Tax Report #927

New York State Bar Association

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April 20, 1998

The Honorable Donald C. Lubick
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose a report of the New York State Bar Association Tax Section concerning the issues raised by Notice 98-11. The report makes the following observations:

1. After a careful review of the statute and the legislative history of the Revenue Act of 1962, it is not clear to us that the Treasury Department currently has the authority to promulgate regulations treating foreign branches as foreign corporations for purposes of section 954(c) of the Internal Revenue Code.

2. We believe that it would be appropriate to treat payments received by a related foreign branch that is treated as a corporation under foreign law in the same manner as payments received by a related foreign corporation, and that Treasury and Congress could take this opportunity to revisit the policies of subpart F to determine whether

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such payments (either to a corporation or a branch) should, or should not, result in subpart F inclusions.

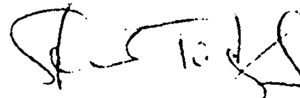
3. We discuss two ways in which the current statutory distinction between corporations and branches could be eliminated. First, taking the opposite approach of the Notice, section 954(c) could be amended so that, generally, neither payments received by a related foreign corporation nor by a related foreign branch would be treated as subpart F income. Alternatively, the approach of the Notice could be adopted, under which the existing regime of section 954(c) could be extended to payments received by related foreign branches that are treated as foreign corporations. If the second approach is adopted, however, we recommend that consideration be given to treating such payments as subpart F inclusions of the payor in both cases so that associated foreign tax credits may be claimed.

4. We are concerned that broad regulatory authority to interpret the "principles of subpart F" would be difficult to administer. Subpart F represents a balance of competing economic policies. In any case not explicitly covered by the statute, it may be difficult for the Treasury and taxpayers to discern which policy should control the tax result. Therefore, we believe that guidance in this area should generally be narrowly targeted.

The report does not provide comments on the temporary regulations implementing Notice 98-11 or on the proposed legislative moratorium on regulations under Notice 98-11.

Please let me know if we can be of any further assistance to you in addressing these issues.

Very truly yours,



Steven C. Todrys
Chair

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NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Report on Notice 98-11

April 17, 1998

I -- Background

This Report responds to a request by the Internal Revenue Service (the "Service") for comments on Notice 98-11, 1998-6 I.R.B. 18 (the "Notice"), which was released on January 16, 1998.[1] Regulations substantially implementing the Notice (the "Regulations") were issued on March 23, 1998 and generally apply to arrangements entered into after January 15, 1998.[2] The Report also considers the Administration's associated legislative proposal (the "Legislative Proposal") that would direct the Treasury Department to prescribe regulations clarifying the tax treatment of hybrid entities, securities and transactions "which would otherwise have results that are inconsistent with the purposes of U.S. law,"[3] but only insofar as the Legislative Proposal relates to the issues raised by the Notice and Regulations.

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[1] This report was prepared by an ad hoc subcommittee of the NYSBA Tax Section. David P. Hariton and Steven C. Todrys were the principal draftspersons. Helpful comments were received from Kimberly S. Blanchard, Dickson G. Brown, Samuel J. Dimon, Patrick C. Gallagher, Robert A. Jacobs, Bruce Kayle, Sherwin Kamin, Edward D. Kleinbard, Stephen B. Land, Richard O. Loengard, J. Ross McDonald, James M. Peaslee, Yaron Z. Reich, Michael L. Schler, Lewis R. Steinberg and Willard B. Taylor.

[2] The Report does not comment on the technical issues raised by the Regulations.

[3] "Prescribe Regulatory Directive to Address Tax Avoidance Through Use of Hybrids," p. 144 of the General Explanation of the Administration's Revenue Proposals, released by the Treasury Department on February 2, 1998.

The Notice specifically describes an arrangement whereby a foreign subsidiary of a U.S. corporation (the "CFC") effectively reduces its local foreign tax liability by establishing a branch in a third, low-tax foreign country (the "Branch") and paying interest to the Branch (i.e., by contributing equity to the Branch and having the Branch lend the equity back to the CFC). The local taxing jurisdiction apparently (a) treats the Branch as a separate company, (b) permits the CFC to deduct interest paid to the Branch and (c) does not require the CFC to include the interest which the Branch receives in the CFC's own income or otherwise protect itself through rules analogous to the U.S.'s subpart F rules. The interest payments do not exist for U.S. tax purposes, because they are merely payments between branches of a single CFC. In a similar arrangement specifically described in the Notice, the Branch is owned by a related CFC organized in the same foreign country as the payor. The interest payments therefore exist for U.S. tax purposes, but they are exempted from subpart F by reason of the exception for interest payments between related members organized in the same country.

The introduction to the Notice states that certain taxpayers are using arrangements involving hybrid branches "to circumvent the purposes of subpart F. . . . These arrangements generally involve the use of deductible payments to reduce the taxable income of a controlled foreign corporation (CFC) under foreign law, thereby reducing the CFC's foreign tax and, also under foreign law, the corresponding creation in another entity of low-taxed, passive income of the type to which subpart F was intended to apply." The Notice states that such arrangements are "contrary to the policies and rules of subpart F" and that "[o]ne of the purposes of subpart F is to prevent CFCs . . . from structuring transactions designed to manipulate the inconsistencies between foreign tax systems to inappropriately

generate low- or non-taxed income on which United States tax might be permanently deferred." Similarly, the preamble to the Regulations states that "one of the purposes of subpart F is to prevent CFCs from converting active income that is not easily moveable and is earned in a jurisdiction in which a business is located for non-tax reasons, into passive, easily moveable income that is shifted to a lower tax jurisdiction primarily for tax avoidance. Moreover, when subpart F was first created it was realized that related person transactions can be easily manipulated to reduce both United States and foreign taxes. Consequently, in enacting subpart F, Congress provided that transactions of CFCs that involve related persons generally give rise to subpart F income with certain enumerated exceptions."

The Notice also states that subpart F was enacted by Congress to limit deferral, but that limited deferral was retained to protect the competitiveness of CFCs doing business overseas. This limited deferral allows a CFC engaged in active business in a foreign country to "compete in a similar tax environment with non-U.S. owned corporations located in the same country." The Notice states, however, that U.S. international tax policy seeks to balance this need to keep U.S. business competitive with "the objective of neutrality of taxation as between domestic and foreign business enterprises (seeking neither to encourage nor to discourage one over the other)." The Notice concludes that "[s]ubpart F strongly reflects and enforces that balance. These hybrid transactions upset that balance." The preamble to the Regulations contains similar language.

The Notice goes on to state that "Treasury and the Service believe that it is appropriate to prevent taxpayers from using these types of hybrid branch arrangements to reduce foreign tax while avoiding the corresponding creation of subpart F income" and that "[r]egulations will provide that, when such arrangements are undertaken, the branch and the

CFC will be treated as separate corporations for purposes of subpart F." The Regulations implement the Notice by either (i) treating branches as corporations in cases where income would not otherwise exist for U.S. tax purposes, such as where a CFC pays interest to its own tax-haven branch or (ii) denying the application of the same-country related person exception from subpart F income contained in Section 954(c)(3) in cases where the relevant tax-haven branch is owned by a related CFC organized in the same foreign country as the payor.

The Legislative Proposal does not imply that the Treasury lacks the authority under current law to issue the Notice and the Regulations. The Legislative Proposal would grant the Treasury broader authority, however, to "prevent the use of hybrid entities and hybrid securities that, contrary to the purposes of the subpart F rules, result in deductions for foreign tax purposes with respect to certain cross-border payments that do not generate subpart F income." The Treasury would still be expected to exercise its authority primarily to deny tax benefits, or recharacterize tax results, which "circumvent the purposes of the subpart F rules," or which are otherwise "inconsistent with the purposes of U.S. law."

II -- Summary and General Comment

1. It is not clear to us that the Treasury currently has the authority to promulgate regulations treating foreign branches as foreign corporations for purposes of either (i) applying Section 954(c) to payments between a CFC and its own branch or (ii) denying the application of Section 954(c)(3) to payments made to a branch of a related controlled foreign corporation formed in the same country as the payor. While we acknowledge (and supported) the Treasury's exercise of authority to promulgate Treas. Reg. §301.7701-3 classifying entities as corporations, partnerships or as disregarded, we do not believe that Section 7701 of the Code permits the Treasury to classify the same entity in a different

manner for different purposes of the Code. We also believe that the legislative history of the Revenue Act of 1962 (the "1962 Act"), which introduced subpart F to the Code, is inconclusive on the issue of authority.

2. In one sense, the Notice raises a narrow issue -- the somewhat arbitrary distinction in the statute between interest received by a CFC from a related corporation organized in a different country (subject to subpart F) and interest received by a mere branch of the payor corporation (or a related corporation organized in the same country) which is treated for foreign tax purposes as a separate corporation formed in a different country (not subject to subpart F). We believe that it would be appropriate to treat these two cases in the same manner, and that the Treasury and Congress could take this opportunity to revisit the policies underlying subpart F as they apply to interest (and other items of foreign personal holding company income) paid by a controlled foreign corporation to a foreign related entity. We have identified two ways in which this statutory distinction could be corrected.

First, taking the opposite approach of the Notice and the Regulations, Section 954(c) could be amended so that interest received by a CFC from a related CFC organized in a different country would only be treated as subpart F income on a "look-through" basis, i.e. to the extent it reduces the payor's subpart F income (so that such payments could never serve to increase or reduce subpart F income, regardless of how they affected foreign tax). In that case, no special rule would be necessary for payments to branches since payments to related corporations would not give rise to subpart F income.

Second, pursuant either to regulatory authority (if it exists) or statutory amendment, a foreign branch could be treated as a corporation solely for purposes of applying Section 954(c) to the transaction, an approach taken by the Regulations. Where payments are

made by a CFC to its own tax-haven branch, this approach would permit associated foreign tax credits of the CFC to accompany the resulting subpart F inclusions. Consistent with this approach, the related party exception of Section 954(c)(3) might also be modified to treat payments made between related CFCs as subpart F inclusions of the payor, rather than of the payee so that associated foreign tax credits of the payor may be claimed.[4]

3. The Notice, Regulations and the Proposed Legislation also raise a broader question concerning the scope of regulatory authority to determine the "principles of subpart F." Our review of the legislative history of the 1962 Act, discussed below, indicates that those principles may often be difficult to ascertain. Unlike areas of the tax law where anti-abuse rules have been promulgated, the rules of subpart F do not reflect, for example, any fundamental economic principles concerning the determination of taxable income. Subpart F was a compromise between an Administration that sought to end all deferral of income earned by foreign subsidiaries and a Congress that was only willing to end deferral with respect to certain types of income. The lines drawn in subpart F represent a series of legislative judgments intended to balance the competing policies of permitting U.S. multinationals to compete effectively with their foreign counterparts while preventing U.S. multinationals operating in foreign jurisdictions from having an unfair competitive advantage over their U.S. counterparts. In any particular case not explicitly covered by the statute, therefore, it may be difficult to discern which policy should control the tax result. Without more direction, it may be difficult for the Treasury to exercise regulatory authority based on the "principles of subpart F" and for taxpayers to predict how that authority would be exercised.

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[4] Section 954(d)(2) might be similarly modified.

III -- Question of Authority

It appears to us that the Notice and the Regulations are not an exercise of Treasury's authority under Section 7701 of the Code to properly classify foreign entities for U.S. tax purposes, but rather an effort to exercise its authority to administer the rules of subpart F. More specifically, while the Notice states that the recent introduction of the "check-the-box" regime for foreign entity classification has "facilitated the creation of arrangements involving hybrid branches which circumvent the purposes of subpart F," similar arrangements existed under prior law, provided that the hybrid branch in question could meet the requirements of prior law for treatment as something other than a corporation for U.S. tax purposes (i.e., could lack at least two of the four "corporate characteristics" that were deemed to distinguish corporations from other kinds of entities). The Notice and the Regulations do not cut back on the application of the check-the-box regime to the classification of foreign entities, but, rather, expand the subpart F rules. This interpretation is in our view technically consistent with the application of the Notice and the Regulations: a hybrid entity is recharacterized not for all purposes, but solely for purposes of applying the rules of subpart F to income arising from a specific transaction.

The specific provision of subpart F that the Notice and the Regulations expand is Section 954(c) of the Code, which generally requires a U.S. parent to include in its own income any dividends, interest, royalties or rents (among other things) that are received by one of its controlled foreign corporations, other than dividends, interest, royalties or rents received from a related corporation organized in the same foreign country and actively engaged in business in that country. This rule was introduced by the 1962 Act as part of a

compromise between Congress and the Administration over the Administration's proposal to end all deferral.

In 1962, the Administration had proposed that deferral of income earned by foreign subsidiaries be ended in order to prevent U.S. multinationals from "accumulating profits in tax havens" and "exploiting the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liability both at home and abroad."[5] Congress rejected this proposal, however, because it "recognized the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same country."[6] Congress "nevertheless saw no need to maintain the deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated."[7] This legislative history supports the view that the focus of Section 954(c) is to eliminate

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[5] Message of the President cited and quoted in the Senate Report, H.R. Rep. No. 1447, 87th Cong., 2d Sess. 57 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 78-79 (1962); 1962-3 C.B. 784.

[6] S. Rep. No. 1881 at 83; Senate Report, 1962-3 C.B. 789. Similar language appears in the House Report. H.R. Rep. No. 1447 at 62; 1962-3 C.B. 461-62:

"Your committee's bill does not go as far as the President's recommendations. It does not eliminate tax deferral in the case of operating businesses owned by Americans which are located in the economically developed countries of the world. Testimony in hearings before your committee suggested that the location of investments in these countries is an important factor in stimulating American exports to the same areas. Moreover, it appeared that to impose the U.S. tax currently on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax."

[7] H.R. Rep. No. 1447 at 62; S. Rep. No. 1881 at 84; 1962-3 C.B. 466, 789.

deferral on passive investment income from portfolio investments. On the other hand, Sections 954(d) and (e) of the Code are primarily designed to prevent U.S. multinationals from lowering foreign tax by moving active earnings from high-tax to low-tax jurisdictions.

Nevertheless, Section 954(c) requires a U.S. parent to include in income any dividends, interest, royalties or rents received by one of its foreign subsidiaries from a related person organized in a different foreign country, and this rule does prevent U.S. multinational corporations from lowering foreign tax by causing controlled corporations organized in high-tax jurisdictions to make deductible payments of interest, royalties or rents to related controlled foreign corporations organized in low-tax jurisdictions. This rule not only eliminates deferral on the earnings used to make the payments, but because the payments are treated as subpart F income of the payee, rather than of the payor, the resulting inclusions of income by the U.S. parent are not accompanied by indirect credits for foreign taxes paid by the payor in respect of the associated earnings. In other words, the income of the payor and payee are treated as separate pools of earnings for those purposes.

Despite this clear statutory result, it is not clear from the legislative history of the 1962 Act whether Congress focused on the shifting of active earnings to low-tax jurisdictions through cross-border payments of passive investment income. The floor debates suggest that some members of Congress viewed the legislation as limiting the ability of U.S. multinationals to avail themselves of tax havens to lower their foreign tax, with no technical distinction in this regard between the purposes of Section 954(c) on the one hand and the purposes of Sections 954(d) and (e) on the other.[8] On the other hand, the House and

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[8] See Appendix A for a list of relevant quotations from the Floor Debates.

Senate Committee Reports do seem to draw such a distinction,[9] and do not suggest that Section 954(c) was intended to accomplish more than the elimination of deferral on income from passive investments.[10]

In any event, Section 954(c) by its express terms prevents U.S. multinationals from using deductible payments between related corporations organized in different countries to lower their foreign tax, but does not expressly limit the use of similar payments from or to related partnerships or branches. This is in contrast to Section 954(d), which contains a specific rule treating branches as corporations for purposes of its application.[11] Thus, while it might be appropriate to eliminate the inconsistency between the treatment of deductible cross-border payments made between related corporations and the treatment of such payments made by or to related branches, we do not find any requirement for doing so in the legislative history.[12]

9/ See notes 6 and 7, supra. After discussing the proposed elimination of deferral on foreign personal holding company income, both reports go on to separately discuss the proposed elimination of deferral on subpart F sales and services income.

10/ Moreover, if Section 954(c) was enacted partly to deal with the shifting of income to low-tax jurisdictions, it is not clear why it treats as subpart F income the dividends received by a controlled foreign corporation from a related corporation organized outside the local jurisdiction, since such dividends are presumably not deducted by the paying corporation.

11/ Section 954(d)(2).

12/ We note that the most recent Congressional action in this area is the repeal of Section 956A of the Code, which repeal permits continued deferral on pools of accumulated earnings derived by U.S. multinationals from the active conduct of business outside the United States and passively invested within low-tax jurisdictions.

For these reasons, we do not think it clear that the Treasury has the authority to expand the application of Section 954(c) of the Code to treat as subpart F income certain payments made to or from related branches or partnerships merely because those payments serve to lower worldwide foreign tax. In addition, because it is based upon the same standards as the Notice, we are concerned that the Legislative Proposal will not be an effective means of resolving the question of authority. Specifically, the Legislative Proposal would direct Treasury to "set forth the appropriate tax results under hybrid transactions in which the intended results are inconsistent with the purposes of U.S. tax law." However, without further Congressional direction, the purposes of U.S. tax law are unclear insofar as this particular aspect of subpart F is concerned.[13]

IV -- Legislative Alternatives

There are two basic alternatives which could be considered to rectify the statutory inconsistency between payments made to certain related corporations and payments made to related branches. The first would be to expand the exception from the definition of foreign personal holding company income contained in Section 954(c)(3) of the Code to include payments received from a related person organized in a different foreign country than the payor. As a result, payments to a related corporation would not result in subpart F income, and there would be a need for a rule dealing with payments to a related branch.

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[13] We recognize that international transactions are complex and constantly changing and it may be difficult to draft statutory provisions that deal with all transactions that may be inconsistent with the policies underlying subpart F. Assuming that a clear policy is set by Congress, we believe that it may be appropriate to grant regulatory authority to deal with transactions that are contrary to that policy.

(The payments would still not qualify for the exception to the extent that they served to reduce the payor's subpart F income.) This approach would be consistent with the conclusion that U.S. multinationals should be able to use cross-border interest, rents and royalties to lower their foreign taxes without losing deferral.

The second alternative would be to adopt a rule consistent with the Notice and the Regulations treating branches as separate corporations for purposes of Section 954(c). This approach would be consistent with the view that U.S. multinationals should not be able to use cross-border interest, rents and royalties to lower their foreign taxes without losing deferral. If this approach is adopted, we believe it should be accompanied by a rule effectively treating such payments as dividends received by the U.S. Parent from the payor corporation. This would generally end deferral on the earnings used to make such payments, but it would permit the U.S. Parent to credit its allocable share of the foreign taxes paid in respect of such earnings. The Regulations effectively achieve this result in a case where income would not otherwise exist (because, for example, a CFC is paying deductible interest to its own tax-haven branch). In such a case, the Regulations, unlike Section 954(d)(2), treat the resulting income as subpart F income of the paying CFC, rather than of a separately incorporated payee.[14] We also think it would be reasonable to amend Section 954(c)(3) to likewise treat subpart F income arising from payments made between two related CFCs as income of the payor, rather than of the payee.[15]

14/ It may be appropriate to amend Section 954(d)(2) to reach the same result.

15/ If no action is taken, U.S. taxpayers will continue to utilize the distinction between corporations and branches. Similar anomalies exist elsewhere in the tax law, and this result may be acceptable if the policy reason for treating interest paid to a related foreign corporation as subpart F income is, for example, outweighed by the complexity (continued...)

V -- Policy Considerations

Any legislative proposal would raise policy issues similar to those issues that were debated and discussed in 1962. While a full and serious consideration of these issues is beyond the scope of this report, we note below a few of the points that we think are likely to be considered by Congress in weighing such a proposal.

The Notice suggests, correctly we think, that one of the objectives of U.S. tax policy is to permit U.S. multinational corporations to compete on an even footing with foreign competitors in foreign jurisdictions in cases where the foreign jurisdictions impose lower rates of tax than those imposed by the United States. This objective is sometimes referred to as the "capital import neutrality" objective. The Notice also suggests, correctly we think, that one of the objectives of U.S. tax policy is to maintain neutrality of taxation between domestic and foreign business enterprises, neither encouraging nor discouraging the one over the other. This objective is sometimes referred to as the "capital export neutrality" objective.

We note that these two objectives tend to conflict with each other: If a foreign country imposes a lower effective rate of tax than the United States, there can be no capital export neutrality unless the United States responds by eliminating deferral, but elimination of deferral violates the principles of capital import neutrality. Conversely, if the United States retains deferral for income derived by U.S. multinational corporations in what are effectively low-tax jurisdictions in order to maintain capital import neutrality, it will necessarily be violating capital export neutrality and encouraging U.S. multinational corporations to invest more capital outside the United States, where effective tax rates are lower. It does not matter,

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[15](...continued)
resulting from the multiple classification (as a corporation for some purposes and as a disregarded entity for others) of branches.

in this regard, whether a foreign country lowers its effective rate of tax by expressly lowering the nominal rate of tax which it imposes on income derived from the conduct of such business within its boundaries (e.g., by tax holidays) or whether it does so by permitting (wittingly or unwittingly) persons conducting such business to enter into a variety of cross-border transactions involving related tax-haven entities which effectively permit them to reduce or eliminate the nominal amount of income which they derive from such business for local tax purposes. If Congress chooses to retain deferral despite low rates of foreign tax, the manner in which the low rates are obtained may not be relevant, so long as the means of arriving at them are likewise available for local competitors.

The Notice states that U.S. tax policy seeks to balance the competing objectives of capital import and export neutrality, and subpart F strongly enforces and reflects that balance. Transactions designed to manipulate the inconsistencies between foreign tax systems to "inappropriately generate low- or non-taxed income on which United States tax might be permanently deferred" upset that balance, according to the Notice. Finding the proper "balance" may be difficult. In some sense, Congress rejected, in 1962, the goals of capital export neutrality in favor of the goals of capital import neutrality: the Administration asked Congress to repeal deferral because U.S. multinational corporations were using transactions with tax-havens to "sharply reduce or eliminate their worldwide tax," but Congress retained deferral to permit U.S. multinational corporations to compete on an even footing with local companies operating in foreign countries with low effective rates of tax. However, Congress did limit the ability of U.S. multinational corporations to enter into some cross-border transactions which served to lower their effective rates of worldwide foreign tax (most specifically, certain related-party sales and services transactions) and also ended

deferral on income from capital that was not being used to actively compete with local companies.

One tax-based argument against an extension of the rules of subpart F to cover transactions of the sort described in the Notice is that these transactions may serve to effectively increase the revenues collected by the U.S. by reducing the amount of foreign taxes paid by U.S. multinational corporations (and therefore the amount of foreign taxes that are credited against U.S. federal income tax liability when they repatriate their earnings). The counterarguments to this view are that (i) the deferral of U.S. tax may be indefinite if the earnings are not repatriated and (ii) no additional U.S. tax revenues are generated if the U.S. taxpayer is in an "excess credit" position. In addition, U.S. tax revenues can be adversely affected if U.S. business capital flows from within the U.S., where the income derived therefrom would be subject to full current U.S. tax, to foreign jurisdictions, where U.S. tax on the income is only imposed when it is repatriated.

VI -- Administrative Concerns

We believe the Notice, Regulations and Legislative Proposal raise two administrative concerns. First, we question whether the hybrid branch transactions described in the Notice and the Regulations required preemptive action by the Treasury. We believe it would have been preferable for the Treasury to deal with the issue through the normal regulatory process, rather than through the issuance of the Notice and temporary regulations. Concerns about transactions consummated in the "window period" could have been dealt with through some form of transition rule that would have phased out the benefit of pre-effective date arrangements at some point in time.

Second, the Notice suggests an intention to issue regulations broader than the hybrid branch examples described in the Notice to deal with arrangements that are "contrary to the policies and rules of subpart F." While the Regulations are generally directed to the hybrid branch arrangements described in the Notice, we are concerned by the broad scope of the Notice and the Legislative Proposal because of the difficulty that taxpayers will have in ascertaining whether transactions violate the policies of subpart F. To avoid this problem, we believe that regulations in this area should generally be narrowly targeted and should be accompanied by examples of transactions which do, and do not, result in recharacterization, along with a discussion of the rationale underlying the conclusions.

Appendix A -- Quotations from Relevant Floor Debates

1. Summary of Senate Amendments to the Bill (Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 4, p. 4357)

> "Both the House and Senate versions of this provision [(CFCs)] are concerned primarily with tax-haven devices."

2. Senate Floor Debates on Conference Report, by Mr. Kerr (OK-D; Finance Committee member) (Daily Congressional Record p. 20,551; Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 4, p. 4534)

> "This measure does not touch, tax wise, the operations of a legitimate manufacturing or similar operating company in another country which is a subsidiary of a company in the United States. It does, however, tax to U.S. shareholders income from tax-haven operations.

3. House Floor Debates on Conference Report, by Mr. Mills (Ark-D; Chairman of W&M Committee) (Daily Congressional Record p. 20,583; Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 4, p. 4507)

> "On the matter of deferred income of [CFCs], the direction of these amendments was to apply the provisions more particularly with respect to tax-haven income, that is, situations where the whole foreign corporation arrangement exists more for tax purposes than for business purposes."
>
> "The revised provisions concentrate on relatively passive forms of income where there is reason to believe that the incomes are being diverted to the foreign corporation principally for tax advantage." (Id., at p. 20585 and part 4, p. 4510)

4. House Floor Debates on Conference Report, by Mr. Byrnes (Wis-R) (Daily Congressional Record p. 20,589; Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 4, p. 4519)

> "I concur in the provisions [(CFCs)] of the conference report as I concurred in the provisions of the House bill which sought to tax the income of American-owned "paper" companies, those set up in tax-haven countries for the sole purpose of avoiding U.S. income taxes on transactions which would otherwise have been taxable in the United States."

5. House Floor Debates on Conference Report, by Mr. Baker (TN-R) (Daily Congressional Record p. 20,590; Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 4, p. 4521)

> "The bill closes many loopholes and tax evasion devices in the field of tax-haven corporations . . ."

6. House Floor Debates on Conference Report, by Mr. Betts (OH-R) (Daily Congressional Record p. 20,591; Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 4, p. 4522)

"The tax-haven abuse situation which cries for correction could have been dealt with on the basis of less sweeping change imposing less stringent conditions."

7. Senate Floor Debates, by Secretary of the Treasury, Mr. Dillon (testimony before the Senate Finance Committee on April 2, 1962) (Daily Congressional Record p. 17,142; Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 3, p. 3347)

"H.R. 10650, as passed by the House of Representatives, apart from tax havens, deals only peripherally with tax deferral for foreign income . . ."

8. Senate Floor Debates, by Mr. Kerr (OK-D) (Daily Congressional Record p. 17,240; Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 3, p. 3383)

"The amendment [McCarthy's amendment to tax foreign income only if earnings retained by the foreign corporation exceeded the "reasonable needs of the business"] would legalize foreign tax-havens to the fullest extent. The amendment would encourage all existing tax-havens to continue and encourage others to be created, because it permits the accumulation of earnings in foreign owned corporations, and once they reinvest them, they cannot be reached by American taxation."

9. Senate Floor Debate, by Mr. Lausche (OH-R) (Daily Congressional Record p. 17,241; Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 3, p. 3387)

"I believe that every reasonable effort should be made to eliminate the tax havens which admittedly exist in foreign countries. In my judgment, the House and Senate committee have striven to reach that objective . . . . I wish to eliminate tax-havens."

10. Senate Floor Debate, by Mr. Kerr (OK-D) (Daily Congressional Record p. 17,509; Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 3, p. 3619)

"As the House passed the bill . . . it eliminated tax-havens."

11. Senate Floor Debate, by Mr. Javits (NY-R) (Daily Congressional Record p. 17,510; Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 3, p. 3622)

"I sought [in my amendment which would treat all the European Economic Community as one country for purposes of Section 954(c)] to exclude specifically holding companies subject to tax and holding company tax havens."

12. House Floor Debates, by Mr. Ullman (OR-D) (Daily Congressional Record p. 4894; Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 2, p. 1510)

"Section 13 [CFCs] would also eliminate the present tax deferral privilege on the typical tax-haven operation of U.S. business subsidiaries - mere paper companies in many cases - which exist mainly for the purpose of receiving income they have done nothing to earn. This income, from dividends, interest, rents and royalties would, in normal circumstances be received by a U.S. parent corporation and taxed."

13. House Floor Debates, by Mr. King (CA-D or UT-D) (Daily Congressional Record p. 4967; Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 2, p. 1603)

> "The basis of the [CFC] provisions of the committee bill is simply that the present law does not justify continued unlimited deferral as an encouragement to investment of new U.S. funds in the developed countries."

14. House Floor Debates, by Mr. Barry (NY-R) (Daily Congressional Record p. 4969; Revenue Act of 1962, Legislative History of H.R. 10650, 87th Cong, 2nd Sess. (1962) part 2, p. 1606)

> "I am afraid that the casual reader of the bill and the committee report might be led to the conclusion that the bill is merely designed to reach such things as passive income or personal holding company-type income or tax haven income or income siphoned abroad but in truth derived from activities carried on in the United States. Let me say that if the proposed new taxes were confined to these kinds of income, it could properly be regarded as true tax-haven measure free from foreign implications."