New York State Bar Association

Tax Section

Report on Limitation on Benefits Provisions and Section 1(h)(11)

June 26, 2006

Report No. 1113

New York State Bar Association Tax Section

Report on Limitation on Benefits Provisions and Section 1(h)(11)*

The Office of Tax Policy and Internal Revenue Service 2005-2006 Priority Guidance Plan identifies treaty aspects of the definition of "qualified foreign corporation" ("QFC") under Section 1(h)(11) as an item in need of guidance.[1] Guidance would be welcome in that area, and this Report offers recommendations.

---

* The principal author of this Report is Deborah L. Paul. Helpful comments were received from Kimberly Blanchard, Peter Blessing, Peter Canellos, Peter Connors, Alan Granwell, Elizabeth Kessenides, Charles Kingson, Abraham Leitner, Richard Loengard, Richard Reinhold, Clemens Schindler (who also provided valuable research assistance), Michael Schler, David Sicular, Andrew Solomon, Eiko Stange, Andrew Walker.

[1] Office of Tax Policy and Internal Revenue Service, 2005-2006 Priority Guidance Plan, August 8, 2005, at International Issues, G.1.

Under Section 1(h)(11), a foreign corporation (that is not a passive foreign investment company) is a QFC if it "is eligible for benefits of a comprehensive income tax treaty with the United States."[2] Congress' decision to base Section 1(h)(11) on treaty eligibility presumably stemmed from a perception that dividends from a foreign corporation should be eligible for Section 1(h)(11) only if the foreign corporation's income is subject to tax in the corporation's resident jurisdiction. U.S. treaty negotiators have, over the years, grappled with an analogous concern—how to limit treaty benefits to treaty jurisdiction taxpayers. Accordingly, most U.S. treaties contain a "limitation on benefits" ("LOB") provision intended to provide treaty benefits only to treaty country residents[3] who have a stronger nexus with the treaty country than mere residence. We believe that, for purposes of Section 1(h)(11), the "eligible for benefits" requirement generally means that the foreign corporation must be a resident of the relevant treaty jurisdiction. Furthermore, as we stated in a prior Report, if the treaty contains an LOB clause, we believe that the foreign corporation must satisfy the LOB clause, as well,[4] although some would argue that the statute does not contain this additional requirement.

As will become apparent, despite the common purpose of Section 1(h)(11) and LOB provisions to cover treaty jurisdiction taxpayers, Section 1(h)(11)'s reliance on treaty eligibility is nevertheless an awkward fit. This Report discusses two aspects of QFC qualification under treaties.

First, the Report considers how the "base erosion" test found in many treaties should be applied when the dividend-paying foreign corporation owns subsidiaries. Specifically, it considers under what circumstances payments made by, and gross income of, a subsidiary should be taken into account for purposes of a base erosion test. This issue is not unique to Section 1(h)(11). It arises in applying treaties generally.

---

[2] The treaty must be one that the Secretary determines is satisfactory for purposes of Section 1(h)(11) and must include an exchange of information program.

[3] Under the United States Model Income Tax Convention (September 20, 1996) [hereinafter, the "U.S. Model"], a "resident" of a contracting state is generally defined as "any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature." Residency in a treaty jurisdiction is thus not necessarily the same criterion as being organized in the treaty jurisdiction. In Notice 2006-3, Section 3.02(2)(c) and Notice 2004-71, Section 3.03(2)(c), relating to information reporting in connection with Section 1(h)(11), the IRS refers to a foreign corporation "organized" in a treaty jurisdiction. We question whether the reference was intended to be to a foreign corporation "resident" in a treaty jurisdiction.

[4] *See* NYSBA Report on Dividends Provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Sept. 4, 2003), at 19.

We recommend that the Department of the Treasury ("Treasury") confirm that U.S. tax classification of a subsidiary is not relevant to the question whether payments made by, and gross income of, the subsidiary should be taken into account for purposes of applying a base erosion test to the parent corporation. We further recommend that if a subsidiary's losses are permitted to be used currently against the parent's income for local tax purposes, then the subsidiary's gross income and deductible payments generally should be taken into account in measuring the parent's qualification under the base erosion test. We make those recommendations both for purposes of Section 1(h)(11) and treaty analysis generally[5] and believe that Treasury has authority to adopt such guidance under existing treaties.

Second, the Report considers how the "active trade or business" test found in many treaties should apply in the context of Section 1(h)(11). The active trade or business test provides treaty benefits for specific items of income, while other LOB provisions typically provide treaty benefits for all items of income. We recommend that the active trade or business test be interpreted to permit a foreign corporation to qualify as a QFC if the foreign corporation and its subsidiaries have substantial business activities in the treaty jurisdiction and substantially all the U.S. source income (if any) of the foreign corporation and its subsidiaries qualifies for treaty benefits under the active trade or business test. We make this recommendation for purposes of Section 1(h)(11) only.

I. Treatment of Subsidiaries under the Base Erosion Test

The United States began including LOB provisions in treaties in the 1980s in order to combat treaty shopping.[6] LOB provisions are designed to establish that the person claiming treaty benefits has a nexus with the contracting state beyond residence.[7] Thus, LOB provisions require that the person claiming treaty benefits fit within one of a series of specified categories. One of these categories for entities is satisfaction of a two-pronged test, the "ownership/base erosion test". Under the ownership prong of this test, generally, at least 50

---

[5] Some of us would favor guidance interpreting base erosion in this manner for purposes of Section 1(h)(11), but not for treaty analysis generally.

[6] *See* Peter H. Blessing, *Watching Evolution: The LOB Article (and Related Benefit-Limiting Concepts) of U.S. Income Tax Treaties*, Tax Forum Paper No. 589 (2006), at 2 [hereinafter, "Blessing"]; H. David Rosenbloom, *Tax Treaty Abuse: Policies and Issues*, 15 Law and Pol'y Int'l Bus. 763 (1983).

[7] *See* Blessing, *supra* note 6, at 2; Berman and Hynes, *Limitation on Benefits Clauses in U.S. Income Tax Treaties*, 12 TM Int'l Jl. 692 (Dec. 8, 2000) 12 TMINTLJ 692; Anders, *The Limitation on Benefit Clause of the U.S. German Tax Treaty and Its Compatibility with European Union Law*, 18 Nw. J. Int'l L. & Bus. 165 (1997); Streng, *"Treaty Shopping": Tax Treaty "Limitation of Benefits" Issues*, 15 Hous. J. Int'l L. 1 (1992).

percent of the ownership of the entity must be in the hands of residents of the contracting states.[8] The base erosion prong is generally failed if 50 percent or more of the entity's gross income is paid in the form of deductible payments to persons who are not residents of the contracting states. The base erosion test backstops the ownership test, as explained in the Technical Explanation to the U.S.-German treaty:[9]

> The rationale for this two-part test is that since treaty benefits can be indirectly enjoyed not only by equity holders of an entity, but also by that entity's various classes of obligees, such as lenders, licensors, service providers, insurers and reinsurers, and others, it is not enough, in order to prevent such benefits from inuring substantially to third-country residents, merely to require substantial ownership of the entity by treaty country residents or their equivalent. It is also necessary to require that the entity's deductible payments be made in substantial part to such treaty country residents or their equivalents. For example, a third-country resident could lend funds to a German-owned German corporation to be reloaned to the United States. The U.S. source interest income of the German corporation would be exempt from U.S. withholding tax under Article 11 (Interest) of the Convention. While the German corporation would be subject to German corporation income tax, its taxable income could be reduced to near zero by the deductible interest paid to the third-country resident. If, under a Convention between Germany and the third country, that interest is exempt from German tax, the U.S. treaty benefit with respect to the U.S. source interest income will have flowed to the third-country resident.

Over time, base erosion tests have become increasingly refined. Regarding payments, in early versions, the test refers to meeting "liabilities",[10] in later versions to

---

[8] Under the ownership test, some treaties look solely at "the ultimate owner", disregarding any intermediate owner. Newer treaties following the U.S. Model, however, require that within a chain of ownership each person has to be entitled to the benefits of the treaty. In some treaties with Member States of the European Union, every person resident in the EU is treated as a good owner.

[9] Treasury Department Technical Explanation of the Convention and Protocol between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital and to certain other Taxes Signed at Bonn on August 29, 1989, discussion of Article 28. A Protocol to the U.S.-German Convention of 1989 was signed on June 1, 2006 but is subject to ratification in both countries.

[10] U.S.-Austria Convention, Article 16(1)d)(ii); U.S.-Cyprus Convention, Article 26(1)(b); U.S.-Czech Republic Convention, Article 17(1)f)ii); U.S.-Finland Convention, Article 16(1)(d)(ii); U.S.-Germany Convention, Article 28(1)(e)(bb) (but Technical Explanation refers to deductible payments); U.S.-Portugal, Article 17(1)(e)(ii); U.S.-Spain Convention, Article 17(1)(g)(ii); U.S.-Sweden Convention, Article 17(1)(d)(ii). *See also* U.S.-Belgium Supplementary Protocol, Article 12A(1)(a)(ii)("meet liabilities for interest or royalties"); Section 884(e)(4)(A)(ii)(but Treas. Reg. Sec. 1.884-5(c) refers to "deductible payments").

"deductible payments" [11] and in the U.S. Model and many subsequent treaties[12] to "payments that are deductible for income tax purposes in the person's State of residence". Regarding the period over which the base erosion percentage is meant to be calculated, early versions specify no period,[13] later versions refer to the "taxable year"[14] and others refer to the "taxable year" and provide a formula for determining gross income based on the prior year and the average of a specified number of prior years.[15] Under the ownership/base erosion test in the U.S. Model, for example, a resident of a Contracting State is entitled to benefits if the resident satisfies the 50 percent ownership test and:

> less than 50 percent of the person's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State (unless the payment is attributable to a permanent establishment situated in either State), in the form of payments that are deductible for income tax purposes in the person's State of residence.

Suppose the foreign corporation ("parent") owns a subsidiary. Under what circumstances should payments made by the subsidiary, and gross income of the subsidiary, be taken into account for purposes of the base erosion test as applied to parent?[16] We consider below the effect of the subsidiary's U.S. tax classification, its status for foreign tax purposes as fiscally transparent, foreign loss sharing or other combined reporting regimes and cross-border loss sharing.

---

11 U.S.-Denmark Convention, Article 22(2)f)ii); U.S.-France Convention, Article30(1)(d)(ii).

12 U.S.-Estonia Convention, Article 22(2)c)(ii)B); U.S.-Ireland Convention, Article 23(2)c)ii)B); U.S.-Japan Convention, Article 22(1)(f)(ii); U.S.-Latvia Convention, Article 23(2)c)(ii)B); U.S.-Luxembourg Convention, Article 24(2)(c)(ii)B); U.S.-Netherlands 2004 Protocol, Article 26(2)f)ii); U.S.-United Kingdom Convention, Article 23(2)f)(ii).

13 U.S.-Austria Convention, Article 16(1)d)(ii); U.S.-Cyprus Convention, Article 26(1)(b); U.S.-Czech Convention, Article 17(1)f)ii); U.S.-Germany Convention, Article 28(1)(e)(bb) ; U.S.-Spain Convention, Article 17(1)(g)(ii).

14 U.S. Model Treaty, Article 22(2)f)ii); U.S.-Estonia Convention, Article 22(2)c)(ii); U.S.-Japan Convention, Article 22(1)(f)(ii); U.S.-Luxembourg Convention, Article 24(2)(c)(ii)B); U.S.-Netherlands 2004 Protocol, Article 26(2)f)ii); U.S.-United Kingdom Convention, Article 23(2)f)(ii).

15 U.S.-Denmark Convention, Article 22(2)f)(ii) and (6)a); U.S.-France Convention, Article 30(1)(d)(i) and (6)(b); U.S.-Ireland Convention, Article 23(2)c)ii) and (8)a).

16 Because this Report relates in part to Section 1(h)(11), we examine the fact pattern involving parent, which is the potential dividend paying corporation, and its subsidiaries. A comprehensive analysis of LOB provisions would also examine the question whether the base erosion test, as applied to a subsidiary claiming treaty benefits, should take into account income and deductions of the subsidiary's parent or other affiliates.

A. U.S. Tax Classification of a Subsidiary

We believe that a subsidiary's classification for U.S. tax purposes should not be relevant to the question whether the subsidiary's income and deductions should be taken into account in a base erosion test applied to parent. Suppose that parent owns a subsidiary that is a disregarded entity for federal income tax purposes. Suppose that the subsidiary incurs various deductions and has gross income. It might be argued that the subsidiary's items of gross income and deduction should be taken into account in the base erosion test, because for U.S. tax purposes, those are items of income and deduction of parent. Further, under the U.S. Model, and similarly in many other treaties, a term not defined in the treaty has "the meaning which it has at that time under the law of that State for the purposes of the taxes to which the Convention applies," unless the "context otherwise requires." Article 3(2).[17] Indeed, the term "gross income" in a base erosion test is interpreted to mean "gross income" under U.S. principles.[18] It might be argued that if qualification under Section 1(h)(11) (or eligibility for treaty benefits against U.S. tax) is the purpose for which the analysis is being made, the U.S. tax characterization of the subsidiary's income and payments as the parent's income and payments should apply. Although we believe that Treasury would have the authority under *Biddle v. Commissioner*[19] and Article 3(2) to promulgate guidance to that effect, that approach does not take account of the purposes of the base erosion test and thus the context "otherwise requires."[20]

The purpose of the base erosion test is to prevent third country residents from receiving U.S. source income, subject to beneficial treaty withholding rates, through a treaty country entity, which zeroes out its income for treaty country tax purposes through deductible payments to third country residents. As stated in the Technical Explanation to the U.S. Model, the purpose of the base erosion test "is to determine whether the income derived from the source State is in fact subject to the tax regime of that other State." Thus, base erosion tests test whether

---

17 The U.S. Model states that the term "person" "includes an individual, an estate, a trust, a partnership, a company, and any other body of persons." Article 3(1)a).

18 The discussion of base erosion in the Technical Explanation to the U.S. Model states that, because the term "gross income" is not defined in the U.S. Model, "the United States will ascribe the meaning to the term that it has in the United States. In such cases, 'gross income' will be defined as gross receipts less cost of goods sold." Technical Explanation to the U.S. Model, discussion of Article 22. *See also* PLR 200551016, *infra* note 52 (dividends, exempt from Dutch tax under a "participation exemption," are gross income for purposes of the U.S.-Netherlands treaty).

19 302 U.S. 573 (1938).

20 *See* Blessing, *supra* note 6, at 33-34 (disregarded entity status for U.S. tax purposes does not seem relevant for purposes of applying the base erosion test to a resident of another contracting state).

parent's deductible payments to third parties are excessive.[21] Whether parent is being used as an intermediary in the manner that base erosion tests aim to prevent is independent of the U.S. tax classification of parent's subsidiaries.

Suppose that parent is resident in one jurisdiction and subsidiary, a disregarded entity for U.S. tax purposes, is resident in another foreign jurisdiction. The fact that subsidiary is disregarded for U.S. tax purposes generally has no bearing on whether subsidiary is regarded for tax purposes in parent's jurisdiction. Assuming subsidiary is regarded for tax purposes in parent's jurisdiction, generally, subsidiary's gross income will not be includible by parent and subsidiary's deductions will not be deductible by parent for tax purposes in parent's jurisdiction.[22] Thus, subsidiary's income and deductions should not be taken into account for purposes of a test designed to determine whether deductions against parent's jurisdiction's tax regime are excessive.

Suppose instead that parent and subsidiary are resident in the same jurisdiction and subsidiary is disregarded for U.S. tax purposes. In such a case, as discussed below, subsidiary may, in certain cases, facilitate the type of intermediary arrangement that base erosion tests are aimed against, but that is not a function of U.S. tax classification of the subsidiary.

U.S. individuals do engage in treaty shopping in order to bring dividends from their foreign corporations within the ambit of Section 1(h)(11), but including the income and deductions of disregarded entity subsidiaries in the base erosion test of a parent by reason of those subsidiaries being disregarded for U.S. tax purposes would not likely be an effective means of countering such tax planning.[23] In cases where U.S. individuals own a foreign corporation (the "Historic Corporation") that is prepared to pay a dividend but is not eligible for treaty benefits, the U.S. individuals might attempt to contribute the stock of that corporation to a foreign corporation, resident in a different jurisdiction, that is eligible for treaty benefits (the "New Parent Corporation"), and then eventually cause the Historic Corporation to distribute

---

[21] Base erosion tests do not pick up all deductions. For example, "[d]epreciation and amortization deductions, which are not 'payments,' are disregarded for this purpose." Technical Explanation to the U.S. Model, discussion of Article 22.

[22] There are jurisdictions that permit a non-resident subsidiary's losses to offset a parent's income, as discussed below under Section I.B.2. and 4. But, this does not make the U.S. tax classification of the subsidiary relevant to base erosion.

[23] Jeffrey Rubinger, *Turning Water into Wine: The Use of Offshore Holding Companies to Convert Low-Taxed Income into "Qualified Dividend Income"* (May 11, 2004), 2004 TNT 92-53

funds to New Parent Corporation which would distribute the funds to the U.S. individuals. Taxes imposed by the New Parent Corporation's jurisdiction may provide obstacles, but many jurisdictions have beneficial "participation exemptions" which exempt dividend income from subsidiaries and gain on sales of stock of subsidiaries. An election to treat the Historic Corporation as a disregarded entity may facilitate avoidance of Subpart F on distributions from the Historic Corporation to the New Parent Corporation, but will often not be essential to the tax planning.[24] Thus, treating Historic Corporation's income and deductions as New Parent Corporation's income and deductions for purposes of the base erosion test if a disregarded entity election is made for the Historic Corporation likely would not deter such treaty shopping.

The conclusion that U.S. tax classification of a subsidiary should not be relevant to the base erosion calculation for parent is consistent with Treasury Regulation Section 1.894-1(d)(1). Under that Regulation, eligibility for treaty benefits with respect to an item of income received by an entity that is fiscally transparent for purposes of U.S. tax law or the tax law of another jurisdiction depends on the item of income being "derived by" a resident of the applicable treaty jurisdiction. An item of income paid to an entity is considered to be derived by the entity only if the entity is not fiscally transparent under the laws of the entity's jurisdiction. The item is considered to be derived by an interest-holder in the entity only if the interest holder is not fiscally transparent in the interest holder's jurisdiction and the entity is fiscally transparent under the laws of the interest holder's jurisdiction.[25] Thus, local law classification controls for purposes of Treasury Regulation Section 1.894-1(d)(1).

B. Foreign Tax Classification of a Subsidiary

While a subsidiary's U.S. tax classification should not be relevant to the parent's qualification under a base erosion test, the subsidiary's classification for local tax law purposes is relevant. If a subsidiary's deductions may be used against a parent's income for local tax purposes, then an end-run around the base erosion test is possible, unless the base erosion test takes into account the subsidiary's deductions.

Recall that the structure that motivated base erosion tests in the first place was a scenario where a third-country resident would lend funds to a treaty jurisdiction corporation

---

[24] For example, recently enacted Section 954(c)(6), applying a look-through rule for dividends from related persons, may cause such a distribution not to be considered foreign personal holding company income.

[25] Treas. Reg. Sec. 1.894-1(d)(1). *See also* Treas. Reg. Sec. 1.894-1(d)(5), examples 1,2, 7 and 8.

owned by treaty residents, which funds would be reloaned to the United States. The U.S. source interest income of the treaty jurisdiction corporation would be exempt from U.S. withholding tax under the U.S. treaty with the treaty jurisdiction, and the treaty jurisdiction corporation would reduce its treaty jurisdiction income tax by offsetting its U.S. source interest income with the deductible interest paid to the third-country resident. If a subsidiary's deductible payments offset parent's income under local tax law but are not taken into account under the base erosion test, then the base erosion test could be avoided by having the third-country resident lend money to a subsidiary of parent with parent reloaning the funds to the United States.[26] If the subsidiary's deductible payments to the third country resident are not taken into account for base erosion purposes, then the transaction would not cause parent to run afoul of the base erosion test. Indeed, counterintuitively, the transaction would enhance parent's qualification under the base erosion test by increasing parent's gross income. The U.S. source interest income of parent would be exempt from U.S. withholding under the U.S. treaty, and parent would reduce its treaty jurisdiction income by offsetting parent's interest income with the subsidiary's deductible payments. That treatment does not seem appropriate. Such use of a subsidiary should not lead to parent's satisfaction of the base erosion test.

The transaction described above—in which deductible payments of a subsidiary to non-treaty residents are separated from the parent's gross income—is reminiscent of arrangements designed to separate income earned in foreign subsidiaries from a foreign parent's foreign tax liability in order to take advantage of the "technical taxpayer" rule for foreign tax credit purposes.[27] Under Treasury Regulation Section 1.901-2(f)(3), much turns on whether subsidiaries in a combined group are jointly and severally liable under local law for the group's income. In the *Guardian Industries* case, the court concluded that Luxembourg subsidiaries of a Luxembourg parent were not jointly and severally liable,[28] while in a private ruling, the IRS concluded that German subsidiaries in a German Organschaft were.[29] In a prior Report, we argued for an expansion of Treasury Regulation Section 1.901-2(f)(3) in order to limit the potential for related parties to separate foreign tax liability from the taxable income giving rise to

---

[26] Perhaps the loaned funds would be distributed or loaned from subsidiary to parent. Under many local tax regimes, there would not be any incremental tax resulting from such a distribution or loan.

[27] *See* Treas. Reg. Sec. 1.901-2(f)(1) and (3). *See also* L. Sheppard, *Where Else is the Guardian Industries Result Available?* (April 17, 2006) 2006 TNT 74-4.

[28] *Guardian Industries Corp. and Subsidiaries v. U.S.*, *65* Fed. Cl. 50, 2005-1 U.S.T.C. P50,263 (2005).

[29] PLR 200225032.

the tax liability.[30] Likewise, we believe that related parties should not be able to avoid application of the base erosion test by separating deductions from gross income where the overall tax liability of the related parties may be reduced on account of the deductions.

1. Subsidiary is Not Liable to Tax for Local Tax Law Purposes

Suppose that the subsidiary is itself not liable to tax for local tax law purposes.[31] Instead, as under the U.S. partnership tax regime, income and deductions of the subsidiary are allocated to the parent and the parent owes tax on those amounts. In this scenario, the subsidiary's income and deductible payments should clearly be taken into account in the base erosion test for parent.

2. Subsidiary is Liable to Tax for Local Tax Law Purposes but Subsidiary's Losses may be Used under Local Tax Law against Parent's Income

Suppose that the subsidiary is liable to tax for local tax law purposes, but parent and subsidiary file on a basis that permits subsidiary's losses to be used against parent's income.[32] There are numerous variations of such regimes.

Under one variation ("Consolidation Regimes"), tax liability of the group is calculated by reference to the group's aggregate income and loss. For example, in the Netherlands, a subsidiary that is part of a "fiscal unity" is liable for tax, but all the subsidiary's assets, liabilities and activities are attributed to the parent. Tax is imposed as if there were a single taxpayer.[33] As we understand it, for purposes of calculating tax, the Netherlands fiscal unity regime treats subsidiaries similarly to "disregarded" entities under U.S. tax law.

Likewise, under Australia's new tax consolidation regime, effective from July 1, 2003, groups of corporations are treated as a single entity. Subsidiaries are treated as part of the

---

30 NYSBA Tax Section Report on Regulation Section 1.901-2(f)(3) and the Allocation of Foreign Taxes Among Related Persons, April 4, 2005 [hereinafter, the "NYSBA Foreign Tax Credit Report"], at 4 (the "joint and several" requirement of Treas. Reg. Sec. 1.901-2(f)(3) should be removed, and the circumstances under which foreign income tax should be viewed as "imposed on the combined income of two or more related persons" should be defined).

31 Such a subsidiary would generally not qualify as a "resident" of the treaty country for treaty purposes. *See, e.g.*, U.S. Model, Article 4(1) (resident must be liable to tax in contracting state).

32 The extent to which a subsidiary is liable to tax in a combined filing regime is sometimes a matter of debate. In *Guardian Industries*, for example, Luxembourg experts disagreed with one another on the central question whether subsidiaries were jointly and severally liable for the group's tax liability.

33 See International Fiscal Association, cahiers de droit fiscal international, volume 89b (2004) [hereinafter "IFA Cahiers"], chapter on the Netherlands, Rudolf J. de Vries, at 465-8.

parent. All assets, liabilities, actions and events relating to the subsidiary are attributed to the parent. Thus, losses incurred by the subsidiary offset the group's consolidated income.[34]

Under another variation ("Attribute Transfer Regimes"), each member of the group separately computes its tax liability, but the regime permits tax attributes, such as losses, to be transferred from one member to another. Under the U.K. "group relief" regime, for example, each company in a group calculates its own profits, losses and tax liability, but a company that is part of a group may "surrender" its losses to another company (the "claimant company") in the group. The claimant company may use the surrendering company's losses against the claimant company's profits for the year in which the surrendering company incurred the losses. Carrybacks and carryforwards of surrendered losses are not permitted.[35]

As a policy matter, under a Consolidation Regime or an Attribute Transfer Regime, we believe that the subsidiary's deductible payments should be taken into account in determining whether parent satisfies the base erosion test.[36] Otherwise, it would not be difficult for taxpayers to satisfy the base erosion test by placing income in the parent and "bad" deductions in a subsidiary. Such a structure would appear to violate the purposes of base erosion tests.

Nevertheless, as a matter of treaty interpretation it could be argued that Treasury does not have the authority to interpret base erosion tests to take into account a subsidiary's income and deductions for purposes of determining parent's qualification under the base erosion test, because most base erosion tests refer to the "person's" income and deductions. In testing the parent corporation's qualification, the term "person" would generally refer to the parent corporation.[37] Arguably, base erosion must be analyzed corporation by corporation. If Treasury

---

[34] IFA Cahiers, chapter on Australia, Paul O'Donnell and Ken Spence, at 124, 126, 130-1. The precise extent to which subsidiaries in an Australian consolidated group are liable to tax has been a subject of discussion in relation to the crediting of Australian tax arising from income earned by such subsidiaries in a *Guardian Industries* context. *See* the NYSBA Foreign Tax Credit Report, at 16-17 (each member generally jointly and severally liable, but if group members enter into a tax sharing agreement, then each member is liable as allocated under the tax sharing agreement); L. Sheppard, *IRS Will Continue to Fight Check-the-Box Foreign Tax Credits*, October 12, 2004, 2004 TNT 197-6 (IRS denies any deal was struck with Australia regarding creditability of taxes attributable to subsidiary income).

[35] IFA Cahiers, chapter on the United Kingdom, Yash Rupal, at 688, 693-4.

[36] *See* Blessing, *supra* note 6, at 34 (applying base erosion on a standalone basis to companies that are part of a fiscal grouping seems "too easily susceptible of abuse").

[37] In the U.S.-France Convention, the term "person" "includes, but is not limited to, an individual and a company." Article 3(1)(d). The U.S.-German Convention is the same. Article 3(1)(d). In the U.S. Model,

believes that it does not have the authority to interpret treaty references to "person" to cover combined filing groups, then we would recommend that new treaties be drafted in a manner that does measure base erosion on a group-wide basis. In addition, Treasury could consider applying base erosion by reference to combined groups for purposes of the Section 1(h)(11) "eligibility for benefits" test under existing treaties but not for treaty interpretation generally. Guidance aimed only at Section 1(h)(11) might be simpler than guidance for purposes of treaty analysis generally.

On balance, although a substantial minority disagree, we believe that Treasury does have the authority (for Section 1(h)(11) purposes and treaty analysis generally) to interpret existing base erosion tests to take into account income and deductions of subsidiaries that report on a basis that permits the deductions of one entity to offset income of another. *Biddle v. Commissioner*[38] has long stood for the proposition that foreign tax regimes must be interpreted in light of U.S. tax principles and concepts. As mentioned above in Section I.A., under *Biddle* and Article 3(2) of the U.S. Model and similar treaties,[39] we believe that Treasury would have the authority to adopt guidance interpreting the term "person" to mean a parent together with subsidiaries that are disregarded entities for U.S. tax purposes (although, as discussed above, we do not recommend such an approach). By the same token, we believe that Treasury has the authority to disregard the disregarded entity regulations and instead adopt guidance applying an interpretation that is consistent with the purposes of base erosion tests.

The purpose of the base erosion tests is to ensure that the income derived from the source state is in fact subject to the tax regime of the other state. Where a treaty partner imposes tax on a combined basis, the truest measure of the extent to which the income of parent is subject to tax in the treaty jurisdiction is a measure that takes into account income and deductions of the combined filing group. Thus, under a Consolidation Regime, the fact that the parent reports the income and deductions of the subsidiary provides a basis for viewing such income and deductions as parent's for base erosion purposes. Indeed, under some such regimes, parent is the only entity liable for the group's combined liability.[40] Under an Attribute Transfer Regime, the

---

"'person' includes an individual, an estate, a trust, a partnership, a company, and any other body of persons." Article 3(1)a).

38 302 U.S. 573 (1938).

39 As mentioned, Article 3(2) provides that a term not defined in the treaty has "the meaning which it has at that time under the law of that State for the purposes of the taxes to which the Convention applies," unless the "context otherwise requires."

40 *See* discussion of *Guardian Industries*, *supra* notes 27-30, 32 and 34, and accompanying text.

subsidiary's deductions could be considered to be those of the relevant "person" (parent), because parent claims those deductions under the Attribute Transfer Regime. Applying the base erosion test to the treaty jurisdiction filing group ensures that the U.S. source income derived by the group is in fact subject to the tax regime of the treaty jurisdiction and therefore such a rule is entirely consistent with the purpose behind the base erosion test. Moreover, if base erosion is not applied on a groupwide basis, the base erosion test could be avoided. Therefore, we believe that Treasury has authority to adopt such a rule.

The IRS has in the past imposed U.S. concepts for purposes of treaty interpretation. Under the authority of Section 7701(l), the anti-conduit regulations of Treasury Regulation Section 1.881-3 disregard conduit entities under specified circumstances for purposes of Section 881, "including for purposes of applying any relevant income tax treaties."[41] Section 7701(l) could lend support for the IRS's authority here as well. The "directly or indirectly" language found in most base erosion tests also lends support.[42]

There are a number of methodologies that could be adopted to take income and payments of a subsidiary into account. Under a "Consolidated Methodology," the base erosion test would apply on a consolidated basis to a foreign corporation that is a parent of a group. All the income and deductible payments of the parent and its subsidiaries (other than income and deductions arising from intercompany transactions) would be taken into account in calculating whether the parent satisfies the base erosion test under this approach. For example, suppose that parent and subsidiary file on a combined basis in a Consolidation Regime.[43] Suppose that parent has $100 of gross income, subsidiary has $1 of gross income, and subsidiary has a total of $101 of deductions, of which $1 represent payments to treaty residents and $100 represent deductible payments to non-treaty residents (the "Conduit Example"). Under the Consolidated Methodology, the base erosion test, as applied to parent, would be calculated by comparing the sum of parent and subsidiary's gross incomes of $101 with the sum of parent and subsidiary's

---

41 Treas. Reg. Sec. 1.881-3(a)(3)(ii)(C).

42 Section 884(e)(4)(A)(ii) and Treas. Reg. Sec. 1.884-5(c) also incorporate a "directly or indirectly" test. However, "directly or indirectly" in base erosion tests and Section 884 modifies the making of deductible payments, as distinguished from the person's gross income, and was likely intended to capture the making of payments through intermediaries (whether related or unrelated, whether filing on a combined basis with the "person" or not).

43 Although the facts of this example assume that parent and subsidiary file under a Consolidated Regime, the Consolidated Methodology could equally be applied to Attribute Transfer Regimes.

deductible payments to non-treaty residents of $100 (and disregarding any intercompany payments). Parent would fail the base erosion test.

Other approaches may also be appropriate. Suppose that under an Attribute Transfer Regime, parent has $1 of gross income, subsidiary has $100 of gross income, subsidiary has $101 of deductible payments of which $100 are paid to treaty residents and $1 is paid to a non-treaty resident and subsidiary elects to surrender its $1 of net loss to parent (the "Non-Conduit Example").[44] These facts raise the issue as to how much of subsidiary's loss should be attributed to the payments subsidiary made to treaty residents as compared to payments subsidiary made to non-treaty residents. Under one approach, parent would fail the base erosion test, because parent's gross income is $1 and parent used $1 of net loss of subsidiary and subsidiary made at least $1 of deductible payments to non-treaty residents. This approach is inappropriately punitive, as it treats all surrendered losses as bad to the extent of any bad payments made by the subsidiary. Another approach (the "Pro Rata Methodology") would be to measure base erosion by using parent's gross income ($1) and by apportioning the surrendered loss between bad and good deductions based on the proportion of subsidiary's gross deductions that were bad and good. Thus, 1/101th of the $1 of surrendered loss would be considered to represent a bad payment. Under this approach, parent would satisfy the base erosion test, because 1/101th of a dollar is less than 50 percent of the $1 of gross income of parent.[45] Further, under this approach if subsidiary had positive taxable income so that zero losses were eligible to be surrendered, none of the subsidiary's gross income or deductions would be taken into account for purposes of the base erosion test.

The appropriate approach may depend on the type of local combined regime. For example, the Pro Rata Methodology may be more appropriate for an Attribute Transfer Regime, while the Consolidated Methodology may be more appropriate for a Consolidation Regime.

Some local tax regimes permit filing on a basis that permits a parent corporation currently to utilize losses incurred by a subsidiary to reduce tax liability in the parent's

---

[44] Although the facts of this example assume that parent and subsidiary file under an Attribute Transfer Regime, the approaches described in this paragraph could equally be applied to Consolidated Regimes.

[45] Under the Consolidated Methodology, comparing the sum of the gross income of the parent and the subsidiary ($101 in the Non-Conduit Example) with the sum of the bad payments of the parent and the subsidiary ($1 in the Non-Conduit Example), parent would satisfy the base erosion test in the Non-Conduit Example, because the $1 of aggregate bad payments is less than 50 percent of the aggregate gross income of $101.

jurisdiction, even if the subsidiary is not a resident of parent's jurisdiction. The subsidiary is permitted to be a member of the filing group despite the subsidiary's non-residence.[46] The principles discussed above in this Part I.B.2. would appear to be equally applicable in such a context. If deductible payments may be lodged in a non-resident subsidiary, while "good" gross income is earned by the parent, the base erosion test may be avoided. That being said, taking into account a non-resident subsidiary's deductible payments and gross income for purposes of base erosion is arguably more difficult to reconcile with the references to "person" in the base erosion provisions than is the case with a resident subsidiary.

3. Subsidiary is Liable to Tax for Local Tax Law Purposes and Subsidiary's Losses may Not be Used under Local Tax Law against Parent's Income

Suppose that local tax law does not permit parent and subsidiary to offset parent's income with subsidiary's losses, or that parent and subsidiary have not elected to apply such regime. There may nonetheless be ways that parent and subsidiary could avoid the application of a base erosion test by placing good income in parent and bad deductions in subsidiary.

Suppose, for example, that a third country resident lends funds to subsidiary, subsidiary lends those funds to parent and parent lends those funds to a U.S. person. Subsidiary and parent each have offsetting interest income and expense on their separate returns. Thus, no tax may be due in the treaty jurisdiction. Yet, parent arguably satisfies the base erosion test. Either its deductible payments to subsidiary are ignored, because they are payable to a related person or they are treated as good deductible payments because subsidiary, like parent, is a resident of the treaty jurisdiction. This example is no more sympathetic than the Conduit Example. It uses an intercompany note, rather than a combined reporting system, to zero out the local country tax.

In this example, parent should not satisfy the base erosion test. That result could be obtained by applying the Consolidated Methodology. Thus, in the example (assuming there were no gross income or deductions other than as described), parent's interest income would be compared with subsidiary's deductible payments to the third party, and, because the amount of the deductible payments would be the same (or almost the same) as the gross income, parent

[46] As discussed below in Section I.B.4., the *Marks & Spencer* decision may require European Union jurisdictions to permit such loss utilization in certain circumstances.

would fail the base erosion test. However, application of the Consolidated Methodology to a parent that is not using the subsidiary's losses under local tax law is more difficult as a technical authority matter than it is in the case of a Consolidated Regime or an Attribute Transfer Regime, because of the treaties' reference to income and deductible payments of the "person."

Another approach may be to evaluate parent's satisfaction of the base erosion test solely by reference to parent's items but to treat the intercompany interest expense as bad either in total (because, for example, subsidiary does not satisfy the base erosion test or any other LOB provision) or on a look-through basis (i.e., treating parent's interest payments to subsidiary as bad to the extent that subsidiary's payments, including subsidiary's interest payments to the third-country resident, are bad).[47] Analyzing parent on a stand-alone basis in this manner presents no authority question under the treaties.

The above example is an extreme case and may well be covered by the anti-conduit rules of Treasury Regulation Section 1.881-3. To take a less extreme example, suppose that subsidiary operates a business that earns about $100 of net income a year and that parent is a holding company. A third country resident could lend funds to subsidiary, subsidiary could distribute those funds to parent and parent could onlend those funds to a U.S. person. Suppose that the amount of interest per year on each of the loans is $100, that the interest on subsidiary's borrowing is fully deductible by the subsidiary and that under a participation exemption or dividends received deduction regime under local tax law, the distribution from subsidiary to parent is tax exempt. Parent will owe tax on $100 of interest income per year, and subsidiary will owe zero tax, because subsidiary's operating income is reduced by subsidiary's $100 of annual interest expense. Thus, parent and subsidiary together would owe tax on the same amount of income ($100) as they would have owed tax on if they had not entered into the conduit arrangement. This case too may be covered by Treasury Regulation Section 1.881-3. It is debatable whether parent should fail the base erosion test on these facts.

4. Cross-Border Loss Sharing: *Marks & Spencer.*

Situations in which parent is a taxpayer in a different jurisdiction from subsidiary raise yet further complexities and highlight the ambiguities relating to timing that are inherent in

---

[47] *Cf.* new Section 954(c)(6) (look-through for certain payments among related controlled foreign corporations for purposes of determining foreign personal holding company income).

base erosion tests. Many local tax regimes do not permit parent to deduct losses incurred by a subsidiary that is resident in a different jurisdiction from parent but do permit parent to deduct losses incurred by a subsidiary that is resident in the same jurisdiction as parent.[48] In *Marks & Spencer*, the taxpayer argued that such treatment by the United Kingdom violated European Community law, because it discriminated against persons establishing subsidiaries outside the U.K. The European Court of Justice held that the U.K. parent was entitled to deduct losses of its foreign subsidiary if it was able to demonstrate that the losses could not be utilized by the subsidiary or a third party in the subsidiary's state of residence.[49]

Thus, under *Marks & Spencer*, if the subsidiary can carryback or carryforward its loss in the subsidiary's state of residence, parent would not be able to deduct the foreign subsidiary's losses. Typically, under *Marks & Spencer*, the type of event that would trigger the parent's right to deduct the foreign subsidiary's losses is the expiration of the loss carryback and loss carryforward periods in the subsidiary's state of residence.[50] It is unclear, under *Marks & Spencer* whether parent is entitled to deduct the subsidiary's loss in the year that the triggering event occurs or in the year that the subsidiary originally incurred the loss (in which case such year would be required to be reopened by the parent's jurisdiction if the statute of limitations on that year had closed). For example, suppose that in Year One, subsidiary incurs a $100 loss and suppose that subsidiary's jurisdiction permits losses to be carried forward for five years (i.e., to Years Two through Six). *Marks & Spencer* could be interpreted to require that parent be permitted to deduct the $100 in Year Seven. Alternatively, it could be interpreted to require that

---

[48] *See* discussion above in Section I.B.2 regarding local tax regimes that permit combined reporting with non-resident subsidiaries.

[49] *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Judgment of the Court (Grand Chamber) (December 13, 2005) (Articles 43 EC and 48 EC generally do not prevent a Member State from preventing a resident parent company from deducting losses incurred in another Member State by a subsidiary established in that other Member State while allowing the resident parent to deduct losses incurred by a resident subsidiary, but it is contrary to Articles 43 EC and 48 EC to do so where the non-resident subsidiary has "exhausted the possibilities available in its State of residence of having the losses taken into account"). *See also* Press Release No. 107/05 of the Court of Justice of the European Communities (December 13, 2005) (it is "contrary to freedom of establishment to preclude the possibility for the resident parent company to deduct the losses incurred by non-resident subsidiaries from its taxable profits, if the parent company shows that those losses were not and could not be taken into account in the State of residence of those subsidiaries.").

[50] Another trigger for the parent's utilization of the subsidiary's losses might be liquidation of the subsidiary.

parent be permitted to deduct the $100 in Year One (and require that parent's jurisdiction reopen parent's Year One if the statute of limitations on parent's Year One has closed).[51]

In light of the possibility that subsidiary's losses may be used against parent's income eventually under *Marks & Spencer*, the scenario raises the issue whether these losses of subsidiary should be taken into account under the base erosion test. We believe that the subsidiary's losses should not be taken into account. To begin with, *Marks & Spencer* is a highly controversial case and it is unclear how it will be applied. There is a great deal of debate over what it requires. Further, whatever is required, it is clear that, in general, it does not require that a parent be permitted currently to deduct the subsidiary's losses. Rather, the parent deduction (whether it is taken in Year One or Year Seven in the example) is not triggered until years have passed. Any approach that required taking into account the subsidiary's deductions years after the payments were made giving rise to the deductions would be very difficult to administer. Further, *Marks & Spencer* does not appear to present significant planning opportunities of the type that the base erosion test is aimed against.

That being said, *Marks & Spencer* does highlight significant timing issues inherent in base erosion tests. First, suppose a single corporation incurs a net operating loss in Year One and has taxable income in Year Two. Suppose that the net operating loss is driven by large deductible payments to non-treaty residents. Arguably, the corporation should not satisfy the base erosion test, because if gross income and deductible payments for Year One and Year Two are looked at together, the deductible payments would be excessive. However, many treaties apply base erosion to the "taxable year". It would appear that under those tests parent satisfies base erosion in Year Two. In other treaties, gross income is measured based on a retrospective average, but deductions do not appear to be. Under those formulations, as well, parent may satisfy base erosion. Thus, taxpayers may be able to structure around base erosion tests by compartmentalizing gross income in some years and bad deductions in other years. If in the case of a single corporation without subsidiaries, losses in one year do not affect the base erosion calculation in a later year, then certainly a subsidiary's losses should not be taken into account in analyzing the parent's base erosion in the *Marks & Spencer* case, where the

---

[51] *See* Michael Lang, *The Marks & Spencer Case - The Open Issues Following the ECJ's Final Word*, 46 European Taxation 54 (2006), at 62-63.

subsidiary's losses become deductible by the parent corporation years after the subsidiary incurs the losses.

Second, it is unclear how base erosion tests are meant to deal with payments that are not deductible in the year they are made but are instead disallowed under a special rule or are deductible in a later year, for example, under thin capitalization rules or rules analogous to the "applicable high yield discount obligation" rules. Treasury Regulation Section 1.884-5(c) applies its own variant of a base erosion test and states that the term "deductible payments" for that purpose:

> includes payments that would be ordinarily deductible under U.S. income tax principles without regard to other provisions of the code that may require the capitalization of the expense, or disallow or defer the deduction. Such payments include, for example, interest, rents, royalties and reinsurance premiums.

It is not clear whether the above rule applies for purposes of treaty interpretation or is limited to the application of Section 884.[52]

In sum, we believe that U.S. tax classification of a subsidiary is not relevant to the question whether payments made by, and gross income of, the subsidiary should be taken into account for purposes of parent's qualification under a base erosion test. Further, we believe that, as a general matter, if a subsidiary's losses are permitted to be used currently against parent's income for local tax purposes, then the subsidiary's gross income and deductible payments should be taken into account in measuring parent's qualification under the base erosion test and that Treasury has the authority to promulgate such a rule under existing treaties. We believe that *Marks & Spencer*-type losses of subsidiaries, deferred and contingent as to utilization, should not result in a subsidiary's income and deductions being taken into account for purposes of parent's base erosion qualification.

---

[52] Additional issues under base erosion include whether debt or equity status of a foreign corporation's outstanding interests should be analyzed under U.S. tax principles or foreign. For example, in Luxembourg, a common holding company jurisdiction, "preferred equity certificates" and "convertible preferred equity certificates" are generally considered to be equity for U.S. tax purposes and debt for Luxembourg tax purposes. Indeed, these instruments may be the very interests on which a dividend potentially qualifying under Section 1(h)(11) is made. Another issue is whether dividends from a subsidiary to a parent, exempt under parent's jurisdiction's "participation exemption" are considered gross income for purposes of base erosion. The IRS has privately ruled that such dividends do count as gross income for purposes of the U.S.-Netherlands treaty. *See* PLR 200551016.

II. Active Trade or Business Test

Many treaties provide that a foreign corporation satisfies the LOB provision of the treaty with respect to an item of income derived from the U.S. if the income is connected with an active trade or business conducted by the foreign corporation in the treaty jurisdiction (the "active trade or business test"). There is uncertainty as to how to apply this test for purposes of Section 1(h)(11), because the active trade or business test was designed to determine whether income earned by the foreign corporation is eligible for treaty benefits, whereas Section 1(h)(11) requires a determination whether dividends paid by the foreign corporation are eligible for Section 1(h)(11) benefits. The active trade or business test presupposes an item of income derived from the U.S., while Section 1(h)(11) presupposes a dividend received by a U.S. individual.

We believe that dividends from certain foreign corporations should be entitled to qualify for Section 1(h)(11) under an active trade or business test contained in a treaty by reason of the foreign corporation and its subsidiaries having substantial business activities in the treaty jurisdiction, despite the foreign corporation and its subsidiaries having little or no income derived from the United States. Indeed, the absence of U.S. source income shows that the foreign corporation was not engaged in the treaty shopping that LOB provisions were intended to prevent.

Consider the case of a foreign corporation resident in a treaty jurisdiction and having, either directly or through subsidiaries, substantial business activities in the treaty jurisdiction. Suppose the foreign corporation is not publicly traded and either cannot determine its status under a base erosion/ownership test because of the uncertainties inherent in that test or fails the base erosion test because the corporation has issued debt to lenders without regard to whether those lenders are residents of the U.S. or the treaty jurisdiction. Suppose further that the treaty contains an active trade or business test but that the foreign corporation and its subsidiaries either derive no income from the United States or that substantially all such income qualifies under the active trade or business test (the "Active Business Example"). Such a foreign corporation should qualify as a QFC, because its conduct of substantial business activities in the treaty jurisdiction, together with the fact that any U.S. source income of the group qualifies for

treaty benefits, means that the foreign corporation does not implicate the tax residence concerns underlying LOB provisions and Section 1(h)(11).

Most of the tests in an LOB provision provide treaty benefits to all the income derived by a corporation from the United States (the "Generic Tests"). The ownership/base erosion test and the publicly-traded test are examples of Generic Tests. Active trade or business tests, by contrast, provide item-by-item treaty benefits. In the U.S. Model, the active trade or business test provides as follows: [53]

> A resident of a Contracting State not otherwise entitled to benefits shall be entitled to the benefits of this Convention with respect to an item of income derived from the other State, if: i) the resident is engaged in the active conduct of a trade or business in the first-mentioned State, ii) the income is connected with or incidental to the trade or business, and iii) the trade or business is substantial in relation to the activity in the other State generating the income. Article 22, Section 3a).

One point of view could be that a corporation may never qualify as a QFC on the basis of an active trade or business test, because active trade or business tests apply to individual items of income derived from the U.S. and thus cannot be squared with Section 1(h)(11). This view would interpret Section 1(h)(11) to require satisfaction of a Generic Test in an LOB provision. The view arguably finds support in the Conference Report relating to Section 1(h)(11). The conferees intended that:

> a company will be eligible for benefits of a comprehensive income tax treaty within the meaning of this provision if it would qualify for the benefits of the treaty with respect to *substantially all* of its income in the taxable year in which the dividend is paid. (emphasis added)[54]

It could be argued that the legislative history requires satisfaction of a Generic Test, because Generic Tests apply to all the corporation's income, not to particular items.

---

[53] The U.S. Model provides that making or managing investments is not considered to be an active trade or business unless it is a banking, insurance or securities activity conducted by a bank, insurance company or registered dealer. Furthermore, substantiality of the trade or business is determined based on all the facts and circumstances. A safe harbor provides that a trade or business is substantial if, over a specified period, the asset value, the gross income and the payroll expense related to the trade or business in the treaty jurisdiction equal at least 7.5 percent of the foreign corporation's (and related parties') proportionate share of the asset value, gross income and payroll expense that are related to the activity that generated the income in the United States, and the average of the three ratios exceeds 10 percent.

[54] H.R. Conf. Rep. No. 108-126 (2003).

But, it is not clear what was intended by the sentence in the legislative history. If it was meant to require satisfaction of a Generic Test, then it is not clear why it refers to "substantially all" the foreign corporation's income, a term not found in the treaties, rather than "all," as a Generic Test would protect all the corporation's income derived from the United States. Further, the sentence does not by its terms prohibit reliance on an active trade or business test. The argument requiring satisfaction of a Generic Test is not mandated by the legislative history. Thus, another reading would permit qualification if substantially all of the corporation's U.S. source income[55] qualified under an active trade or business test.

We think that a sensible reading of the legislative history would permit a foreign corporation to qualify as a QFC under an active trade or business test in an LOB provision if the foreign corporation and its subsidiaries have substantial business activities in the treaty jurisdiction and substantially all of the U.S. source income (if any) of the foreign corporation and its subsidiaries qualifies under the active trade or business test. This test would appropriately target foreign corporations, such as the corporation in the Active Business Example, with a substantial business in the treaty jurisdiction, consistent with the purpose of the active trade or business test.

A corporation without any U.S. source income should be able to qualify as a QFC under the active trade or business test, hence the reference to "(if any)" in our recommendation. The absence of U.S. source income should, if anything, be a favorable fact in relation to Section 1(h)(11), because it highlights the absence of treaty shopping. Moreover, in many treaties, the Generic Tests, like the active trade or business test, presuppose items of income derived from the United States. The U.S.-France treaty, for example, provides in Article 30, Section 1, that a resident of one State "that derives income from the other Contracting State shall be entitled in that other State to all of the benefits of this Convention only if such resident is one of the following."[56] Section 1 then lists various LOB tests, such as the ownership/base erosion test and

---

55 A treaty generally would not address income of the foreign corporation derived outside the United States.

56 U.S.-France Convention, Article 30(1). The following treaties similarly presuppose income derived from the U.S. for their Generic Tests: U.S.-Austria Convention, Article 16(1); U.S.-Belgium Supplementary Protocol Article 12A (1); U.S.-Czech Republic Convention, Article 17(1); U.S.-Finland Convention, Article 16(1); U.S.-German Convention, Article 28(1); U.S.-Ireland Convention, Article 23(1); U.S.-Japan Convention, Article 22(1); U.S.-Netherlands 2004 Protocol, Article 26(1); U.S.-Spain Convention, Article 17(1); U.S.-Sweden Convention, Article 17(1); U.S.-Switzerland Convention, Article 22(1); U.S.-United Kingdom Convention, Article 23(1).

a publicly-traded test.[57] Thus, if the active trade or business test cannot serve as the basis for QFC status because of its presupposition of income derived from the U.S., the same logic would imply that foreign corporations without income derived from the U.S., resident in jurisdictions with treaties like the U.S.-France treaty, would always qualify as QFCs, because the Generic Tests would be irrelevant depending, as they do, on there being some income derived from the United States. Under this argument, qualification as a "resident" would be sufficient to convey eligibility for treaty benefits and therefore QFC status as long as the foreign corporation does not derive income from the United States and the relevant treaty's LOB provision presupposes income derived from the United States. While it is arguable that lack of income derived from the U.S. should mean that a foreign corporation need only satisfy the residence provision of the applicable treaty, the notion that lack of income derived from the U.S. is sufficient under some treaties but not under others does not appear to have been intended by Congress. We do not believe that lack of income derived from the U.S. obviates the need to qualify under an LOB provision. By the same token, we do not believe that lack of income derived from the U.S. prevents an active trade or business test from serving as the basis for QFC status.

A more sensible reading, consistent with the evident purposes of the legislation and LOB provisions, would be to treat an entity as a QFC under an active trade or business test contained in a treaty if the foreign corporation and its subsidiaries have substantial business activities in the treaty jurisdiction[58] and substantially all of the U.S. source income (if any) of the foreign corporation and its subsidiaries qualifies for treaty benefits under the active trade or business test.[59] Treaty negotiators included the active trade or business test in LOB provisions,

---

[57] In other treaties, the Generic Tests do not presuppose income derived from the United States. For example, the U.S. Model Treaty provides that "A resident of a Contracting State shall be entitled to benefits otherwise accorded to residents of a Contracting State by this Convention only to the extent provided in this Article."

[58] *Cf.* Section 7874(a)(2)(B)(iii) (Section 7874 does not apply if expanded affiliated group has "substantial business activities" in foreign acquiror's country of residency); Treas. Reg. Sec. 1.7874-2T(d) (facts and circumstances test and ten percent safe harbor regarding substantial business activities).

[59] We believe that both the "substantial business activities" prong and the "substantially all the U.S. source income" prong are best analyzed with respect to parent and its subsidiaries together. For example, it should not make a difference whether parent directly has substantial business activities in the treaty jurisdiction or has those activities through subsidiaries. See Treasury Department Technical Explanation of U.S.-German Treaty, discussion of Article 28, Examples II and III (business activities carried on by subsidiaries enable parent corporation to satisfy active trade or business test). Further, it should not be sufficient for substantially all of parent's U.S. source income (if any) to be eligible for the active trade or business test, while the U.S. source income of a subsidiary is not. That being said, the "substantially all" test will need further refinement to address situations where parent owns subsidiaries in multiple jurisdictions. U.S. source income of a subsidiary resident in a jurisdiction different from

because they recognized that foreign corporations conducting a bona fide business in the treaty jurisdiction should, under certain circumstances, be entitled to treaty benefits. Section 1(h)(11) should likewise permit foreign corporations conducting business activities in foreign jurisdictions to qualify if a substantiality threshold is satisfied. Thus, we believe that the active trade or business test should be interpreted to provide for QFC status in cases like the Active Business Example where the business activities of the foreign corporation and its subsidiaries in the treaty jurisdiction are substantial and either there is no U.S. source income or substantially all the U.S. source income of the foreign corporation and its subsidiaries is eligible for treaty benefits under the active trade or business test.

The requirement that there be "substantial" business activities in the treaty jurisdiction does not, in our view, require that "substantially all" the business activities of the foreign corporation and its subsidiaries be in the treaty jurisdiction. We believe that a foreign corporation may qualify as a QFC under this test even if it and its subsidiaries have substantial business activities in multiple jurisdictions.

---

parent's jurisdiction, for example, will not be eligible for the active trade or business test of the treaty with parent's jurisdiction.