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Financing Foreign Subsidiaries of U.S. Multinationals

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INTRODUCTION

This article is intended to assist practitioners in identifying a number of the more important tax variables involved in developing a tax-

efficient means of financing the activities of a U.S. multinational (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 affiliated group, who should borrow from third parties? Should working capital provided from within the group be intragroup debt or equity?)

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 at a relatively high rate within the group; (2) utilization of foreign tax credits to reduce incremental U.S. tax on (a) foreign after-tax income that is included in U.S. taxable income as actual dividends, branch profits or pursuant to Subpart F³ and (b) other foreign-source income such as income from exports and foreign sales; (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 pay-

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³ Sections 951-965 of the Internal Revenue Code of 1986, as amended (the "Code"). All "\$" references are to the Code, or Treasury regulations promulgated thereunder, unless otherwise noted.

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ments 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.

These goals are affected by the obvious differences in tax treatment in different jurisdictions resulting from different tax rates, timing rules, policies toward deferral 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.

The Treasury Department in the Clinton administration expressed increasing concerns about international tax “arbitrage”⁴ and unintended base erosion that will somehow lead the world’s tax collector community into a downward spiral (a “race to the bottom”).⁵ The Bush administration has not expressed quite the same position on international tax arbitrage (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 ap-

pears to remain a continuing concern about such arbitrage within the government.⁶

⁶ The Bush Administration’s concern about arbitrating foreign and domestic hybridity is illustrated by Regs. §1.894-1(d)(2)(ii), dealing with domestic reverse hybrids, released as a final regulation by T.D. 8999, 67 Fed. Reg. 40157 (1/12/02). When issued in proposed form as 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* former 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 has been concerned about the impact of hybrid arrangements on international tax policy. *See also*, 2001 U.S.-U.K. Income Tax Treaty, Art. 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 has focused its concern on arrangements that lead 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. 606. *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 (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). 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 have been 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>, reprinted at 2007 WTD 49-16, Doc 2007-6222 (3/12/07)), and, more recently, 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 has 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, 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, proposed and temporary regulations under §704(b), issued in T.D. 9121, 69 Fed. Reg. 21405 (4/21/04), and finalized in T.D. 9292, 71 Fed. Reg. 61648 (10/19/06), rely on the principles of Regs. §1.904-6 for determining the proper classification of in-

⁴ *See, e.g.*, Department of Treasury, Office Tax Policy, The Deferral of Income Earned through U.S. Controlled Foreign Corporations: A Policy Study, December 2000 (hereinafter, “Treasury Subpart F Study”), at Chap. 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]”).

⁵ *See, e.g.*, Altshuler and 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 fn. 14 below; Harry Grubert is a senior economist in the Office of Tax Policy in the Treasury Department); Danilack, former Associate Chief Counsel (International), “Remarks before the NYU Conference on Advanced Topics in International Taxation, March 16, 2000,” published in *BNA Daily Tax Report* (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,” *BNA Daily Tax Report* at G-10 (12/10/99); 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.

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 announced in March 2007.⁷ The designation evidently gained impetus from the concerns about cross-border arbitrage expressed 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 IRS recently attempted to reassure taxpayers that a “tiered” issue is not necessarily a cause for alarm. For example, in April of 2008, Frank Ng, the Commissioner of the LMSB, 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.”⁸

Despite these general assurances regarding designation as a Tier I issue, the Service’s directives to the

field regarding hybrid financing and “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,⁹ 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.”¹⁰

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.¹¹ 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

come 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.

⁷ Announced on the IRS website at <http://www.irs.gov/businesses/article/0,,id=167377,00.html>, reprinted at 2007 WTD 49-16, Doc 2007-6222 (3/12/07).

⁸ 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 (4/18/08) (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 April 7).

⁹ LMSB-04-0407-035 (6/15/07), reprinted at 2007 WTD 134-19, Doc 2007-1234 (6/15/07).

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

¹¹ 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). In May 2007, the IRS announced expansion of the Centre to add an office in London. The Japanese NTA will also join the group. IR-2007-104 (5/23/07).

Study Team was released January 11, 2008, and is available at the OECD website.¹²

Various academic,¹³ legislative,¹⁴ trade association,¹⁵ and professional commentators¹⁶ have joined 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.¹⁷ Whatever the correct answer, the decision to finance in one form or another will also have to account 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,¹⁸ or whether it is somehow suspect and thus a provocation for attack by the IRS,¹⁹ the popular tax press,²⁰ or populist legislators.²¹

Prudence dictates that, in analyzing any potential financing structure, consideration be given to an exit strategy. 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 any time soon.

¹³ See Reuven Avi-Yonah, "Commentary [on International Tax Arbitrage]," 53 *Tax L. Rev.* 167 (2000); "Tax Competition and Multinational Competitiveness: The Balance of Subpart F — Review of the NFTC Foreign Income Project," *Tax Notes Int'l*, Apr. 19, 1999, at 1575; "The Structure of International Taxation: A Proposal for Simplification," 74 *Tax. L. Rev.* 1301 (1996), "The Ingenious Kerry Tax Plan," *Tax Notes Today*, 2004 *TNT* 81-31 (4/26/94); Brauner "An International Tax Regime in Crystallization," 56 *Tax L. Rev.* 259 (2003).

¹² <http://www.oecd.org/dataoecd/28/34/39882938.pdf>.

¹⁴ 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," *Tax Notes Today*, July 14, 1999, 99 *TNT* 134-2, Doc. 1999-23851. 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, Rangel and Buckley, Viewpoint, "Current International Tax Rules Provide Incentives for Moving Jobs Offshore," *BNA Daily Tax Report* at 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 abusive 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," *BNA Daily Tax Report* at 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 avoidance 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 avoidance as either tax shelters or unintended loopholes or whether the effects of the recommendations on international tax avoidance are unintentional. The 2005 Joint Committee on Taxation recommendations affecting international tax avoidance 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. More recently, 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. (10/25/07).

¹⁵ 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).

¹⁶ 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).

¹⁷ See statements of then-IRS Chief Counsel B. John Williams

in "Chief Counsel Statement on Transfer Pricing, International Tax Issues," 2003 *TNT* 54-47, para. 22; statements to the same effect by Nicholas J. DeNovio, former Deputy Chief Counsel (Technical), IRS, 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 Law.* 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 the notice's 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 2004 Tax Court decision upholding 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). *United Parcel Service of America Inc. vs. Comr.*, 254 F.3d 1014 (11th Cir. 2001), *rev'g and rem'g* T.C. Memo 1999-268 (1999), holds rather explicitly that tax-motivated choices of the way to conduct a bona fide business are not properly 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 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 controlled foreign corporation 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 controlled foreign corporation. Citing to *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.

¹⁸ See, however, the discussion by the Staff of the Joint Committee on 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.

¹⁹ See *Del Commercial Props., Inc. v. Comr.*, 251 F.3d 210 (D.C. Cir. 2001), *cert. denied*, 534 U.S. 1104 (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.")

²⁰ See Sheppard, "Cross-Border Tax Arbitrage, 'Hybridity,'

SUMMARY OF KEY U.S. TAX CONSIDERATIONS

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

Domestic Corporations

The United States taxes domestic corporations on their worldwide income²² (including their pro rata share of “subpart F income” of “controlled foreign corporations” of which they are a “United States shareholder”).²³ (See the discussion of the Subpart F anti-deferral regime below.)

Foreign Corporations

The United States taxes foreign corporations on income effectively connected with a U.S. trade or business,²⁴ and on passive income from U.S. sources.²⁵

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 the income remaining after (foreign) tax to the US MNC. Transactions between branches of the same taxpayer are generally disregarded.²⁶

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.²⁷

Subpart F (generally)

Subpart F requires that a “United States shareholder”²⁸ (hereinafter a “U.S. shareholder”) of a “controlled foreign corporation”²⁹ (hereinafter, a “CFC”) include in income a pro rata share³⁰ 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.³¹ Subpart F also causes current inclusion in taxable income of a U.S. shareholder of its pro rata share of any investment by a CFC in “United States property.”³² “United States property” for this purpose generally includes tangible property located in the United States, stock of domestic corporations, debt obligations of U.S. persons, and the right to the use within the United States certain intellectual property rights acquired or developed by the CFC for use within the United States.³³ Exceptions apply to various types of property, including bank deposits, export property, and stock and obligations of a domestic

tionment 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 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 1.987-11. REG-208270-86, 71 Fed. Reg. 52876 (10/16/06). In addition, final regulations under §704(b), Regs. §1.704-1(b)(4)(viii) issued in T.D. 9292, 71 Fed. Reg. 61648 (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.

²⁷ §707(a).

²⁸ A “United States shareholder” is a U.S. person that owns directly, indirectly, or constructively 10% or more of the voting stock of a controlled foreign corporation. §951(b). A U.S. person is any U.S. citizen or resident, domestic corporation, domestic partnership, nonforeign estate, or trust subject to the primary jurisdiction of a U.S. court and the control as to all substantial decisions by a U.S. person. §957(c).

²⁹ 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, indirectly or constructively) by “United States shareholders” (i.e., U.S. persons which own (directly, indirectly, or constructively) 10% or more voting stock interests in the foreign corporation).

³⁰ §951(a)(2).

³¹ §951(a)(1).

³² §§951(a)(1)(B) and 956.

³³ §956(c).

Mules and Hinnies.” *Tax Notes Today* (2/17/98), 98 *TNT* 31-2, Doc 98-6196; Lee Sheppard, “A Scheme to Use Excess Foreign Tax Credits,” *Tax Notes Today* (12/21/98), 98 *TNT* 244-3, Doc. 98-37374.

²¹ See, e.g., H.R. 2345, 110th Cong. 1st Sess. (5/16/07), §101 proposing, inter alia, new §7701(p)(1)(B)(i)(I) under which foreign tax effects would be disregarded in assessing “economic substance.”

²² §§11, 61.

²³ §951.

²⁴ §882.

²⁵ §881.

²⁶ 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 appor-

corporation that is not a §951(b) U.S. shareholder of the CFC or a 25% affiliate of the CFC.³⁴

Subpart F Anti-Deferral Regime

In General

Subpart F income of a CFC is includible in the income of a U.S. shareholder for the taxable year of the CFC that ends with or within the taxable year of the U.S. shareholder.³⁵

Subpart F Income

Subpart F income³⁶ for most U.S. taxpayers is comprised of “foreign base company income,”³⁷ which, in turn, is generally comprised of: (1) foreign personal holding company income³⁸ (FPHCI), (2) foreign base company sales income³⁹ (FBCSI) and (3) foreign base company services income.⁴⁰ Various tests operate at the level of FPHCI, others are foreign base company income, and yet others at the level of Subpart F income.

Passive Income

Dividends, interest, rents, and royalties received by a CFC are FPHCI unless one of several exceptions applies.

Same Country Exception. FPHCI does not include interest and dividends if the dividends or interest are received from a related corporation that (1) is organized (i.e., incorporated) under the laws of the same country as the recipient,⁴¹ and (2) has a substantial part of its assets used in its trade or business in the country of incorporation.⁴² The same country exception from FPHCI does not apply, however, in the case of interest that reduces Subpart F income of the payor.⁴³

The same country exception from FPHCI also does not apply to any dividend with respect to any stock that is attributable to earnings and profits accumulated before the payor was a same country subsidiary of the recipient.⁴⁴

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

³⁴ §956(c)(2).

³⁵ §951(a).

³⁶ §952(a).

³⁷ §954.

³⁸ §954(c).

³⁹ §954(d).

⁴⁰ §954(e).

⁴¹ §954(c)(3)(A)(i).

⁴² §954(c)(3)(A)(ii).

⁴³ §954(c)(3)(B).

⁴⁴ §954(c)(3)(C).

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) 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).

This provision represents the most significant change in U.S. international tax rules since the issuance of the “check-the-box” regulations. It provides 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 disregarded entities (i.e., corporations), but with additional flexibility for foreign tax credit planning purposes. The provision also will 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 2008⁴⁵ 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.

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.⁴⁶ 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).⁴⁷ Another helpful Subpart F reform that was enacted as part of the Ameri-

⁴⁵ At present, a bill (S. 2886) is before the Senate that would extend this provision through 2009.

⁴⁶ 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 will lead to increased jobs moving overseas.

⁴⁷ See National Foreign Trade Council, “The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part One: A Reconciliation of Subpart F” and “Part Two: Conclusions

can Jobs Creation Act of 2004⁴⁸ (the AJCA) was a provision that would permit gain from the sale of a partnership interest by a CFC that is at least a 25% owner of the partnership to be deferred from U.S. tax to the extent a proportionate sale of the partnership's underlying assets would also qualify for deferral.⁴⁹ The 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.⁵⁰

High Tax Exception. Cross-border dividends and interest are only excludible from foreign base company income (not from FPHCI) if they qualify for the high tax exception (§954(b)(4) and Regs. §1.954-1(d)). The high tax exception is calculated on the basis of "items" of income. 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.

The 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.

and Recommendations" (12/15/01). 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, at Chap 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 U.S. 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 suffers from a lack of agreement as to who is competing with whom: Dell Ireland with Dell Austin?, or Dell worldwide with Lenovo? etc.

⁴⁸ P.L. 108-357 (10/22/04).

⁴⁹ §954(c)(4).

⁵⁰ P.L. 108-357, §413 (10/22/04).

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 controlled foreign corporation."⁵¹

● **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.⁵² Examples of foreign currency gains that will not be "directly related to the business needs" (and will be included in the FPHCI) are: (1) accounts receivable from the sale of goods giving rise to FBCSI, (2) 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)),⁵³ and (3) foreign currency gains on borrowings, to the extent interest expense on such borrowings would be allocated against Subpart F income of the borrower under the interest allocation rules.⁵⁴

● **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."⁵⁵ A discussion of hedging is beyond the scope of this article. 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.⁵⁶ Related party hedging transactions cannot, however, be integrated with any debt instruments for purposes of

⁵¹ §954(c)(1)(D).

⁵² Regs. §1.954-2(g)(2)(ii)(B)(I)(ii).

⁵³ Regs. §1.954-2(g)(2)(ii)(B)(I)(ii) states, foreign currency gain or loss is directly related to the CFC's business needs if it "[a]rises 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 determine "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 were not to be taken into account, then Regs. §1.954-2(g)(2)(ii)(B) would presumably refer to "foreign base company income" rather than to Subpart F income.

⁵⁴ Regs. §1.954-2(g)(2)(iii).

⁵⁵ Regs. §1.954-2(g)(2)(ii)(B)(2).

⁵⁶ Regs. §1.988-5(a)(1), (9).

the integration rules,⁵⁷ 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”⁵⁸ (i.e., they can be integrated with a qualifying hedging transaction).

- **Foreign Currency Losses.** Foreign currency losses in excess of foreign currency gains do not offset other categories of FPHCI.⁵⁹ 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 which do not generate exclusively Subpart F income.⁶⁰ It should be noted, however that a US MNC’s choice to borrow from or lend to a related party in a nonfunctional currency (relative to the US MNC) may be subject to closer scrutiny from the IRS.⁶¹

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.”⁶² A U.S. 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.⁶³

⁵⁷ Regs. §1.988-5(a)(5)(iii).

⁵⁸ Regs. §1.988-5(a)(3).

⁵⁹ Regs. §1.954-1(c)(1)(ii). A limited exception is provided by Regs. §1.954-2(g)(4).

⁶⁰ A controlled foreign corporation 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).

⁶¹ See FSA 200046019 (U.S. company’s interest expense and currency gain from unhedged borrowing from related party should be disregarded as lacking economic substance); PLR 8730003 (U.S. company’s loans to a foreign subsidiary operating in hyperinflationary jurisdiction did not constitute valid indebtedness, but instead were equity contributions, because loans were made without “monetary correction” clauses to adjust loans’ real economic value for inflation; therefore U.S. company was not entitled to deduct losses resulting from effects of inflation and reduction in value of foreign currency at repayment). See also *AMP, Inc. v. U.S.*, 185 F.3d 1333 (Fed. Cir. 1999).

⁶² §951(a)(1)(B).

⁶³ §956(a).

Shareholder Obligations

United States property includes stock or debt obligations of a U.S. shareholder or any 25% domestic affiliate.⁶⁴ A direct loan is measured by the amount of the loan.

Guarantees and Pledges

If a CFC is a guarantor or pledgor with respect to the obligations of a U.S. person, it is treated as holding the collateralized/guaranteed obligation.⁶⁵ In this case, the entire amount of the guaranteed obligation is deemed held by the CFC, not merely the amount pledged.⁶⁶

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. 76-125⁶⁷ and later, also unsuccessfully, in *Ludwig v. Comr.*⁶⁸ *Ludwig* distinguished the status of a 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, because commercial understanding of what is occurring in a pledge of stock is at variance with the IRS view. There have been no reported cases in which the IRS has been successful or unsuccessful in applying the indirect pledge rule.

Conduit Transactions

Taxpayers may seek to avoid a taxable investment in U.S. 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.⁶⁹

Nonbank Banks

Taxpayers may seek to avoid a taxable investment in United States property by causing a CFC to make

⁶⁴ §956(c)(1)(B), (C) and (c)(2)(F).

⁶⁵ §956(d).

⁶⁶ 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*.

⁶⁷ 1976-1 C.B. 204.

⁶⁸ 68 T.C. 979 (1977).

⁶⁹ Rev. Rul. 76-192, 1976-1 C.B. 205; Rev. Rul 87-89, 1987-2 C.B. 195, *obsoleted as to other situations per* Rev. Rul 95-96, 1995-2 C.B. 322.

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.*,⁷⁰ 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 Court⁷¹ and reinstated 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.⁷² The AJCA included a provision that effectively overturns the *The Limited* 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 Company Act of 1956.

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 U.S. property.⁷³ To date the government does not appear to have repudiated the view that §956 is a “two-way street.”⁷⁴

Additional Exceptions

The 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

⁷⁰ 113 T.C. 169 (1999).

⁷¹ 286 F.3d 324 (6th Cir. 2002).

⁷² A similar approach has found favor in the Ninth Circuit Court of Appeals. See *Jacobs Engineering Group, Inc. v. U.S.*, 99-1 USTC ¶50,355 (unpublished opinion, referenced in a “Table of Decisions Without Reported Opinion,” at 168 F.3d 499 (9th Cir. 1999)) (“spirit” of regulation under §956 should trump taxpayer’s technical compliance).

⁷³ Rev. Rul. 90-112, 1990-2 C.B. 186 (taxpayers may use revenue ruling affirmatively to support current inclusion of undistributed foreign-source income if they had excess foreign tax credits that could shelter such inclusion from tax cost).

⁷⁴ 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)”).

securities dealer; and (2) certain obligations of a U.S. person that is not a U.S. corporation.

Repatriation of Foreign Earnings

The AJCA enacted a repatriation provision⁷⁵ that permitted an election (for a single taxable year) for certain dividends from CFCs in excess of regular distributions to be taxed at 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 United States with 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 the 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 U.S. tax liability due to the lack of intention to bring the earnings to the United States, and other limitations. Another provision temporarily reducing taxes on repatriated funds does not appear likely in the near future.⁷⁶ On January 30, 2008, the Senate Finance Committee voted 16 to five against amending an economic stimulus bill to include a similar provision that would reduce taxes on funds repatriated within a 90-day period. 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 on Taxation) and Senator John Kerry (D-MA).

Foreign Tax Credit

Direct Credit

The United States allows a credit against U.S. income tax otherwise due with respect to worldwide income for foreign taxes incurred,⁷⁷ but limits the amount of the credit to the same proportion of U.S. tax as foreign-source net income bears to worldwide net income.⁷⁸

Indirect/Deemed Paid Credit

In addition to a credit for taxes paid or accrued by the U.S. taxpayer, the United States allows a credit for

⁷⁵ §965.

⁷⁶ 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.

⁷⁷ §901.

⁷⁸ §904(a).

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”).⁷⁹ The deemed paid credit arises in respect of dividends from foreign corporations⁸⁰ or Subpart F inclusions in respect of a CFC.⁸¹ Interest paid by a foreign corporation does not bring up/carry a deemed paid credit.

Limitations on the Foreign Tax Credit

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

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.⁸² Foreign taxes allocated (for U.S. tax purposes) to one category cannot offset U.S. tax otherwise due on income in another category.

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).

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.⁸³

- *Passive Basket.* Interest, dividends, rents, and royalties are generally in the “passive” basket.⁸⁴ 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.⁸⁵
- *General Basket.* General basket income means income other than passive basket income.

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 interest payment is allocated in calculating its earnings and profits).⁸⁶

- If the controlled foreign corporation 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,⁸⁷ and the excess will be general basket income.⁸⁸
- 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.⁸⁹
- Dividends from a CFC will be apportioned among baskets in proportion to the accumulated earnings of the CFC in each category.⁹⁰
- Interest from a noncontrolled foreign corporation 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 noncontrolled foreign corporation.⁹¹ The noncontrolled foreign corporation 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, 2003.⁹²

10/50 Basket. Dividends from noncontrolled foreign corporations were, until taxable years beginning after 2002, in a special company-by-company bas-

⁷⁹ §902(a).

⁸⁰ §902(a).

⁸¹ §960.

⁸² §904(d).

⁸³ §904(d)(2); Regs. §1.904-2T(a)(1).

⁸⁴ §904(d)(2)(A).

⁸⁵ §§904(d)(2)(A)(i); 954(c)(1)(D); Regs. §1.954-1(g)(2)(ii)(B)(1)(ii).

⁸⁶ §904(d)(3)(B) – (D); Regs. §1.904-5(c)(2).

⁸⁷ Regs. §1.904-5(c)(2)(ii)(C).

⁸⁸ §904(d)(3)(A).

⁸⁹ 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 be 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.

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

⁹¹ §904(d)(4) (effective for taxable years beginning after Dec. 31, 2002).

⁹² §904(d)(4)(c)(iv).

ket⁹³ (the “10/50 basket”). Thus, dividends (10/50 basket) and interest (passive basket) from a noncontrolled foreign corporation were in separate baskets for taxable years beginning before January 1, 2003.

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.⁹⁴ For taxable years beginning after 2006 (when the two-basket rule is in effect), such taxes are treated as imposed on general limitation income.

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 U.S. 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, the 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.⁹⁵

Tax Credit Source Rules

Interest⁹⁶ and dividends⁹⁷ 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 dividends⁹⁸ and interest⁹⁹ from foreign corporations engaged in a U.S. trade or business, and for dividends and interest from CFCs that derive U.S.-source income.¹⁰⁰

Rents and royalties are sourced according to the location of use of the underlying property.¹⁰¹

Foreign currency gains and losses recognized by a U.S. taxpayer are sourced on the basis of the residence of the taxpayer¹⁰² (i.e., U.S.-source except for foreign branch transactions).

Foreign currency gains and losses recognized by a foreign corporation are also sourced on the basis of the residence of the taxpayer¹⁰³ (i.e., foreign-source, except for U.S. branch effectively connected transactions).

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.¹⁰⁴ 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.¹⁰⁵ 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.¹⁰⁶ 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.¹⁰⁷

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 taxable year (in the

⁹³ §904(d)(1)(E).

⁹⁴ §904(d)(2)(H).

⁹⁵ In addition, the AJCA of 2004 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 uncertainty 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 and T.D. 8708, 1991-1 C.B. 137 at 924.

⁹⁶ §861(a)(1).

⁹⁷ §861(a)(2).

⁹⁸ §861(a)(2)(B).

⁹⁹ §884(f).

¹⁰⁰ §904(h).

¹⁰¹ §861(a)(4).

¹⁰² §988(a)(3)(A).

¹⁰³ *Id.*

¹⁰⁴ §904(f)(5)(E); Regs. §1.904(f)-7T(b)(3); *see generally* Ocasal and Lubkin, “New Temporary Regulations Under §904: Implementing the Jobs Act and Trying to Keep it Simple,” 37 *Tax Mgmt. Int’l J.* 199 (Apr. 11, 2008).

¹⁰⁵ §904(f)(5)(A).

¹⁰⁶ §904(f)(5)(C).

¹⁰⁷ §904(f)(5)(C); Regs. §1.904(f)-8T(b).

same basket as the original source of the loss).¹⁰⁸ 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.¹⁰⁹ The recapture is calculated on a basket-by-basket basis (i.e., the OFL is maintained on an SLL basis).

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.¹¹⁰ These rules are intended to provide relative parity with the OFL rules.¹¹¹

¹⁰⁸ §904(f)(1).

¹⁰⁹ §904(f)(1)(A).

¹¹⁰ §904(g); Regs. §1.904(g)-2T.

¹¹¹ H.R. Rep. No. 108-548, at 187 (6/16/04); *see also* S. Rep. No. 108-192, at 19-20 (11/7/03).

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. federal 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 avoid effective double taxation of the same income or a 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.¹¹² In February 2004, the government recognized that its first approach to this problem — comparing a transaction's anticipated business profits with tax benefits —

¹¹² Notice 98-5, 1998-1 C.B. 334.

was unworkable. Notice 2004-19¹¹³ 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 signaled a determined effort to apply this principle, announcing several initiatives. The initiatives are now reflected in the various final and proposed separation regulations:¹¹⁴ (1) the partnership anti-splitter regulations;¹¹⁵ (2) the proposed changes (repeal?) to the “technical taxpayer” rules dealing with hybrid entities, reverse hybrid entities and foreign consolidated groups;¹¹⁶ and (3) the proposed

¹¹³ Notice 2004-19, 2004-11 I.R.B. 606.

¹¹⁴ 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).

¹¹⁵ See T.D. 9121, 69 Fed. Reg. 21405 (4/21/04). 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.

¹¹⁶ REG-124152-06, 71 Fed. Reg. 44240 (8/4/06). The changes to the technical taxpayer rule 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 amendments, if finalized, would limit the use of structures described in *Guardian Indus. 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 must 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 pass-thru 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 hy-

regulations regarding foreign tax credit capture transactions effected via highly structured arrangements.¹¹⁷

The various changes to the foreign tax credit regime enacted by the AJCA improve taxpayers’ ability to cross-credit foreign taxes. 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 10 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.

brid. 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.*

Note, however, the curious results when these proposed rules are applied to a foreign tax on the owners of a domestic reverse hybrid entity with regard to income that is considered to be the domestic reverse hybrid’s for U.S. federal income tax purposes. See generally the comments of James Peaslee, *reprinted at* 2006 *TNT* 191-14, Doc 2006-20444 (9/27/06) (these rules would, if finalized, effectively cede primary taxing jurisdiction over the domestic reverse hybrid’s profits to the foreign government taxing the hybrid’s owners).

¹¹⁷ REG-156779-06, 72 Fed. Reg. 15081 (3/30/07); see also TAM 200807015. The proposed regulations dealing with highly structured transactions are intended to address 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 the preamble, the parties to such structured arrangements 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.

The proposed regulations would provide guidance under Regs. §1.901-2(e)(5) relating to the amount of taxes paid for purposes of §901. The proposed regulations would revise Regs. §1.901-2(e)(5) in two ways: (1) treat as a single taxpayer all foreign entities in which the same U.S. person has a direct or indirect interest of 80% or more (a “U.S.-owned foreign group”); and (2) treat amounts paid to a foreign taxing authority as noncompulsory payments if those amounts are attributable to certain structured passive investments. REG-156779-06, 72 Fed. Reg. 15081 (3/30/07). 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.

Carryover of Excess Foreign Tax Credits

Due to the various limitations on the foreign tax credit, excess credits may not be usable in the current year and may be claimed in other years. Under the 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.

Acquisition of Foreign Tax Credits

A similar concern attaches, in the Treasury's view, if foreign taxes are paid, but are not economically close to other income in the same basket, particularly if the foreign income was acquired in order to acquire the credit,¹¹⁸ 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.¹¹⁹ This reasoning carried the day in the Tax Court in *Compaq Computer Corp. v. Comr.*¹²⁰ and in the U.S. district court summary judgment in favor of the government in *IES Indus. Inc. v U.S.*¹²¹ 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*

¹¹⁸ Notice 98-5, 1998-1 C.B. 334.

¹¹⁹ This rigorously ignores the whole point of a foreign 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, 71 Fed. Reg. 61648 (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.

¹²⁰ *Compaq Computer Corp. v. Comr.*, 113 T.C. 2314 (1999).

¹²¹ N.D. Iowa 1999 (unpublished opinion).

corporate tax shelters requiring automatic disclosure and listing under the corporate tax shelter regulations.¹²² The substantive position was rejected by the Fifth Circuit in *Compaq*¹²³ and by the Eighth Circuit in *IES Indus. Inc.*¹²⁴ which found both business purpose and economic substance in the identical transaction when foreign taxes are treated as "taxes."¹²⁵ 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.¹²⁶ 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. The administration's FY2006 budget included a legislative proposal seeking broad regulatory authority to address this issue.¹²⁷ The request for authority has not appeared in subsequent revenue proposals for FY2008 or FY2009, and it may be surmised that the Treasury Department concluded that it had sufficient authority to deal with at least some of the kinds of foreign tax credit capture transactions that the earlier requests for authority might have been contemplating.¹²⁸

The perceived abuses relating to the acquisition of foreign tax credits were addressed, at least in part, by the AJCA, which extended the statutory minimum holding period required in the underlying property to claim foreign tax credits for withholding taxes imposed on income other than dividends (e.g., interest, rents, and royalties).¹²⁹

¹²² Notice 2003-76, 2003-49 I.R.B. 1181, *modified (and effectively withdrawn in this regard)* by Notice 2004-19, 2004-11 I.R.B. 606.

¹²³ 277 F. 3d 778 (5th Cir. 2001).

¹²⁴ 253 F. 3d 350 (8th Cir. 2001).

¹²⁵ See Dilworth and Harter, "The Fifth Circuit's *Compaq* Decision: Foreign Taxes are 'Taxes' (Nothing More, Nothing Less)," 2 *J. Tax'n. Global Trans.* 11 (2002). A newer version appears in a PLI Series with a "Coda" to describe the application of *Compaq* holding in subsequent cases and administrative pronouncements. Dilworth, "*Compaq*: Find Another Poster Child: The Business Purpose Doctrine is Alive and Well in the Fifth Circuit" (2008).

¹²⁶ Notice 2004-19, 2004-11 I.R.B. 606.

¹²⁷ See General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals (Feb. 2005).

¹²⁸ See Prop. Regs. §1.901-2(e)(5)(iii) and (iv), REG-156779-06, 72 Fed. Reg. 15081 (3/30/07); see also TAM 200807015.

¹²⁹ §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 the taxpayer has an obligation to make "related payments with respect to positions in substantially similar or

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.

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 U.S. shareholder’s interest expense *is* taken into account for U.S. tax purposes in calculating the foreign-source income amount in the limiting fraction for the foreign tax credit.¹³⁰ 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).¹³¹

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 ($\$150,000 \times (\$3,000,000/\$3,600,000)$) of the \$150,000 to U.S.-source income and \$25,000

($\$150,000 \times (\$600,000/\$3,600,000)$) to foreign-source income.¹³²

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 is paid.”¹³³ 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, since 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.

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.¹³⁴ To mitigate this result, the AJCA included a significant provision for elective worldwide fungibility, discussed 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.¹³⁵ The provision is currently scheduled to apply for taxable years beginning after December 31, 2008 and the double counting burden will be a continuing factor until and unless the provision becomes effective.¹³⁶ The effective date may be postponed on a recurring basis to meet budget revenue estimating needs.

¹³² Regs. §1.861-9T(g) Ex. (1).

¹³³ §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).

¹³⁴ 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 the 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.

¹³⁵ See the American Jobs Creation Act of 2004. P.L. 108-357 (10/22/04). The new provision is included in §864(f).

¹³⁶ A provision included in tax “extenders” and energy legislation passed by the House on May 21, 2008, however, if enacted, would delay the application of the worldwide allocation of interest provisions in §864(f) from Dec. 31, 2008, to Dec. 31, 2018. Section 402 of H.R. 6049, 110th Cong., 2d Sess. (5/21/08).

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).

¹³⁰ Regs. §§1.861-8, -9, -10, -10T, -11T, and -12T.

¹³¹ 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).

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.

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.¹³⁷ (In other words, interest expense cannot be isolated in a single member with little or no foreign-source income or foreign assets.)

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]¹³⁸ based on the average total value of assets within such grouping for the taxable year.”¹³⁹ 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, earnings and profits of the investee corporation)¹⁴⁰ 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).¹⁴¹

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.

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:

“Qualified Nonrecourse Indebtedness”

Interest on “qualified nonrecourse indebtedness”¹⁴² (“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) with restrictions in the loan on the disposal or use of the property.

“Integrated Financial Transactions”

If a taxpayer borrows as part of an “integrated financial transaction,”¹⁴³ 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;¹⁴⁴ (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).

¹³⁷ §864(e)(1). Regs. §1.861-11T.

¹³⁸ Regs. §1.861-8(f)(1).

¹³⁹ Regs. §1.861-9T(g)(1)(i).

¹⁴⁰ An asset’s “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).

¹⁴¹ See Regs. §1.861-9T(g)(3).

¹⁴² Regs. §1.861-10T(b).

¹⁴³ Regs. §1.861-10T(c).

¹⁴⁴ 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. (I)*. 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.

“CFC Netting Rules”

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 income¹⁴⁵ (rather than apportioning the expense between U.S. 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);¹⁴⁶ 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).¹⁴⁷ 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 purposes 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.¹⁴⁸ Moreover, under certain circumstances equity investments in foreign subsidiaries will effectively be treated as loans to the subsidiary.¹⁴⁹

Elective Worldwide Fungibility Approach

For taxable years beginning after 2008, a one-time election may be made to allocate and apportion third-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.¹⁵⁰ 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 limita-

tion. Such a move has been under consideration since enactment in 1986 of the asset-based interest expense allocation rules on a consolidated group basis. As 2009 draws nearer, however, a number of proposals are presently before Congress that, if enacted, would delay¹⁵¹ or repeal this provision¹⁵² so it remains to be seen whether this election will be available.

Hybrid Entities

In General

The U.S. federal tax system contemplates the existence of corporations,¹⁵³ partnerships,¹⁵⁴ trusts,¹⁵⁵ estates¹⁵⁶ and individuals.

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.

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, or 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 the net item of partnership income, gain, expense, or loss (an “entity” approach).

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.

Entity Classification

Because other types of entities exist, both in the United States and abroad, these other entities must be

¹⁴⁵ Regs. §1.861-10(e).

¹⁴⁶ Regs. §1.861-10(e)(2).

¹⁴⁷ Regs. §1.861-10(e)(3).

¹⁴⁸ See Regs. §1.861-10(e)(8)(vi).

¹⁴⁹ Regs. §1.861-10(e)(8)(v).

¹⁵⁰ §864(f).

¹⁵¹ H.R. 6049 (delays effective date until 2018); H.R. 3920 (delays effective date until 2012); H.R. 5720 (delays effective date until 2010).

¹⁵² H.R. 3970.

¹⁵³ §7701(a)(3) (corporations and associations taxed as corporations).

¹⁵⁴ §7701(a)(2).

¹⁵⁵ §§7701(a)(30)(E), 7701(a)(31), 641-685.

¹⁵⁶ *Id.*

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.¹⁵⁷ In addition, many civil law jurisdictions have more than one form of “society” invested with legal personality.

Guiding Principle

The status of a legal person as a partnership or corporation, and the existence of a “trust,” are determined under U.S. law on the basis of the 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).

Kintner Regulations

Before 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* regulations¹⁵⁸ provided a six-factor test to distinguish corporations, partnerships, and trusts.

Check-the-Box

In April 1995, the Service announced that it was considering repealing the *Kintner* regulations and replacing them with an elective regime.¹⁵⁹ 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 be free to elect classification as either a corporation or partnership.¹⁶⁰

The elective “check-the-box” regime was implemented in final regulations in December 1996, effective January 1, 1997.¹⁶¹ The *per se* list covers specified entities in 87 countries, the European Union, and

U.S. territories and possessions.¹⁶² Entities in any country not listed in the *per se* list are “eligible entities.”¹⁶³ 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”).

Transactions within a single taxpayer are typically not given U.S. tax effect.¹⁶⁴ 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.

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 transparent), 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 used in financing structures.

¹⁶² Regs. §§301.7701-2, -2T.

¹⁶³ See Regs. §301.7701-3(a) (“A business entity that is 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 Preamble of T.D. 8697, 61 Fed. Reg. 66584, at B (12/18/96) (“the regulations are clarified with respect to entities formed in the following jurisdictions: . . . the Netherlands Antilles. . .”; the final regulations approved by T.D. 8697 do not, however, list an Naamloze Vennootschap of the Netherlands Antilles as a *per se* corporation, thus entitling it to be an eligible entity).

¹⁶⁴ See fn. 26, above, and Regs. §1.446-3(c)(1)(ii). 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 Ann. 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, 71 Fed. Reg. 61648 (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.

¹⁵⁷ See, e.g., Ely and Grissom, “The LLC/LLP Scorecard,” *Tax Notes*, Nov. 17, 1997, at 833. Wyoming enacted the first LLC statute in 1977. See Wyo. Stat., §§17-15-101 through 17-15-136 (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).

¹⁵⁸ 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).

¹⁵⁹ Notice 95-14, 1995-1 C.B. 297.

¹⁶⁰ A classification election could not be made by a true trust because it would not be a business entity.

¹⁶¹ T.D. 8697, 61 Fed. Reg. 66584 (12/18/96). Notice 2004-68, 2004-43 I.R.B. 706, adds several additional foreign entities to the *per se* list.

Outlook

The stability of the elective regime and hybrid entities is unclear. Soon after the elective regime was finalized, the IRS severely limited the use of elective classification to erode the foreign tax base without a corresponding inclusion of U.S. taxable income.¹⁶⁵ The IRS and Treasury had, at that time, concluded that “capital export neutrality” was the guiding principle of the original deferral decisions that were implemented on the enactment 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.

Notice 98-11

It proved difficult to confirm the capital export neutrality premise for the compromises originally enacted in Subpart F.¹⁶⁶ It also proved to be controversial as a 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.¹⁶⁷

Under the agreement reached by the IRS and negotiators representing Congressional leadership, the hybrid 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.¹⁶⁸ To date, no such final regulations have been promulgated and, accordingly, the earliest effective date is at least five years in the future.

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.¹⁶⁹ 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 2005.¹⁷⁰

Partnerships/Subpart F

In response to *Brown Group*,¹⁷¹ the Service adopted 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 §702.¹⁷² The AJCA did enact a look-through approach to sales of a partnership interest by a CFC that owns at least 25% of the capital or profits interest in the partnership.¹⁷³

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.¹⁷⁴ The IRS has summarized its official view of the pre-

¹⁶⁵ Notice 98-11, 1998-6 I.R.B. 18, *withdrawn by* Notice 98-35, 1998-27 I.R.B. 35; T.D. 8767, 1998-16 I.R.B. 4 (temporary regulations, also issued as proposed regulations in REG-104537-97, 63 Fed. Reg. 14669 (3/26/98)), *removed and withdrawn by* T.D. 8827, 1999-30 I.R.B. 120. 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. Preamble of REG-113909-98, 64 Fed. Reg. 37727 (7/13/99), 1999 *TNT* 137-63. The July 1999 proposed regulations are an amended version of the March 1998 temporary and proposed regulations, which were withdrawn after a great deal of negative comment.

¹⁶⁶ See National Foreign Trade Council, “The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part One: A Reconciliation of Subpart F” and “Part Two: Conclusions and Recommendations” (12/15/01).

¹⁶⁷ T.D. 8827, 64 Fed. Reg. 37677 (7/13/99).

¹⁶⁸ Preamble of REG-113909-98, 64 Fed. Reg. 37727 (7/13/99), and Prop. Regs. §1.954-9(c).

¹⁶⁹ 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 Corp. v. Comr.*, 122 T.C. 224 (2004).

¹⁷⁰ See Joint Committee on Taxation, “Options to Improve Tax Compliance and Reform Tax Expenditures,” JCS-02-05 (1/27/05).

¹⁷¹ *Brown Group Inc. v. Comr.*, 77 F.3d 217 (8th Cir. 1996), *vacating and remanding* 104 T.C. 105 (1995), *nonacq.*, 1996-2 C.B. 2, and in Notice 96-39, 1996-2 C.B. 209.

¹⁷² 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), and 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, 67 Fed. Reg. 48020 (7/23/02), finalizing REG-112502-00, 65 Fed. Reg. 56836 (9/20/00).

¹⁷³ §954(c)(4).

¹⁷⁴ See generally, Plumb, “The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal,” 26 *Tax L. Rev.* 369 (1971).

ponderant characteristics in Notice 94-47.¹⁷⁵ 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 nontax characterization may inform the evaluation of the fundamental characteristics of debt or equity for U.S. tax purposes.¹⁷⁶

Debt instruments payable in stock of the obligor are typically treated as equity for U.S. tax purposes.¹⁷⁷

The IRS has greater latitude (than taxpayers) to re-characterize as equity an instrument that is in form debt, or as debt an instrument that is in form equity.¹⁷⁸

Instruments structured in form to be equity are rarely characterized as debt.

Stock dividends are generally not taxable income to the shareholder.¹⁷⁹

Circular cash flows (distribution and reinvestment) may in certain circumstances be treated a stock dividend for U.S. tax purposes, but are generally treated as actual dividends or interest paid for foreign tax purposes.¹⁸⁰

Treaty Benefits

The 2006 U.S. Model Treaty provides for zero withholding on interest¹⁸¹ and the 1992 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.¹⁸²

Important industrial countries which do not by treaty provide zero withholding tax on interest paid to

residents of the treaty jurisdiction include Canada, Japan, and Australia. The recently signed fifth protocol to the U.S.-Canada Treaty will, if ratified, reduce withholding on interest to zero.¹⁸³

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.¹⁸⁴

Dividends are ordinarily subject to source country withholding tax, at the rate of 5% on dividends to a “direct investor”¹⁸⁵ (as distinguished from a “portfolio investor,” typically taxed at 15%).¹⁸⁶

It has been a topic of ongoing discussion whether a withholding tax distinction between “direct investment dividends” and direct investment interest is appropriate.¹⁸⁷ A number of jurisdictions do not, as a matter of domestic law, impose withholding tax on dividends paid to nonresidents.¹⁸⁸ Recently negotiated U.S. tax treaties and protocols have provided a zero rate of withholding for dividends from certain qualified stock holdings.¹⁸⁹

Reduction of source country withholding tax on related party financing by claiming treaty benefits may

The Commentary also notes that Contracting States may agree to eliminate taxation of interest at source entirely.

¹⁸³ For the President’s letter of transmittal of the protocol to the Senate, see 2008 *TNT* 52-58, Doc 2008-5698 (3/14/08); for the text of the protocol, see 2007 *TNT* 185-82, Doc 2007-21595 (9/21/07).

¹⁸⁴ 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.

¹⁸⁵ See, e.g., U.S. Model Treaty (2006), Art. 10(2)(a); OECD Model Treaty (1992, as amended through 1997), Art 10, ¶2(a).

¹⁸⁶ See, e.g., U.S. Model Treaty (2006), Art. 10(2)(b); OECD Model Treaty (1992, as amended through 1997), Art 10, ¶2(b).

¹⁸⁷ 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).

¹⁸⁸ 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.

¹⁸⁹ See, e.g., the 2001 U.S.-U.K. Income and Capital Gains Tax Convention, the 2001 U.S.-Australia Protocol to the 1982 Con-

¹⁷⁵ 1994-1 C.B. 357, 1994-19 I.R.B. 9.

¹⁷⁶ CCA 200134004, FSAs 200142005, 200145005, 200146013, 200148039, and 200206010. See Feder and Nauheim, “IRS Takes a Fresh Look at Cross-Border Tax Planning,” 2 *Tax Plan. Int’l Fin.*, No. 4 (Apr. 2002).

¹⁷⁷ See Notice 94-47, 1994-1 C.B. 357, 1994-19 I.R.B. 9.

¹⁷⁸ See, e.g., §385(c).

¹⁷⁹ See §305.

¹⁸⁰ Rev. Rul. 80-154, 1980-1 C.B. 68.

¹⁸¹ U.S. Model Income Tax Treaty (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).

¹⁸² OECD Model Income Tax Treaty (1992, as amended through 1997), 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 goes on to note that this approach may result, in certain cases, in partial double taxation and “lead to adverse economic consequences.” *Id.*, ¶13. Warning that, “in certain cases the practice of taxation at the source can constitute an obstacle to international trade,” the Commentary suggests that source State taxation be prevented at least with respect to certain categories of interest.

be limited by treaty provisions designed to discourage “treaty shopping.”¹⁹⁰

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 third countries. Consequently, all recent (since 1980) U.S. income tax treaties contain “Limitation on Benefits” provisions, as does, for example, the 2006 U.S.

vention, the 2003 U.S.-Japan Income Tax Convention and the 2004 U.S.-Netherlands Protocol to the 1992 Convention, the 2006 U.S.-Belgium Income Tax Convention and Final Protocol, the 2006 U.S.-Germany Protocol to the 1989 Income Tax Convention, the U.S.-Denmark Protocol to the 1999 Income Tax Convention, the 2006 U.S.-Finland Protocol to the 1989 Income Tax Convention, the 2005 U.S.-Sweden 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 2007 U.S.-Canada Protocol to the 1980 Income Tax convention does not have the provision first included in the 2001 U.S.-U.K. Income and Capital Gains Tax Convention.

¹⁹⁰ 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).

Model Treaty in Article 22. 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 United States has not concluded a treaty could achieve such benefits merely by forming a company in a country with which the United States has concluded a treaty. A few treaties¹⁹¹ incorporate a “derivative benefits” concept whereby residents of a country with which the United States has concluded a treaty may also “derive” certain benefits of a second treaty concluded by the United States 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. 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.¹⁹²

¹⁹¹ See, e.g., U.S.-Canada Treaty.

¹⁹² See, e.g., Art. 1(8) of the 2001 U.S.-U.K. Treaty, Art. 7 of the 2004 U.S.-Netherlands Protocol to the 1992 Convention, or Art. 4(6)-(7) that will, if ratified, be created by the fifth protocol to the U.S.-Canada Treaty that was signed on Sept. 21, 2007, and is currently awaiting ratification by the U.S. Senate.

ILLUSTRATIVE APPLICATIONS

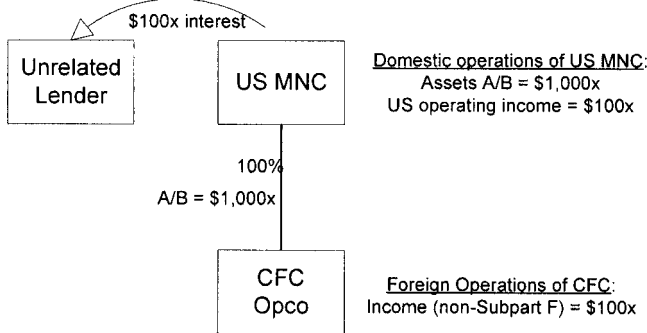
The following section provides hypothetical situations to illustrate the interaction of the rules outlined above. The examples do not apply the temporary look-through rules of §954(c)(6) because it is likely that such rules will expire at the end of this year. The examples also do not reflect the eventual efficacy of the worldwide interest expense allocation regime under §864(f).

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

General Facts. During 2009, 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.¹⁹³ 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.

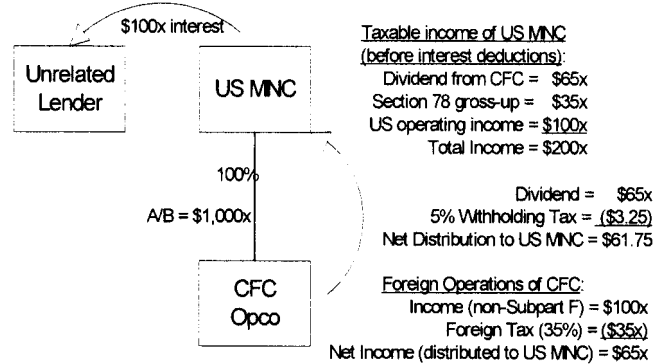


Example A. Foreign Tax Rate (35%) = U.S. Tax Rate (35%).

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

¹⁹³ This example assumes that none of the distribution will be treated as a §965 dividend.

\$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:



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 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).

“Asset method” of interest allocation. However, under the “asset method” of interest expense allocation, US MNC cannot allocate its interest expense to offset exclusively U.S.-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 \$1000x (adjusted basis in foreign assets)/\$2000x (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% times \$100x worldwide net taxable income (\$200x – \$100x interest expense) = \$35x U.S. tax liability.

Foreign tax credit limitation: \$35x (total U.S. tax due) times \$50x (foreign-source net income)/\$100x (worldwide net income) = \$17.50 maximum foreign tax credit.

Residual U.S. tax = \$35x minus \$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, plus 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 (\$20.75x) 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.

Debt Financing of CFC Opco, Instead of Equity. If in this example US MNC were to have received \$100x as interest¹⁹⁴ 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 minus \$100x interest expense, not subject to withholding tax¹⁹⁵), plus

\$35x U.S. tax on net taxable income of \$100x (\$100x of domestic operation income plus \$100x interest income from CFC Opco, minus \$100x interest expense).

In this case (in which no reliance is placed on the foreign tax credit to generate 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

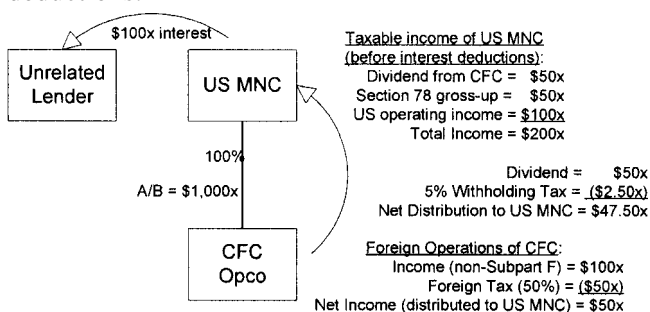
¹⁹⁴ This assumes complete elimination of local taxable income only for the purpose of identifying the economic impact of a movement from deductible interest to non-deductible dividends. It does not take into account CFC Opco's constraints under local law on debt to equity ratios for related party debt.

¹⁹⁵ Certain countries may impose a withholding tax on interest payments to foreign lenders.

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 distribution 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:



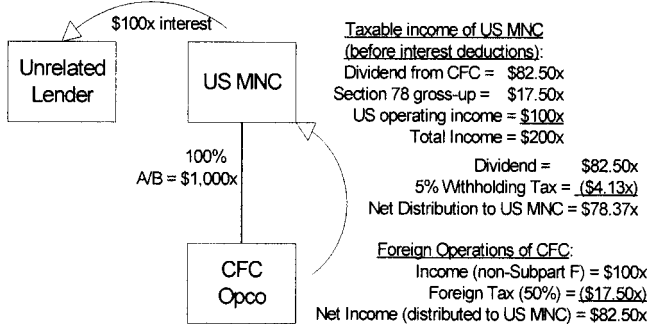
As in the prior example, under the "asset method" of interest expense allocation, US MNC's net foreign-source income is reduced by \$50x (\$100x interest expense times \$1000x (adjusted basis in foreign assets) /\$2000x (adjusted basis in all assets)). As in the prior example, this reduces US MNC's foreign-source income to \$50x and lowers US MNC's foreign tax credit limitation to \$17.50x. Therefore, US MNC will owe additional U.S. federal income tax of \$17.50x, and 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, plus U.S. tax of \$17.50x).¹⁹⁶ (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.)

¹⁹⁶ 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.

In such a jurisdiction, it would likely be generally advantageous to finance CFC Opco with debt, since 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 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.

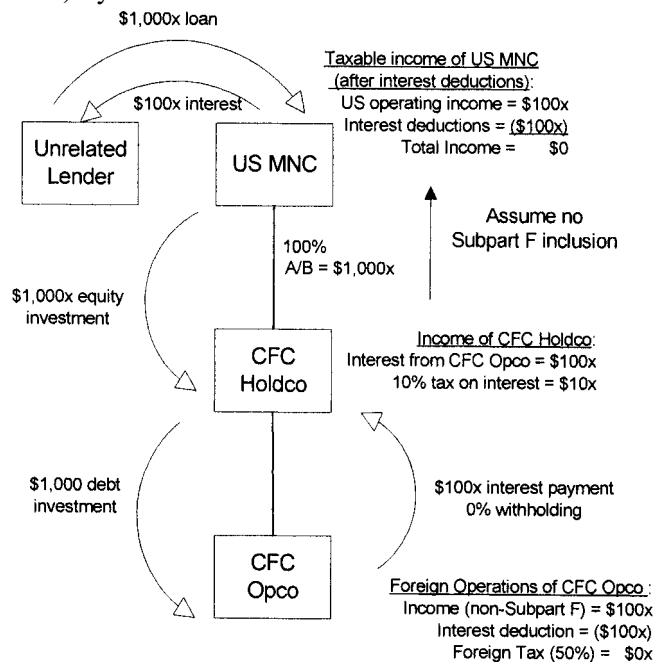
As in the prior examples, under the “asset method” of interest expense allocation, US MNC's net foreign-source income is reduced by \$50x to \$50x, and lowers US MNC's foreign tax credit limitation to \$17.50x. Therefore, US MNC will owe additional U.S. federal income tax of \$17.50x, and the combined 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).

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),¹⁹⁷ 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 dividends¹⁹⁸ and taxes interest¹⁹⁹ 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. rate (after allowance for any foreign tax credits), US MNC would have a net economic advantage consisting of two interest deductions²⁰⁰ with only a partial offset for CFC Holdco taxes on the interest, until distribution (if ever) by CFC Holdco.



¹⁹⁷ See above.

¹⁹⁸ For example, pursuant to a participation exemption such as that provided under the Netherlands or Luxembourg tax regime.

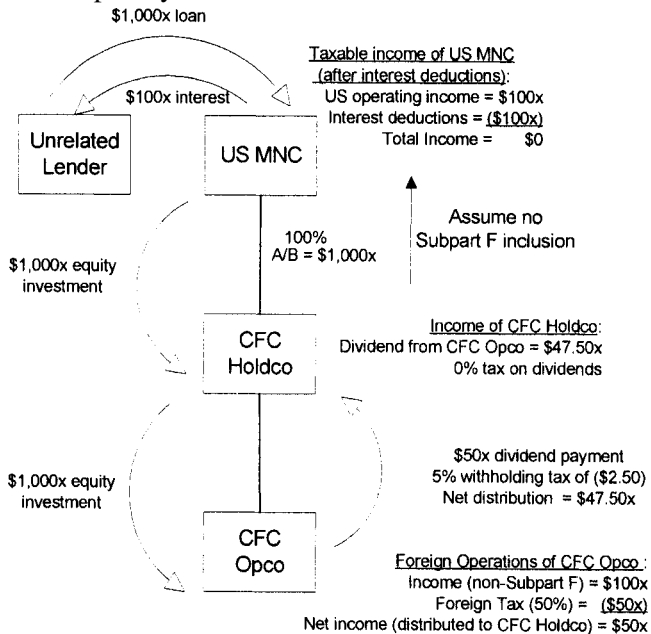
¹⁹⁹ For example, pursuant to a low general corporate income tax rate such as in Ireland.

²⁰⁰ 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.

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 United States. 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 the above examples 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,²⁰¹ as would dividends from CFC Opco (unless CFC Opco is taxed in our example at 28.75% or more).²⁰²

If CFC Opco is a DRE,²⁰³ 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.²⁰⁴ 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 foreign law effects that motivated the issuance of Notice 98-11.²⁰⁵ 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. More recently, the Joint Committee on Taxation staff have recommended 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. treat-

²⁰¹ See the discussion of Subpart F earlier in this article.

²⁰² 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%).

²⁰³ See the discussion of hybrid entities earlier in this article.

²⁰⁴ See the discussion of the interest expense allocation rules earlier in this article.

²⁰⁵ 1998-6 I.R.B. 18, discussed above in connection with hybrid entities.

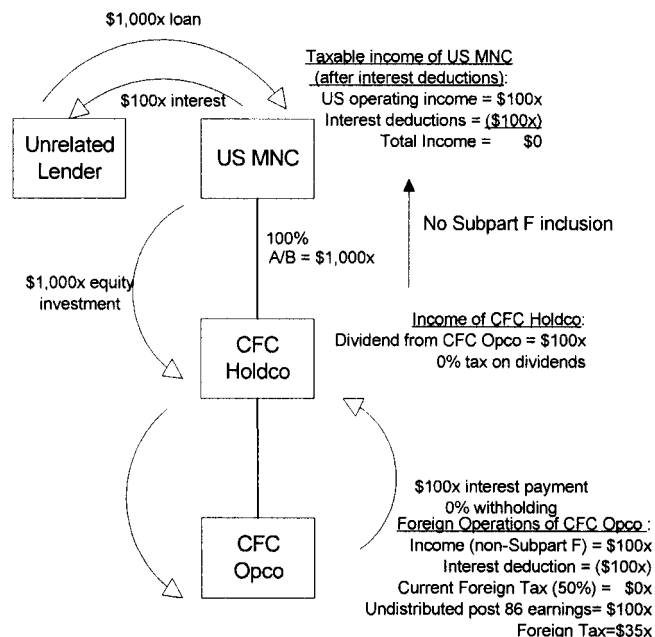
ment of disregarded entities and disregarded transactions.²⁰⁶

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 exception²⁰⁷ from FPHCI. In the preceding example (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 F. Hybrid Instrument

For example, assume the same facts as the previous example (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,²⁰⁸ unless CFC Opco is a DRE.²⁰⁹ 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 qualifies for the high tax exception (because in our example CFC Opco has high-taxed earnings).²¹⁰

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.

²⁰⁶ Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," JCS-02-05, pp. 182-185.

²⁰⁷ §954(b)(4); discussed above in connection with hybrid entities.

²⁰⁸ See the discussion of interest expense allocation rules, above.

²⁰⁹ See the discussion of hybrid entities, above.

²¹⁰ See the discussion of interest expense allocation rules, 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.