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Financing Foreign Subsidiaries of U.S. Multinationals

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I. INTRODUCTION

This article is intended to assist practitioners in identifying a number of the more important tax variables involved in developing a tax-efficient approach to financing the activities of a U.S. multinational corporation (hereinafter, a ''US MNC'') and its domestic and foreign subsidiaries and affiliates. The variables listed will affect the structural decisions involved in many, if not all, financing decisions of US MNCs. (For example, within the multinational affiliated group, who should borrow from third parties? Should working capital provided from within the group be intragroup debt or equity?)

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A. Key Variables and Goals

The more important tax goals sought by US MNCs making decisions on how to structure the financing of their international operations include:

(1) *deduction of interest* against income otherwise taxed (within or without the United States) at a relatively high rate within the group;

(2) *utilization of (or preservation for future utilization of) foreign tax credits* to reduce incremental U.S. tax on: (a) foreign-source after-tax (foreign tax) income that is included in U.S. taxable income as actual *dividends, branch profits*, or pursuant to *Subpart F*;[1] and (b) *other* foreign-source income included in U.S. taxable income, such as income from *exports* and *foreign licensing*;

(3) *deferral of inclusion* in U.S. taxable income of low-taxed foreign-source income until actually distributed to a U.S. person;

(4) *minimization of foreign withholding tax* on cross-border payments of dividends or interest;

(5) *matching foreign currency and interest rate risk management gains and losses* with the corresponding items of gain or loss on the hedged exposure; and

(6) *utilizing tax treaties* to minimize double taxation.

Any financing structure should be tested under each of these goals. Trade-offs should be made on purpose, not by accident.

B. Disorderly Universe

These goals are affected by the obvious differences in tax treatment in different jurisdictions resulting from different tax rates, timing rules, policies toward deferral (or exemption) of income earned by foreign subsidiaries, credits against home country tax for foreign direct or indirect taxes, different bases for measuring income, gain, loss or expense, etc. Less obvious, but no less important, are the differences between taxing jurisdictions in characterizing financial instruments as debt versus equity and in characterizing different forms of business enterprise as taxable entities or instead as fiscally transparent.

1. Recent U.S. Policy: Flux

a. Clinton Administration. The Clinton Administration expressed concerns about international tax ''arbitrage'' [2] and unintended base erosion that could lead the world's tax collector community into a downward spiral (a ''race to the bottom'').[3]

b. The Bush Administration. The Bush Administration did not express quite the same position on international tax arbitrage (i.e., one based on a goal of preventing harmful tax competition that would erode the fiscal foundation of the community of modern welfare states, etc.), but there remained a continuing concern about such ''tax arbitrage'' within the government.[4]

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[1] Sections 951–964 of the Internal Revenue Code of 1986, as amended (the ''Code''). Unless the context indicates otherwise, all ''§'' references are to the Code and all ''Regs. §'' references are to the regulations issued thereunder (and set forth in 26 CFR).

[2] *See, e.g.,* Department of Treasury, Office Tax Policy, The Deferral of Income Earned Through U.S. CFCs: A Policy Study, December 2000 (hereinafter, ''Treasury Subpart F Study''), at Ch. 5, Part II, B, 3, p. 67 (noting that ''avoiding application of foreign base company rules by using dual resident companies'' can occur ''because of arbitrage between the U.S. and foreign determination of where [a] corporation reside[s]'').

[3] *See, e.g.,* Rosanne Altshuler and Harry Grubert, ''Governments and Multinational Corporations in the Race to the Bottom,'' 41 *Tax Notes Int'l* 459 (2/6/06) (Professor Altshuler served as a principal adviser to each of the Staff of the Joint Committee on Taxation in the preparation of the ''Options'' Report and the President's Advisory Panel in the preparation of the Report of the President's Advisory Panel, both of which are cited in footnote 21 below; Harry Grubert is a senior economist in the Office of Tax Policy in the Treasury Department); Michael Danilack, then–Associate Chief Counsel (International), ''Remarks Before the NYU Conference on Advanced Topics in International Taxation, March 16, 2000,'' published in *BNA Daily Tax Rpt.* (3/17/00); Sheppard, ''Treasury Official Discussed International Arbitrage,'' 2000 *TNT* 152-2 (8/8/00) (discussing remarks by Patrick Brown of the Office of International Tax Counsel); Hoffman, ''Treasury Officials Caution Tax Arbitrage May Attract Future Scrutiny by Authorities,'' 237 *BNA Daily Tax Rpt.* G-10 (12/10/99); Donald Lubick, Treasury Assistant Secretary (Tax Policy), ''Remarks Before the GWU/IRS Annual Institute on Current Issues in International Taxation, December 11, 1998,'' published at 98 *TNT* 239-48, Doc. 98-36775.

[4] The Bush Administration's concern about arbitraging foreign and domestic hybridity was illustrated by Regs. §1.894-1(d)(2)(ii), dealing with domestic reverse hybrids, released as a final regulation on June 12, 2002 (T.D. 8999). When issued in proposed form on Feb. 27, 2001 (*see* REG-107101-00, 66 Fed. Reg. 12445 (2/27/01), the rules provided the Commissioner with the authority to recharacterize any transaction between related parties if the transaction's effect is to avoid the ''principles'' of the regulations. *See id.*, at Prop. Regs. §1.894-1(d)(2)(ii)(C). Those principles, as described in the Preamble to the proposed rules, appear to be limited to precluding taxpayers from using domestic reverse hybrids to exploit differences between U.S. and foreign law. Practitioners were concerned that this could be construed as undertaking a more generally applicable anti-hybrid policy. The final regulations (perhaps more reflective of the Bush Administration's position on the matter than the proposed regulations, issued a month into the administration's tenure) eliminated the reference to the ''principles of the regulation,'' replacing it with a more objective approach. In any event, it is clear that the Bush Administration was also concerned about the impact of hybrid arrangements on international

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c. Obama Administration. The Obama Administration has proposed substantial changes to the foreign tax credit regime, to the ''check-the-box'' regulations and to the treatment of expenses associated with undistributed earnings of foreign affiliates.[5] The ''check-the-box'' proposals did not appear in the 2011 Green Book or the 2012 Green Book, but the substantive importance of the omission should not be overemphasized. The proposal will likely resurface when concerns about business recovery have abated sufficiently to permit the reproposal.[6]

The proposals may have been conflated, at least in the minds of some voices in the crowd, with tax evasion by individual taxpayers who have squirreled away funds in undisclosed foreign bank accounts. Thus, while there may be little common behavioral characteristics between taxpayers who use secret foreign bank accounts to avoid disclosure of taxable income, and ''deferred'' tax on undistributed income of foreign affiliates, the energy to change the existing architecture for taxing foreign business income may depend on the visceral conviction that they are really all just different manifestations of the same behavior. Tax arbitrage will probably share in the visceral condemnation.

The Obama Administration has proposed very substantial changes in three areas that are very significant to decisions concerning financing foreign subsidiaries of US MNCs. First, the Administration has proposed in each of the 2010 Green Book, the 2011 Green Book and the 2012 Green Book to *defer certain deductions for expenses associated with undistributed foreign earnings* of foreign subsidiary corporations. The 2011 Green Book and the 2012 Green Book each reduced the expense deferral category to only interest, while the 2010 Green Book proposed both a deferral of interest as well as a deferral of allocable general and administrative expense. The deferral of allocable interest and any other such expenses would continue until the associated earnings are subject to U.S. federal income tax.

Second, the 2010 Green Book, the 2011 Green Book and the 2012 Green Book propose to permit a *foreign tax credit* with respect to distributed income of foreign affiliates only on the basis of a *worldwide pool* of all affiliate earnings. A distribution from, for example, a German subsidiary would not be treated as a distribution that ''carries'' associated German taxes to

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tax policy. *See also* 2001 U.S.-U.K. Income Tax Treaty, Article 23(4)(c) and the Department of Treasury Technical Explanation to the treaty (denying U.K. tax credits otherwise available for payments of U.S. corporate taxes by payor of an amount treated as interest for U.S. tax purposes, and as a dividend for U.K. tax purposes). It appears from the technical explanation, though, that the denial of U.K. foreign tax credits reflected a British desire to curb a perceived abuse rather than a negative American stance on hybridity. The Bush Administration focused its concern on arrangements that led to perceived abuses of the foreign tax credit rules through the ''inappropriate'' separation of foreign taxes from related foreign income. *See, e.g.,* Notice 2004-19, 2004-11 I.R.B. 6-6. *See also* REG-124152-06, 71 Fed. Reg. 44240 (8/4/06) (proposed changes to the ''technical taxpayer'' regulations) and REG-156779-06, 72 Fed. Reg. 15081–15091 (3/30/07) (proposed changes to separation transactions and highly structured transactions, often referred to as foreign tax credit ''generator'' transactions, that just appear wrong even if the basis for the concern is hard to articulate). The anti-generator transaction regulations were issued in temporary and proposed form in mid-2008. T.D. 9416, 73 Fed. Reg. 40728 (7/16/08). These arrangements involve among other structures, entities that take advantage of consolidated tax reporting systems in foreign countries and foreign reverse hybrids. Foreign tax credit ''generator'' transactions were designated as a ''Tier I'' issue in the LMSB Industry Issue Focus initiative (announced on the IRS website at http://www.irs.gov/businesses/article/0,,id=167377,00.html and reprinted at 2007 *WTD* 49-16, Doc. 2007-6222 (3/12/07)) and, an industry directive memorandum was issued to alert the field to these structures. LMSB-04-0208-003 (3/11/08), reprinted at 2008 *TNT* 55-10, Doc. 2008-6075 (3/11/08). The Bush Administration also pushed for increased reporting of transactions involving foreign disregarded entities treated as branches for U.S. tax purposes, requiring disclosure of transactions involving foreign hybrids. See Announcement 2004-4, 2004-4 I.R.B. 357 (12/30/03) and Form 8858, which includes (among other things) an abbreviated income statement, abbreviated balance sheet, summary information on taxable income or earnings and profits, and information relating to the foreign currency rules. Consistent with this heightened regard for disregarded entities, 2004 proposed and temporary regulations under §704(b) (issued in T.D. 9121) were finalized in October 2006 (T.D. 9292), rely on the principles of Regs. §1.904-6 for determining the proper classification of income that may be specially allocated (along with the associated taxes) to the partners of a partnership in a cross-border context. Regs. §1.904-6 looks to foreign law to make its determination, and if the entities held by the partnership are disregarded for U.S. income tax purposes (as may well be the case), following principles of those regulations could result in treating the income and foreign taxes of such disregarded entities as having more substance than U.S. tax law would normally give them. The enactment of new §909 in 2010 pre-empted the hybrid entity splitter provisions in Prop. Regs. §1.901-2(f)(2)(iii). *See* Notice 2010-92, 2010-52 I.R.B. 916. The temporary and proposed ''anti-generator'' regulations were set to expire July 15, 2011, and the Treasury issued final regulations on July 13, 2011 (T.D. 9535).

[5] Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, May 11, 2009 (the ''2010 Green Book''), available at www.treas.gov/offices/tax-policy/library/grnbk09.pdf, Department of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, Feb. 2010 (the ''2011 Green Book''), available at www.treas.gov/offices/tax-policy/library/grnbk11.pdf; and Department of the Treasury, General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals, Feb. 2011 (the ''2012 Green Book'') available at www.treas.gov/offices/tax-policy/library/grnbk12.pdf.

[6] *See* Parillo, ''Obama Administration Still Vigilant on Check-the-Box, Treasury Official Says,'' 2010 *TNT* 56-2, Doc. 2010-6296 (3/24/10), referring to remarks of Manal Corwin, then International Tax Counsel at the Department of the Treasury.

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be taken as a credit against U.S. federal income tax on such a dividend. Instead, the taxes associated with the German distribution would be determined by looking at all foreign taxes on all foreign affiliate earnings, and then deeming the amount of taxes carried with the German dividend to be a share of all foreign taxes on all foreign affiliates that corresponds to the amount of the worldwide pool represented by the amount of the German dividend.[7]

Third, the 2010 Green Book proposed a major change in ''*check-the-box*'' *classification*: to treat many foreign ''eligible entities'' currently eligible for elective classification as corporations or as passthrough entities) as *per se* corporations. The effect would be to eliminate the disregarded entity (and concomitant disregarded transaction) treatment of many eligible entity foreign subsidiaries of first-tier foreign corporations. The 2011 Green Book and the 2012 Green Book do not repeat this proposal, but the deletion may be only temporary (until the business sector is farther along on the road to recovery).[8]

In addition to their appeal at a visceral level (''get those MNCs''), the changes are estimated, according to Treasury sources, to raise significant amounts of revenue that could be used to fund a down payment on the cost of health care reform, rate reductions for individuals, or other tax or non-tax political priorities. The possible adverse impact, if any, on US MNCs is at most a tertiary concern that probably is reinforced by an optimistic view of the ability of the American business enterprises to overcome any momentary disadvantages such increased costs might place on them. This optimism is fundamental to the Obama Administration's tax policy for taxing income or loss (or, perhaps more accurately, hoped-for income) from cross-border trade and investment.[9] Whether or not ultimately proven to be a sound assumption, the changes that depend on such optimism are likely to be vigorously pursued during the next several years.

The effect of many of the Budget proposals is generally not reflected in this outline. The proposals are not supposed to be effective until 2012,[10] and in all likelihood will be enacted, if at all, only after the election of the next Congress in 2012.

2. 2010 Legislation

The Obama Administration also supported passage of H.R. 1586, the ''Education, Jobs and Medicaid Assistance Act,'' which passed August 10, 2010. The revenue raisers included a measure to reduce the foreign tax credit with respect to foreign taxes on income not taken into account by the U.S. taxpayer. The *foreign tax credit ''separation'' provisions* will be effective after December 31, 2010, but apply to foreign taxes incurred in prior years. The IRS has indicated that backward-looking application to separation transactions will be limited to taxes incurred in taxable years prior to 1997.[11]

3. Regulatory Initiatives Against Arbitrage, Etc.

The Internal Revenue Service (the ''Service'' or the ''IRS'') has designated ''International Hybrid Instrument Transactions'' and ''Foreign Tax Credit Generator'' transactions as ''Tier I'' issues under its Industry Issue Focus program and has formed issue management teams to tackle these cases in a coordinated fashion.[12] These actions evidently gained impetus from the concerns about cross border arbitrage ex-

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[7] The possible conflict between this approach and most bilateral tax treaties to which the United States is a party was discussed in a 2009 article by one of the authors, Robert H. Dilworth, ''Proposed Multilateral FTC Pooling and U.S. Bilateral Tax Treaties,'' 124 *Tax Notes* 1227 (9/21/09). The general response was that such a conflict was unlikely, but more recent incarnations have been accompanied by a ''just-in-case'' suggestion to enact the legislation with a specific treaty override to avoid all doubt. *See* Staff of the Joint Committee on Taxation, ''Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal,'' JCS-2-10 (8/16/10) at 239. The proposal is unlikely to be enacted, particularly if foreign trading partners object. Ancedotal reports suggest that some foreign trading partners are indeed aware of the issue and are also unenthusiastic about yet another U.S. treaty override (at least without consultation).

[8] See footnote 6 above.

[9] The intellectual architect of this policy was probably Stanley Surrey, who was the first Assistant Secretary of Tax Policy (under President Kennedy). Then-Secretary of the Treasury Dillon stated: ''It is sometimes contemplated that if U.S. firms are to compete successfully abroad they must enjoy as favorable a tax treatment as their foreign competitors. I believe this argument has been overly stressed. A difference in tax rates, I said before, should not handicap companies producing abroad, although it may slow the rate of expansion.'' Statement of Hon. Douglas Dillon, Secretary of the Treasury, before the House of Representatives Committee on Ways and Means, May 3, 1961, reproduced at Committee on Ways and Means, 90th Cong., 1st Sess., Legislative History of H.R. 10650, 87th Cong., The Revenue Act of 1962 (Part I) (1967), at p. 170. The maxim seems to have assumed the status of higher truth over the past 48 years and may not have been tested recently by the proponents of the changes in the 2010, 2011, or 2012 Green Books.

[10] The foreign tax credit and expense deferral proposals are similar to proposals by then-Chairman Rangel in H.R. 3970 110th Cong., 1st Sess. (Oct. 25, 2007). The treatment of certain otherwise disregarded entities as *per se* corporations is similar to proposals by the Staff of the Joint Committee on Taxation in Options To Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05 (Jan. 27, 2005). The antecedent proposals are discussed in various articles, including a 2009 article by one of the authors of this paper, Robert H. Dilworth, ''Tax Reform: International Tax Issues and Some Proposals,'' 35 *Int'l Tax J.* 5 (Jan.-Feb. 2009).

[11] H.R. 1586, §211(c), 111th Cong., 2d Sess. (2010). *See* Notice 2010-92, 2010-52 I.R.B. 916.

[12] *See* Industry Issue Focus paper available at http://www.irs.gov/businesses/article/0,,id=167377,00.html and reprinted at 2007 *WTD* 49-16, Doc. 2007-6222 (3/12/07) (designat-

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pressed by then–IRS Commissioner Mark Everson in testimony before the Senate Finance Committee June 13, 2006, and may have also been influenced by information gathered through certain cooperative efforts with the tax authorities of various jurisdictions described below. The International Hybrid Instrument Transactions group was moved down to ''monitoring'' status in 2009.[13]

The IRS has attempted to reassure taxpayers that a ''tiered'' issue is not necessarily a cause for alarm: For example, in April 2008, Frank Ng, then–Commissioner of the IRS's Large and Mid-Size Business (LMSB) division, said that the ''LMSB is actively working to combat the perception among taxpayers and practitioners that the Service views a tiered issue as an abusive transaction. Rather, the IRS puts some issues on a tiered list because they represent high compliance risk.'' [14]

Despite these general assurances regarding designation as a Tier I issue, the Service's directives to the field regarding ''generator'' transactions appear to evidence a belief that these types of transactions may lead to inappropriate results: The IRS stated that the field should closely scrutinize the tax treatment of hybrid financing involving a purchase (subscription) or a repurchase agreement,[15] and flatly stated that ''[o]verall, the Service finds [foreign tax credit ''generator''] transactions to be particularly offensive because they are designed strictly to generate credits in any amounts desired by the parties.''[16] The ''separation'' legislation enacted in August 2010 was based at least in part on a concern that the foreign tax credit should not support crediting of foreign taxes imposed on income that will not be subject to U.S. tax. The IRS and Treasury are empowered to provide by regulation for application to certain unrelated-party transactions that might be described in the ''generator'' initiatives.[17]

C. Multilateral Joint International Tax Shelter Information Centre

Similarly, the tax administrators in the United States have joined their counterparts in Australia, Canada, Japan and the United Kingdom to establish a ''Joint International Tax Shelter Information Centre'' to share information about abusive tax schemes, including what the tax administrators may view as abusive international tax arbitrage.[18] In addition, the United States participated actively in the OECD Tax Intermediaries Study that includes, at its core, a worry about international tax arbitrage. The ''Study Team'' was comprised of officials of the U.K. Revenue & Customs and the OECD Secretariat. The report of the Study Team was released January 11, 2008 and is available at the OECD website.[19]

D. Vocalized Concerns About 'Arbitrage'

Various academic,[20] legislative,[21] trade association[22] and professional commentators [23] have joined

ing these transactions as ''Tier I'' matters); Parillo, ''Issue Management Teams Play Key Role in IRS Compliance Efforts,'' 2008 *WTD* 218-7 (reflecting comments of Bettie N. Ricca, deputy associate Chief Counsel (International Field Service and Litigation). *See also* Tandon, ''Service Honing Its Strategy as FTC Cases Head to Court, Official Says,'' 2009 *TNT* 102-4 (comments of Roland Barral, area counsel for the financial services industry, IRS Office of Chief Counsel (LMSB)).

[13] ''Industry Director Directive on International Hybrid Instrument Transactions Directive #2,'' LMSB-04-0509-122 (5/22/09), available at 2009 *TNT* 98-70, Doc. 2009-11806.

[14] Coder, ''LMSB Repeats Assurances on Tiered Issues,'' 2008 *TNT* 70-5, Doc. 2008-7942 (4/10/08) (reporting the comments of several IRS personnel at an Apr. 8, 2008 District of Columbia Bar Section of Taxation luncheon on LMSB's industry issue focus (IIF) program). *See also* Coder, ''IRS Officials Work to Demystify Tiered Issues,'' 2008 *TNT* 68-1, Doc. 2008-6878 (4/8/08) (quoting Drita Tonuzi, deputy division counsel with LMSB as saying ''Just because we designate an issue as Tier I does not mean that we think of it as a shelter, as a bad transaction . . .We think it's a high-priority transaction that needs our expedited attention, some strategy, some guidance'' at the Tax Executives Institute's midyear conference in Washington on Apr. 7, 2008).

[15] LMSB-04-0407-035, reprinted at 2007 *WTD* 134-19, Doc. 2007-1234 (6/15/07).

[16] LMSB-04-0208-003, reprinted at 2008 *TNT* 55-10, Doc. 2008-6075 (3/11/08).

[17] §908(e)(2). *See* Staff of the Joint Committee on Taxation, ''Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, scheduled for consideration by the House of Representatives on August 10, 2010,'' JCX-46-10 (8/10/10), p. 5 (''Accordingly, the Secretary may issue regulations that treat an unrelated counterparty as a covered person in certain sale-repurchase transactions and certain other transactions deemed abusive.'').

[18] Joint International Tax Shelter Information Centre, Memorandum of Understanding for the Creation of a Joint International Tax Shelter Information Centre Between the Australian Tax Office and the Minister of National Revenue of Canada and the Internal Revenue Service of the United States of America and the Board of Inland Revenue of the United Kingdom and the Board of H.M. Customs and Excise of the United Kingdom (4/23/04), 2004 WL 1080239. According to the IRS, an initial focus of the Joint International Tax Shelter Information Centre will include ways in which financial products are used in abusive tax transactions by corporations and individuals to reduce their tax liabilities, and to identify promoters developing or marketing those arrangements. IR-2004-61 (5/3/04). The program now includes Australia, Canada, China, Japan, South Korea, the United Kingdom and the United States.

[19] http://www.oecd.org/dataoecd/28/34/39882938.pdf.

[20] *See* Avi-Yonah, ''Commentary [on International Tax Arbitrage],'' 53 *Tax L. Rev.* 167 (2000); ''Tax Competition and

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in a vigorous debate attempting to identify the arbitrage problem and to suggest solutions to whatever problem is perceived to exist. The majority view appears to be that legal rights and obligations should be determined under applicable (foreign or state) commercial law, but the federal income tax characterization of such rights and obligation should be determined by applying the provisions and principles of U.S. federal tax law without regard to the treatment of such rights or obligations under foreign tax law unless specifically required by the pertinent federal tax provisions.[24] Whatever the correct answer, the decision to finance in one form or another will also have to ac-

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Multinational Competitiveness: The Balance of Subpart F — Review of the NFTC Foreign Income Project,'' *Tax Notes Int'l* (4/19/99), at 1575; ''The Structure of International Taxation: A Proposal for Simplification,'' 74 *Tex. L. Rev.* 1301 (1996), ''The Ingenious Kerry Tax Plan,'' 2004 *TNT* 81-31 (4/27/04); Brauner, ''An International Tax Regime in Crystallization,'' 56 *Tax L. Rev*. 259 (2003).

[21] *See* Archer, ''Statement at Ways and Means Hearing on Impact of U.S. Tax Rules on International Competitiveness, June 30, 1999,'' published at 99 *TNT* 126-41, Doc. 1999-22566; Houghton, ''Statement at Ways and Means Hearing on Impact of U.S. Tax Rules on International Competitiveness, June 30, 1999,'' published at 99 *TNT* 126-45, Doc. 1999-22485; Goulder, ''News Story: Archer Bill Takes Aim at International Competitiveness,'' 99 *TNT* 134-2, Doc. 1999-23851 (7/14/99). *See also* Joint Committee on Taxation, Factors Affecting the International Competitiveness of the United States (5/30/91), JCS-6-91; Joint Committee on Taxation, Background Materials on Business Tax Issues Prepared for the House Committee on Ways and Means Tax Policy Discussion Series (4/14/02), JCS-23-02. *See also* Rep. Charles Rangel and John Buckley, Viewpoint, ''Current International Tax Rules Provide Incentives for Moving Jobs Offshore,'' 54 *BNA Daily Tax Rpt.* J-1 (3/22/04). Senator John Kerry announced on Mar. 26, 2004, a sweeping international tax reform plan proposing to generally end deferral and close international tax loopholes, including restricting tax avoidance through hybrid structures and other ''abuses.'' See ''Kerry Unveils Corporate Tax Proposals, Predicts Plan Will Create 10 Million Jobs,'' 59 *BNA Daily Tax Rpt.* G-11 (3/29/04). Subsequently, the Joint Committee on Taxation issued a report containing several fairly fundamental recommendations that, if enacted, would significantly alter or prevent the use of common international tax arbitrage techniques. *See* ''Options to Improve Tax Compliance and Reform Tax Expenditures,'' JCS-02-05, pp. 178–197 (1/27/05). Although the report was issued at the request of ranking members of the Senate Finance Committee for recommendations to ''curtain tax shelters. . .and close unintended tax loopholes,'' it is unclear whether the recommendations outlined in the report were intended to target international tax arbitrage as either tax shelters or unintended loopholes or whether the effects of the recommendations on international tax arbitrage are unintentional. The 2005 Joint Committee on Taxation recommendations affecting international tax arbitrage are: (1) a recommendation that would look to the place of management and control of a foreign publicly traded corporation to determine its residency; (2) a recommendation that would require single member foreign entities to be treated as per se corporations; and (3) a recommendation that would replace the current worldwide deferral-based system of taxation for foreign corporate investments with a system that would generally end deferral but provide a limited exemption for active subsidiary income somewhat similar to the exemption systems employed by a number of other industrialized nations (but with a largely unprecedented expense-matching and disallowance system for expenses incurred to generate exempt income). The President's Advisory Panel on Fundamental Tax Reform included similar proposals in its ''Simplified Income Tax'' proposals presented Nov. 1, 2005. Chairman Rangel has proposed a variant that would defer deduction of losses associated with deferred foreign income until the deferred foreign income might be taken into account. H.R. 3970, 110th Cong., 1st Sess. (Oct. 25, 2007). As noted, many of the various proposals have continued to be republished in the Obama 2010, 2011, and 2012 Green Books, and were also addressed by various components of the ''Education, Jobs and Medical Assistance Act'' that passed Aug. 10, 2010. The issue is not going to go away regardless of the party in control of some combination of the Congress or the White House.

[22] *See* National Foreign Trade Council, ''The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part One: A Reconsideration of Subpart F,'' and ''Part Two: Conclusions and Recommendations'' (12/15/01).

[23] See Harter, ''International Tax Arbitrage: Is It a Problem? Whose Problem Is It?'' 41 *Tax Mgmt. Memo.* 139 (Apr. 2000); Rosenbloom, ''The David R. Tillinghast Lecture: International Tax Arbitrage and the 'International Tax System,' '' 53 *Tax L. Rev.* 139 (2000).

[24] See statements of then-IRS Chief Counsel B. John Williams in ''Chief Counsel Statement on Transfer Pricing, International Tax Issues,'' 2003 *TNT* 54-47, ¶22; statements to the same effect by Nicholas J. DeNovio, former Deputy Chief Counsel (Technical), Internal Revenue Service, at the Spring meeting of the Section of Taxation, American Bar Association, Washington, D.C., May 7, 2004. For precedents relating to similar issues in a domestic context, see authorities quoted in Smith, ''Substance and Form: A Taxpayer's Right to Assert the Priority of Substance,'' 44 *Tax Lawyer* 137, 166, at fn. 261 (1990). *See also* Notice 2003-46, 2003 I.R.B. 53, withdrawing Prop. Regs. §1.7701-3(h) (the proposed ''extraordinary transaction'' regulations), for a discussion of IRS and Treasury concerns relating to certain transactions. The Notice does not specifically address the issue of hybridity, but its two examples of transactions under consideration both involve situations where U.S. federal tax characterization and foreign tax characterization generally would differ. The Notice states that the IRS and Treasury continue to examine the potential use of the entity classification rules to achieve results inconsistent with the policies and rules of specific Code provisions and treaties, and that this examination will focus on the substantive rules of the Code and treaties (rather than on the check-the-box rules that facilitate hybridity). This approach seems consistent with the Chief Counsel statements referred to above, and the *Dover* case, in which the Tax Court upheld a taxpayer's avoidance of Subpart F treatment by converting the sale of shares into a sale of assets through a retroactive check-the-box election. *See Dover Corp. v. Comr.*, 122 T.C. 324 (2004). The Eleventh Circuit's decision in *United Parcel Service of America Inc. v. Comr.*, 254 F.3d 1014 (11th Cir. 2001), *rev'g and rem'g* T.C. Memo 1999-268 (1999), 78 T.C.M. (CCH) 262, holds rather explicitly that tax-motivated choices of the way to conduct a bona fide business are not properly to be addressed under the sham transaction doctrine. It is consistent with longstanding precedent such as *Nassau Lens Co., Inc. v. Comr.*, 308 F.2d 39 (2d Cir. 1962) and *Sam Siegel v. Comr.*, 45 T.C. 566 (1966) (*acq.* 1966-2 C.B. 3), but may not be completely *au courant* in the post-Enron era. Notice 2003-46 expressed the government's concerns about cases in which a taxpayer, seeking

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count for a volatile enforcement environment. In this environment, it is less clear whether minimizing foreign tax is a laudable goal that imbues a financing structure with business purpose,[25] or whether it is somehow suspect and thus a provocation for attack by the IRS,[26] the tax press,[27] or politically sensitive legislators in search of an easy accomplishment when so much of what ails the voters seems beyond their grasp.[28]

E. 'Fundamental' Tax Reform Again on the Agenda

In addition to ''abuse-driven'' legislative efforts to change the framework for taxing income from cross-border trade and investment,[29] ''fundamental'' tax reform is again a hot topic.[30] The current flavor under vocal, and occasionally thoughtful, scrutiny is ''territoriality.''

The interest in a ''territorial'' system of taxing income from cross-border trade and investments dates back at least to the run-up to enactment of Subpart F in 1962.[31] More recently the idea has come up in various studies by the Staff of the Joint Committee on Taxation [32] and by advisory panels or commissions appointed by Presidents George W. Bush [33] and Barack Obama.[34] The various studies and proposals tend to reflect a shared DNA based on the sharing of economists who have assisted the working groups.

The U.S. flavor of territoriality as currently proposed would exempt from residual residence-based corporate income tax all dividends from ''active'' foreign business.[35] Active foreign business would, in turn, be income from business *other* than related-party business interest, rents and royalties.[36] All foreign business income (and all foreign portfolio investment

to dispose of an entity, makes an election to disregard it merely to alter the tax consequences of the disposition — essentially, the fact pattern in *Dover*. The notice specifically mentions that the IRS and Treasury are considering more restrictive treatment for situations in which a taxpayer disposes of a CFC by liquidating the corporation (through an actual liquidation or by electing to treat the corporation as a disregarded entity) and selling its assets rather than by selling the stock of the CFC. Citing to the classic case of *Comr. v. Court Holding Co.*, 324 U.S. 331, 334 (1945), the notice also warns that the government will continue to apply common-law doctrines such as substance over form in order to prevent perceived abusive transactions of this kind.

[25] See, however, the discussion by the Staff of the Joint Committee of Taxation of Enron Corporation's activities as an accommodation party for a foreign taxpayer seeking foreign tax benefits, concluding that fee income received for the facilitation of (foreign) tax avoidance by a non-U.S.-taxpayer constituted a bona fide non-tax benefit to Enron. See discussion of ''Project Valhalla,'' in Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations,'' JCS-3-03, Vol. I, p. 289. In contrast, the foreign tax benefits and reduced domestic financing costs alleged to be provided by the ''foreign tax credit generator transactions'' did not seem to impress the IRS when it decided to issue. Regs. §1.901-2(e)(T)(5)(iv) in 2008, T.D. 9416 (7/16/08). This position may have been a response to *foreign* tax collectors' concerns as much as an indigenous U.S. concern about protecting the federal treasury. See footnote 18, above, describing the Joint International Tax Shelter Information Centre.

[26] *See Del Commercial Properties v. Comr.*, 251 F.3d 210 (D.C. Cir. 2001), *cert. denied*, 122 S. Ct. 872 (2002) (''The Commissioner does not concede that foreign tax avoidance is a legitimate business purpose, and we do not need to address that question here.'').

[27] *See* Sheppard, ''Cross-Border Tax Arbitrage, 'Hybridity,' Mules and Hinnies,'' 98 *TNT* 31-2, Doc. 98-6196 (2/17/98); Sheppard, ''A Scheme to Use Excess Foreign Tax Credits,'' 98 *TNT* 244-3, Doc. 98-37374 (12/21/98).

[28] *See, e.g.,* H.R. 2345, 110th Cong., 1st Sess. (May 16, 2007), §101 proposing, *inter alia*, new §7701(p)(1)(B)(i)(I) under which foreign tax effects would be disregarded in assessing ''economic substance.'' As enacted, however, new §7701(o)(3) specifies only federal, state, or local tax benefits be ignored in determining economic substance.

[29] See, e.g., Staff of the Joint Committee on Taxation, ''Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010,'' JCX-46-10 (8/10/10), discussing, *inter alia*, ''splitting'' foreign tax credits and the income on which the foreign taxes are imposed, a new limitation on ''hopscotch'' §956 inclusions to limit ''inappropriate use of excess taxes,'' and repeal of the former ''80/20'' regime for dividends from domestic corporations that derived 80% or more of their gross income from foreign-sources.

[30] For some reason, ''fundamental'' seems to be an essential label for any change that is important enough to attract the attention of politicians who do not sit on the regular tax-writing committees.

[31] *See, e.g.,* Barlow & Wender, ''Foreign Investment and Taxation,'' at 247 (1955).

[32] Staff of the Joint Committee on Taxation, ''Options to Improve Tax Compliance and Reform Tax Expenditures,'' JCS-02-05 (1/27/05) (herein sometimes referred to as the ''JCT Options Report'').

[33] President's Advisory Panel on Tax Reform, ''Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System'' (Nov. 2005) (herein sometimes referred to as the ''Bush Advisory Panel Report'').

[34] President's Economic Recovery Advisory Board (PERAB), ''The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation'' (Aug. 2010) (''PERAB Report'') and National Commission on Fiscal Responsibility and Reform (''Fiscal Commission'') ''The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform'' (Dec. 2010) (hereinafter sometimes referred to as the ''Moment of Truth'').

[35] Bush Advisory Panel Report at 134; PERAB Report at 89 (''Option 1''); Moment of Truth at 32 (Recommendation 2.2.3).

[36] Bush Advisory Panel Report at 240 (''Mobile Income''); PERAB Report at 90 (''. . .critical (and technical) details would need to be resolved, including the share of foreign corporate income exempted from U.S. taxes. . . .''); Moment of Truth at 33 (Recommendation 2.2, Figure 9, ''Taxation of Passive Foreign-

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income) not falling in the relatively narrow class of "active" foreign business income would be taxed currently (whether or not distributed).

All interest, rents, royalties actually received by a U.S. taxpayer, and all undistributed "mobile" foreign business income of foreign subsidiaries would continue to be taxed on a residence basis. A foreign tax credit would be allowed for foreign taxes on the non-exempt income, but there would be no credit for foreign taxes on "exempt" foreign business income. The elimination of "cross-crediting" seems to be an important goal of the advocates who see a dividend exemption system as a desirable incremental burden on international business.

Interest (and perhaps other expenses of owning exempt-income-producing assets) allocable to assets producing tax exempt income would be non-deductible. In this respect, the U.S. flavor of territorial taxation is markedly different than the system in other OECD countries that are characterized as having a "territorial" system.[37]

It is worth noting that the United Kingdom flirted with this approach to dividend-exemption territoriality, but abandoned explicit expense allocation to exempt income when a number of U.K.-parented MNCs migrated to Ireland or elsewhere outside the United Kingdom in response to the proposal.[38] The United States will probably wrestle with amelioration of expense disallowance in any dividend exemptions system that makes it all the way to serious consideration, but will no doubt end up with something less generous than full deductibility of expenses allocable to exempt income.

Source Income, Taxed currently under Subpart F, Maintain Current Law") (unclear whether "present law" includes existing §954(e)(6)).

[37] *See, e.g.,* Staff of the Joint Committee on Taxation, "Background and Selected Issues Related to the U.S. International Tax System and Systems That Exempt Foreign Business Income," JCX-33-11 (5/20/11) at 9, 14 (Australia), 19 (Canada), 23 (France), 25 (Germany), 28 (Japan), 31 (Netherlands), 36 (Spain), 40 (Switzerland), 43 (United Kingdom). In some jurisdictions a partial economic proxy for expense allocation and disallowance is found in either a partial rather than complete dividend exemption or in an overall limit on debt financing, such as a thin capitalization regime.

[38] *See*, *e.g.,* testimony of Stephen Edge before the House of Representatives Committee on Ways and Means, Hearing on How Other Countries Have Used Tax Reform To Help Their Companies Compete in the Global Market and Create Jobs, May 24, 2011, available online at http://waysandmeans.house.gov/uploadedfiles/edge.pdf.

It is at best unclear whether the United States will go forward with any flavor of a territorial system. The various incarnations have attracted criticism from a variety of points on the political spectrum. The ongoing vigorous enthusiasm from some taxpayer proponents seems to be grounded in the assumption that the regime proposed as a revenue raiser can be materially modified in the United States to eliminate the expense disallowance and, perhaps, to carve back some elements of the proposal to tax multi-country business income as if it were "mobile" and accordingly properly taxed by the residence country rather than exempt.

If a regime were to be established that materially discourages debt financing of foreign operations, whether by external debt or intra-group debt, the discussion in this paper would have to be redone. In the short term, territoriality, and the associated impact on debt financing, is still over the horizon.

F. Keep the Door Open to Exit Strategies

It is always hard to predict what tax policy notion will or will not gain traction. Prior versions of this article have declined to illustrate the application of §954(c)(6) as an alternative to foreign-to-foreign transactions among entities treated for U.S. tax purposes as disregarded entities of the same single member. That decision was based on the assumption that the short period of applicability available upon enactment as part of TIPRA [39] made it unlikely that many US MNCs would rely on the relief from Subpart F it could provide. Now, going on six years of "temporary" extensions, it seems appropriate to illustrate how it might be a preferable basis for certain foreign-to-foreign financing transactions.

Prudence dictates, however, that, in analyzing any potential financing structure, consideration be given to an exit strategy to unwind debt structures. Given the substantial lack of consensus as to what is or is not tax-good or tax-evil, there is a great risk of instability in any momentary consensus that supports a particular body of legislation and regulatory guidance. That instability is unlikely to be fixed anytime soon.

[39] Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222 (May 16, 2006).

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II. SUMMARY OF KEY U.S. TAX CONSIDERATIONS

A. Basic U.S. Tax Jurisdictional Rules: Current Taxation Versus Deferral

1. Domestic Corporations

The United States taxes domestic corporations on a residence basis: on their worldwide income [40] (including their pro rata shares of ''Subpart F income'' of controlled foreign corporations (CFCs) of which they are ''United States shareholders'').[41] See discussion of Subpart F anti-deferral regime, at §II, B, below.

2. Foreign Corporations

The United States taxes foreign corporations on a source basis: on income effectively connected with a U.S. trade or business,[42] and on passive income from U.S. sources.[43]

3. Foreign Branches

The income, gain or loss of foreign branches of a US MNC is currently recognized by the US MNC for U.S. tax purposes, without regard to source or character. However, income (other than Subpart F income) earned by foreign corporate subsidiaries or affiliates of a US MNC is taxed only on actual distribution of after (foreign) tax income to the US MNC. Transactions between branches of the same taxpayer are generally disregarded.[44]

4. Partnerships

Partnerships are not taxable entities for U.S. tax purposes, but their income, gain or loss is taken into account currently by their partners. Transactions between a partner and the partnership are treated as transactions that give rise to, for example, interest or compensation for services.[45]

5. Subpart F (Generally)

Subpart F requires that a ''United States shareholder'' [46] of a CFC [47] include in income a pro rata share [48] of the ''Subpart F income'' of that CFC for the taxable year of the CFC that ends with or within the taxable year of the U.S. shareholder.[49] As discussed at §II, B, 3, below, Subpart F also causes current inclusion in taxable income of a United States shareholder of its pro rata share of any investment by a CFC in ''United States property.'' [50] United States property for this purpose generally includes tangible property located in the U.S., stock of domestic corporations, debt obligations of U.S. persons and the right to use within the U.S. certain intellectual property rights acquired or developed by the CFC for use within the United States.[51]

B. Subpart F Anti-Deferral Regime

1. In General

Subpart F income of a CFC is includible in the income of a United States shareholder for the taxable

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[40] §§11, 61.

[41] §951.

[42] §882.

[43] §881.

[44] *See, e.g.,* Regs. §1.446-3(c)(1)(ii) (an agreement among separate units of the same taxpayer is not a notional principal contract, ''because a taxpayer cannot enter into transactions with itself''); Regs. §§1.1503(d)-5(c)(1)(ii), -7(c), *Exs. 6*, *23–25*. But see §987, which provides a complex scheme to identify and value remittances between branches that use a functional currency other than the U.S. dollar and the home office (or other branches). Such remittances generally trigger foreign currency gain or loss. Computing §987 gains and losses accurately requires maintaining records of currency transactions going back to 1986, which few foreign disregarded entities have done. These computations have become important to taxpayers, however, with the introduction of Form 8858, which requires the reporting of §987 gains and losses and remittances from foreign disregarded entities. Section 987 gains and losses are recognized for a variety of purposes throughout federal income tax law, including for interest expense apportionment purposes under Regs. §1.861-9T(g) and (h). In particular, see Regs. §1.861-9T(g)(2)(ii), which focuses on the special rules for valuing assets of domestic corporations' qualified business units that have functional currency other than the U.S. dollar. The entire matter of remittances subject to §987 has become increasingly confused as a result of the withdrawal of the 1991 proposed regulations and the substitution of a new set of proposed regulations in 2006 that largely ignore the mandate for functional currency profit and loss accounting. *See* Prop. Regs. §§1.987-1 through 4 and 1.987-6 through 11. REG-208270-86, 71 Fed. Reg. 52876 (10/16/06). The current state of play for the architecture in the 2006 proposed regulations is quite unclear and taxpayers often rely on an alternative regime thought, by them at least, to be reasonable in anticipation of regulations under a 25-year-old statute that has not yet been regulated. In addition, final regulations under §704(b) (Regs. §1.704-1(b)(4)(viii), issued in T.D. 9292 (10/19/06)) may result in recognizing otherwise-disregarded transactions between related disregarded entities for purposes of identifying foreign income and associated taxes that may be specially allocated to partners in a partnership that owns such disregarded entities.

[45] §707(a).

[46] A United States shareholder is a United States person that owns directly or indirectly 10% or more of the voting stock of a CFC. §951(b). A United States person is any domestic corporation, domestic partnership, domestic estate or trust or United States citizen or resident. §957(c).

[47] A foreign corporation more than 50% of the combined voting power of all classes of stock of which, or more than 50% of the value of all classes of stock, is owned, directly or indirectly, by ''United States shareholders'' (i.e., United States persons which hold 10% or more *voting* stock interests in the foreign corporation).

[48] §951(a)(2).

[49] §951(a)(1).

[50] §§951(a)(1)(B) and 956.

[51] §956(c). Exceptions apply to various types of property, including bank deposits, export property and stock and obligations of a domestic corporation that is not a §951(b) U.S. shareholder of the CFC or a 25% affiliate of the CFC. §956(c)(2).

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year of the CFC that ends with or within the taxable year of the United States shareholder.[52]

2. Subpart F Income

Subpart F income[53] for most U.S. taxpayers is comprised of ''foreign base company income,''[54] which, in turn, is generally comprised of: (1) foreign personal holding company income[55] (FPHCI); (2) foreign base company sales income[56] (FBCSI); and (3) foreign base company services income.[57] Various tests operate at the level of FPHCI, others are foreign base company income, and yet others are at the level of Subpart F income.

a. *Passive Income*. Dividends, interest, rents and royalties received by a CFC are FPHCI unless one of several exceptions applies. For reasons of convenience, certain nonpassive direct investment dividends, interest, rents and royalties are also lumped together with portfolio (passive) dividends, interest, rents and royalties as FPHCI. True ''passive'' FPHCI is in principle taxable because of a policy against incorporated pocketbooks. Direct investment (business) interest, rents and royalties are included as FPHCI because of the idea that foreign-to-foreign ''base erosion'' will make foreign direct investment more attractive than domestic (U.S.) direct investment.[58]

i. *Same-Country Exception.* Same-country dividends and interest may be excluded from FPHCI if: (1) dividend or interest is paid by a related corporation organized (i.e., incorporated) under the laws of the same country as the recipient;[59] and (2) the payor of dividend or interest has a substantial part of its assets used in its trade or business in the country of incorporation.[60]

[52] §951(a).

[53] §952(a).

[54] §954.

[55] §954(c).

[56] §954(d).

[57] §954(e).

[58] *See* Statement of Hon. Douglas Dillon, Secretary of the Treasury, before the House of Representatives Committee on Ways and Means, May 3, 1961, at 24–26. The same notions can be found in more recent advocacy to end deferral. A more complete review can be found in Robert Dilworth's 2009 article on international tax reform cited at footnote 10. Deferral of U.S. tax on income from foreign-to-foreign base erosion is likely to have little effect on direct investment location decision making, compared to factors like employee capacity, labor cost, proximity to markets, etc., but railing against it probably satisfies a need to try to do something to keep jobs from migrating abroad.

[59] §954(c)(3)(A)(i).

[60] §954(c)(3)(A)(ii).

Same-country exception does not apply to interest that reduces Subpart F income of the payor.[61]

Same-country exception does not apply to dividends attributable to earnings and profits accumulated before payor was same-country subsidiary of the recipient.[62]

Note that country of incorporation (U.S. test) is different from residence test in many countries (place of management and control).

ii. *Temporary Look-Through Provision.* The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) enacted a ''temporary'' provision (applicable for taxable years beginning after 2005 and before 2009), which was subsequently extended through 2009 by the Tax Extenders and Alternative Tax Relief Act of 2008 and through 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010) pursuant to which dividends, interest, rents and royalties received by a CFC from another, related CFC (regardless of whether it is incorporated in the same country) will not be treated as FPHCI to the extent attributable to non-Subpart F income of the payor (i.e., one must ''look-through'' to the income of the CFC paying the item — if the item is not attributable to Subpart F income of the CFC, it will not be Subpart F income in the hands of the CFC receiving it). There are currently proposals to further extend this look-through rule.

This provision represents the most significant change in U.S. international tax rules governing financing foreign subsidiaries since the issuance of the ''check-the-box'' regulations. So long as it applies, it would provide US MNCs with considerable flexibility. US MNCs often use foreign disregarded entities to move active foreign income that is not subject to Subpart F among their foreign operations. This provision will enable taxpayers to achieve similar results using foreign regarded entities (i.e., corporations), but with additional flexibility for foreign tax credit planning purposes. The provision also can eliminate the need to comply with the complex foreign branch rules under §987 associated with use of foreign disregarded entities. Although the CFC look-through provision itself does not present major technical complexities, the fact that it is scheduled to sunset after years beginning before January 1, 2012, means that taxpayers intending to restructure in light of the new CFC look-through rule must anticipate the potential need to restructure again when it expires. Moreover, CFC restructuring may become technically complex with respect to the laws of the foreign countries where the CFCs are located, requiring taxpayers to analyze and coordinate U.S. and foreign law in such restructurings.

[61] §954(c)(3)(B).

[62] §954(c)(3)(C).

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This provision is the result of an ongoing debate regarding the manner in which Subpart F might be reformed in order to make U.S. multinationals more competitive with multinationals headquartered in other countries;[63] or instead less competitive and more inclined to invest in domestic enterprise (ignoring the effects of labor cost, proximity to markets, etc.). For example, the National Foreign Trade Council (NFTC) has advocated a number of legislative proposals to modify Subpart F (including a CFC look-through proposal).[64] Another Subpart F reform that was enacted (as part of the American Jobs Creation Act of 2004 (AJCA)) was a provision that would permit gain from the sale of an at least 25%-owned partnership interest by a CFC to be deferred from U.S. tax to the extent a proportionate sale of the partnership's underlying assets would also qualify for deferral.[65] AJCA also repealed other anti-deferral regimes (relating to foreign personal holding companies and foreign investment companies) for taxable years beginning after 2004, where overlaps with the Subpart F rules had resulted in additional complexity and compliance burdens.[66]

iii. *High-Tax Exception.* Cross-border dividends and interest are excludible from foreign base company income (not from FPHCI) only if they qualify for the high-tax exception (§954(b)(4) and Regs. §1.954-1(d)).

Section 954(b)(3) provides that foreign base company income does not include any ''item'' of income received by a CFC if such income was subject to an effective income tax rate imposed by a foreign country greater than 90% of the maximum rate of tax specified in §11.

Items are defined on the basis of various subcategories of FPHCI, FBCSI, and the other subcategories of Subpart F income, and various baskets of active and passive income determined for purposes of the foreign tax credit limitation.

Effective tax rate on each item is calculated by a *hypothetical* calculation of the foreign tax that would be applicable to the foreign tax credit limitation category of accumulated earnings (of the recipient CFC) in which the item is included (the test prescribed by §960).

Interest from a lower-tier CFC will *not* include any taxes paid by the payor in the hypothetical §960 calculation.

Dividends from a lower-tier CFC *will* include a pro rata portion of any foreign taxes paid by the payor CFC in making the hypothetical §960 calculation.

The hypothetical calculation is subject to the same limit on the number of tiers of ownership permitted to take foreign taxes into account.

iv. *Foreign Currency Transactions.* Foreign currency gains in excess of foreign currency losses are a category of FPHCI, unless the gains arise from a transaction ''directly related to the business needs of the CFC.'' [67]

Business Needs Exception. Foreign currency gains will not be treated as ''directly related'' to the business needs of a CFC if the transaction in connection with which the foreign currency gain arises is one which gives rise to Subpart F income.[68]

Examples of Transactions That Fail the Business Needs Test. Foreign currency gains from the following transactions will not be ''directly related to the business needs'' (and will be included in the FPHCI):[69]

- Accounts receivable from the sale of goods giving rise to FBCSI.
- Loans to an affiliate that would give rise to interest that would be FPHCI (determined after calculating the high-tax exception of §954(b)(4)).[70]
- Foreign currency gains on borrowings, to the extent interest expense on such borrowings would

[63] The recent debate over international tax reform has received significant attention and has attracted concern by some commentators and Members in Congress who argue or fear that Subpart F reform, or the failure to eliminate Subpart F, will lead to increased jobs moving overseas.

[64] *See* NFTC Study cited at footnote 22, above. The Treasury Department at the end of the Clinton Administration stated that advocates of change (who based their arguments on the need for competitiveness) had not carried their burden of proof that the Subpart F regime makes U.S. multinationals measurably less competitive. *See* Treasury Subpart F Study (footnote 2, above) at Ch. 4, p. 61 (''the available data provide no reliable basis for evaluating whether Subpart F has had a significant effect on the multinational competitiveness''). The thrust of their argument seems to be that US MNC's enjoy other (nontax) advantages that more than compensate for tax burdens under Subpart F and other atypical features of the U.S. regime for taxing international operations of US MNCs. More recently, the Treasury Department had expressed concern that U.S. multinationals might suffer anti-competitive effects under Subpart F rules that would discourage regional selling activities in the European Union. The competitiveness discussion suffers from a lack of agreement as to who is competing with whom: Dell Ireland with Dell Austin? or Dell worldwide with Lenovo, etc.?

[65] §954(c)(4).

[66] P.L. 108-357, §413 (Oct. 22, 2004).

[67] §954(c)(1)(D).

[68] Regs. §1.954-2(g)(2)(ii)(B)(1)(ii).

[69] A taxpayer, however, could elect under Regs. §1.954-2(g)(3)(i) to exclude foreign currency gain or loss otherwise includible in the computation of FPHCI and include such foreign currency gain or loss in the category of Subpart F income to which such gain or loss relates.

[70] Regs. §1.954-2(g)(2)(ii)(B)(ii) refers to ''(ii) Arises from a transaction or property that does not itself (and could not reasonably be expected to) give rise to Subpart F income other than foreign currency gain or loss.'' The high-tax exception applies to de-

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be allocated against Subpart F income of the borrower under the interest allocation rules.[71]

Hedging Transactions. Hedging transactions that give rise to foreign currency gain will not qualify as ''directly related'' unless currency gains from the hedged exposure would also be ''directly related.''[72] A discussion of hedging is beyond the scope of this paper. Management of currency, interest rate and commodity risk is complicated by highly meticulous designation mechanics designed to eliminate after-the-fact hedge identification. Currency gains from a fully integrated hedging transaction will not be separately accounted for, but will instead be treated as an adjustment to interest expense or interest income.[73] Related-party hedging transactions cannot, however, be integrated with any debt instruments for purposes of the integration rules,[74] and currency gains from such hedging transactions and the hedged exposures will be separately accounted for under Subpart F. In contrast, related-party debt transactions can be ''qualifying debt instruments'' [75] (i.e., they can be integrated with a qualifying third-party hedging transaction).

Foreign Currency Losses. Foreign currency losses in excess of foreign currency gains do not offset other categories of FPHCI.[76]

Thus, a CFC that has both general basket non-Subpart F income and FPHCI will be at risk of generating additional FPHCI income if its borrowings give rise to foreign currency gain, but without a symmetrical reduction of FPHCI if the borrowing gives rise to foreign currency losses.

This phenomenon encourages operating in the functional currency of CFCs that do not generate exclusively Subpart F income.[77] It should be noted, however, that a US MNC's choice to borrow from or lend to a related party in a non-functional currency (relative to the US MNC) may be subject to closer scrutiny from the IRS.[78]

3. Investment of Earnings in United States Property

Subpart F also includes as taxable income of each United States shareholder of a CFC a pro rata share of the earnings of the CFC invested in ''United States property.'' [79] A United States shareholder's inclusion is the pro rata share of an amount equal to the lesser of the average investment in U.S. property during the taxable year (to the extent such investment exceeds amounts previously taxed under §§951(a)(1)(B) and 956), or the CFC's current or accumulated earnings.[80]

a. *Shareholder Obligations.* United States property includes stock or debt obligations of a U.S. shareholder or any 25% domestic affiliate.[81] The amount of U.S. property from a direct loan is measured by the amount of the loan, while the amount of U.S. property from stock ownership is measured by the basis.

b. *Guarantees and Pledges.* If a CFC is a guarantor or pledgor with respect to the obligations of a United States person, it is treated as holding the collateralized/guaranteed obligation.[82] In this case, the entire amount of the guaranteed obligation is deemed held by the CFC, not merely the amount pledged.[83]

c. *Indirect Pledges and Guarantees.* The IRS asserts that a pledge of stock of a CFC by a shareholder is tantamount to a guarantee *by the CFC*. The notion was first asserted, unsuccessfully, in Rev. Rul. 76-125 [84] and, also unsuccessfully, in the *Ludwig* case.[85] The opinion in *Ludwig* distinguished the status of a

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termine ''adjusted net base company income'' (one step earlier than ''Subpart F income''). Regs. §1.954-1(d)(1). An item excluded from ''net foreign base company income'' will then not be included in Subpart F income. If the high-tax exception was not to be taken into account, then Regs. §1.954-2(g)(2)(B) would presumably refer to ''foreign base company income'' rather than to Subpart F income.

[71] Regs. §1.954-2(g)(2)(iii).

[72] Regs. §1.954-2(g)(2)(ii)(B)(2).

[73] Regs. §1.988-5(a)(1), (9).

[74] Regs. §1.988-5(a)(5)(iii).

[75] Regs. §1.988-5(a)(3).

[76] Regs. §1.954-1(c)(ii). A limited exception is provided by Regs. §1.954-2(g)(4).

[77] A CFC generating exclusively Subpart F income would offset net foreign currency losses against Subpart F income by operation of the limitation to earnings and profits under §952(c).

[78] *See* FSA 200046019 (the IRS concluded that a U.S. company's interest expense and currency gain from an unhedged borrowing from a related party should be disregarded as lacking economic substance); PLR 8730003 (U.S. company's loans to a foreign subsidiary operating in hyperflationary jurisdiction did not constitute valid indebtedness, but instead were equity contributions, since the loans were made without ''monetary correction'' clauses to adjust the loans' real economic value for inflation; therefore the U.S. company was not entitled to deduct losses resulting from the effects of inflation and the reduction in value of the foreign currency at repayment). *See also AMP, Inc. v. U.S.*, 185 F.3d 1333 (Fed. Cir. 1999).

[79] §951(a)(1)(B).

[80] §956(a).

[81] §956(c)(1)(B), (C), (c)(2)(F).

[82] §956(d).

[83] Regs. §1.956-2(c) provides that once the CFC is treated as a guarantor or pledgor, it is treated as holding the amount of the obligation. The value of the pledged property is not relevant. *See, e.g.,* Regs. §1.956-2(c)(3), *Exs. 1*, *2*.

[84] 1976-1 C.B. 204.

[85] *Ludwig v. Comr.*, 68 T.C. 979 (1977). The court expressed irritation with the government's issuance of Rev. Rul. 76-125 in the middle of the controversy, and its subsequent attempt to rely on

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creditor of a shareholder from that of a creditor of the corporation, and further pointed to a lack of regulatory authority to support Rev. Rul. 76-125. The IRS and Treasury responded by promulgating in 1980 Regs. §1.956-2(c), which sets forth the characteristics of a pledge of CFC stock that the IRS believes should be treated as a guarantee by the CFC. This can be a trap for the unwary, as commercial understanding of what is occurring in a pledge of stock is at variance with the IRS view. Some taxpayers are comfortable pledging 65% or less of the CFC stock.

d. *Conduit Transactions.* Taxpayers may seek to avoid a taxable investment in United States property by making an investment in an intermediate entity that is tied to an investment by that entity in a debt obligation of a U.S. corporation related to the CFC. Such arrangements may be challenged depending upon the independence of the intermediate transaction.[86]

e. *Nonbank Banks.* Taxpayers may seek to avoid a taxable investment in United States property by causing a CFC to make an investment in obligations of a related U.S. corporation that are excluded from the definition of ''United States property,'' such as deposits with persons ''carrying on the banking business.'' In *The Limited Inc. v. Comr.*,[87] the Tax Court held that CDs issued by a subsidiary bank of The Limited that did not take deposits from or make loans to the unrelated public were not obligations of a person carrying on the banking business. The taxpayer argued that a bank is necessarily ''carrying on the banking business.'' The Tax Court engaged in a somewhat curious reading of legislative history in concluding that the banking business Congress must have intended could not have included the kind of bank that did not do business with the public in quite the same way as banks did when the banking exception was included in the original enactment of §956. The decision was appealed to the Sixth Circuit Court of Appeals which reversed the Tax Court [88] and reinstituted an approach to Subpart F based on close textual analysis rather than continuing down the more recent path of attempting to divine a spirit of Subpart F that the Tax Court followed in the original decision.[89] AJCA included a provision that effectively overturns the *The Limited* decision by limiting the exception from the definition of U.S. property for deposits with persons carrying on a banking business to deposits with banks and certain bank holding companies as defined by the Bank Holding Act of 1956.

f. *Affirmative Use of §956.* In principle, §956 is available to both taxpayers and the government in causing a current inclusion under §956(a)(1)(B) with respect to an investment of earnings of a CFC in United States property.[90] To date, the government does not appear to have repudiated the view that §956 is a ''two-way street.'' [91] As noted above, affirmative use to effect an inclusion of high-tax lower-tier CFC income, to offset current U.S. tax on low-tax foreign income, was the target of H.R. 1586, enacted in August 2010, that limited the amount of foreign taxes deemed paid in the event of investments in United States property by a lower-tier CFC.[92]

g. *Additional Exceptions.* AJCA provided two new exceptions from the definition of U.S. property: (1) certain securities held by a CFC in the ordinary course of its business as a securities dealer; and (2) certain obligations of a U.S. person that is not a U.S. corporation.

4. Repatriation of Foreign Earnings

AJCA enacted a repatriation provision [93] that permitted an election (for a single taxable year) for certain dividends from CFCs in excess of regular distributions to be taxed a reduced 5.25% rate. This provision significantly affected funding decisions by US MNCs during that brief period and enabled companies to repatriate funds for both new investment in the United States as well as the payment of recurring expenses in the U.S. without the §956 impediment. In order to qualify for the reduced temporary rate, a number of limitations applied, including payment of a cash dividend from CFCs in excess of historical repatriation amount, an amount of foreign earnings consistent with what has previously been reported for book purposes as not requiring the recording of a current

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the Revenue Ruling as authority for its position against the taxpayer.

[86] Rev. Rul. 76-192, 1976-1 C.B. 205; Rev. Rul. 87-89, 1987-2 C.B. 195, *obsolete as to other situations per* Rev. Rul. 95-96, 1995-2 C.B. 322. *See Schering-Plough Corp. v. U.S.*, 651 F. Supp. 2d 219 (D.N.J. 2009).

[87] 113 T.C. 169 (1999).

[88] 286 F.3d 324 (6th Cir. 2002).

[89] A similar approach has found favor in the Ninth Circuit Court of Appeals. *See Jacobs Engineering Group, Inc. v. U.S.*, 83 AFTR 2d 99-1453, 99-1 USTC ¶50,355 (unpublished opinion, referenced in a ''Table of Decisions Without Reported Opinion,'' at 168 F.3d 499 (9th Cir. 1999) (finding that the ''spirit'' of a regulation under §956 should trump the taxpayer's technical compliance with it).

[90] Rev. Rul. 90-112, 1990-2 C.B. 186 (recognizing that the position taken in the ruling would enable taxpayers to use it affirmatively to support a current inclusion of undistributed foreign-source income if they had excess foreign tax credits that could shelter such an inclusion from tax cost).

[91] *See* 1996 FSA Lexis 204 (''If the loan guarantee is bona fide, the Service will not challenge its validity for 956 purposes even if the only purpose for the guarantee was to cause an inclusion under §951(a)(1)(B)'').

[92] §960(c), added by P.L. 111-226, 111th Cong., 2d Sess. (Aug. 10, 2010).

[93] §965.

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U.S. tax liability due to the lack of intention to bring the earnings to the U.S., and other limitations. Another provision temporarily reducing taxes on repatriated funds does not appear likely in the near future: On January 30, 2008, the Senate Finance Committee voted 16 to 5 against amending an economic stimulus bill to include a similar provision that would reduce taxes on funds repatriated within a 90-day period.[94] During the debate over this amendment, the amendment and the original repatriation provision were criticized by Edward Kleinbard (the Chief of Staff of the Joint Committee of Taxation) and Senator John Kerry (D-Mass.). On February 3, 2009, the Senate rejected a proposed amendment to the American Recovery and Reinvestment Act of 2009 [95] that would have enacted the second once-in-a-lifetime repatriation proposal. The Senate rejected the amendment by a vote of 55 to 42. The debate surrounding the proposed amendment has been characterized by some observers as a significant impetus to imposing a substantially increased tax burden on corporate income from cross-border trade and investment.[96] The amendment was proposed by Sens. Barbara Boxer (D-Calif.) and John Ensign (R-Nev.). Although its sponsors were bipartisan, the bill was rejected by a majority comprised of both Democrats and Republicans. The first version (2004) had been opposed by the Bush Administration, and partisan support was accordingly a bit tepid. Versions of the same idea are still floating around Washington in 2011.

C. Foreign Tax Credit

1. Direct Credit

The U.S. allows a credit against U.S. income tax otherwise due with respect to worldwide income for foreign taxes incurred,[97] but limits the amount of the credit to the same proportion of U.S. tax as foreign-source income bears to worldwide income.[98]

2. Indirect/Deemed Paid Credit

In addition to a credit for taxes paid or accrued by the U.S. taxpayer, the U.S. allows a credit for taxes paid by a foreign corporation of which the U.S. taxpayer (if a corporation) owns 10% or more of the voting stock (the ''deemed paid credit'').[99] The deemed paid credit arises in respect of dividends from foreign corporations [100] or Subpart F inclusions in respect of a CFC.[101] Interest does not bring up/carry a deemed paid credit.

3. Limitations on the Foreign Tax Credit

The U.S. limits the amount of the foreign tax credit to the same proportion of U.S. tax as foreign-source income bears to worldwide income.

a. *Separate Baskets.* The limitation on the aggregate amount foreign tax that may be credited is calculated on the basis of separate categories (or ''baskets'') of foreign-source income.[102] Foreign taxes allocated (for U.S. tax purposes) to one category cannot offset U.S. tax otherwise due on income in another category.

i. *Not an Item-by-Item Limitation.* The basket limitation regime is not, however, an item-by-item limitation. Foreign taxes imposed on income not in a separate category (i.e., income that defaults to the general basket) or on U.S.-source income may be creditable if there is excess limitation from other sources in the appropriate basket (most frequently, the general basket).

ii. *Reduction of Baskets.* For taxable years beginning after 2006, the previous nine baskets of income were reduced to two: a passive basket and a general basket. Carryforwards of income limitations in the baskets from preceding years were assigned to one of these two baskets as appropriate.[103]

- *Passive Basket.* Interest, dividends, rents, and royalties are generally in the ''passive'' basket.[104] Foreign currency gains and losses are in the passive basket except to the extent attributable to transactions that do not otherwise give rise to Subpart F income.[105]
- *General Basket.* General basket income means income other than passive basket income.

iii. *Look-Through Rule.* Interest, dividends, rents and royalties received/accrued by a U.S. shareholder from a CFC are treated as allocable to general basket or other basket income on a ''look-through'' basis (i.e., income to which the CFC's deduction for that in-

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[94] *But see* Senate Republican Policy Committee, ''Additional Pro-Growth Stimulus Ideas That Congress Should Consider,'' published at 2008 *TNT* 28-47 (issued shortly after the Senate Finance Committee vote, the report includes a recommendation to establish a ''repatriation window'' akin to the AJCA temporary repatriation provision).

[95] *See* O'Toole, ''Senate Adds Auto Loan Interest Deduction to Stimulus Bill,'' 2009 *TNT* 21-1 (2/4/09).

[96] See Sheppard, ''Practitioners Question U.S. Tax Exceptionalism,'' 2009 *TNT* 88-7 (5/9/09), reporting remarks of Joshua Odintz, Democratic tax counsel for the Senate Finance Committee at a May 7, 2009 meeting of the Wall Street Tax Association to the effect that ''multinationals had poisoned the well by asking for a renewal of the section 965 repatriation tax holiday.''

[97] §901.

[98] §904(a).

[99] §902(a).

[100] *Id.*

[101] §960.

[102] §904(d).

[103] §904(d)(2); Regs. §1.904-2T(a)(1).

[104] §904(d)(2)(A).

[105] Sections 904(d)(2)(A)(i) and 954(c)(1)(D); Regs. §1.954-1(g)(2)(ii)(B)(1)(ii).

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terest payment is allocated in calculating its earnings and profits).[106]

If the CFC has income in the passive basket, interest paid by it to a related person will be treated by the related person as coming entirely from such passive income (i.e., will retain the passive basket character in the hands of the related-party payee) up to the amount of such income in the hands of the payor,[107] and the excess will be general basket.[108]

The look-through rule does not apply to foreign currency gains or losses associated with a loan, even if the interest on such loan would be characterized on a look-through basis.[109]

Dividends from a CFC will be apportioned among baskets in proportion to the accumulated earnings of the CFC in each category.[110]

Interest from a non-CFC is passive basket income (i.e., there is no look-through for purposes of categorizing the interest in the hands of the shareholder/lender/lessor/licensor).

From and after January 1, 2003, there is a look-through for *dividends* from a non-CFC.[111] The non-CFC Look-through rule will not be applied to interest, rents, and royalties. Look-through will also apply to excess limitation carryforwards in the ''10/50 company basket'' with respect to dividends from such companies for taxable years beginning before January 1, 2003.[112]

iv. *10/50 Basket.* Dividends from non-CFCs were, until taxable years beginning before 2003, in a special company-by-company basket[113] (the ''10/50 basket''). Thus, dividends (10/50 basket) and interest (passive basket) from a non-CFC were in separate baskets for taxable years beginning prior to January 1, 2003.

v. *Income Tax Base Differences.* For taxable years beginning after 2004, an election may be made to treat creditable foreign taxes imposed on amounts that do not constitute income under U.S. tax principles as imposed either on general limitation or financial services basket income.[114] For taxable years beginning after 2006 (when the two-basket rule is in effect), such taxes are treated as imposed on general limitation income.

b. *The Limiting Fraction.* The foreign tax credit allowable with respect to income in any basket is limited to the U.S. tax otherwise due on worldwide income multiplied by a limiting fraction, the numerator of which is the foreign-source income in that basket and the denominator of which is worldwide income (both U.S.-source and foreign-source) in all categories. If the United States reduces the numerator of the limiting fraction (foreign-source income in the relevant basket) by amounts not taken into account by the foreign taxing jurisdiction in calculating taxable income for foreign tax purposes, the amount so allocated may be, in economic effect, non-deductible for U.S. tax purposes, if and to the extent the reduction in limitation results in a loss of foreign tax credit.

For taxpayers in an alternative minimum tax position, AJCA repealed the 90% limitation on the use of foreign tax credits in computing the alternative minimum tax. The repeal of this limitation generally had been viewed as a long overdue change.[115]

c. *Tax Credit Source Rules.* Interest[116] and dividends[117] ordinarily are sourced based on the nationality of the payor (a foreign borrower typically pays foreign-source income to a lender and a foreign corporation typically pays foreign-source dividends to its shareholders). There are resourcing rules for dividends[118] and interest[119] from foreign corporations engaged in a U.S. trade or business, and for dividends and interest from CFCs that derive U.S.-source income.[120]

Rents and royalties are sourced according to the location of use of the underlying property.[121]

Foreign currency gains and losses recognized by a U.S. taxpayer are sourced on the basis of the resi-

[106] §904(d)(3)(B), (C) and (D); Regs. §1.904-5(c)(2).

[107] Regs. §1.904-5(c)(2)(ii)(C).

[108] §904(d)(3)(A).

[109] If, however, the foreign currency gain or loss arises from a hedging transaction that is fully integrated with the loan in accordance with the very specific requirements of Regs. §1.988-5(a), the currency gains or losses will not be treated under the special source, timing, and character rules for foreign currency gain or loss, but will instead by taken into account as payments of principal and interest on a synthetic loan denominated in the currency of the hedge. The reconstructed interest payments then would be subject to look-through treatment.

[110] §904(d)(3)(D); Regs. §1.904-5(c)(4)(i).

[111] Section 904(d)(4) (effective for taxable years beginning after Dec. 31, 2002).

[112] §904(d)(4)(iv).

[113] §904(d)(1)(E).

[114] §904(d)(2)(H).

[115] In addition, AJCA clarified, by adding §902(c)(7), that a domestic corporation is entitled to claim foreign tax credits deemed paid under §902 either directly or indirectly through a partnership, provided the U.S. corporation owns indirectly through the partnership at least 10% of the foreign corporation's voting stock. This clears up any uncertainly in this area based on prior administrative statements that did not provide such an unqualified, clear view on this issue. *See* Rev. Rul. 71-141, 1971-1 C.B. 211; T.D. 8708, 1991-1 C.B. 137 at 924.

[116] §861(a)(1).

[117] §861(a)(2).

[118] §861(a)(2)(B).

[119] §884(f).

[120] §904(h).

[121] §861(a)(4).

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dence of the taxpayer[122] (i.e., U.S.-source except for foreign branch transactions).

Foreign currency gains and losses recognized by a foreign corporation are also sourced on a residence of the taxpayer basis[123] (i.e., foreign-source, except for U.S. branch effectively connected transactions).

d. *Treatment of Foreign Losses. Separate Limitation Losses in General.* If any basket has more expenses allocated to it than income, there will be a separate limitation loss (SLL) in that basket.[124] The SLL in each basket will be carried over to any other positive limitation basket in the same year, to reduce all foreign limitations to zero before being applied against U.S.-source income.[125] If *and to the extent* foreign taxes paid with respect to the income in such other baskets are rendered noncreditable as a result, the effect is the same as denying a deduction for the losses.

Recharacterization of Subsequent Income. If an SLL from any basket was allocated to income from any other basket, subsequent income in an SLL basket will be recharacterized as income in that other basket.[126] Foreign taxes on the subsequent positive income will, however, remain in the same basket and will not be carried over to the recharacterized basket along with the income.[127]

Overall Foreign Loss. If in any year there is an overall foreign loss (OFL), a portion of foreign-source income is recharacterized (or ''recaptured'') as U.S.-source income in each succeeding tax year (in the same basket as the original source of the loss).[128] The recapture is in an amount equal to the lesser of prior years' unrecharacterized OFLs or 50% of the foreign-source income for such succeeding taxable year.[129] The recapture is calculated on a basket-by-basket basis (i.e., the OFL is maintained on a SLL basis).

e. *Treatment of Domestic Losses.* For losses arising in taxable years beginning after 2006, where a taxpayer's foreign tax credit limitation has been reduced as a result of an overall domestic loss (ODL), a portion of U.S.-source income is recharacterized as foreign-source income in each succeeding tax year. The recapture is in an amount equal to the lesser of prior years' unrecharacterized ODLs or 50% of the U.S.-source income for such succeeding taxable year.[130] These rules are intended to provide relative parity with the OFL rules.[131]

4. Cross-Crediting

The basketing regime is designed to prevent ''cross-crediting.'' Cross-crediting is using foreign taxes attributable to one basket to offset U.S. income tax on another category (or ''basket'') of foreign-source income. The reason for preventing cross-crediting, in addition to raising U.S. tax revenue, is to limit the foreign tax credit to situations in which the allowance of the foreign tax credit is necessary to minimize effective double taxation of the same income or closely related kind of income. The limitation regime is not intended to result in a ''per item'' regime in which only foreign tax on a particular item is to be offset against U.S. tax on the same item. For example, foreign taxes associated with ''general basket'' distributions from, or Subpart F inclusions in respect of, foreign subsidiaries are clearly intended to be available to offset U.S. tax otherwise due with respect to general basket foreign-source income from foreign sales of inventory property.

On the other hand, the Service has, since at least 1998, expressed concern about taxpayers' ability to exploit base and timing differences between U.S. and foreign law in a way that just does not seem right.[132] In February 2004, the government recognized that its first approach to this problem — comparing a transaction's anticipated business profits with tax benefits — was unworkable. Notice 2004-19[133] withdrew Notice 98-5 and announced a new principle to explain the problem that cried out for a solution: the ''inappropriate separation'' of foreign taxes from the foreign income on which those taxes were imposed. Notice 2004-19 signalled a determined effort to apply this principle, announcing several initiatives. The initiatives are now reflected in the various final and proposed separation regulations:[134] (1) the partnership

[122] §988(a)(3)(A).

[123] *Id.*

[124] §904(f)(5)(E); Regs. §1.904(f)-7T(b)(3); *see generally* Ocasal and Lubkin, ''New Temporary Regulations Under Section 904: Implementing the Jobs Act and Trying to Keep It Simple,'' 37 *Tax Mgmt. Int'l J.* 199 (Apr. 2008).

[125] §904(f)(5)(A).

[126] §904(f)(5)(C).

[127] *Id.*; Regs. §1.904(f)-8T(b).

[128] §904(f)(1).

[129] §904(f)(1)(A).

[130] §904(g); Regs. §1.904(g)-2T.

[131] H.R. Rep. No. 108-548, at 187 (June 16, 2004); *see also* S. Rep. No. 108-192, at 19–20 (Nov. 7, 2003).

[132] Notice 98-5, 1998-1 C.B. 334.

[133] 2004-11 I.R.B. 606.

[134] In 2006, the Administration's pursuit of legislative authority to deal with separation transactions was ended, but the legislative history recited that there was no inference to be drawn from not providing such authority by new legislation. Some commentators continue to assert that one or more of the separation transaction regulations are not within the regulatory authority of the Treasury Department. *See* Dolan, ''Re: Proposed Regulation for Determining the Amount of Taxes Paid for Purposes of Section 901 (REG-156779-06),'' *Tax Notes Today* Doc. 2007-13277 (5/31/07).

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anti-splitter regulations;[135] (2) the proposed changes (repeal?) to the ''technical taxpayer'' rules dealing with hybrid entities, reverse hybrid entities, and foreign consolidated groups (now pre-empted in large measure by new §909 as added to the Code in August 2010);[136] and (3) the final regulations promulgated in 2011 regarding foreign tax credit capture transactions effected via highly structured arrangements.[137]

The various changes to the foreign tax credit regime enacted by the American Jobs Creation Act of 2004 [138] (AJCA) improved taxpayers' ability to apply foreign taxes as credits against a wider range of foreign business income. In particular: (1) the reduction in the number of foreign tax credit baskets from nine to two (consisting only of passive and general income); (2) the extension of the foreign tax credit carryforward period from five to ten years; (3) allowing taxpayers to allocate foreign taxes to baskets for items treated as income for foreign tax credit purposes but not U.S. tax purposes; (4) allowing look-through treatment for carryforwards in the 10/50 basket; and (5) the recharacterization of overall domestic losses, all move in the direction of allowing foreign tax credit limitations to be computed on a basis that more closely resembles a taxpayer's overall foreign effective tax rate.

5. Carryover of Excess Foreign Tax Credits

Because of the various limitations on the foreign tax credit, excess credits may not be usable in the current year but may be claimed in other years subject to various limitations. Under AJCA, excess foreign tax credits may be carried forward 10 years and carried back one year (prior law permitted a five-year carryforward and a two-year carryback). Transition rules apply to permit pre-AJCA excess credits that are unexpired to carry into the new regime.

6. Section 909 Deferred Foreign Taxes

If a credit for foreign taxes is subject to §909, the deferral of foreign taxes carries with it an extended time (beyond the normal carryforward and carryback periods). When the associated income is taken into account (if ever), the associated foreign taxes will then be allowed as a foreign tax credit.

7. Acquisition of Foreign Tax Credits

A similar concern attaches, in the Treasury's view, if foreign taxes are paid, but are not economically

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[135] *See* T.D. 9121 (4/20/04). The partnership splitter regulations attack partnership structures that ''split'' foreign taxes from the underlying income and specially allocate them to partners to maximize foreign tax credit utilization.

[136] REG-124152-06, 71 Fed. Reg. 44240 (8/4/06). The still proposed (not final) technical taxpayer rule changes deal with perceived abuses arising from the use of foreign consolidated groups, hybrid entities, and reverse hybrids and establish a rule that is generally designed to treat as the ''technical taxpayer'' the party treated under foreign law as the owner of the income on which the foreign tax is imposed. The proposed regulations have been substantially preempted by new §909, enacted as part of the ''Education, Jobs and Medical Assistance Act,'' P.L. 111-226 (111th Cong., 2d Sess.).

Section 909, like the proposed regulations, limits use of structures described in *Guardian Industries Corp. v. U.S.*, 477 F.3d 1368 (Fed. Cir. 2007). *Guardian* involved the claiming of foreign tax credits for taxes paid by a Luxembourg disregarded entity that was the parent of a Luxembourg consolidated group and wholly owned by a U.S. corporation. The Federal Circuit held that under Regs. §1.901-2(f)(1), the disregarded entity was the party liable for the tax of its subsidiaries based on the relevant regulations and Luxembourg law.

The proposed regulations provide that if foreign law is imposed on the combined income of two or more persons, foreign law is considered to impose legal liability on *each* such person for the amount of the tax that is attributable to such person's portion of the base of the tax. Prop. Regs. §1.901-2(f)(2)(i). Therefore, if foreign tax is imposed on the combined income of two or more persons, such tax shall be allocated among, and considered paid by, such persons on a pro rata basis. *Id.* For this purpose, the term ''person'' includes a disregarded entity. *Id.* Foreign tax is imposed on the combined income of two or more persons if such persons compute their taxable income on a combined basis under foreign law (for example, the foreign parent of a foreign consolidated group). Prop. Regs. §1.901-2(f)(2)(ii). Further, the proposed regulations deem a foreign tax on the income of a reverse hybrid (i.e., an entity treated as a corporation in its jurisdiction and as a passthru in the jurisdiction of its owners) to be imposed on a combined basis with the reverse hybrid and its owners and establish rules for allocating the foreign tax between its owners and the reverse hybrid. Prop. Regs. §1.901-2(f)(2)(iii). If the reverse hybrid's owners only have income from the reverse hybrid, the entire amount of foreign tax imposed is considered to be paid by the reverse hybrid. *Id.* The proposed changes to the technical taxpayer rule have not been issued in temporary or final form, and have been severed from the regulations project addressing structural financing transactions to generate foreign tax credits. Notice 2007-95, I.R.B. 2007-49. See footnote 137, below. Section 909 may have preempted the proposed regulations, but the basic thrust of the challenges will be substantially the same. *See* Notice 2010-92, 2010-52 I.R.B. 916.

[137] T.D. 9535 (7/13/11). *See also* TAM 200807015. The regulations apply to ''highly structured transactions'' that purport to convert what would otherwise be an ordinary course financing arrangement between a U.S. person and a foreign counterparty, or a portfolio investment of a U.S. person, into some sort of equity ownership in a foreign special purpose vehicle. Specifically, according to Treasury, the parties to such structured arrangements seek to exploit differences between U.S. and foreign law in order to permit the U.S. taxpayer to claim a credit for the purported foreign tax payments while also allowing the foreign counterparty to claim a foreign tax benefit.

Regs. §1.901-2(e) as amended treats amounts paid to a foreign taxing authority as noncompulsory payments if those amounts are attributable to certain structured passive investments. In Notice 2007-95, the Service announced it was severing the proposed rule for U.S.-owned foreign groups from the portion of Prop. Regs. §1.901-2(e)(5) addressing the treatment of foreign payments attributable to certain structured passive investment arrangements while continuing to study the appropriate treatment of U.S.-owned foreign groups.

[138] P.L. 108-357 (Oct. 22, 2004).

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close to other income in the same basket, particularly if the foreign income was acquired in order to acquire the credit,[139] or if the foreign income was acquired because it would bring with it foreign taxes that could be credited by the acquirer but might not have been creditable to the transferor of the income-producing property. The route taken to this conclusion relied on an economic substance argument, with all the fuzziness of such doctrines. The argument further forced the conclusion under economic substance principles by treating foreign taxes as an expense rather than a tax.[140] This reasoning carried the day in the Tax Court decision in *Compaq Computer Corp. v. Comr.*,[141] and in the District Court summary judgment in favor of the government in *IES Industries Inc. v. U.S.*[142] Indeed the Service saw the problem of affirmative acquisition of foreign tax credits as important enough that it identified transactions described in Notice 98-5 as *per se* corporate tax shelters requiring automatic disclosure and listing under the corporate tax shelter regulations.[143] The substantive position was rejected in both cases — by the Fifth Circuit in *Compaq*[144] and by the Eighth Circuit in *IES Industries Inc.*,[145] which found both business purpose and economic substance in the identical transaction when foreign taxes are treated as "taxes." [146] Disheartened by the reversals, with which it vigorously disagreed, the Service and Treasury withdrew Notice 98-5 and deleted it from the most recent list of per se reportable tax shelters.[147] In doing this, however, the government warned that it would continue to attack such foreign tax credit acquisition transactions with traditional economic substance tools. Foreign tax credit capture transactions, at least when based on short holding periods, must be looked at with great caution.

Other perceived abuses relating to the acquisition of foreign tax credits were addressed, at least in part, by AJCA, which extended the statutory minimum holding period to claim foreign tax credits for withholding taxes imposed on income other than dividends (e.g., interest, rents and royalties).[148]

D. Interest Expense Allocation Rules

The regime for allocating and apportioning interest against foreign-source income is sufficiently important and complicated to be a separate category of the basic building blocks for developing a tax-efficient financing structure. These rules contain many uncertainties and ambiguities that have yet to be resolved.

1. Treatment of U.S. Interest Expense

Under most tax regimes, interest expense incurred by a (foreign) shareholder of a domestic corporation is not taken into account by a taxing authority of the domestic corporation in calculating the taxable income of that corporation, nor is it allowed as a deduction from withholding tax on dividends or interest paid by the domestic corporation to the foreign shareholder/creditor. When the "foreign shareholder" is a U.S. corporation, and when the United States taxes that corporation on its dividends, interest, rents and royalties from that foreign corporation, some portion of the United States shareholder's interest expense *is* taken into account for U.S. tax purposes in calculating the foreign-source income amount in the

[139] Notice 98-5, 1998-1 C.B. 334.

[140] Rigorously ignoring the whole point of a credit as distinguished from a deduction for foreign tax. *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess., p. 76 ("Credit is allowed under existing law against United States tax liability for income tax paid abroad. This provision gives foreign countries a prior tax claim on the income of United States enterprises operating abroad, and in effect treats the taxes imposed by the foreign country as if they were imposed by the United States."). The Tax Court decision in *Compaq* and Notice 98-5 (now withdrawn) in effect treat all foreign taxes as if they were only deductible expenses (rather than the equivalent of "taxes imposed by the United States") and, if they are deductible under anti-abuse rules applicable to deductible expenses, would allow a "super deduction" in the form of a foreign tax credit. The final regulations under §704(b) (Regs. §1.704-1(b)(4)(viii), issued in T.D. 9292 (10/19/06)) take a different view of foreign taxes as expenses, denying taxpayers the ability to specially allocate foreign taxes separately from the income with which those taxes are associated because the taxes are presumed to be creditable and therefore are not considered to constitute a true expense. Only in the unusual circumstance where a taxpayer can show that a foreign tax will be deducted and not credited will such special allocations be respected under those regulations.

[141] 113 T.C. 2314 (1999).

[142] N.D. Iowa 1999 (unpublished opinion).

[143] Notice 2000-15, 2000-12 I.R.B. 826, as supplemented and superseded by Notice 2003-76, 2003-49 I.R.B. 1181; effectively withdrawn by Notice 2004-19, 2004-11 I.R.B. 606.

[144] 277 F.3d 778 (5th Cir. 2001).

[145] 253 F.3d 350 (8th Cir. 2001).

[146] *See* Dilworth and Harter, "The Fifth Circuit's Compaq Decision: Foreign Taxes are 'Taxes' (Nothing More, Nothing Less)," 2 *J. Tax'n Glob. Trans.* 11 (2002); *see also* Dilworth, "*Compaq*: Find Another Poster Child: The Business Purpose Doctrine Is Alive and Well in the Fifth Circuit," *Int'l Tax J.* (7/15/09).

[147] Notice 2004-19, 2004-11 I.R.B. 606.

[148] §901(1). The minimum holding period generally is 15 days within a 31-day testing period, not counting periods during which a taxpayer is protected from risk of loss. Additionally, credits will be denied when the withholding tax is paid on an item of income or gain to the extent taxpayer has an obligation to make "related payments with respect to positions in substantially similar or related property." §901(l)(1)(B). Because of this latter provision, §901(l) may operate to deny credits in a significant number of non-abusive situations in the absence of regulations. *See* Notice 2005-90, 2005-51 I.R.B. 1163 (describing future regulations intended to specifically exempt foreign withholding taxes imposed in certain back-to-back licensing arrangements from §901(l)'s ambit); *see generally* Harter and Harper, "Notice 2005-90 — Will Code Sec. 901(l) Swallow the Universe?" 6 *J. Tax'n Global. Trans*. 11 (2006).

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limiting fraction for the foreign tax credit.[149] The object is to deny the economic benefit of an interest deduction that has produced income not subject to incremental U.S. tax (because the U.S. tax otherwise due with respect to such income is fully offset by the credit for foreign taxes on the income).[150]

2. Apportionment Based on Asset Value

Generally, interest expense of a US MNC is allocated to *all* of its gross income and apportioned to gross income from different sources based on the value of the assets generating the income (rather than the amount of the income itself). For example, a U.S. taxpayer that has $150,000 of deductible interest expense and $3,600,000 of assets, $3,000,000 of which generate U.S.-source income and $600,000 of which generate foreign-source income, should apportion $125,000 ($150,000 × ($3,000,000/$3,600,000)) of the $150,000 to U.S.-source income and $25,000 ($150,000 × ($600,000/$3,600,000)) to foreign-source income.[151] Additional examples of interest expense apportionment are provided in III, below.

This allocation and apportionment is premised on the notion that ''money is fungible,'' and that consequently, interest expense is attributable to all of the taxpayer's activities and property ''regardless of any specific purpose of incurring an obligation on which interest in paid.''[152] This fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. In other words, because borrowing will generally free other funds for other purposes, the Service believes it is reasonable to attribute part of the cost of borrowing to such other purposes.

3. Treatment of Foreign Subsidiary Borrowing

U.S. interest expense allocation rules do not provide any offset or otherwise take into account interest incurred by foreign subsidiaries of US MNCs. Thus, for foreign tax credit purposes, foreign-source income is effectively reduced by interest incurred by a foreign subsidiary, *and* by an allocated share of the US MNC's interest expense. This implicit double counting often results in economic double taxation.[153] To mitigate this result, AJCA included a significant provision, described further in II, D, 8, below, that will permit the interest on foreign borrowings to be taken into account in determining the amount of U.S. interest expense allocated against foreign-source income.[154] The provision is currently scheduled to begin to apply for taxable years beginning after December 31, 2020, and the double counting burden will be a continuing factor until and unless the provision becomes effective.[155]

4. Highly Leveraged Industries

The impact of the interest allocation rules is particularly important for groups in industries such as utilities, which have relatively high domestic leverage and limited (often regulated) rates of return on the assets carried with such leverage. The interest allocated against foreign equity acquired by such taxpayers may arise on debt incurred years (or decades) earlier than the foreign equity investment.

5. Affiliated Groups

A U.S. affiliated group of corporations must allocate and apportion interest expense of its members as though the group was one corporation.[156] (In other words, interest expense cannot be isolated in a single member with little or no foreign-source income or foreign assets.)

6. Asset Method

Under the ''asset method'' of apportionment, ''the taxpayer apportions interest expense to the various statutory groupings [e.g., income in the different foreign tax credit baskets, and other income, the source of which has operative effect under the Code][157] based on the average total value of assets within each such grouping for the taxable year.'' [158] Asset valuation for this purpose may be based on one of two methods: ''tax book value'' (i.e., adjusted basis plus, in the case of stock in 10%-owned corporations, earn-

[149] Regs. §§1.861-8, -9, -10, -10T, -11T and -12T.

[150] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, May 4, 1987, pp. 941–945 (explanation of §1215 of the Act and §864 of the Code).

[151] Regs. §1.861-9T(g), *Ex. (1)*.

[152] §864(e)(2), Regs. §1.861-9T(a). *See generally* Andrus, ''Allocating Interest Expense for the Foreign Tax Credit,'' 41 *Tax Notes* 1105 (1988), and Andrus, Dilworth and O'Donnell, ''U.S. Tax Considerations in Financing Foreign Subsidiaries,'' *TAXES* (Oct. 1990).

[153] The rationale for this structure was economic rather than theoretical: revenue gain from this asymmetry was useful in the scoring of the tax benefits and burdens of the 1986 Act. The asymmetry was challenged from time to time by legislative proposals but the cost has been too great to obtain Congressional approval and a Presidential signature until enactment of AJCA. The delayed post-2008 effective date of the AJCA provision designed to alleviate (to some extent) the double counting reflects this significant tax cost.

[154] *See* the American Jobs Creation Act of 2004 (P.L. 108-357, Oct. 22, 2004). The new provision is included in §864(f).

[155] ''Hiring Incentives To Restore Employment Act,'' H.R. 2847, §551(a), P.L. 111-147, 111th Cong., 2d Sess.

[156] §864(e)(1). Regs. §1.861-11T.

[157] Regs. §1.861-8(f)(1).

[158] Regs. §1.861-9T(g)(1)(i).

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ings and profits of the investee corporation)[159] or fair market value. Assets are placed in a statutory grouping if "they generate, have generated, or may reasonably be expected to generate" income within that grouping (and assets not matched with a statutory grouping are placed in the residual group).[160]

Under the "asset method," shares of a foreign subsidiary are "assets" of a US MNC and consequently attract interest expense. Therefore, interest expense of a US MNC is apportioned to foreign-source income in the same category as income from that foreign subsidiary. As noted above, the interest expense of the foreign subsidiary cannot offset U.S.-source income of the US MNC but can only serve to further reduce foreign-source income of the foreign subsidiary.

7. Specific Allocations

The regulations, however, provide exceptions to the fungibility approach. Under the below exceptions, interest expense is allocated exclusively to income from the property financed on which interest is paid or accrued:

a. *"Qualified Nonrecourse Indebtedness."* [161] Interest on "qualified nonrecourse indebtedness" ("QNI") is allocated solely to the income generated by that asset. QNI is defined to mean any borrowing: (1) specifically incurred for the purpose of purchasing tangible personal property with a useful life of more than one year; (2) the proceeds of which are actually applied to purchase the property; (3) with respect to which the creditor can look only to the identified property as security for the payment of interest and principal (i.e., there is no cross-collateralization or other credit enhancement); (4) with respect to which the cash flow from the property that services the borrowing is reasonably expected to fulfill the terms of the loan; and (5) there are restrictions in the loan on the disposal or use of the property.

b. *"Integrated Financial Transactions."* [162] If a taxpayer borrows as part of an "integrated financial transaction," interest on the borrowing is allocated exclusively to income from the transaction. An "integrated financial transaction" must meet all of the following requirements: (1) the indebtedness must be incurred to make an identified term investment;[163] (2) the debt must be identified at the time of borrowing; (3) the term investment must be acquired within 10 business days after the borrowing; (4) the reasonably expected return on the term investment must be sufficient to cover debt service; (5) the income produced by the term investment must be interest or an interest equivalent; (6) the maturity dates of the debt and investment must not be within 10 business days; (7) the investment must not relate to the normal operation of the taxpayer's trade or business; and (8) the borrower must not constitute a financial services entity (as defined in §904 and the regulations thereunder).

c. *"CFC Netting Rules."* [164] A US MNC that borrows funds from a third-party lender and also lends funds to its CFC will be required to allocate a portion of its interest expense on the third-party indebtedness directly against foreign-source income (rather than apportioning the expense between domestic and foreign-sources under the standard "asset method"), if the US MNC has both: (1) "excess related-group indebtedness" (i.e., an increase in loans from the US MNC to its CFC from a five-year historic average of such loans expressed as a percentage of assets);[165] and (2) "excess U.S. shareholder indebtedness" (i.e., an increase in loans from third-party lenders to the US MNC from a five-year historic average of such loans expressed as a percentage of assets).[166] This netting rule prevents the tax benefit that would otherwise result from placing all debt at the US MNC level. A hybrid instrument may not be used to avoid the application of this rule. The regulations provide that an instrument that is treated as equity for U.S. tax purpose and as debt for foreign tax purposes will be treated as allocable related-party indebtedness for purposes of determining the amount of interest expense that is reallocated.[167] Moreover, under certain circumstances equity investments in foreign subsidiaries will effectively be treated as loans to the subsidiary.[168]

8. Elective Worldwide Fungibility Approach

For taxable years beginning after 2020, a one-time election may be made to allocate and apportion third-

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[159] "Tax Book Value" generally is the asset's adjusted basis, but if the taxpayer owns 10% or more of the stock of a corporation not included in the taxpayer's affiliated group, the stock's "tax book value" is its adjusted basis increased by the taxpayer's share of the corporation's accumulated earnings and profits. *See* §864(e)(4) and Regs. §1.861-12T(c). Taxpayers applying the tax book value method can elect to apply an "alternative tax book value" method to determine the "value" of certain tangible property for years beginning on or after Mar. 26, 2004. *See* Regs. §1.861-9(i).

[160] *See* Regs. §1.861-9T(g)(3).

[161] Regs. §1.861-10T(b).

[162] Regs. §1.861-10T(c).

[163] An identified term investment might consist, for example, of a purchase of a portfolio of stocks approximating the composition of a stock index coupled with a forward contract to sell the stock at a designated future date for a specified price. Regs. §1.861-10T(c)(4), *Ex. 1*. A taxpayer might borrow to finance such an investment in order to exploit a difference between the interest rate on the borrowing and the interest rate implicit in the difference between the current and forward prices for the stocks.

[164] Regs. §1.861-10(e).

[165] Regs. §1.861-10(e)(2).

[166] Regs. §1.861-10(e)(3).

[167] *See* Regs. §1.861-10(e)(8)(vi).

[168] Regs. §1.861-10(e)(8)(v).

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party interest expense of U.S. members of a worldwide affiliated group to foreign-source income in an amount equal to the excess, if any of: (1) the worldwide affiliated group's interest expense, multiplied by a fraction representing the group's foreign assets over its worldwide assets; over (2) third-party interest expense incurred by foreign members of the group that would otherwise be allocated to foreign-sources.[169] The worldwide affiliated group generally includes 80%-or-greater-owned U.S. corporations and CFCs. The rules permit certain elections to apply these rules separately to a financial institution and financial services group of the taxpayer. The consideration of foreign interest expense in the determination of the amount of U.S. interest expense that potentially is allocable against foreign-source income will greatly improve some of the inefficiencies currently present in the computation of the §904 foreign tax credit limitation. Such a move has been under consideration since enactment in 1986 of the asset-based interest expense allocation rules on a consolidated group basis. These rules originally were enacted as part of the American Jobs Creation Act of 2004 with an original effective date of taxable years beginning after December 31, 2008. In 2008, Congress delayed the effective date by two years until 2011. It remains to be seen whether this election will ever be available.

E. Hybrid Entities

1. In General

The United States federal tax system contemplates the existence of corporations,[170] partnerships,[171] trusts,[172] estates[173] and individuals.

a. *Double Taxation of Corporations.* The United States has a so-called ''classic'' system in which the income of corporations is taxed twice, once when earned by the corporation and again when distributed (or deemed distributed) to shareholders.

b. *Partnerships.* Partnerships are not taxable entities for U.S. tax purposes. Partnership income is taxed once (to the partners).

- Certain items of income, gain, expense of loss are treated as if earned directly by the partners (an ''aggregate approach'').
- Certain items of income, gain, expense or loss are mixed and netted at the partnership level and the partners are treated as deriving net items of partnership income, gain, expense or loss (an ''entity'' approach).

c. *Trusts.* Trusts are subject to a mixed regime. Trusts are taxable if and to the extent income is accumulated by a trust; beneficiaries are taxable on trust income that is not accumulated by a trust. Further, trust beneficiaries are allowed a credit for taxes paid by a trust on accumulated income. Grantors of grantor trusts are treated as the owners of trust property and are taxed directly on any income of that property.

2. Entity Classification

As other types of entities exist, both in the U.S. and abroad, these other entities must be classified to fit within the U.S. federal tax system. For example, all 50 U.S. states (and at least one foreign country) have added the ''limited liability company'' or (LLC) as a new form of entity, in addition to traditional corporations.[174] In addition, many civil law jurisdictions have more than one form of ''society'' invested with legal personality:

a. *Guiding Principle.* The status of a legal person as a partnership or corporation, and the existence of a ''trust,'' are determined under United States law on the basis of the legal characteristics of the legal person (or the property ownership characteristics in the case of a trust) prescribed under the applicable law (either state law for domestic persons or foreign law for foreign persons).

b. *Kintner Regulations.* Prior to 1997, distinguishing associations (i.e., corporations) from partnerships was based on a case-by-case evaluation of the principal characteristics of the entity in question. The so-called Kintner regulations [175] provided a six-factor test to distinguish corporations, partnerships and trusts.

c. *Check-the-Box.* In April 1995, the Service announced that it was considering repealing the *Kintner* regulations and replacing them with an elective regime.[176] In May 1996, the IRS and Treasury proposed a new elective regime in which business entities would either be *per se* corporations or would instead

[169] §864(f).

[170] Including associations taxed as corporations. §7701(a)(3).

[171] §7701(a)(2).

[172] §§7701(a)(30)(E), (31), 641–685.

[173] *Id.*

[174] *See, e.g.,* Ely and Grissom, ''The LLC/LLP Scorecard,'' *Tax Notes* (11/17/97), p. 833. Wyoming enacted the first LLC statute in 1977. *See* Wyo. Stat., §§17-15-101 through -136 (1977). In 1988, the Service ruled that a Wyoming LLC could be treated as a partnership for federal tax purposes. *See* Rev. Rul. 88-76, 1988-1 C.B. 260. Over the years following the 1988 revenue ruling, numerous other states enacted LLC statutes. *See* Del. Code Ann. Tit. 6, §§18-101 to 18-1106 (as amended through 1999).

[175] Former Regs. §301.7701-2(a). These regulations were known as the *Kintner* regulations because they were promulgated in response to the decision in *U.S. v. Kintner*, 216 F.2d 418 (9th Cir. 1954).

[176] Notice 95-14, 1995-1 C.B. 297.

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be free to elect classification as either a corporation or a partnership.[177]

The elective ''check-the-box'' regime was implemented in final regulations in December 1996, effective January 1, 1997.[178] The *per se* list covers specified entities in 87 countries, the European Union, and U.S. territories and possessions.[179] Entities in any country not listed in the *per se* list are ''eligible entities.'' [180] Entities other than *per se* entities in the listed countries are eligible entities.

Single-member entities (other than corporations) are ''disregarded'' as entities separate from the member (''DRE''). This position, first announced in the final ''check-the-box'' regulations published December 27, 1996, has caused the IRS and Treasury much angst. The central characteristic on which much related-party financing is often based is the notion that a taxpayer cannot contract with itself. Transactions within a single taxpayer can thus be disregarded even though other countries treat the transactions as occurring (''arbitrage'').

Transactions within a single taxpayer are typically not given U.S. tax effect.[181] For example, a loan by a shareholder to its wholly owned DRE in a foreign jurisdiction may give rise to interest deductions for foreign purposes in the borrowing country (where the DRE is not disregarded) without giving rise to interest income for U.S. tax purposes in the hands of the recipient.

d. *Hybrid Entities.* By virtue of the flexibility provided by the check-the-box regulations, taxpayers are able to create foreign entities viewed under U.S. tax principles as part of the owner (i.e., fiscally nonexistent except as branches), but viewed under foreign law of the entity's place of organization as an entity separate from its owner (i.e., non-fiscally transparent). Such entities are referred to as ''hybrid entities.'' Entities which are non-fiscally transparent for U.S. tax purposes, but are fiscally transparent under foreign law are referred to as ''reverse hybrids.'' Both hybrid entities and reverse hybrid entities are frequently used in related-party financing structures.

e. *Outlook.* The stability of the elective regime and hybrid entities is unclear. Soon after the elective regime was finalized, the IRS sought to severely limit the use of elective classification to erode the foreign tax base without a corresponding inclusion of U.S. taxable income.[182] The IRS and Treasury had, at that time, concluded that ''capital export neutrality'' was the guiding principle of the original deferral provisions that were the core components of Subpart F in 1962, and that this fundamental requirement was eroded when hybrid branches (disregarded entities) were used to reduce foreign tax without a corresponding increase in U.S. taxable income.

f. *Notice 98-11.* It proved difficult to confirm the capital export neutrality premise for the compromises originally enacted in Subpart F.[183] It also proved to be controversial as a current policy matter. In July 1999, the IRS withdrew regulations that had been intended to treat as Subpart F income amounts attributable to foreign base erosion transactions involving ''hybrid branches'' of CFCs.[184]

Under the agreement reached by the IRS and negotiators representing Congressional leadership, the hy-

[177] A classification election could not be made by a true trust because it would not be a business entity.

[178] T.D. 8697 (12/18/96). Notice 2004-68, 2004-43 I.R.B. 706, adds several additional foreign entities to the *per se* list.

[179] Regs. §301.7701-2, -2T.

[180] *See* Regs. §301-7701-3(a) (stating ''a business entity not classified as a corporation under §301.7701-2(b). . .(an eligible entity) can elect its classification for federal tax purposes as provided in this section''). *Compare* 61 Fed. Reg. 21989 (proposed check-the-box regulations listing a *Naamloze Vennootschap* of the Netherlands Antilles as a *per se* corporation) *with* T.D. 8697 (Preamble states ''the regulations are clarified with respect to entities formed in the following jurisdictions: . . . the Netherlands Antilles. . .''; the final regulations themselves do not list a *Naamloze Vennootschap* of the Netherlands Antilles as a *per se* corporation, thus entitling it to be an eligible entity).

[181] See, e.g., Regs. §1.446-3(c)(1)(ii), cited at footnote 44, above. It should be noted, however, that although a transaction may be ''disregarded'' as a contractual act, the payments among disregarded entities may nonetheless have a tax effect as, for example, a ''remittance'' by a qualified business unit for the purposes of the special currency gain or loss regime under §987. Section 987 gain or loss is recognized for various purposes, including interest expense apportionment under Regs. §1.861-9T(g). The use of foreign disregarded entities as branches will become significantly more complicated as Form 8858 comes into use. That form would require a comprehensive information return to be filed for each foreign disregarded entity, including its foreign currency transactions. *See* Announcement 2004-4, 2004-4 I.R.B. 357. In addition, final regulations under §704(b) (Regs. §1.704-1(b)(4)(viii), issued in T.D. 9292, 10/19/06) may result in recognizing otherwise-disregarded transactions between related disregarded entities for purposes of identifying foreign income and associated taxes that may be specially allocated to partners in a partnership that owns such disregarded entities.

[182] Notice 98-11, 1998-6 I.R.B. 18 (1/18/98), withdrawn by Notice 98-35, 1998-27 I.R.B. 35 (6/19/98); T.D. 8767, 1998-16 I.R.B. 4 (3/26/98) (temporary regulations, also issued as proposed regulations at 63 Fed. Reg. 14669, REG-104537-97 (3/26/98)), removed and withdrawn by T.D. 8827, 1999-30 I.R.B. 120 (7/13/99). In announcing its intention to withdraw the temporary and proposed regulations as well as Notice 98-11, Notice 98-35 announced an intention to propose other regulations to curtail the use of hybrid entities to reduce foreign taxes. The proposed regulations, as Notice 98-35 had indicated, are not proposed to be effective until five years after they are finalized. REG-113909-98, 64 Fed. Reg. 37727–37733 (7/13/99), 1999 *TNT* 137-63. The July 1999 proposed regulations are an amended version of the June 1998 temporary and proposed regulations, which were withdrawn after a great deal of negative comment.

[183] *See* NFTC Study, cited at footnote 22, above.

[184] T.D. 8827 (7/13/99).

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brid branch regulations were not to be implemented in final form until on or after July 1, 2000, and would then apply only to transactions occurring in taxable years beginning five years after the date final regulations are promulgated.[185] To date, no such final regulations have been promulgated and, accordingly, the earliest effective date is at least five years in the future. That said, the first Obama Administration budget proposals included the elimination of the disregarded entity where the regarded parent and the disregarded subsidiary were in different countries.[186] It was dropped in succeeding budgets for Fiscal Year 2011 and 2012, but that is more a product of expediency than principle or inherent balances in the U.S. tax treatment of income from cross-border trade and direct investment.

Limitations on the use of disregarded entities were initially proposed by the IRS and Treasury in response to concerns regarding the potential use of the entity classification rules to achieve results considered by the IRS and Treasury to be inconsistent with the policies and rules of certain Code provisions and treaties. The proposed limitations were withdrawn, and the IRS and Treasury have announced that the continuing examinations of this issue will focus on the substantive rules of the Code and treaties.[187]

In spite of this withdrawal, the possibility of limitations in the use of foreign disregarded entities resurfaced in the recommendations made by the Joint Committee on Taxation in 2005 and by the Bush Tax Advisory Panel.[188]

g. *Partnerships/Subpart F.* In response to the *Brown Group* case,[189] the Service issued proposed, now finalized regulations, that generally apply an ''entity'' approach to characterize gross income as, for example, sales income, at the partnership level, but apply an aggregate approach (i.e., test at the partner level) to test whether a transaction is in a particular country or whether an entity is a related person. If any part of the partnership's gross income would be Subpart F income if received directly by partners that are CFCs, such items must be separately taken into account by each partner under §702.[190] AJCA did enact a look-through approach to sales of 25%-or-more-owned partnership interests.[191]

F. Hybrid Instruments

An instrument will be classified as either debt or equity, for U.S. tax purposes, based on common law determinations of its preponderant characteristics.[192] The IRS has summarized its official view of the preponderant characteristics in Notice 94-47.[193] The IRS has indicated in a number of Field Service Advice memoranda that the U.S. tax characterization is not necessarily affected by the foreign *tax* characterization of an instrument, although foreign non-tax characterization may inform the evaluation of the fundamental characteristics of debt or equity for U.S. tax purposes.[194]

Debt instruments payable in stock of the obligor are typically treated as equity for U.S. tax purposes.[195]

The IRS has greater latitude (than taxpayers) to recharacterize as equity an instrument in form debt, or as debt an instrument in form equity.[196]

Instruments structured in form to be equity are rarely characterized as debt.[197] Caution is always in order.

Stock dividends are generally not taxable income to the shareholder.[198]

Circular cash flows (distribution and reinvestment) may in certain circumstances be treated a stock divi-

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[185] REG-113909-98, 64 Fed. Reg. 37727 (7/13/99), at Prop. Regs. §1.954-9(c).

[186] 2010 Green Book, at 28.

[187] Prop. Regs. §301.7701-3(h) (extraordinary transaction proposed regulations), withdrawn by Notice 2003-46, 2003-28 I.R.B. 53. Moreover, the Tax Court rejected an effort by the IRS to deny a taxpayer certain beneficial effects of treating the sale of a newly disregarded entity as a sale of its assets, following a retroactive check-the-box election by that entity. *See Dover Corporation v. Comr.*, 122 T.C. 224 (5/5/04).

[188] *See* JCT Report (cited at footnote 21, above); 2010 Green Book (footnote 5, above); Bush Advisory Panel Report (footnote 33, above).

[189] *Brown Group Inc. v. Comr.*, 77 F.3d 217 (8th Cir. 1996), *vac'g and rem'g* 104 T.C. 105 (1995), *nonacq.* I.R.B. 1996-32 (7/16/96) *and under* Notice 96-39, 1996-2 C.B. 209.

[190] Regs. §§1.702-1(a)(8)(ii); 1.952-1(g)(3); 1.954-1(g)(4); 1.954-2(a)(5)(v); 1.954-3(a)(6)(iii); 1.954-4(b)(2)(iii); 1.956-2(a)(3). The government clearly agrees with Emerson that a foolish consistency is the hobgoblin of small minds. These regulations have been effective since July 23, 2002. T.D. 9008 (7/23/02) (finalizing REG-112502-00).

[191] §954(c)(4).

[192] *See generally* Plumb, ''The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal,'' 26 *Tax L. Rev*. 369 (1971).

[193] 1994-1 C.B. 357, 1994-19 I.R.B. 9.

[194] ILM 200134004; FSAs 200142005, 200145005, 200146013, 200148039, 200206010. *See* Feder and Nauheim, ''IRS Takes a Fresh Look at Cross-Border Tax Planning,'' 2 *Tax Planning Int'l Fin.* 4 (Apr. 2002).

[195] *See* Notice 94-47, 1994-1 C.B. 357, 1994-19 I.R.B. 9.

[196] *See, e.g.,* §385(c).

[197] *See Helvering v. Richmond, F&P Co.*, 90 F.2d 971 (4th Cir. 1937) and *Richmond, Fredericksburg & Potomac R.R. Co. v. Comr.*, 528 F.2d 917 (4th Cir. 1975). The *same* ''guaranteed stock'' was treated, for certain purposes, as debt in the first opinion but as equity several decades later, for perhaps different purposes.

[198] *See* §305.

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dend for U.S. tax purposes, but as actual dividends or interest paid for foreign tax purposes.[199]

G. Treaty Benefits

The 2006 U.S. Model Treaty provides for zero withholding[200] and the 2010 OECD Model Treaty provides for 10% withholding on interest paid by a resident of one treaty jurisdiction to a resident of the other treaty jurisdiction.[201]

Important industrial countries that do not by treaty provide zero withholding tax on interest paid to residents of the treaty jurisdiction include Brazil (no treaty), Taiwan (no treaty), Japan (10% withholding on interest paid to non-bank lenders) and Australia (10% withholding on interest paid to non-bank lenders).

The Cayman Islands, the Netherlands Antilles (Aruba and Curacao), Bermuda and a number of other no-tax or low-tax jurisdictions typically have little or no treaty network. Loans by entities in such jurisdictions will generally not enjoy the zero withholding rate provided by double tax treaties with countries in which an operating company affiliate is located.

A number of important industrial countries do not, as a matter of domestic law, impose withholding tax on interest paid to related nonresidents.[202]

Dividends are ordinarily subject to source country withholding tax, at the rate of 5% on dividends to a ''direct investor''[203] (as distinguished from a ''portfolio investor'' (typically taxed at 15%).[204]

It has been a topic of ongoing discussion as to whether a withholding tax distinction between ''direct investment dividends'' and direct investment interest is appropriate.[205] A number of jurisdictions do not, as a matter of domestic law, impose withholding tax on dividends paid to nonresidents.[206] Recently negotiated U.S. tax treaties and protocols have provided for a zero rate of withholding for dividends from certain qualified stock holdings.[207] The limitation of benefits provisions in such newer treaties often make treaty exemption less useful than might seem at first impression.

Reduction of source country withholding tax on related party financing, by claiming treaty benefits, may be limited by treaty provisions designed to discourage ''treaty shopping.''[208]

The United States has pursued anti-treaty shopping provisions with greater vigor than most countries.

The Commentaries to the OECD Model authorize a tax authority to deny benefits, under substance-over-form principles, to a nominee in one contracting state deriving income from the other contracting state on behalf of a third-country resident. In addition, although the text of the OECD Model does not contain express anti-abuse provisions, the Commentaries contain an extensive discussion approving the use of such provisions in tax treaties in order to limit the ability of third-state residents to obtain treaty benefits.

The United States holds strongly to the view that its bilateral tax treaties should include provisions that specifically prevent misuse of treaties by residents of

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[199] Rev. Rul. 80-154, 1980-1 C.B. 68.

[200] U.S. Model Tax Convention on Income (2006), Art. 11, ¶1. The 2006 U.S. Model Treaty provides for 15% withholding on certain contingent interest (which does not qualify for the portfolio interest exception). Art. 11, ¶2.

[201] OECD Model Tax Convention on Income and on Capital (2010), Art. 11, ¶2. The Commentary of the OECD Committee on Fiscal Affairs indicates that permitting taxation at source of up to 10% is a ''compromise solution'' adopted because of the belief that exclusive taxing jurisdiction for either the source state or the residence state ''could not be sure of receiving general approval.'' Commentary on Art. 11, ¶3. However, the Commentary also notes that contracting states may agree to eliminate taxation of interest at source entirely.

[202] For example, Austria, Denmark, Finland, Iceland, Luxembourg, The Netherlands, Norway, Slovenia and Sweden in most cases do not impose withholding tax on interest payments. France and Ireland, among others, exempt significant categories of indebtedness from otherwise applicable withholding taxes.

[203] *See, e.g.,* U.S. Model Treaty (2006), Art. 10, ¶2(a); OECD Model Treaty (2010), Art. 10, ¶2(a).

[204] *See, e.g.,* U.S. Model Treaty (2006), Art. 10, ¶2(a); OECD Model Treaty (2010), Art. 10, ¶2(b).

[205] For a discussion of the merits of eliminating withholding tax on direct dividends, see Dilworth, Dunahoo, Merrill, Pan and Parker, ''Zero Withholding Tax on Direct Dividends: Policy Arguments for a New U.S. Treaty Model,'' 20 *Tax Notes Int'l* 1113 (3/6/00).

[206] Some countries, such as the United Kingdom, which have an integrated, as distinguished from a ''classical'' system for taxing corporate income, do not impose withholding tax on dividend distributions. The Cayman Islands, the Netherlands Antilles (Aruba and Curacao), Bermuda, and a number of other no-tax or low-tax jurisdictions also typically impose no withholding tax on dividends.

[207] *See, e.g.,* the U.S.-U.K. 2001 Income and Capital Gains Tax Convention, the U.S.-Australia 2001 Protocol to the 1982 Convention, the U.S.-Japan 2004 Income Tax Convention and the U.S.-Netherlands 2004 Protocol to the 1992 Convention, the U.S.-Belgium 2006 Income Tax Convention and Final Protocol, the U.S.-Germany 2006 Protocol to the 1989 Income Tax Convention, The U.S.-Denmark Protocol to the 1999 Income Tax Convention, the U.S.-Finland 2006 Protocol to the 1989 Income Tax Convention, the U.S.-Sweden 2005 Protocol to the 1994 Income Tax Convention and the U.S.-Mexico Protocol to the 1992 Income Tax Convention. Not all newer treaties and protocols contain the zero withholding provision. For example the U.S.-Canada 2007 Protocol to the 1980 Income Tax convention does not have the provision first included in the U.S.-U.K. 2001 Income and Capital Gains Tax Convention.

[208] For example, a number of member states of the European Union have limitations on the benefits of zero withholding on dividends otherwise required by the EU Parent-Subsidiary Directive (Council Directive 90/435 July 23, 1990).

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third countries. Consequently, all recent (since 1980) U.S. income tax treaties contain ''Limitation on Benefits'' provisions.[209] Generally speaking, these provisions deny treaty benefits to companies that are residents of a treaty country (e.g., by virtue of their place of incorporation) but that: (1) are ultimately owned by residents of other countries (i.e., not signatories of the treaty); or (2) pay significant deductible expenses to residents of other countries. Without these limitations (often referred to as the ''ownership'' and ''base erosion'' tests, respectively), foreign persons who are residents of countries with which the U.S. has not concluded a treaty could achieve such benefits merely by forming a company in a country with which the U.S. has concluded a treaty. A few treaties[210] incorporate a ''derivative benefits'' concept whereby residents of a country with which the U.S. has concluded a treaty may also ''derive'' certain benefits of a second treaty concluded by the U.S. with another country. In these circumstances, the second treaty will generally allow residents of the first country to be counted favorably when applying the ownership and base erosion tests. The derivative benefits concept has yet not been included in the U.S.'s ''model'' treaty.

In the same spirit, the United States has also been including in recent tax treaties provisions to limit the use of payments made to entities that are treated as fiscally transparent under either country's tax laws, consistent with U.S. domestic law.[211]

III. ILLUSTRATIVE APPLICATIONS

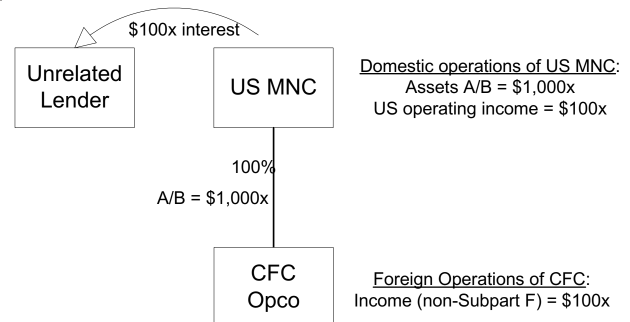
The following section provides hypothetical situations to illustrate the interaction of the rules outlined above.[212]

A. Basic Paradigm: US MNC Borrows from Third Party and Invests in Foreign Subsidiary Equity

During 2005, US MNC has domestic assets with an adjusted basis of $1,000x. These domestic assets produce net income of $100x. US MNC pays annual interest expense of $100x to an unrelated financial institution.

US MNC also owns 100% of the stock of CFC Opco with an adjusted basis (increased by retained earnings) of $1,000x. CFC Opco has non-Subpart F income of $100x, before foreign taxes are imposed.

US MNC causes CFC Opco to distribute as a dividend all of its current year income after the imposition of foreign taxes.[213] Pursuant to a tax treaty, this dividend will be subject to 5% withholding tax imposed by the foreign country in which CFC is incorporated. The dividend will also carry a ''deemed paid credit'' under §902, and, consequently, will be grossed up under §78.



Example A: Foreign Tax Rate (35%) = U.S. Tax Rate (35%)

If CFC Opco operates in a jurisdiction that imposes a 35% tax on net income (equal to the U.S. tax rate), then CFC Opco will have $65x of net income available for distribution to US MNC. This $65x distribution will be reduced by a 5% withholding tax ($3.25x) imposed by the foreign country in which CFC Opco is incorporated. Consequently, US MNC will receive an actual distribution of $61.75x, but will include $65x in taxable income. As a precondition to claiming the ''deemed paid'' credit under §902 with respect to this $65x distribution, US MNC must also include in taxable income the $35x in foreign tax paid by CFC Opco. When added to US MNC's other (domestic operation) income, this results in $200x of taxable income, before the allocation of interest expense deductions:

i. *Allocation of Interest Against U.S. Income.* If no interest expense is allocated to foreign-source income, US MNC will have a U.S. tax liability before foreign tax credit of $35x on $100x net taxable income ($200x – $100x interest expense). This tax liability will be reduced by a foreign tax credit of $3.25x and minus a ''deemed paid'' foreign tax credit of $35x (i.e., US MNC will pay no U.S. federal income tax, and will have an excess foreign tax credit of $3.25 that it can carry back or forward to different taxable

[209] *See* 2006 U.S. Model Treaty, Art. 22.

[210] *See, e.g.,* U.S.-Canada Income Tax Treaty.

[211] *See, e.g.,* Art. 1(8) of the 2001 U.S.-U.K. Income Tax Treaty, Art. 7 of the U.S.-Netherlands 2004 protocol to the 1992 Income Tax Treaty, or Art. 4(6)–(7) created by the fifth protocol, signed on Sept. 21, 2007, to the U.S.-Canada Income Tax Treaty.

[212] These hypothetical illustrations do not reflect the eventual efficacy of the worldwide interest expense allocation regime under §864(f).

[213] This example assumes that none of the distribution will be treated as a §965 dividend.

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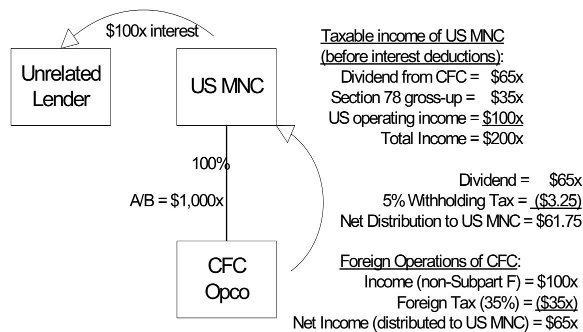

years). Under this approach, all of the interest expense is effectively treated as reducing the US MNC's domestic operating income, and U.S. tax otherwise due on the $100x foreign-source income is fully offset by the credit for foreign taxes paid by CFC Opco and deemed paid by US MNC upon distribution of earnings from CFC Opco. Under this approach, the combined U.S. and foreign tax burden on US MNC and CFC Opco's operations is $38.25x (i.e., the aggregate *foreign* income and withholding tax on CFC Opco's income).

ii. *"Asset Method" of Interest Allocation.* However, under the "asset method" of interest expense allocation (see §II, D, above). US MNC cannot allocate its interest expense to offset exclusively domestic source income, but must apportion its $100x interest expense between U.S.- and foreign-source income based on the value of its assets that give rise to U.S.- and foreign-source income. Consequently, US MNC's net foreign-source income is reduced by $50x ($100x interest expense times $1,000x (adjusted basis in foreign assets)/$2,000x (adjusted basis in all assets)). This reduction in foreign-source income reduces US MNC's foreign tax credit limitation and causes US MNC to owe additional U.S. federal income tax of $17.50x (and to have an excess foreign tax credit of $20.75x). This tax liability is computed as follows:

> U.S. tax rate of 35% × $100x worldwide net taxable income ($200x – $100x interest expense) = $35x U.S. tax liability.
>
> Foreign tax credit limitation: $35x (total U.S. tax due) × $50x (foreign-source net income)/ $100x (worldwide net income) = $17.50 maximum foreign tax credit.
>
> Residual U.S. tax = $35x – $17.50x = $17.50x
>
> The combined U.S. and foreign tax burden on US MNC and CFC Opco's operations is thus $55.75x (total foreign taxes of $38.25x + additional U.S. tax of $17.50x).
>
> If US MNC had other foreign-source income taxed at a foreign tax rate lower than 35%, the excess credit of $20.75x ($55.75x – $35x) could have been applied against U.S. federal income tax otherwise due with respect to that income. Only to the extent that interest expense allocated against foreign-source income reduces the foreign tax credit allowed is there a *de facto* denial of an interest deduction. This effect is illustrated in Example C, below.

iii. *Debt Financing of CFC Opco, Instead of Equity.* If in this example US MNC were to have received $100x as interest[214] from CFC Opco rather than as a dividend, the total U.S. and foreign tax burden would have been $35x (which would also be the result if debt were to finance CFC Opco in Example B (high foreign tax rate) and Example C (low foreign tax rate), below). This tax liability is computed as follows:

> $0x foreign tax on net taxable income of $0 ($100x net operating income in foreign jurisdiction – $100x interest expense, not subject to withholding tax),[215] plus
>
> $35x U.S. tax on net taxable income of $100x ($100x of domestic operation income + $100x interest income from CFC Opco – $100x interest expense).
>
> In this case (in which no reliance is placed on the foreign tax credit to generate a beneficial tax position), it would appear that debt is a preferable means of financing CFC Opco. However, to the extent that US MNC has other foreign operations generating foreign tax credits, the interest expense allocation against foreign-source income ($50x in our example), may reduce foreign tax credit benefits.
>
> *Example B: Foreign Tax Rate (50%) > U.S. Tax Rate (35%)*
>
> If CFC Opco operates in a jurisdiction that imposes a 50% tax on net income (higher than the U.S. tax rate), then CFC Opco will have $50x of net income available for distribution to US MNC. This $50x distribution will be reduced by a 5% withholding tax ($2.50x) imposed by the foreign country in which CFC Opco is incorporated. Consequently, US MNC will receive an actual dis-

[214] This assumes complete elimination of local taxable income only for the purpose of identifying the economic impact of a movement from deductible interest to non-deductible dividends. It does not take into account CFC Opco's constraints under local law on debt-to-equity ratios for related-party debt.

[215] Certain countries may impose a withholding tax on interest payments to foreign lenders.

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tribution of $47.50x, but will include $50x in taxable income. As a precondition to claiming the ''deemed paid'' credit under §902 with respect to this $50x distribution, US MNC must also include in taxable income the $50x in foreign tax paid by CFC Opco. When added to US MNC's other (domestic operating) income, this results in $200x of taxable income, before the allocation of interest expense deductions:

As in the prior example, under the ''asset method'' of interest expense allocation (see §II, D, above). US MNC's net foreign-source income is reduced by $50x ($100x interest expense × $1,000x (adjusted basis in foreign assets)/$,2000x (adjusted basis in all assets). As in the prior example, this reduces US MNC's foreign-source income to $50x and lowers US MNC's foreign tax credit limitation to $17.50x. Therefore, US MNC will owe additional U.S. income tax of $17.50x, and

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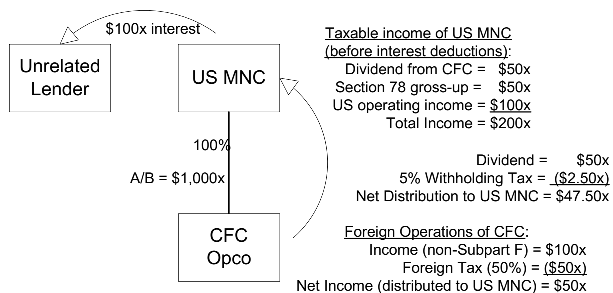
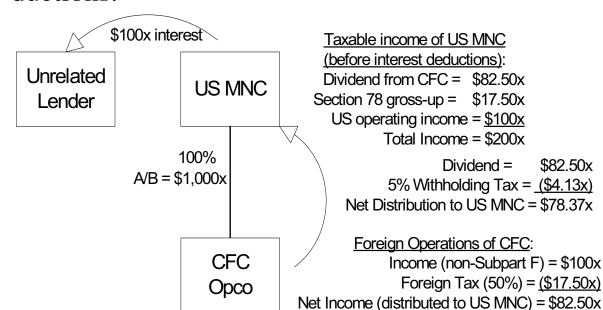


the combined U.S. and foreign tax burden on US MNC and CFC Opco's operations will be $70x (total foreign taxes of $52.50x + U.S. tax of $17.50x).[216] (US MNC would probably elect to deduct rather than to credit foreign taxes, if it has no other foreign-source income to absorb some or all of the excess foreign tax credits.)

In such a jurisdiction, it would likely be advantageous to finance CFC Opco with debt, because interest would offset income otherwise taxed at 50%, while the corresponding interest income would be taxed at a 35% rate. In this example, the combined amount of U.S. and foreign tax on the U.S. and foreign income would be $35x if CFC Opco were financed with debt. (*See* §III, A, iii, above, for the computation of the $35x tax liability.)

Example C: Foreign Tax Rate (17.5%) < U.S. Tax Rate (35%)

If CFC Opco operates in a jurisdiction that imposes a 17.50% tax on net income (lower than the U.S. tax rate), then CFC Opco will have $82.50x of net income available for distribution to US MNC. This $82.50x distribution will be reduced by a 5% withholding tax ($4.13x) imposed by the foreign country in which CFC Opco is incorporated. Consequently, US MNC will receive an actual distribution of $78.37x, but will include $82.50x in taxable income plus $17.50x of the foreign tax deemed paid under §902 with respect to this $82.50x distribution. When added to US MNC's other (domestic operating) income, this again results in $200x of taxable income, before the allocation of interest expense deductions:



In this example US MNC has ''lost'' the benefit of an interest deduction equivalent to $11.80 ($4.13 of tax is rendered non-creditable against U.S. tax imposed at a 35% rate). If CFC Opco's effective rate were reduced to 13%, its combined foreign tax burden would be less than 17.5%, and in this example the interest expense allocation would have had no effect on US MNC's overall tax burden.

As in the prior examples, under the ''asset method'' of interest expense allocation (see §II, D, 6, above), US MNC's net foreign-source income is reduced by $50x to $50x, and lowers US MNC's foreign tax credit limitation to $17.50x. Therefore, US MNC will owe additional U.S. federal income tax of $17.50x, and the combined U.S. and foreign tax burden on US MNC and CFC Opco's operations is $39.13x (total foreign taxes of $21.63x plus U.S. tax of $17.50x).

B. Intermediate Holding Company

This example illustrates the results if, in the previous example in which CFC Opco operates in a high-tax jurisdiction (Example B),[217] US MNC did not directly invest in or lend to CFC Opco, but instead borrowed from an unrelated financial institution and invested the proceeds of that loan in the equity of a foreign holding company (CFC Holdco) organized in a jurisdiction that does not tax dividends [218] and taxes interest [219] from affiliates at a relatively low rate. CFC Holdco would invest the same amount in CFC Opco pursuant to an instrument treated as, alternatively, debt or equity.

Example D: CFC Holdco Invests in CFC Opco Debt

If CFC Opco pays deductible interest to CFC Holdco, and if CFC Holdco is not taxed at a rate equal to or greater than the effective U.S.

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[216] In this example, if US MNC has no other foreign-source income to absorb the excess credit (either currently or in carryback or carryover years) it would probably elect to deduct foreign taxes rather than claim a foreign tax credit. Cross-crediting of excess foreign tax credits is a potential target of the ''territorial'' tax regime proposal in the 2005 Joint Committee on Taxation staff recommendation relating to a dividend exemption system for foreign business income. *See* ''Options to Improve Tax Compliance and Reform Tax Expenditures,'' JCS-20-05, pp. 186–197.

[217] See III, A, above.

[218] For example, pursuant to a participation exemption such as that provided under the Netherlands or Luxembourg tax regime.

[219] For example, pursuant to a low general corporate income tax rate such as in Ireland.

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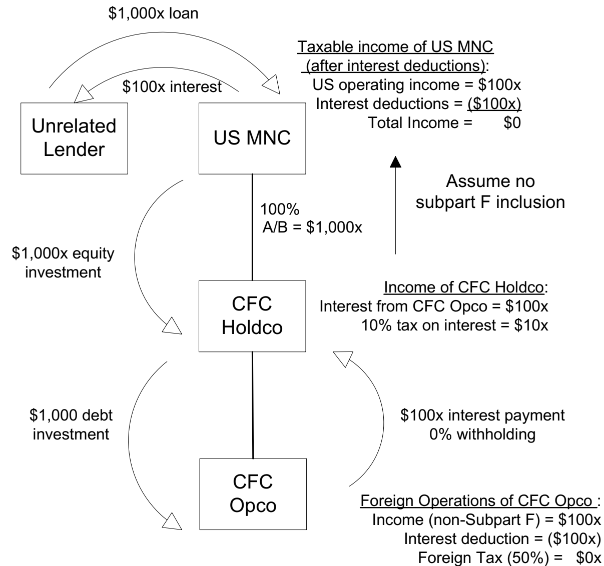
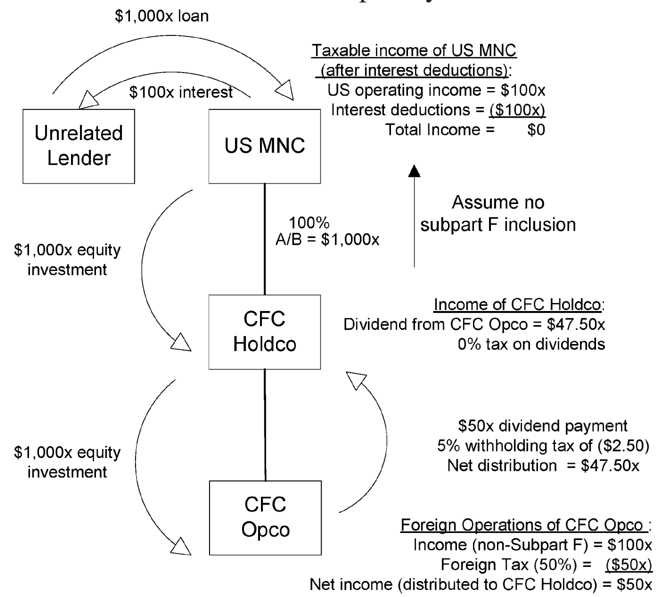
rate (after allowance for any foreign tax credits), US MNC would have a net economic advantage consisting of two interest deductions[220] with only a partial offset for CFC Holdco taxes on the interest, until distribution (if ever) by CFC Holdco.



Using this strategy, the combined U.S. and foreign tax burden on US MNC and CFC Opco's operations would be $10x. The reduction compared with direct US MNC loans to or investments in CFC Opco assumes that CFC Holdco's interest income is not taxed currently in the U.S. (e.g., because the same-country exception applied). If it were to be taxed currently, US MNC would be taxed, after allowance for foreign tax credits, at a combined effective rate of 35% (because the 10% CFC Holdco rate is below the 13% threshold pointed out in Example C, above, for this particular combination of U.S. and foreign assets, income and debt).

Example E: CFC Holdco Invests in CFC Opco Equity

Alternatively, if CFC Opco pays dividends to CFC Holdco, and if CFC Holdco is not taxed on the dividend payment, US MNC would have a current combined U.S. and foreign tax burden equal to the foreign rate on foreign-source income, since its interest expense would continue to offset only its domestic income. If the CFC Opco rate is high, CFC Holdco would have a correspondingly high incentive to fund CFC Opco by debt.



The impact of equity financing, compared to debt financing, is significant.

These structures, when the effective rate of foreign tax is less than 90% of the U.S. rate, were the original targets of the Subpart F regime. CFC Holdco's interest from CFC Opco ordinarily give rise to foreign personal holding company income,[221] as would dividends from CFC Opco (unless CFC Opco is taxed in our example at 28.75% or more).[222]

If CFC Opco is a DRE,[223] the dividends and interest from CFC Opco would not be treated as existing and would therefore not give rise to FPHCI. In addition, the use of DREs within these structures can help fit the transaction with the same-country or high-tax exceptions discussed above. For example, if CFC Holdco and CFC Opco are organized in the same country, but a third-country DRE is inserted as a holding company between CFC Holdco and CFC Opco, the dividends and interest would not be disregarded, but they might qualify for the same-country exception from FPHCI.[224] For foreign tax law purposes, the DRE would not be disregarded and the tax effects would be unchanged compared to CFC Holdco as a corporation for U.S. tax purposes.

It is the ability to achieve tax characterization ''arbitrage'' between U.S. effects (or non-effects) and for-

[220] US MNC would also generate an OFL as a result of the allocation of interest to foreign-source income. Such OFL would be applied to reduce foreign-source income in subsequent years and would, in effect, result in merely a timing difference on a fully distributed basis. The CFC Netting Rule may operate to increase the amount of the OFL in this example.

[221] See II, B, 2, above.

[222] The high-tax exception of §954(b)(4) would apply because the combined operating level tax and dividend withholding tax would be in excess of 31.5% (i.e., 90% of the U.S. rate of 35%).

[223] See II, E, 2, c, iii, above.

[224] II, B, 2, a, i, above.

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eign law effects that motivated the issuance of Notice 98-11.[225] The uncertainty, as a matter of U.S. tax policy, as to whether reduction of *foreign* tax is desirable or undesirable, explains, at least in part, the moratorium on implementing regulations to carry out the policy expressed in Notice 98-11. The Joint Committee on Taxation staff in 2005 recommended legislative elimination of the ''disregarded entity'' provisions for foreign entities with the intention of eliminating the foreign tax reduction provided by this form of ''entity arbitrage'' between U.S. and non-U.S. treatment of disregarded entities and disregarded transactions.[226] As noted above, similar proposals were made by the Obama Administration in the 2010 Green Book.

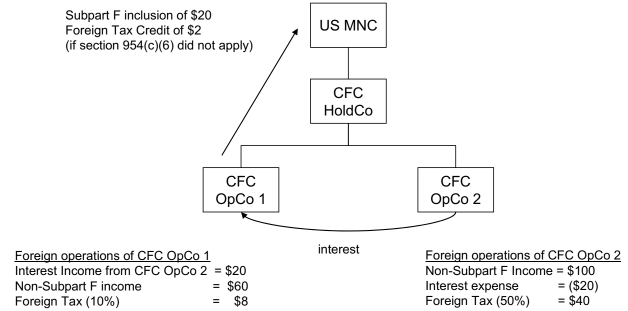
Example F: Look-Through Rule Under §954(c)(6)

Examples D and E above had assumed that dividend and interest income received by CFC Holdco would not be taxed currently in the U.S. (e.g., because the same-country exception applied). The below example illustrates the application of the rules described above if dividend and interest income were taxed currently in the United States (as would normally be the case) and illustrates the application of §954(c)(6) (discussed in §II, B, 2, a, ii, above).

In this example, US MNC owns all of the stock of CFC Holdco. CFC Holdco owns all of the stock of CFC Opco 1 and CFC Opco 2. CFC Opco 2 has $100 of non-Subpart F income and pays to CFC Opco 1 $20 of interest, all of which is allocable to income that is neither Subpart F income nor income treated as effectively connected with the conduct of a U.S. trade or business.

If the look-through rule of §954(c)(6) were not to apply, US MNC would include in its income the $20 of CFC Opco 1's interest income (FPHCI) received from CFC Opco 2.

If the look-through rule of §954(c)(6), however, were to apply, US MNC would not include the $20 of CFC Opco 1's interest income received from CFC Opco 2 because the interest income is attributable to CFC Opco 2's non-Subpart F / non-U.S. trade or business income.[227]



Note that if CFC Opco 1 and CFC Opco 2 made elections to be disregarded as entities separate from their owner, CFC Holdco 2, this structure would provide certain of the same benefits as application of §954(c)(6). In this regard, if CFC Opco 1 and 2 were both disregarded entities, then US MNC would not include the $20 of CFC Opco 1's interest income because, for U.S. federal income tax purposes, the loan would be disregarded.

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[225] 1998-6 I.R.B. 18, Outline II, e, 2(f).

[226] ''Options to Improve Tax Compliance and Reform Tax Expenditures,'' JCS-02-05, pp. 182–185.

[227] The example in many respects is the same as the examples in the earliest proposals for what became Subpart F. Then-Secretary of the Treasury Dillon stated in 1961 (emphasis added):

> As you can see [referring to a tabular summary of selected foreign country tax rates], in most of these countries, and particularly *in those countries which are our more important competitors*, the tax rates are substantially at the same level as the U.S. corporation income tax. . . These statutory rates, however, do not give adequate weight to the variety of arrangements that have been made by American firms in their foreign operations which may bring down rather substantially the rates of tax imposed on income from their foreign operations. Thus an American company operating in West Germany through a German subsidiary will be subject to tax there at the West German income tax rate of 51%, and hence it cannot benefit significantly from U.S. tax deferral. However, to the extent that the profits of the German subsidiary can be diverted from the sweep of the German tax system, a lower tax can be attained. And this is precisely what is achieved through a proliferation of corporate entities in tax haven countries like Switzerland.

Statement of Hon. Douglas Dillon, Secretary of the Treasury, before the House of Representatives Committee on Ways and Means, May 3, 1961, reproduced at Committee on Ways and Means, 90th Cong., 1st Sess., Legislative History of H.R. 10650, 87th Cong., The Revenue Act of 1962 (Part I) (1967), at p. 164–165. The opposite view is that American competitiveness depends on limiting the burden on foreign business income to source-country levels. The rejoinder is then that American business is inherently more competitive than anyone else. See footnote 9, above. And so it has gone for 50 years. However, once the disregarded entity rules enabled the ''tax nothing,'' the base line moved and the comparison became more focused on direct and indirect means to the same end.

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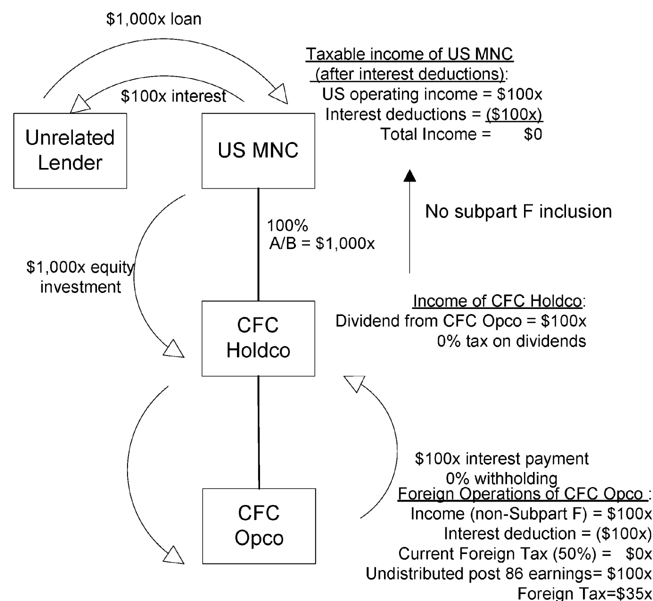
Making check-the-box elections could have significant implications for the US MNC group, however, so a taxpayer's particular structure should be carefully analyzed. For instance, high-taxed and low-taxed earnings would be combined and blended. Thus a dividend distribution from CFC Holdco, to US MNC generally would result in a deemed paid foreign tax credit based on the combined earnings and profits and foreign taxes of CFC Holdco, including CFC Opco 1 and CFC Opco 2. This structure would also generally cause the complex rules of §987 to apply and could potentially cause the foreign base company sales income and foreign base company services income rules to apply.[228]

C. Hybrid Instrument: Foreign Debt/U.S. Equity

As noted above, CFC Holdco's income from CFC Opco will not be included in income of US MNC as Subpart F income if it qualifies for the high-tax exception[229] from FPHCI. In Example E, an equity investment by CFC Holdco would leave the effective rate of tax on CFC Opco unchanged. An optimum solution might be an instrument treated as debt by CFC Opco's residence jurisdiction and as equity by CFC Holdco's jurisdiction and by the United States.

Example G: Hybrid Instrument

For example, assume the same facts as in Example E, except that CFC Holdco lends to CFC Opco by means of a 25-year loan, payable at maturity (at CFC Opco's election) in CFC Opco equity, and that the instrument is "stapled" to common stock of CFC Opco. Further, CFC Opco's jurisdiction treats the instrument as debt, and payments on the debt as deductible interest. In addition, CFC Opco has $100x undistributed post-1986 undistributed earnings from prior years that has been subject to foreign tax at an effective rate of 35%.



If CFC Holdco receives interest from CFC Opco (for U.S. tax purposes), US MNC would have Subpart F income,[230] unless either CFC Opco is a DRE, or, if it is a separate entity for U.S. tax purposes, the interest is eligible for exclusion from FPHCI under §954(c)(6).[231] If the payment on the hybrid is treated as a dividend (for U.S. tax purposes), however, it may not be excluded from FPHCI because it may not qualify for the high-tax exception (because in our example CFC Opco's deduction causes it to have low-taxed earnings).[232]

The fact that CFC Opco's jurisdiction characterizes the payment as interest, while the United States and CFC Holdco's jurisdiction characterize the payment as equity does not in principle change the analysis. To the extent the U.S. tax effects depend on the DRE status of CFC Opco, however, the stability of any structure must be viewed cautiously.

[228] *See generally* Braiterman, "Intragroup Transactions: The Kinder, Gentler Subpart F," 2007 *TNT* 89-20; Calianno and Collins, "The CFC Look-Through Rule: Congress Changes Landscape of Subpart F," *Tax Notes* (7/10/06).

[229] §954(b)(4); II, B, 2, a, iii, above.

[230] II, B, 2, above.

[231] II, E, 2, c, iv, above.

[232] II, B, 2, a, iii, above. In making the calculation, CFC Holdco's tax on income in the same "basket" would also be taken into account in determining the applicability of the high-tax exception.

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