39153, supports the position that Notice 2004-70 erred in stating that "for purposes of Section 1(h) (11), Section 951(a)(1) inclusions are not dividends and therefore cannot constitute qualified dividend income."[43]

First, G.C.M. 39153 states that pursuant to Section 301(c)(1) a portion of the distribution which is a dividend (as defined by Section 316) shall be included in

[40] 984 F. 2d 560, 563 (2nd Cir. 1993); *see also Hermann* v. *E.W. Wylie Corp.*, 766 F. Supp. 800, 802-03 (D.N.D. 1991) (holding the court could rely on GCM's interpretation of the Code section involved because it assumed the IRS would insist upon a uniform interpretation of the section).
[41] Gen. Couns. Mem. 39153 (Mar.1, 1984).
[42] Gen. Couns. Mem. 36965 (Dec. 22, 1976).
[43] Gen. Couns. Mem. 39153.

gross income.[44] Second, Section 316 defines "dividend" as any **distribution** of property made by a corporation to its shareholders either **out of its earnings and profits** accumulated or out of its earnings and profits for the taxable year."[45] Finally, G.C.M. 39153 harmonizes Section 316 (defining a dividend) and Section 959 by explaining that Section 959 is an exception to Section 316.[46] Pursuant to Section 959, U.S. shareholders of CFCs must include in their gross incomes certain types of income of CFCs, *despite the fact that such amounts are* **not actually distributed to them**.[47] In footnote 2 of the same G.C.M., the Chief Counsel states that amounts described in Section 951(a)(1)(A) and (B) are included in the gross income for U.S. shareholders as "deemed" dividends.[48] The U.S. shareholder's basis in its stock of the CFC is increased by the amount of any "deemed" dividend.[49] Upon actual distributions of these previously taxed amounts, the U.S. shareholder's basis in the stock is reduced.[50]

The Internal Revenue Service is currently arguing against its own position as set forth in G.C.M. 39153 and G.C.M. 36965. Appellants respectfully submit that

[44] *Id*.
[45] *Id*.
[46] *Id*.
[47] I.R.C. § 959.
[48] Gen. Couns. Mem 39153.
[49] I.R.C. § 961 (a).
[50] I.R.C. § 961 (b).

the Revenue Service's stated position set forth in G.C.M. 39153 and G.C.M. 36965 should be treated as a concession.[51]

4. Private Letter Rulings Evidence the IRS's Established Practice of Treating Section 951 Inclusions as Deemed Dividends.

The Fifth Circuit and the Tax Court have allowed taxpayers to use private letter rulings to reveal the interpretation of a statute by a governmental agency.[52] Consistent with this legislative history, the IRS has concluded in Private Letter Ruling 9024026 (Mar. 15, 1990) that Subpart F income should be treated the **same as an actual dividend distribution**, "unless specifically provided elsewhere in the Code." In that ruling, the Service stated as follows:

> The foreign personal holding company provisions (section 551-558) specifically provide that undistributed foreign personal holding company income is to be treated as a dividend. The Subpart F income is to be treated as a dividend. The Subpart F income rules were enacted in 1962 to supplement the foreign personal holding company rules. Thus, Subpart F income is taxed in largely the same manner as a dividend, unless specifically provided elsewhere in the Code. The mere fact that the timing of income recognition is accelerated under the Subpart F provisions, as under the foreign personal holding company provisions, does not result in treating the Subpart F inclusion any differently than distribution of an actual dividend in the absence of these rules. Based on the forgoing discussion, we conclude

[51] *Cf Rauenhorst v. Comm'r*, 119 T.C. 157, 183 (2002) ("Rev. Rul. 78-197, 1978-1 C.B. 83, is contrary to respondent's litigation position in this case. Accordingly, in this case, we shall not permit respondent to argue against his revenue ruling, and we shall treat his revenue ruling as concession.").

[52] *Transco Exploration Co. v. Comm'r*, 949 F.2d 837, 839 (5th Cir. 1992) (court used private letter rulings to evidence that the Court's construction of a tax provision at issues was compelled by the language of the statute); *Hanover Bank* v. *Comm'r*, 369 U.S. 672, 686-87(1962) (holding prior rulings were significant since they disclosed the interpretation of the statute by the agency charged with administering the revenue laws).

> that solely for purposes of the exclusion from unrelated business income tax treatment under Section 512(b)(1), any Subpart F income received by N from Q will be treated as if it were a dividend.[53]

The IRS has concluded unofficially in other private letter rulings that Subpart F income should be treated as if it were dividends and excluded from the computation of unrelated business taxable income.[54]

The unofficial authorities cited herein are solely to evidence that Appellants' interpretation of the dividend character of Section 951(a)(1)(A)(i) inclusions are consistent with the prior practice and interpretation of the IRS.[55] Although private letter rulings that are not specifically issued to the taxpayers at bar may not be cited as precedent, such letters provide further evidence as to how the court should construe the language of the statute.[56] In addition, the Fifth Circuit has held that "although the Commissioner is entitled to change his mind, he ought to do more

---

[53] *See* Priv. Ltr. Rul. 9024026 (Mar. 15, 1990); *See also* Priv. Ltr. Rul. 9217039 (Jan. 28, 1992) ("Amounts included under section 951 (a) (1) (A) and (B) are treated as deemed dividend payments.").

[54] Priv. Ltr. Rul. 9027051 (Apr. 13, 1990) ("solely for purposes of the exclusion from unrelated business income tax treatment under section 512 (b) (1), any Subpart F income received by P from C will be treated as if it were a dividend."); Priv. Ltr. Rul. 8922047 (Mar. 6, 1989) ("Before the Revenue Act of 1962, which enacted Subpart F of the Code, only dividends paid by foreign corporations and undistributed income of foreign personal holding companies were subject to current tax in the hands of U.S. shareholders. The foreign personal holding company provisions of the Code (sections 551 through 558) specifically provide that undistributed foreign personal holding income is to be treated as a dividend (section 551(b)).

[55] *See Hanover Bank*, 369 U.S. at 686-87 (stating that private letter rulings that are not specifically issued to the taxpayers at bar provides further evidence of the correct interpretation of the statute).

[56] *Id*.

than stride to the dais and simply argue in the opposite direction."[57] The case at bar presents a scenario identical to the one the Fifth Circuit has warned about. The Commissioner has changed his mind and adopted an interpretation that is contrary to the language of the statute, to legislative history, and case law without a clear reasoning other than its interpretation will allow IRS to collect additional revenue.

5. The Internal Revenue Manual Evidences Internal Policy Adopted by the Revenue Service Treating Section 951 Inclusions as Deemed Dividends

Section 4.61.7.43 of the Internal Revenue Manual ("IRM") is consistent with the federal income tax treatment of a Subpart F inclusion as a deemed dividend. The section states that "[i]ncome included in gross income under the provisions of Subpart F as a deemed dividend, is eligible for the indirect foreign tax credit." Similarly, Section 4.61.10 provides as follows:

> Indirect credits result from either:
>
> a. Dividends received (cash or property) from a foreign affiliate per IRC section 902; and
>
> b. Deemed dividends reported under IRC section 951 from a controlled foreign corporation per IRC section 960.

Appellants offer the cited IRM provisions solely as persuasive authority as to the IRS's interpretation of the statute and the regulations.[58]

---

[57] *See Transco Exploration*, 949 F.2d at 83.

[58] *See Fargo* v. *Comm'r*, 447 F. 3d 706 (2nd Cir. 2006); *See also Griswold v. United States*, 59 F.3d 1571, 1576 n. 8 (11th Cir. 1995).

C. The Treasury Department's 2004-70 Notification Is Invalid Because it is Contrary to the Language, Origin, and Purpose of Section 951

The Treasury Department's 2004-70 Notification fails to carry out the congressional mandate in the proper manner. The court should review the validity of the Treasury Department's 2004-70 Notification by applying the *National Muffler* test.[59] The Appellants anticipate that Appellee will argue based on a recent Supreme Court case— *Mayo Foundation for Medical Education and Research v. United States*—that this court should apply the more deferential standard articulated by the Supreme Court in *Chevron*.[60] However, the Supreme Court's holding *in Mayo*, was not so broad as to overrule the *National Muffler* test.[61] In *Mayo*, the Court held that all **final Treasury regulations** should be reviewed under *Chevron*. (emphasis added) Consequently, the *National Muffler* should be used to interpret guidance other than final regulations.[62]

Turning to the case at bar, it is settled law that IRS Notices are not the equivalent of Final regulations.[63] IRS Notices are merely announcements or position of the IRS that are not binding on court and do not have the force of the

---

[59] *Nat'l Muffler Dealers Ass'n*, 440 U.S. at 477.
[60] 131 S. Ct. 704 (2011).
[61] *Id*; Matthew H. Friedman, *Reviving National Muffler: Analyzing the Effect of Mayo Foundation on Judicial Deference as Applied to General Authority of Tax Guidance*, Nw. U. L. Rev. 107, 138 (2012).
[62] *Mayo*, 131 S. Ct. at 713. (the Court stated that *Mayo* did not present "any justification for applying a less deferential standard of review . . . [and] in the absence of such justification, we are not included to carve out an approach to administrative review good for tax law only.").
[63] *Guilzon v. C.I.R.*, 985 F.2d 819, 822 (5th Cir. 1993) (holding that IRS Notices have even less authority than IRS Revenue Rulings, which are not binding on courts)

law.[64] Thus, here, the court should review the validity of the Notice 2004-70 by applying the *National Muffler* test.

1. Notice 2004-70 Is Invalid And Should Be Given No Deference Because Its Interpretation Of Section 951 Income Inclusions Is Unreasonable, Untimely, And Was In Place Only Two Years Prior To This Case.

The IRS issues notices to provide guidance on a particular issue or procedure. In terms of legal authority, notices are the equivalent of revenue rulings and revenue procedure.[65] Consequently, an IRS notice can be examined in the same manner as a revenue rulings or revenue procedure, even though such notice may have no legal standing. Revenue rulings and procedures are official interpretation of tax laws by the IRS.[66] The closest comparisons to such interpretations are interpretive regulations. Interpretive regulations notify taxpayers of the IRS' position on a particular issue or transaction and must be examined under the following factors to determine the validity of the guidance: (i) timing; (ii) duration; (iii) reliance; (v) consistency; and (vi) degree of scrutiny.[67]

The first part of the validity test is whether the interpretation was a "**substantially contemporaneous** construction of the statute by those to have been

[64] *Id*; *United States v. Correll*, 389 U.S. 299, 305-06 (1967) (finding that long-standing and unchanged Treasury regulations are deemed to have received congressional approval and have the effect of law) (quoting *Helvering v. Winmill*, 305 U.S. 79, 83 (1938)).
[65] Rev. Rul 87-138, 1987-2 C.B. 287; Rev. Rul. 90-91, 1990-2 CB 262.
[66] Internal Revenue Manual 4.10.7.2.6.1 (Jan. 1, 2006), available at http://www.irs.gov/irm/part4/irm_04-010-007.html.
[67] *Nat'l Muffler Dealers Ass'n* v. *U.S.*, 440 U.S. at 477.

presumed to have been aware of the congressional intent."[68] Appellants anticipate that Appellee will argue that its interpretation was timely issued because the Notice was issued on November 1, 2004 and the Notice interprets the 2003 Act, which was passed in 2003. Such argument conveniently ignores the fact that the Notice interprets Sections 951 and 956 in order to address the precise question at issue and that Sections 951 and 956 have been around since subpart F was added to the Code. Thus, the Appellee failed to interpret the precise question of this case in the 40 plus years since Subpart F was enacted. In fact, prior to the Notice's publication, Appellee arguably treated the Section 951 inclusions as dividends. As discussed subsequently, this point is supported by the fact that Appellants' 2003 and 2004 Form 5471 instructs taxpayers to list the income inclusions as dividends on their individual income tax return (i.e. Form 1040).[69]

It is evident that Appellee published guidance on the precise issue only after Appellee realized that treating the Section 951 income inclusions as dividends would be against Appellee's interest. Appellee took the position that the income inclusions are not dividends only after Congress passed the 2003 Act which reduced the tax rate applicable to dividend income. During the 40 plus years prior to the enactment of the 2003 Act, while ordinary income and dividend income

[68] *Id*.
[69] Treas. Form 5471 (Rev. December 2004), Instructions for Line 6 of Schedule I.

were taxed at the same rate, Appellee did not take the position that the Section 951 income inclusions are not dividends.

The second factor is **duration**.[70] Pursuant to this factor, courts are expected to give deference to regulations that have been in effect for a long period of time. Notice 2004-70 has been in effect a little more than two years when the issues came before the Tax Court. The Notice is so new that it has not been tested in the courts nor have regulations been promulgated regarding the issues as set forth in the Notice. Given the recentness of the Notice, no deference should be accorded to thereto.

The **reliance** factor is not applicable here because the Notice is so new that no other courts except for the Tax Court here, had a chance to approve or reject it. The fourth factor, **consistency** of the Commissioner's interpretation also weighs in favor of the Appellants. As previously discussed, the IRS Notice is inconsistent with the position the Commissioner took previously in private letter rulings, G.C.M.s, CCAs, and Internal Revenue Manual.

Finally, regarding the **degree of scrutiny** Congress has devoted to the regulation, this factor does not specifically apply here, as there has been no Congressional review of the Notice because the Notices are not subject to Congressional review.

[70] *Nat'l Muffler Dealers Ass'n,* 440 U.S. at 447.

Given the analysis of the Notice, it is the Appellants' position that Appellee's interpretation is not valid because the interpretation is unreasonable. Many courts, including the Supreme Court have struck down regulations because they were unreasonable interpretations of the statutes.[71] The Appellants would argue that this interpretation should be struck down as it is against Congressional intent, unreasonable, untimely and should receive no deference because its lack of duration.

2. Notice 2004-70 is Invalid Even Under the Chevron Two-step Framework Because it is Contrary to Legislative History and Purpose.

Even if the court decides that an IRS Notice is the equivalent of a Treasury Final Regulation, and thus, pursuant to the *Mayo* decision the appropriate standard of review is *Chevron* two-part test, the ultimate conclusion remains the same. Notice 2004-70 is invalid. The Supreme Court laid out a two-part test to be applied when reviewing an agency's construction of its own statutory authority.[72] Under Chevron's two-part framework, the Court first asks whether Congress has "directly addressed the precise question at issue."[73] "If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency."[74] However, if the statute

[71] *U.S.* v. *Vogel Fertilizer Co.*, 455 US 16 (1982); *Rowan Cos., Inc.* v. *U.S.*, 452 U.S. 247 (1981); *Beneficial Corp. & Subsidiaries* v. *United States*, 814 F.2d 1570 (Fed. Cir. 1987).
[72] *Chevron U.S.A Inc. v. Natural Res. Def. Counsel*, 467 U.S. 837, 839 (1984).
[73] *Id*. 842.
[74] *Id*.

is ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.[75]

In applying the test, at step one the court looks at the statutory text, the statute's legislative history, and purpose to determine if Congress had clearly expressed a position on stationary sources.[76] In the case at bar, pursuant to both the statutory text and the legislative history the Section 951 Inclusion should be treated as dividend.[77] As previously addressed above, Congress originally intended for the Section 951 Inclusion to be treated as a deemed dividend.[78] Consequently, because the Congress has "directly addressed the precise question at issue" the court need not proceed with the second step of the test.[79]

Even if the court decides to apply the second part of the test, the court should still rule for the Appellants because the IRS's interpretation is not a reasonable interpretation of Section 951. Appellee's interpretation of Congressional intent is unreasonable in light of the overwhelming evidence against such interpretation. As discussed previously, Appellee's argument ignores the substance of Section 951 and the undeniable similarities between the income inclusions and Section 316 dividends. In addition, subsequent discussion shows that Appellee's argument also ignores Section 951's legislative history and that if

[75] *Id*. at 843.
[76] *See Id*. at 859-65.
[77] *See supra* sec. B.
[78] 1 Legislative History of H.R. 10650, at 135, 146-48.
[79] *Id*. at 839.

Congress intended such income inclusions to be non-dividends, Congress could have expressly provided for such treatment, as it did for FPHC's and PFIC's.

3. Notice 2004-70 Interpretation of Section 951(a)(1) Inclusions Dated Prior to October 8, 2004 Would Violate Retroactivity Principals Established by Section 7805.

Notices released by the IRS are to be considered authority and the IRS will be bound by substantive or procedural guidance provided in a notice to the same extent as a revenue ruling or revenue procedure.[80] The Code prohibits the retroactive application of any temporary, proposed, or final regulation enacted on or after July 30, 1996.[81] Since no exceptions to Section 7805 apply, Notice 2004-70 would only affect the income Appellants included for the last quarter of 2004. Appellee incorrectly argues that Notice 2004-70 is outside the scope of retroactive principles because IRC Section 7805(b)(2) states retroactive principals "shall not apply to regulations issued within 18 months of the date of the enactment of the statutory provision to which the regulation relates." However, Appellee subsequently concedes for the sake of argument, that Notice 2004-70 relates to Section 951 and 956 enacted 40 plus years ago in 1962, more than 18 months (the time when subpart F was added to the code).

Additionally, prior to the enactment of Notice 2004-70, Appellee treated Section 951 Income Inclusions as dividends. As evidenced by the Form 5471

[80] *See*, Rev. Rul. 90-91, 1990-44 (I.R.B.) 11.
[81] IRC § 7805.

requirement that such income be included as dividends on the individual income tax return of the U.S. shareholder. Appellee decided income inclusions were not dividends only after the enactment of the 2003 Act when the dividend tax rate was reduced to become less than the previous ordinary income tax rate at which dividends used to be taxed.

Furthermore, Appellee contends that IRC Section 7805 retroactivity principles apply to regulations, not to notices.[82] Appellee erroneously references Section 7805 (b) (8) to emphasize that notices may be applied without retroactive effect.[83] However, the plain language of Section 7805 (b) (8) simply provides that the Secretary may prescribe the extent, the time frame, as to when a notice as an administrative determination may be applied. Section 7805 (b) (8) does not provide an all-inclusive default rule excluding notices from Section 7805 (b) (1) retroactive principles.

Moreover, the Supreme Court has held that the IRS's statutory interpretation should not be contrary to Congressional intentions.[84] Form 5471 instructions provide evidence that legislative history has treated Section 951(a) (1) income inclusions as dividends prior to the publication of Notice 2004-70.[85] According to Form 5471, U.S. shareholders of a CFC should include Section 951 inclusions on

[82] USCA5 ROA Vol.1 Doc. 36 p. 16-17.
[83] *Id*.
[84] *United States* v. *Shimer*, 367 U.S. 374 (1961).
[85] Treas. Form 5471.

the line designated for ordinary dividends on Form 1040.[86] While Form 5471 does not stand as legal authority and is not binding on the IRS, it bolsters the argument that the legislative intent and history have not always treated Section 951 (a) (1) inclusions as non-dividends.

CONCLUSION

Editora's Section 951 Inclusion should be treated as a dividend and taxed at a rate of fifteen percent (15%). The Notice 2004-70 fails to carry out the congressional mandate and it contradicts the Congress' original purpose.[87] The legislative history indicates that the original intent was to eliminate deferral of taxes by taxing undistributed profits of any CFC as a dividend to American shareholders. Because the Section 951 language has not changed at all since it was first proposed and because nothing in the legislative history indicates that the original intent of Congress has changed, it follows that Section 951 income inclusions should be treated as dividends.

The position taken by the Commissioner in Notice 2004-70 is contrary to the prior concession the Commissioner set forth in G.C.M. 39153 and G.C.M. 36965. Thus, the court should hold that the Notice is unsound and void. Furthermore, Notice 2004-70 should be construed by the court as invalid under the *National Muffler* test and in the alternative invalid under the *Chevron* two-step framework.

[86] Treas. Form 5471 (Rev. December 2004), Instructions for line 6 of Schedule I.
[87] *See* Notice 2004-70, 2004-2 C.B. 724.

Under the *National Muffler* test the Notice is invalid for the following reasons: (i) it was untimely as it was published over 40 years after the statute was enacted, (ii) it is inconsistent with the Commissioner's prior interpretation, and (iii) no reliance has been placed on it as it has been in effect for a short period of time. The notice is also invalid under the *Chevron* two-step framework because (1) the Notice contradicts Congress clear intent of treating Section 951 inclusions as dividends and (2) the Commissioner's interpretation of the statute represents an unreasonable interpretation of the statute.

For the foregoing reason, Appellants respectfully request that this Court determine that no deficiency in tax exists for 2003, 2004, or any other year.

Respectfully Submitted,

/S/ Patrick R. Gordon
Patrick R. Gordon
Gordon Davis Johnson & Shane P.C.
4695 N. Mesa, Ste. 100
El Paso, TX 79912
(915) 545-1133

CERTIFICATE OF SERVICE

I, Patrick R. Gordon, certify that today, October 5, 2012, a copy of the brief for appellant, a copy of the record excerpts, and the official record of this case, consisting of 2 volumes of the pleadings, original exhibits separately certified, Exhibits 1-J through 17-J attached to stipulation of facts, Exhibits 18-J through 67-J attached to second supplemental stipulations of facts, were served upon Teresa T. Milton, by overnight carrier, FedEx, to her at Justice Department, Tax Division, Appellate Section, 950 Pennsylvania Ave., NW, Room 4324, Washington, DC 20530-0001.

/S/ Patrick R. Gordon
Patrick R. Gordon

Additional individuals served under this Certificate of Service:

Mr. Gilbert Steven Rothenberg
U.S. Justice Department
950 Pennsylvania Avenue, N.W.
Washington, DC 20530-0000
With copy of brief and record excerpts only

Mr. John DiCicco
U.S. Justice Department
Tax Division
Appellate Section
P.O. Box 502
Washington, DC 20044-0000
With copy of brief and record excerpts only

Mr. William J. Wilkins
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224-0000
With copy of brief and record excerpts only