NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON INTERNATIONAL PROVISIONS OF H.R. 3970 AND EFFECTS OF REDUCTION IN CORPORATE TAX RATES

December 24, 2008

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On October 25, 2007, House Ways and Means Committee Chairman Charles Rangel introduced H.R. 3970, the Tax Reduction and Reform Act of 2007 (the "Bill"). The Bill includes a wide variety of provisions affecting individuals and businesses. For businesses, the Bill would reduce the maximum corporate income tax rate to 30.5% but would also include a number of base-broadening provisions.[1]

This report (the "Report") addresses three aspects of the Bill.[2] First, the Report comments on the proposed additions of Sections 975 and 976 to the Internal Revenue Code of 1986, as amended (the "Code").[3] These provisions would require deferral of deductions allocable to deferred foreign source income and would change the rules for calculation of the foreign tax credit to prevent the maximization of credits by selectively recognizing or repatriating high-taxed foreign income. Second, the Report addresses the proposed addition of Section 894(d), which would deny treaty benefits (and impose withholding taxes) with respect to deductible payments made by a U.S. taxpayer to a related party controlled by a foreign common

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1. Chairman Rangel has suggested that he would revise the Bill's proposal to further reduce the maximum corporate tax rate to 28%. *See* Ryan J. Donmoyer and Peter Cook, *Rangel Plans Push to Cut Top Corporate Tax Rate to 28 Percent*, Bloomberg Press (Nov. 15, 2008) (*available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=ag7lSuB.yyII&refer=home).

2. This report was prepared by a working group consisting of Alan Appel, Richard Andersen, Marco Blanco, Patrick Brown, Joseph Czajkowski, Georgia Davies Graham, Kevin Glenn, Edward Gonzalez, Abraham Leitner, David Mayo, David Miller, Stephen Mills, Joanna Mork, Richard Reinhold, Michael Schler, Laurence Shoenthal, Willard Taylor, Jeffrey Trey, and Diana Wollman. The principal drafters were Andrew Braiterman and David Mayo, with significant contributions by Edward Gonzalez. Helpful comments were received from Peter Connors, David Hardy, and David Sicular. The assistance of Meredith Stead and Mashiho Yuasa is gratefully acknowledged.

3. Unless otherwise indicated, all "Section" references are to Sections of the Code (including the Sections proposed to be added by the Bill) and the Treasury regulations promulgated thereunder.

parent corporation that would not be entitled to treaty benefits if it received the payments. Finally, the Report addresses the potential effect of the Bill's reduction in the maximum corporate tax rate, along with the scheduled increase of the maximum individual rate to 39.6% after 2010. In particular, the Report considers the effect of these rate changes on individual taxpayers' choices of forms of business entities and the application of the accumulated earnings tax and personal holding company tax.

The Report is not intended to express views on the merits of the policies underlying the Bill. Our comments are instead directed to whether the provisions as drafted would successfully achieve their intended purpose, whether they would be likely to produce unintended consequences, and whether they would be reasonably easy to administer.

I. DEFERRAL OF FOREIGN-RELATED DEDUCTIONS AND CALCULATIONS OF FOREIGN TAX CREDIT

A. Overview of Deduction Deferral and Foreign Tax Credit Provisions

1. General Principles

Section 3201 of the Bill would make fundamental changes to the treatment of U.S. taxpayers' deductions allocable to foreign source income and to the calculation of the foreign tax credit. Proposed Section 975 would, broadly speaking, require that a U.S. taxpayer's deductions allocable to income generated by controlled foreign corporations ("CFCs")[4] be deferred until that income is repatriated and included in income for U.S. federal income tax purposes. Proposed

4. A controlled foreign corporation ("CFC") is a foreign corporation of which more than 50% of the total combined voting power of all classes of stock, or of the value of the corporation's stock, is owned, directly or through attribution, by "United States shareholders" on any day during the foreign corporation's taxable year. Section 957(a). A United States shareholder is a U.S. person that owns, directly or through attribution, stock in the foreign corporation with 10% or more of the total voting power. Section 951(b).

Section 976 would provide in essence that aggregate foreign taxes paid or accrued by a U.S. taxpayer and its CFC subsidiaries would be taken into account as credits on a current basis in proportion to the total amount of the worldwide group's foreign source income that is currently included in income, with the remaining credits being deferred until the deferred income is repatriated. As a result, taxpayers would continue to be able to defer foreign source income, subject to the restrictions of subpart F, but it would no longer be possible to maximize foreign tax credits and the benefit of deferral of low-taxed foreign income by selectively repatriating high-taxed foreign income while continuing to defer low-taxed foreign income. Proposed Sections 975 and 976 would take into account income earned by foreign branches as well as income earned through CFCs.

We believe that proposed Sections 975 and 976, in combination with the proposed reduction of the corporate income tax rate, are properly understood as a step in the direction of fundamental reform of U.S. taxation of international business operations. Although these provisions would not prevent U.S. multinationals from deferring U.S. tax on active income,[5] they would deny the ability to deduct expenses allocable to untaxed foreign source profits, thus diminishing the incentive to move income offshore, and reduce the role of U.S. tax considerations in decisions relating to repatriation of earnings.

2. Proposed Section 975

The Bill would provide that "foreign-related deductions" otherwise allowable for any taxable year would be taken into account in such taxable year only to the extent that such

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5. *Compare* Joint Committee on Taxation Report, ECONOMIC EFFICIENCY AND STRUCTURAL ANALYSES OF ALTERNATIVE U.S. TAX POLICIES FOR FOREIGN DIRECT INVESTMENT (JCX-59-08, June 25, 2008) (discussing distortions resulting from current system and alternatives of territorial system and full inclusion system).

deductions are allocable to "currently-taxed foreign income."[6] Foreign-related deductions would be allocated to currently-taxed foreign income in the same proportion that currently-taxed foreign income bears to the sum of currently-taxed foreign income and "deferred foreign income." These rules would be applied separately with respect to the separate categories of income described in Section 904(d)(1), which provides the "basket" rules for foreign tax credit purposes.[7]

"Foreign-related deductions" would be broadly defined to include all deductions and expenses which would be allocated or apportioned to foreign source gross income if both currently-taxed and deferred foreign income were taken into account for purposes of determining currently taxed and deferred foreign income.[8]

"Currently-taxed foreign income" would be defined as the total amount of foreign source gross income recognized for the taxable year, other than repatriated foreign income;[9] however, gross income would be reduced for this purpose by foreign taxes paid (determined without regard to Sections 902 and 960).[10] "Deferred foreign income" would be defined as the excess of (i) the amount that would be includible in income under subpart F if all CFCs in which the taxpayer is a U.S. shareholder were a single CFC and all earnings and profits ("E&P")[11] of such CFCs were subpart F income over (ii) the sum of the amount of dividends received during the

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6. Proposed Section 975(a)(1).

7. Proposed Section 977.

8. Proposed Section 975(c)(1).

9. Proposed Section 975(c)(2).

10. Proposed Section 975(c)(7)(B).

11. The reference to "all earnings and profits" presumably is meant to include only E&P for the current year.

taxable year from CFCs and the amount includible under subpart F for the year.[12] Amounts potentially includible under Section 78, which provides a gross-up for indirect foreign tax credits, would not be taken into account for purposes of determining currently-taxed and deferred foreign income.[13]

Proposed Section 975(b) provides rules for taking into account in future years deductions that were previously deferred under proposed Section 975(a). "Previously deferred deductions" would be taken into account in the same proportion that "repatriated foreign income" bears to "previously deferred foreign income." "Repatriated foreign income" is defined as the amount included in income on account of distributions out of "previously deferred foreign income."[14] "Previously deferred foreign income" is defined in turn as the excess of the aggregate amount of deferred foreign income for all prior taxable years to which proposed Section 975 applies over the amount of repatriated foreign income for all such years.[15]

3. Proposed Section 976

Proposed Section 976 would change the manner in which allowable foreign tax credits for a taxable year are calculated. It is drafted to operate in tandem with proposed Section 975 and incorporates many of the same definitions.

The amount of foreign income taxes taken into account in a taxable year generally would equal the "total foreign income taxes" for the year multiplied by a fraction, the numerator of

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12. Proposed Section 975(c)(3).

13. Proposed Section 975(c)(7)(A).

14. Proposed Section 975(c)(5).

15. Proposed Section 975(c)(4).

which is the currently-taxed foreign income for the year and the denominator of which is the sum of the currently-taxed foreign income and the deferred foreign income for the year.[16] The "total foreign income taxes" would be defined as the sum of the foreign income taxes paid or accrued during the taxable year plus the additional taxes that would be treated as paid or accrued under Section 902 or 960 if all CFCs owned by the taxpayer were a single CFC and all E&P of such CFCs were subpart F income.[17]

The portion of total foreign income taxes not taken into account in the current year would not be taken into account in subsequent years under the current rules of Section 902, but would instead be taken into account pursuant to proposed Section 976(b). Under proposed Section 976(b), in any year in which there is repatriated foreign income, previously deferred foreign income taxes would be taken into account in an amount that bears the same proportion to such taxes as the repatriated foreign income bears to the total amount of previously deferred foreign income.

As is the case with proposed Section 975, the foreign tax credit rules of proposed Section 976 would be applied separately with respect to different categories of foreign source income.[18]

B. Summary of Comments and Recommendations

The following is a summary of our comments and recommendations relating to proposed Sections 975 and 976:

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16. Proposed Section 976(a).

17. Proposed Section 976(c)(2).

18. Proposed Section 977.

1. As a general matter, proposed Sections 975 and 976 leave open a number of significant issues. In addition to certain changes which we believe should be made to the Bill itself, it is important that additional guidance be provided in the form of legislative history or administrative pronouncements so that taxpayers fully understand the impact of the Bill before it becomes effective.

2. The Bill should clarify that proposed Sections 975 and 976 are to be applied on an affiliated group-wide basis.

3. Proposed Sections 975 and 976 would operate in a distortive manner because they would defer a portion of deductions for operating expenses of foreign branches even though the income of foreign branches is not deferred. Moreover, because foreign source income earned directly by a U.S. taxpayer would be determined on a gross basis, while income earned by CFCs would effectively be determined on a net basis (because it would be based on E&P), the currently allowable portion of deductions that are properly subject to apportionment and foreign tax credits generally would be overstated. We believe that a better approach would be to define currently-taxed foreign income as gross foreign source income net of directly allocable expenses and to defer deductions directly allocable to deferred income before applying the allocation formula.

4. The definition of deferred foreign income should be clarified in three respects. First, effectively connected income earned by CFCs should be excluded from deferred foreign income because it is subject to U.S. tax on a current basis. Second, although proposed Sections 975 and 976 would treat all CFCs as a single CFC, transactions between CFCs should not be eliminated for purposes of calculating deferred foreign income. Third, where a taxpayer

is not the sole direct or indirect owner of a CFC, rules are needed to determine the taxpayer's share of the CFC's E&P or deficit in E&P.

5. The proposed repeal by the Bill of Section 864(f), which permits U.S. taxpayers to apportion interest expense on a worldwide basis beginning in 2011, should be reconsidered in light of its effect on deferral of deductions under proposed Section 975, as opposed to current law under which only the foreign tax credit limitation is affected. In addition, consideration should be given to whether and to what extent the allocation of foreign source interest expense under proposed Section 975 should be consistent with the asset value-based approach applicable to sourcing determinations rather than being based on the relative amounts of current and deferred foreign income.

6. Consideration should be given to expanding the definition of deferred foreign income to include undistributed E&P of non-CFC foreign corporations in which U.S. taxpayers own shares.

7. Foreign withholding taxes imposed on dividends should be creditable in the year in which the dividends are received.

8. Proposed Section 976 as drafted treats interest and royalty payments received by a U.S. taxpayer as currently-taxed foreign income. This may allow taxpayers receiving these payments from CFCs in jurisdictions that do not impose withholding tax to claim credits for foreign taxes paid by CFCs on a more accelerated basis than under current law. This aspect of proposed Section 976 should be revisited.

9. The Bill poses a number of issues with respect to the determination of repatriated foreign income. These issues relate to the types of transactions that are deemed to result in repatriation of foreign income as well as the determination of whether repatriations are deemed

to be paid out of previously deferred foreign income as opposed to other accumulated E&P (*e.g.*, earnings attributable to periods prior to the taxpayer's acquisition of the relevant shares or prior to the Bill's effective date).

10. Consideration should be given to the effect of dilution of a taxpayer's interest in a CFC as a result of the CFC issuing stock to an unrelated person. Such issuances can result in the reduction of a taxpayer's interest in the CFC's E&P without a corresponding reduction in the taxpayer's previously deferred foreign income, thereby precluding the taxpayer from ever being entitled to the full amount of deferred deductions or credits.

11. Consideration should be given to the effect of CFC E&P deficits on the calculation of deferred foreign income pools.

12. Rules are needed to determine the effect on a U.S. affiliated group's previously deferred foreign income, deductions, and foreign income taxes when a member leaves the group. These rules should also address the ongoing tax consequences to the departing member. We believe that the most appropriate rule would be to make these determinations by reference to the portion of the group's previously deferred foreign income that is represented by the undistributed E&P of CFCs owned by the departing group member.

13. The manner of operation of the separate application of proposed Sections 975 and 976 to general limitation and passive limitation income should be clarified.

14. The rules promulgated under Section 905(c) relating to the effect of redeterminations of foreign tax liability should be modified to reflect the fact that the Bill does not differentiate between foreign taxes paid directly by a U.S. taxpayer and foreign taxes paid by CFCs.

15. The Bill provides for translation of foreign corporations' E&P into U.S. dollars based upon the exchange rate in the year in which earned, with currency gain or loss being recognized when the E&P is distributed or deemed distributed. The treatment of this currency gain or loss under proposed Sections 975 and 976 should be clarified.

C. Discussion of Proposed Sections 975 and 976

1. General

As indicated in our comments below, Section 3201 of the Bill leaves open a number of questions and may be interpreted to operate in an unintended manner. There are a number of changes that we believe should be made to the statutory language. Other issues may be appropriately addressed by more detailed legislative history or by regulatory or other administrative guidance. In this regard, it would be helpful if the Bill included an express grant of regulatory authority. It is important that more detailed rules, in whatever form they might take, be provided sufficiently in advance of the Sections' effective date so that taxpayers can adapt to the profound changes contemplated by the Bill.

2. Application to Affiliated Groups

The Bill does not specify whether proposed Sections 975 and 976 are to apply on a group-wide basis. In the case of affiliated groups of U.S. taxpayers, we assume that proposed Sections 975 and 976 are intended to apply on a group-wide, rather than on a company-by-company, basis. Otherwise, the provisions could easily be circumvented by, for example, having high-taxed CFCs owned by one group member and low-taxed CFCs owned by another member.

Although group-wide treatment could be provided for affiliated groups under the consolidated return regulations, an express provision in the statute would provide more clarity. In addition, a statutory provision could provide for group-wide treatment for affiliated groups that do not file consolidated returns in a manner similar to the rules of Section 864(e), which

provides for allocation and apportionment of interest and other expenses on a group-wide basis. Regulatory authority could be provided to permit the expansion of the definition of affiliates along the lines of the rules applicable to allocation and apportionment of interest expense in Temp. Treas. Reg. § 1.861-11T(d)(6) (applying an 80% by vote or value test) and Treas. Reg. § 1.861-11(d)(7) (permitting the Internal Revenue Service to disregard trusts, partnerships and pass-through entities interposed between affiliates).

We also believe that it would be appropriate to provide for separate treatment of financial institution subgroups in the same manner as Section 864(e)(5).[19] As a general matter, the rules of proposed Sections 975 and 976 should operate consistently with the rules governing allocation and apportionment of expenses between domestic and foreign source income.

3. Definitions of Foreign-Related Deductions and Currently-Taxed Foreign Income

We believe that the definition of foreign-related deductions is overly broad and, when applied in conjunction with the definition of currently-taxed foreign income, would likely lead to significant distortions. Proposed Section 975(c)(1) defines foreign-related deductions to include all deductions and expenses that would be allocable to foreign source income if both currently-taxed and deferred foreign income were taken into account. This definition includes deductions that are directly allocable to foreign source income generated by a branch of the taxpayer; in

19. Section 864(e), added to the Code by Pub. L. 99-514, the Tax Reform Act of 1986 ("TRA"), generally requires an affiliated group to be treated as if all members of the group were one taxpayer for purposes of allocating and apportioning interest expense. However, Congress provided for separate treatment of subgroups of financial institutions (entities described in Section 581 or Section 591), if (i) their business is predominantly with persons other than related persons or their customers and (ii) they are required by state or Federal law to be operated separately from any other entity that is not a financial institution. Section 864(e)(5)(B) & (C); Temp. Treas. Reg. § 1.861-11T(d)(4). The rationale for extending the exception is presumably the highly leveraged nature of financial institutions.

contrast, operating expenses of CFCs reduce E&P and therefore reduce deferred foreign income, which is effectively computed on a net basis.

We do not believe that normal operating expenses of a branch should be subject to potential deferral under proposed Section 975. The disparate treatment of expenses incurred by branches and expenses incurred by CFCs can be illustrated by a simple example:

> Example 1: Assume that P, a U.S. corporation, has a foreign branch that generates gross income of 100, directly related expenses of 60, and foreign taxes of 15, and that P incurs no interest expense and has no other foreign-related deductions. Assume that P also owns 100% of the stock of foreign subsidiary FS, which has E&P of 25, reflecting gross income of 100, expenses of 60, and foreign taxes of 15, and that FS's E&P is not subpart F income and is not repatriated.

Under proposed Section 975, P would have foreign-related deductions of 60, currently-taxed foreign income of 85 (the branch's gross income of 100, reduced pursuant to proposed Section 975(c)(7)(B) by the 15 in directly incurred foreign taxes), and deferred foreign income of 25. Under proposed Section 975(a), only 46.36 (85/110 multiplied by 60) of the branch deductions would be allowable in the current year; the remaining 13.64 would be deferred. On the other hand, under proposed Section 976, P would have total foreign income taxes of 30, of which 23.18 (*i.e.*, 85/110 of the total) could be claimed in the current year, subject to the limitations of Section 904.

This result is illogical. Under the assumed facts, the operations of P's branch and FS produce equal income and expenses and are subject to the same rate of foreign tax. The policies underlying proposed Sections 975 and 976 therefore do not support deferring a portion of the branch's deductions or giving P the ability to claim credits on a current basis for foreign taxes paid by FS on its unrepatriated income.

The Bill's definition of currently-taxed foreign income would also result in the overstatement of currently allowable expenses that are appropriately subject to apportionment. This can be illustrated by the following example:

> Example 2: Same facts as Example 1, except that P has interest expense of 30 that is allocable to foreign source income.

The interest expense would result in an additional 30 in foreign-related deductions. Under the Bill, 23.18 (*i.e.*, 85/110 multiplied by 30) of the interest expense would be deductible on a current basis and 6.82 would be deferred, even though the interest expense appears to support currently-taxed and deferred foreign income in equal amounts.

The distortions reflected in these examples could be eliminated by making two changes to proposed Section 975. First, the definition of foreign-related deductions should be revised to exclude expenses that are directly allocable to foreign source income earned directly by a U.S. taxpayer; similarly, any deductions directly allocable to foreign source income earned through CFCs (*e.g.*, stewardship expenses) should be allocated between currently-taxed and deferred foreign income based upon the percentage of current year CFC earnings that are distributed or taxable under subpart F.[20] Second, the definition of currently-taxed foreign income should be changed from currently recognized gross foreign source income to currently recognized gross foreign source income net of directly allocable deductions.[21]

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20. Tracing deductions to specific CFCs would be unduly complicated and inconsistent with the Bill's general approach of treating all CFCs as a single CFC.

21. Alternatively, at least for purposes of proposed Section 975, currently-taxed and deferred foreign income could be based on gross income of the taxpayer and its CFC subsidiaries. This would be consistent with current rules that apportion deductions that are not definitely related to any gross income ratably based upon gross income within and without a statutory grouping. Treas. Reg. § 1.861-8(c)(3). It also arguably would be appropriate insofar as it would recognize that deductible expenses can be properly attributable to money-losing operations.

(Footnote continued on next page)

In addition, it is not clear why currently-taxed foreign income is reduced by foreign taxes and deferred foreign income does not include amounts that would be includible in income under Section 78 if all E&P were treated as subpart F income. Determining currently-taxed and deferred foreign income on a pre-foreign tax basis would appear to produce a better measure of the percentage of foreign income that is currently taxed.

Applying these recommendations to the facts of Example 1, X would have no foreign-related deductions, currently-taxed foreign income of 40 (100 in gross income minus 60 in directly allocable expenses), and deferred foreign income of 40 (the E&P of 25 grossed-up by 15 in foreign taxes). Fifteen (15) in foreign taxes would be creditable in the current year. If the facts of Example 1 were changed so that FS paid only 5 in foreign taxes and FS had E&P of 35, the amount allowable as a current foreign tax credit would be 10. In Example 2, our recommended approach would result in 15 in foreign source interest expense being currently deductible and 15 being deferred.

We also note that the definition of foreign-related deductions includes not only deductions that are actually allocated or apportioned to foreign source income, but also deductions that would be allocated or apportioned to such income if both currently-taxed foreign and deferred foreign income were taken into account. We assume that this is intended to apply to expenses, such as general and administrative expenses, that are apportioned between domestic and foreign source income based upon relative amounts of gross income in such categories; the amount of such expenses that are allocable to foreign source income would be increased if

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However, a gross income approach could be more complicated. In particular, it is hard to see how deferred deductions could be triggered other than by reference to the amount of net income of CFCs that is distributed.

deferred foreign income were instead repatriated on a current basis. We believe that this result is appropriate. However, the Bill should clarify that any incremental deductions that are treated as foreign-related deductions under this "would be" standard are actually treated as allocable to foreign source income, whether recognized currently under proposed Section 975(a) or deferred and recognized in a later year under proposed Section 975(b).

4. Definition of Deferred Foreign Income

The definition of deferred foreign income in proposed Section 975(c)(3) poses at least three issues. First, it appears that effectively connected income ("ECI") earned by a CFC would be included in deferred foreign income. Since ECI is subject to U.S. tax, it appears more appropriate to treat this income as currently-taxed foreign income.

Second, the starting point for determination of deferred foreign income is the amount of income that would be included under subpart F if "all controlled foreign corporations were treated as one controlled foreign corporation." We recommend that the treatment of all CFCs as one CFC be limited to aggregating the U.S. taxpayer's share of E&P and E&P deficits of CFCs in which it owns an interest. More specifically, transactions between CFCs should not be eliminated for purposes of calculating deferred foreign income. Eliminating such transactions would be unduly complicated, especially since the U.S. taxpayer may have very different percentage interests in different CFCs in which it is a United States shareholder. In addition, it would be inconsistent with the approach of proposed Sections 975 and 976, because those provisions do not change the current law rules that determine whether a distribution is a taxable dividend based on the E&P of the particular subsidiary that makes the distribution.

Third, rules are needed for determination of a taxpayer's share of a CFC's E&P or deficit in E&P in situations where the CFC is not directly or indirectly wholly-owned by the taxpayer. If the CFC has positive E&P for the year, application of the current rules for determining a

United States shareholder's pro rata share of a CFC's subpart F income would be appropriate.[22] If the CFC has a deficit in E&P, rules similar to those applicable to investment adjustments under the consolidated return regulations would be appropriate.[23]

5. Allocation of Interest Expense

The application of proposed Section 975 to interest expense poses two categories of issues. The first category relates to the amount of interest that is properly allocated or apportioned to foreign source income. The second category relates to the method of allocation of foreign source interest expense between current and deferred foreign income. These issues are important because, in many cases, interest expense will be the most significant deduction item subject to proposed Section 975.

a. Determination of Foreign Source Interest Expense

Interest expense is generally allocated between domestic and foreign source income by reference to the relative values of the taxpayer's domestic and foreign source income-producing assets.[24] The American Jobs Creation Act of 2004[25] ("AJCA") added Section 864(f) to the Code. Section 864(f) as originally enacted would have applied to taxable years beginning on or after January 1, 2009, but was subsequently postponed to apply only to taxable years beginning on or

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22. Section 951(a)(2) provides that a taxpayer's pro rate share of subpart F income is determined by reference to the amount that would have been distributed to the taxpayer had the subpart F income been paid out as a dividend.

23. Treas. Reg. § 1.1504-32(c)(2) provides rules for allocating a subsidiary's losses among classes and shares of common stock for purposes of determining adjustments to members' bases in stock of the subsidiary. As discussed at I.C.11, *infra*, there are also arguments in favor of excluding CFCs with E&P deficits for purposes of calculating deferred foreign income.

24. Section 864(e)(2), Treas. Reg § 1.861-9T(f)(1) & (g).

25. Pub. L. 108-357, 118 Stat. 1418.

after January 1, 2011.[26] Under Section 864(f), taxpayers would be permitted to apply the interest expense allocation rules on a worldwide basis, taking into account interest expense incurred by foreign subsidiaries. Section 864(f) would permit taxpayers to avoid distortions inherent in taking into account only interest expense incurred by U.S. group members,[27] as illustrated by the following example:

> Example 3: U.S. corporation P is a holding company, the only assets of which are stock of a wholly-owned domestic subsidiary, DS, and a wholly-owned foreign subsidiary, FS. Each of DS and FS has assets with a value of 200 and indebtedness of 100, bearing the same rate of interest.

Absent Section 864(f), FS's indebtedness would be ignored. The P group would have assets with a value of 300 (DS's assets with a value of 200 and the stock of FS with a value of 100). As a result, one third of DS's interest expense would be allocated to foreign source income and, under proposed Section 975, deferred until FS distributes its earnings, even though there is no apparent rationale based upon fungibility of money or otherwise for concluding that DS's indebtedness is supporting P's investment in foreign operations. Section 864(f) would permit taxpayers to avoid this result by allocating interest expense on a worldwide basis, with the result that all of DS's interest expense, which represents half the worldwide group's interest expense, would be allocated to domestic source income. Applying the rationale of Section 864(f) to proposed Sections 975 and 976, interest expense incurred by CFCs would be taken into account

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26. Section 3093 of the Housing and Recovery Act of 2008, Pub. L. 110-289, 122 Stat. 2654, amended subsections 864(f)(5)(D) and (6) to delay the applicability of Section 864(f) to tax years beginning after December 31, 2010.

27. The Senate Finance Committee Report on the AJCA, S. REP. No. 108-192, observed that U.S.-based multinational corporations holding significant assets outside the United States were required to allocate a significant portion of domestic group members' interest expense to foreign-source income because of the asset rule. This interest expense generally is not deductible in computing foreign tax liability, thus increasing the likelihood of taxpayers having excess foreign tax credits and being subject to double taxation of foreign income. The House Ways & Means Committee Report on the AJCA, H. R. REP. NO. 108-548, added that the existing allocation rules made it more costly for such companies to borrow and to invest in the United States.

in determining the amount of foreign source interest expense that must be deferred; foreign source interest expense of a U.S. taxpayer would be deferred only to the extent that the worldwide group's foreign source interest expense exceeds the CFCs' interest expense.

Section 3203 of the Bill would repeal Section 864(f). In the context of foreign tax credit limitations, this may be an acceptable, if not entirely principled, decision. Many taxpayers can to a large extent avoid or mitigate the negative consequences of unfavorable interest expense allocation rules applicable to foreign tax credit calculations as a result of other sourcing and limitation rules that are generally pro-taxpayer.[28] However, deferral of additional interest deductions under proposed Section 975 as a result of repeal of Section 864(f) raises far more serious issues for many taxpayers.[29]

b. Allocation of Foreign Source Interest Expense between Current and Deferred Foreign Income

Apportionment of interest expense between domestic and foreign source income is determined on an asset value basis. In contrast, under proposed Section 975, foreign source interest expense (as determined based on asset value) would then be allocated between currently-taxed and deferred foreign income on the basis of the relative amounts of currently-taxed and deferred foreign income.

It would be more consistent with the Code's general approach to apportionment of interest expense if allocations for purposes of proposed Section 975 were based upon the relative

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28. *See, e.g.*, Section 904(d)(3) (permitting interest and royalties from related CFCs to be treated as general limitation income on a look-through basis, even if not subject to foreign tax); Section 863(b)(2) and Treas. Reg. § 1.863-3(a)(1) (treating a portion of export income as foreign source even if not subject to foreign tax).

29. Of course, for a taxpayer that is in a permanent excess foreign tax credit position, allocation of interest expense to foreign source income is equivalent to a denial (as opposed to mere deferral) of the deduction.

values of assets producing currently-taxed and deferred foreign income. However, using an asset-based allocation method for purposes of proposed Section 975 would pose significant difficulties. Once interest expense is deferred, it is hard to see a workable way to determine how much of the deferred deduction should be taken into account other than by reference to the proportion of previously deferred foreign income that is repatriated. There are further complications to the extent that some but not all income of CFCs owned by the taxpayer is distributed on a current basis.

Congress may wish to consider a hybrid approach where foreign source interest expense is allocated in the first instance between investments in CFCs and investments in other foreign income-producing assets based upon relative values.[30] Interest expense allocated to investments in CFCs would be taken into account in the current taxable year based upon the percentage of the current E&P of the taxpayer's CFCs that is included in income in the taxable year; the deferred interest expense would then be taken into account in future years in proportion to the amount of deferred foreign income that is repatriated. A more conceptually pure approach would also be possible under which interest expense would be allocated among individual CFCs on the basis of asset values and then taken into account as each CFC's E&P is repatriated. However, this approach would be more complicated and would be inconsistent with the general approach of proposed Sections 975 and 976 of treating all CFCs in which a taxpayer owns an interest as a single CFC.

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30. This approach could also be applied to expenses allocated and apportioned in the same manner as interest expense under Temp. Treas. Reg. § 1.861-9T(b).

In addition, we believe that deductions for interest expense that is directly allocable to specific items of foreign source income[31] should be excluded from the normal apportionment formula of proposed Section 975. Instead these deductions should either be allowed currently or deferred based upon whether the income in question is currently includible or deferred. This is a specific application of our more general recommendation at I.C.3, above, regarding directly allocable expenses.

6. Treatment of Investments in Foreign Corporations That Are Not CFCs

Under the Bill, deferred foreign income would be limited to the taxpayer's share of income earned by CFCs; income earned by a non-CFC foreign corporation in which the taxpayer owns a substantial interest would not be taken into account. The effect of this distinction can be illustrated by the following example:

> Example 4: U.S. corporation P has foreign branch operations and also owns 100% of the stock of X, a CFC, and 50% of the stock of Y, a foreign corporation, which is not a CFC because the remaining 50% interest is owned by an unrelated foreign person. Assume that P has currently-taxed foreign income of 100, X has E&P of 100, and P's 50% share of Y's E&P is 100. Assume further that P has foreign source interest expense of 150.

Under proposed Section 975, P would have currently-taxed foreign income of 100 and deferred foreign income of 100, with the result that 75 of foreign source interest expense would be allowable on a current basis and 75 would be deferred. By contrast, if the remaining 50% interest in Y were owned by an unrelated U.S. person with the result that Y were a CFC, P would have deferred foreign income of 200 and 100 in foreign source interest expense (*i.e.*, two-thirds of the total) would be deferred. Moreover, if our suggestion that deductions for expenses

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31. Directly allocable interest expense includes interest allocated under the "CFC netting" rules of Treas. Reg. § 1.861-10(e), the "qualified nonrecourse indebtedness" rules of Temp. Treas. Reg. § 1.861-10T(b), and the "integrated financial transaction" rules of Temp. Treas. Reg. § 1.861-10T(c).

directly allocable to particular items of income be treated separately is adopted, it appears that expenses directly attributable to investments in non-CFC foreign subsidiaries could be currently deductible even if earnings are not currently distributed. Under proposed Section 976, Y's foreign taxes would not be included in total foreign income taxes; whether excluding Y's income and taxes from calculations under proposed Section 976 is helpful or detrimental to the taxpayer would depend on the relative rates of foreign tax paid by Y as compared to P's branch operations and X.

Given the policies underlying proposed Sections 975 and 976, we believe that taking into account earnings and taxes of non-CFC foreign corporations under the new rules is conceptually more correct, at least in cases where the taxpayer has a sufficient interest to claim Section 902 credits. This is especially true in light of taxpayers' ability to manipulate whether income earned through a foreign corporation is treated as earned through a CFC. For example, under proposed Section 975 as currently drafted, if a taxpayer's wholly-owned CFC owns a 50% interest in a joint venture entity with a foreign partner, the CFC's share of the joint venture's undistributed earnings would be included in deferred foreign income if the parties elect to treat the joint venture entity as a partnership for U.S. tax purposes under the check-the-box regulations but not if it is treated as a corporation.

We recognize, however, that there may be practical considerations in favor of limiting deferred foreign income to income earned through CFCs. Current law treats a taxpayer's shareholding in a CFC differently from an equivalent percentage ownership in a non-CFC in a number of respects. For example, only investments in CFCs can produce subpart F income. In addition, although look-through rules apply to dividends received from non-controlled Section 902 corporations as well as CFCs for purposes of the Section 904(d) separate limitation

rules, interest, rents and royalties are subject to look-through treatment only if received from CFCs. This difference in treatment may be justified based on the perceived difficulty of determining a foreign corporation's E&P and other items relevant to U.S. taxation if the corporation is not controlled by U.S. persons. However, other provisions which require these determinations, such as Sections 902 and 1248, operate without regard to whether the foreign corporation is a CFC.

7. Treatment of Withholding Taxes on Dividends

Under proposed Section 976, it appears that foreign withholding taxes imposed upon a dividend received by a taxpayer from a CFC during a taxable year would be included in the year's total foreign income taxes and allowed in the current year or deferred in the same proportions as the year's currently-taxed and deferred foreign income.

We question whether this is appropriate. Withholding taxes on dividends clearly relate to either currently-taxed foreign income (if paid out of current year's E&P) or previously deferred foreign income (if paid out of E&P from prior years). This is most starkly illustrated where a taxpayer receives a dividend subject to a foreign withholding tax in a year in which it has no currently-taxed foreign income. Under proposed Section 976, the credit for the withholding tax would be deferred in its entirety.

We recommend that credits for withholding taxes on dividends always be allowed in the current year. This rule should apply not only to withholding taxes imposed on dividends paid directly to a U.S. taxpayer, but also to withholding taxes on dividends paid by a foreign corporation to a CFC where the dividend is currently includible under subpart F.

Alternatively, the withholding taxes could be treated as relating back to the year in which the E&P was generated and added to the previously deferred foreign income tax pool. However, this alternative would be unduly complicated. Moreover, we do not believe that it would serve

any real purpose. In contrast to the incentive under current law to repatriate income that is subject to a high rate of foreign tax when earned, there is no motivation for a taxpayer to increase foreign tax credits by incurring incremental withholding taxes on dividends.

8. Treatment of Untaxed or Low-Taxed Currently-Taxed Foreign Source Income

We assume that proposed Sections 975 and 976 are intended to be revenue-raising provisions. However, in many cases proposed Section 976 would permit foreign tax credits to be used on a more accelerated basis than under current law, as illustrated by the following example:

> Example 5: Assume that U.S. corporation P owns 100% of the stock of foreign corporation X, all the income of which is general limitation income. P receives 100 in interest or royalty income from X and X has E&P of 100 (after taking into account its payment to P), which is not currently distributed, and pays 40 in foreign income tax. Assume further that P has no other currently-taxed or deferred foreign income.

P would have currently-taxed foreign income of 100, deferred foreign income of 100, and total foreign income taxes of 40. Because the interest or royalty income would be general limitation income under the look-through rules of Section 904(d)(3), P would be entitled to a current foreign tax credit for 20 in foreign taxes paid by X under proposed Section 976.[32] Although this result is certainly consistent with the general principles of the Bill, we question whether it is intended.

In order to avoid this result, proposed Section 976 could be limited to apply only to foreign taxes paid by CFCs, with the result that those taxes would be creditable in the same proportion as earnings of the taxpayer's CFCs are distributed. Another approach would be to exclude foreign source fixed and determinable annual or periodic income that is currently

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32. The same result could apply where interest or royalties are received from unrelated persons and treated as active income.

includible in income by the taxpayer and is not subject to net income tax by a foreign country (or is subject to net foreign income tax at a very low rate – *e.g.*, if it is earned through a foreign disregarded entity organized in a tax haven jurisdiction) from currently-taxed foreign income for purposes of proposed Section 976 and to provide that withholding taxes imposed on such income are creditable in the year paid or accrued in accordance with current law.

9. Determination of Repatriated Foreign Income

a. General

There are a number of issues regarding the determination of repatriated foreign income. These issues fall into two basic categories. The first category involves the types of transactions that should be deemed to constitute repatriations. The second category involves the determination of the extent to which repatriations are deemed to come out of previously deferred foreign income.

b. Transactions Resulting in Repatriation

Proposed Section 975(c)(5) would define "repatriated foreign income" as "the amount included in gross income on account of distributions out of previously deferred foreign income." Distributions for this purpose should include not only actual dividends, but also amounts treated as dividends under Sections 302, 304, and 1248, as well as amounts includible in income pursuant to Section 951(a)(1)(B) as a result of investments in U.S. property within the meaning of Section 956 of the Code and E&P of CFCs includible in income pursuant to Section 367(b) (*e.g.*, as a result of liquidation of a CFC).

Dividends paid from a lower-tier CFC to an upper-tier CFC (including deemed dividends under Section 964(e)) that would be includible in income under subpart F (assuming that Section 954(c)(6) expires as scheduled after the end of 2009 and that the same country exception of Section 954(c)(3) does not apply) should be treated as repatriated foreign income and not as

currently-taxed foreign income, provided that the dividends are paid out of previously deferred foreign income. It is not clear whether this result would follow from proposed Section 975(c) as drafted.

One difficult issue is the treatment of transactions that result in the elimination of more previously deferred foreign income from the group than is actually repatriated. For example, if a taxpayer sells stock in a CFC and the recognized gain is less than the amount of the accumulated E&P, the amount includible in income as a dividend under Section 1248 is limited to the recognized gain. If the CFC had E&P that was included in previously deferred foreign income of 200 and only 150 in gain is recognized and treated as a dividend upon sale of the CFC, it appears from the language of the Bill that the remaining 50 in E&P would still be included in the pool of previously deferred foreign income but could never be repatriated since it is no longer in the U.S. taxpayer's worldwide group. As a result, a portion of previously deferred deductions and foreign taxes would never be taken into account.

In the case of proposed Section 975, we believe that this result should be changed by providing that the full amount of the CFC's E&P allocable to the sold shares is treated as repatriated for purposes of determining the allowance of previously deferred deductions. Alternatively, the E&P in excess of the gain could be applied to reduce the pool of previously deferred foreign income without being treated as repatriated foreign income. Either way, all previously deferred deductions would ultimately be taken into account at such time as there is no E&P left to repatriate, which would be consistent with the policy objectives of proposed

Section 975.[33] We do not believe, however, that a similar change should be made for purposes of proposed Section 976. If previously deferred foreign income will never be taken into account for U.S. tax purposes, it is reasonable (as well as consistent with current law) to deny credits for the associated foreign taxes. Of course, because proposed Section 976 treats all CFCs as a single CFC, the amount of foreign taxes that are never creditable generally would not correspond to the taxes paid with respect to the never-recognized E&P of the sold CFC.

c. Determination of Whether Repatriations Are Paid Out of Previously Deferred Foreign Income

Proposed Sections 975 and 976 require a determination of whether distributions from a CFC are deemed to be paid out of previously deferred income, as opposed to current income, income earned by the CFC in years prior to the taxpayer's ownership of the shares or prior to the CFC becoming a CFC, or income earned by the CFC prior to the effective date of proposed Sections 975 and 976.

The definitions of currently-taxed and deferred foreign income in proposed Sections 975 and 976 appear to assume that dividends are paid first out of current earnings. This is appropriate and consistent with Section 316 but should be clarified. As a corollary, total foreign income taxes for purposes of proposed Section 976 should include taxes paid or accrued by CFCs in the current year, notwithstanding the pooling principles of Section 902.

Clarification is also needed with respect to the treatment of dividends paid by a CFC out of prior years' earnings when the taxpayer also owns stock in another CFC with current year E&P that is not distributed currently. This can be illustrated by the following example:

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33. Yet another approach would be to allow the taxpayer to elect to include the full amount of E&P as a dividend and recognize an offsetting capital loss to the extent the dividend inclusion exceeds the amount of gain otherwise recognized.

> Example 6: U.S. corporation P owns all the stock of two foreign subsidiaries, FS1 and FS2. In Year 1, FS1 has E&P of 100 which it does not distribute, and FS2 has no E&P. In Year 2, FS1 has no E&P and distributes its Year 1 E&P, and FS2 has E&P of 100 which it does not distribute.

Under the Bill, the dividend paid by FS1 in Year 2 would appear to be repatriated foreign income because it is paid out of previously deferred foreign income. However, it also appears that P would have no deferred foreign income in Year 2 because deferred foreign income is defined as the excess of the amount that would be recognized under subpart F if all CFC earnings were subpart F income over the sum of dividends received and actual subpart F income. This would leave FS2's Year 2 E&P in a sort of limbo. We believe that the appropriate result would be to treat the dividend paid by FS1 in Year 2 as currently-taxed foreign income and not to reduce P's previously deferred foreign income; in effect, FS2's Year 2 E&P would replace FS1's Year 1 E&P in the deferred foreign income pool. This would be consistent with the general approach of proposed Sections 975 and 976 of treating all CFCs as a single CFC.

Where a taxpayer increases its interest in a CFC and subsequently receives distributions from the CFC, the logic of proposed Section 976 requires the establishment of separate earnings pools. This can be illustrated by the following example:

> Example 7: Assume that at the beginning of Year 1, U.S. corporation P owns 51% of the stock of foreign corporation X, and that the remaining 49% is owned by unrelated foreign person F. In Year 1, X has E&P of 100. At the beginning of Year 2, P purchases F's stock in X. X has no E&P in Year 2, and at the end of Year 2, X pays a dividend of 100 to P.

It seems clear that only 51 of the dividend should be treated as repatriated foreign income, since P had only 51 in deferred foreign income attributable to its investment in X. It appears that the remaining 49 of dividend income would be treated as currently-taxed foreign income, thereby increasing the amount of the taxpayer's foreign-related deductions incurred in the year of the distribution that are currently deductible, and that any Section 902 credits

associated with that income would be included in total foreign income taxes for Year 2.[34] We believe that this result is inappropriate. A better approach would be to exclude 49 in dividend income from both currently-taxed and deferred foreign income and to instead allow the associated Section 902 credit in the current year in the same manner as under current law.

If X distributes only 50 as a dividend in Year 2, the Bill should provide ordering rules to determine how much of the dividend is paid out of previously deferred foreign income and how much is paid out of the remaining E&P. We think that it would be appropriate to treat dividends as paid out of the most recent E&P first and to determine whether dividends constitute repatriated foreign income on a share-by-share basis.

Similar issues arise when a CFC has E&P arising before the effective date of the Bill. The Bill provides that previously deferred foreign income includes only income earned in years in which its provisions are effective.[35] Dividends paid out of pre-effective date earnings apparently would be treated as currently-taxed foreign income, and associated Section 902 credits would be included in the current year's total foreign income taxes under the current Section 902 rules. As in the case of distributions out of E&P arising prior to the taxpayer's ownership, we believe that dividends paid out of pre-enactment E&P should not be included in currently-taxed income and should be excluded from the formulas under proposed Sections 975 and 976, and that associated foreign taxes should be creditable in accordance with current law. Again, ordering rules are needed. We believe that the simplest approach would be to establish

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34. If the facts were changed so that F were a U.S. person and F recognized 49 of dividend income under Section 1248 on the sale of stock to P, the distribution to P of that E&P would be exempt from tax as previously taxed income under Section 959.

35. Proposed Section 975(c)(4) (defining previously deferred foreign income as "the aggregate amount of deferred income for all prior taxable years to which this part applies").

separate pre- and post-effective date pools of E&P and foreign taxes and to provide that distributions come first out of post-effective date E&P. This would be consistent with the approach taken in the amendments to Section 902 made by the Tax Reform Act of 1986, which provided for separate pools of pre- and post-1986 earnings in connection with establishing the rules for multi-year pooling.

10. Dilution of Taxpayer's Interest in CFC

Dilution of a taxpayer's interest in a CFC as a result of the CFC's issuance of additional equity to an unrelated party poses two issues with respect to the determination of the taxpayer's previously deferred foreign income and repatriated foreign income.

The first issue is whether dividends from the foreign subsidiary can still be treated as repatriated foreign income even if the foreign subsidiary is no longer a CFC. We believe that the answer to this question clearly should be yes, even if income earned by non-CFC subsidiaries is not subject to the rules of proposed Sections 975 and 976,[36] and the language of the Bill appears to support that result.

The second and more complicated issue arises from the fact that the taxpayer's interest in the CFC's accumulated E&P will be reduced. As a result, even if all the accumulated E&P is eventually distributed, the total amount of the taxpayer's repatriated foreign income will be less than the full amount of the taxpayer's previously deferred foreign income, resulting in an inability to claim the full amount of deferred foreign-related deductions and deferred foreign

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36. *See* discussion at I.C.6, *supra*.

income taxes.[37] This result is inappropriate insofar as it applies to proposed Section 975 because that provision is intended to provide for the deferral of foreign-related deductions, not their denial.[38] The simplest solution would be to provide that previously deferred foreign income is reduced by the amount of the reduction in the taxpayer's share of accumulated E&P. However, this reduction would be complicated if there are multiple classes of stock. For purposes of proposed Section 976, we do not believe that it is necessary or appropriate to reduce previously deferred foreign income; it is appropriate to reduce the taxpayer's future foreign tax credits because its future foreign source income will be reduced by the dilution of its interest in the CFC.

11. Effect of CFC Deficits in Earnings and Profits

Losses incurred by a CFC pose a number of issues in the implementation of proposed Sections 975 and 976. Some of these are illustrated by the following example:

> Example 8: Assume that U.S. corporation P has two wholly-owned foreign subsidiaries, FS1 and FS2. In Year 1, FS1 has E&P of 100 and pays foreign taxes of 30, and FS2 has an E&P deficit of 100 and pays no foreign taxes.

In this example, because all CFCs are treated as a single CFC, P has no deferred foreign income. If P has any currently-taxed foreign income, all of its foreign-related deductions (including, for example, interest expense attributable to P's investment in the foreign subsidiaries) would be currently deductible. If P has no currently-taxed foreign income,

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37. This issue is similar to that discussed at I.C.9.b, *supra*, where a taxpayer sells an interest in a CFC and has a Section 1248 inclusion that is less than the accumulated E&P attributable to the sold interest.

38. It is possible that the dilution of the taxpayer's interest in the CFC's deferred foreign income will be offset if the unrelated party contributes built-in gain assets that will generate E&P when sold. However, adjustments to reflect such built-in gain would be unduly complicated and generally would be unnecessary since the taxpayer's deferred foreign income would not be increased by this E&P.

proposed Section 975 would require multiplication of the amount of foreign-related deductions by a fraction with a denominator of zero; it is unclear how much of P's foreign-related deductions should be deferred.

It appears that FS1's foreign taxes would not be currently creditable, however, regardless of whether P has currently-taxed foreign income. The reason for this is that total foreign income taxes for a taxable year, as defined in proposed Section 976(c)(2), would include the increase in foreign income taxes that would be incurred if all CFCs were treated as a single CFC and all E&P were subpart F income; since there is no net E&P, there would be no amount that could be treated as subpart F income and thereby result in FS1's tax liability being included in total foreign income taxes. If FS1's Year 1 E&P were 101 instead of 100, so that the two CFCs had aggregate E&P of 1, half of FS1's entire foreign income tax would be currently creditable if P had currently-taxed foreign income of 1 that was not subject to foreign tax.[39]

Further anomalies may arise when FS1's Year 1 E&P is later repatriated.

> Example 9: Same facts as Example 8 and, in Year 2, neither FS1 nor FS 2 has any E&P or deficit in E&P and FS1's Year 1 E&P is distributed.

Assuming that P has no previously deferred foreign income from other years, the Year 2 dividend from FS1 would be currently-taxed foreign income. If P's Year 1 foreign-related deductions were deferred (*e.g.*, because P had no Year 1 currently-taxed foreign source income), they would not be taken into account in Year 2, although they could be taken into account if there is deferred foreign income in another year which is subsequently repatriated. Because proposed Section 976(a) would only preclude the application of Section 902 in the case of a prior

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39. P would have currently-taxed foreign income of 1, deferred foreign tax of 1, and total foreign income taxes of 30. In contrast, under current law the percentage of FS1's Year 1 foreign taxes that could be currently claimed as a credit would be limited to the percentage of its earnings that are distributed.

year's "total foreign income taxes" that are deferred under proposed Section 976, it appears that FS1's Year 1 foreign taxes would be taken into account in the calculation of Year 2's total foreign income taxes, although it would be helpful if this were clarified. If FS1's Year 1 E&P were 101, on the other hand, it appears that a distribution by FS1 of 1 in Year 2 would result in P being entitled to claim FS1's entire Year 1 foreign tax liability as a credit in Year 2, assuming that P had no other previously deferred foreign income.[40]

As noted at I.C.4 above, proposed Sections 975 and 976 would not change the current rules for determining whether a distribution is a taxable dividend. If a U.S. taxpayer owns stock in a CFC with a deficit in E&P and more than one CFC with positive E&P, consideration must be given to the extent to which future dividends constitute repatriated foreign income, as illustrated by the following example:

> Example 10: Assume that U.S corporation P has three wholly-owned CFCs: FS1, FS2, and FS3. In Year 1, FS1 and FS2 each has E&P of 100, and FS3 has an E&P deficit of 100.

In this example, P has deferred foreign income of 100, and FS1 and FS2 collectively have E&P of 200. One approach would be to prorate the deferred foreign income among the CFCs with positive E&P in proportion to their E&P so that 50 in future dividends from such corporation could be repatriated foreign income. Alternatively, the first 100 in taxable dividends from the two subsidiaries could be treated as repatriated foreign income, regardless of the corporation making the distribution.

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40. Under the facts of the example, this would result in an acceleration of foreign tax credits as compared to current law. However, current law would produce the same result if FS2, rather than being a CFC owned by P, were a disregarded entity owned by FS1.

Some of these issues could be resolved if all CFCs owned by a taxpayer were treated as a single CFC for purposes of determining E&P and the taxability of distributions. However, this would be unduly complicated, especially in situations where a taxpayer's percentage ownership in a CFC changes from year to year. Alternatively, deferred foreign income could be determined without regard to CFCs with E&P deficits. However, in our view this would improperly overstate deferred foreign income.

Additional issues are raised where the CFCs owned by a taxpayer have positive E&P in one year and a deficit in E&P in another year. This can be illustrated by the following example:

> Example 11: Assume that U.S corporation P has a single wholly-owned foreign subsidiary, FS. FS has E&P of 100 and pays foreign taxes of 30 in Year 1 and has a deficit in E&P of 50 in Year 2. P has no other foreign source income.

At the end of Year 2, P has previously deferred foreign income of 100 but has accumulated E&P of only 50. Under the Bill as drafted, if FS distributed all its accumulated E&P, it would have only 50 in repatriated foreign income and therefore would be entitled to claim only half of its previously deferred deductions and previously deferred foreign income taxes. We believe that it would be appropriate to provide that previously deferred foreign income is reduced by E&P deficits for purposes of both proposed Sections 975 and 976, regardless of whether the deficit occurs in a year prior or subsequent to the year in which there is positive E&P. This would be consistent both with the manner in which the Bill as drafted operates with respect to positive and deficit E&P of different CFCs in a single year as well as the pooling rules of current Section 902.[41]

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41. Section 902 provides for pooling of a CFC's earnings, deficits and foreign taxes incurred on a multi-year basis.

12. Consequences of U.S. Member's Departure from Group

Proposed Sections 975 and 976 pose a number of issues when a U.S. corporation (which may own stock in one or more CFCs) ceases to be a member of an affiliated group.[42] These issues involve the allocation of the group's previously deferred foreign income, previously deferred deductions, and previously deferred foreign taxes, as well as the determination of the E&P and foreign taxes paid by any CFCs owned by the departing group member. Although it may be more appropriate to address these issues administratively (*e.g.*, in the consolidated return regulations) rather than by statute, they are sufficiently important that it would be highly desirable to have guidance prior to the effective date of the Bill.

We believe the most workable approach is not to adjust the E&P of CFCs owned by a departing group member, even though the group's tax liability for prior years generally would not have been affected by which CFCs distributed their E&P. A portion of the group's previously deferred foreign income, previously deferred deductions, and previously deferred foreign income taxes should be allocated to the departing group member based upon the percentage of the group's previously deferred foreign income represented by the undistributed E&P of CFCs owned by the departing group member. The amount of previously deferred foreign income taxes that leave the group with the departed group member would thus not be affected by whether the CFCs owned by the departing group member were subject to a higher or lower rate of foreign tax than other CFCs owned by the group. This would be consistent with the

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42. This assumes that, as discussed at I.C.2, *supra*, proposed Sections 975 and 976 apply on a group-wide basis.

general treatment of all CFCs as a single CFC under proposed Sections 975 and 976.[43] Similarly, the previously deferred deductions allocable to the departing group member would be determined without regard to the amount of the expenses that produced the deductions which were incurred by the departing group member.

13. Separate Treatment of General Limitation and Passive Limitation Income

Under proposed Section 977, proposed Sections 975 and 976 would be applied separately with respect to general limitation and passive limitation income. It is unclear whether this would entail offsetting one CFC's E&P deficit in one category against another CFC's positive E&P in the other category.[44] This can be illustrated by the following example:

> Example 12: U.S taxpayer P owns all the stock of two CFCs, FS1 and FS2. In Year 1, FS1 has an E&P deficit of 50, all in the passive limitation category, and FS2 has 100 in E&P, all in the general limitation category.

If proposed Sections 975 and 976 are intended to apply completely separately to general limitation and passive limitation income, P would have 100 in deferred foreign income in the general limitation category. On the other hand, the general principle of proposed Sections 975 and 976 of treating all CFCs as a single CFC would suggest that P has only 50 in Year 1 general limitation deferred foreign income and that subsequent years' passive limitation income earned by either CFC1 or CFC2 would be recharacterized as general limitation income under Section 904(f)(5)(C). This could lead to complications, however. If, for example, a CFC with

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43. There are other possible approaches. For example, if a group has two CFCs, one in a no-tax jurisdiction and the other in a high-tax jurisdiction, the rules could provide that if the CFC that paid the taxes is owned by the departing group member, all the group's deferred foreign income taxes would be allocated to the departing group member.

44. Section 904(f)(5) provides for offsetting of separate limitation losses incurred in a year against separate limitation income in other categories.

an E&P deficit in one category is owned 50% by each of two U.S. taxpayers, it appears that only half of the CFC's subsequent years' E&P could be recharacterized under the Section 904(f)(5) rules if only one of the U.S. taxpayers has an overall E&P deficit in one category offsetting positive E&P in the other category. Further complications could ensue if shares in a CFC are sold.

14. Section 905(c) Adjustments

Under current law, if foreign taxes paid directly by a U.S. taxpayer that give rise to credits in one year are adjusted in a subsequent year, the taxpayer's foreign tax credit (and thus its U.S. tax liability) in the earlier year generally has to be redetermined.[45] In contrast, subject to certain exceptions, redeterminations of a foreign corporation's taxes that gave rise to a credit under Sections 902 or 960 generally result in an adjustment to the foreign corporation's post-1986 earnings and foreign tax pools rather than in a redetermination of the U.S. taxpayer's prior year U.S. tax liability.[46]

Because proposed Section 976 would effectively blend foreign taxes paid directly by a U.S. taxpayer with foreign taxes paid by CFCs, this difference in treatment under Section 905 presumably would no longer be workable. We believe that the best approach would be to require all redeterminations of foreign taxes to result in redetermination of U.S. tax liability and recalculation of previously deferred foreign income taxes, with determinations being made as if the foreign taxes had been adjusted in the year originally paid or accrued.

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45. Temp. Treas. Reg. § 1.905-3T(d)(1).

46. Temp. Treas. Reg. § 1.905-3T(d)(2).

15. Foreign Currency Conversions

Under current law, a foreign corporation's E&P is calculated in the corporation's functional currency and then converted into dollars based on the exchange rate in effect when distributed or deemed distributed.[47] Section 3202(a) of the Bill would amend Section 986(b)(2) to provide that E&P of a foreign corporation would be translated from the foreign corporation's functional currency into U.S. dollars using the average exchange rate in the taxable year in which earned. Section 3202(b) of the Bill would amend Section 986(c)(1) and appears to require recognition of gain or loss to reflect changes in exchange rates between the year in which E&P is earned and the year in which it is distributed or deemed distributed.[48]

This rule presumably is necessary in order to make the provisions of proposed Sections 975 and 976 that treat all CFCs as a single CFC work properly. Otherwise, the pooling of E&P of CFCs with different functional currencies would be difficult if not impossible to implement.

The Bill should be revised to clarify whether currency gain or loss recognized under amended Section 986(c)(1) would be treated as currently-taxed foreign income or otherwise and, more generally, the effect of the proposed changes to Section 986 on the calculation of repatriated foreign income. Treatment of currency gain or loss as repatriated foreign income would not work correctly because the amount of the currency gain or loss was not reflected in previously deferred foreign income. Instead, repatriated foreign income should be determined by reference to the CFC's aggregate previously deferred income as translated into U.S. dollars in the

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47. Section 986(b).

48. The language of the Bill appears to be misdrafted, as the amended provision relates to previously taxed E&P described in Section 959 or 1293(c).

years earned multiplied by the percentage of the CFC's previously deferred foreign income as calculated in its functional currency that is distributed. On the other hand, currency gain or loss should not be treated as currently-taxed foreign income because it should not increase or reduce the amount of foreign-related deductions or foreign tax credits that can be taken into account in the year of distribution. We believe that the best approach would be to treat the currency gain or loss as a separate category that would not affect calculations under proposed Sections 975 and 976.

II. LIMITATIONS ON TREATY BENEFITS

A. Overview of Provision

Section 3204 of the Bill would add a new Section 894(d) to the Code that would limit treaty benefits with respect to certain related-party deductible payments received by members of a foreign-owned controlled group.[49] More specifically, proposed Section 894(d) would deny treaty benefits if a U.S. corporate taxpayer is a member of a controlled group of corporations whose common parent is a foreign corporation, the U.S. corporation makes a deductible payment to a foreign group member that is otherwise eligible for exemption from or reduction in withholding tax under a U.S. income tax treaty, and the foreign common parent would not be eligible for treaty benefits if it received the payment. The definition of controlled group is the

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49. An identical provision was included in the proposed Middle Class Tax Fairness Act of 2008 (H.R. 6595) and the proposed Alternative Minimum Tax Relief Act of 2008 (H.R. 6275).

same as that of Section 1563(a)(1) except that the ownership threshold is lowered from at least 80% to more than 50%.[50]

B. Discussion

The legislative history to proposed Section 894(d) as set out in H.R. 6275 indicates that it is intended to prevent treaty shopping.[51] In particular, the legislative explanation states that some instances of treaty shopping involve inversion transactions where former U.S. parents of multinational groups became subsidiaries of foreign corporations established in tax havens. The sponsors believe that it is inappropriate to grant treaty benefits to a foreign subsidiary of a foreign parent corporation that would not have qualified for treaty benefits if the payments were made directly to the parent.

The House Ways and Means Committee Report and the Joint Committee Report on the Alternative Minimum Tax Relief Act of 2008 (JCX-50-08) explain that treaty benefits will be granted as long as a U.S. treaty would have reduced withholding tax on direct payments to the parent corporation, regardless of the amount of such reduction. Therefore, the proposal leaves the door open for treaty shopping structures where the parent is covered by a treaty but the affiliate receives the benefit of a more favorable treaty. This feature is perhaps indicative that the target of the proposed legislation is companies formed in tax havens that are used as the situs for inverted companies.

Although the proposal requires only that the parent be eligible for some treaty benefits, regardless of the rate, it raises some troubling issues. A treaty partner has a vital interest in

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50. In addition, for this purpose, Sections 1563(a)(4) and (b)(2) do not apply. Partnerships controlled by members of the group are treated as part of the controlled group.

51. House Ways & Means Committee Report, H.R. REP. NO. 110-728, on H.R. 6275.

ensuring that its residents enjoy the benefits reflected in the treaty. Proposed Section 894(d) would operate as an override to treaties. Although treaty overrides have been judicially accepted,[52] the unilateral abrogation of treaty obligations may still violate international legal principles. Under Article 60 of the Vienna Convention, in case of a material breach of a bilateral treaty by one party, the other treaty partner has the right to terminate the treaty or to suspend its operation in whole or in part. Consequently, the unilateral override could result in the treaty partner's denial of treaty benefits to U.S. persons.

Furthermore, the proposal seems to deviate from the U.S. bilateral anti-treaty-shopping approach. Most treaties to which the United States is a party have sophisticated limitation on benefits provisions that are the product of bilateral negotiations. Limitation on benefits provisions generally include an active trade or business test that grants treaty benefits for items of income that are derived in connection with an active trade or business. Therefore, a company resident in a treaty country that is not beneficially owned by residents of either treaty partner might still enjoy treaty benefits if it is engaged in an active business in the country of its organization. We believe that it is anomalous to provide by statute that, even where a treaty provides that benefits are available without regard to ownership, ownership by a third country foreign corporation results in loss of benefits, and we question whether this result is intended. Furthermore, treaties' competent authority provisions generally permit the tax authorities to grant treaty relief if the structure's principal purpose is not the obtaining of treaty benefits. Consequently, when determining whether benefits apply, limitation on benefits provisions take

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52. Treaties and Federal law are considered to have equal authoritative weight, so that a later in time legislation can supersede provisions in a treaty. *See, e.g., Whitney v. Robertson*, 124 U.S. 190, 194 (1888); Rev. Rul. 80-223, 1980-2 CB 217.

into account the economic substance of the foreign entity. In contrast, the proposal does not consider whether there is any economic substance or a valid non-tax business reason for organization of the income recipient in the treaty jurisdiction. It simply denies treaty benefits when the mechanical requirements of proposed Section 894(d) are met. For example, if a Bermuda company has a substantial operating subsidiary in the United Kingdom that, because London is a financial center, raises funds that it lends to affiliates, the provision would deny the U.K. subsidiary the benefits of the treaty. This result appears inappropriate, especially if the U.K. subsidiary earns substantial income that is subject to U.K. tax.[53] In such cases, a treaty partner, such as the United Kingdom, may be concerned that an active business enterprise conducted within its borders is not being treated by the U.S. in accordance with the terms of the treaty. Clearly, there are situations that are less sympathetic but modern limitation on benefits provisions do not generally leave significant gaps. Consideration could be given to following the approach of Section 884(e), which sets forth its own standard for determining eligibility for treaty benefits for purposes of the branch profits tax, but only in the case of treaties that do not have post-December 31, 1986 limitation on benefits provisions.[54] Alternatively, proposed Section 894(d) could be more narrowly tailored to focus on structures resulting from inversion transactions, including those that were effected prior to the effective date of Section 7874(d).

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53. Even if the parent is a resident of a country with a treaty that includes an active trade or business clause in its limitation on benefits provision, it appears that proposed Section 894(d) would deny treaty benefits where the income is derived in connection with an active trade or business carried on in the subsidiary's but not the parent's country of residence.

54. *See* Treas. Reg. §§1.884-1(g) and 1.884-5. The "qualified resident" standard of Treas. Reg. § 1.884-5 is broadly similar to the limitation on benefits clauses in modern U.S. treaties.

Finally, we note that, to the extent that proposed Section 894(d) does promote valid policy objectives, it is arguably under-inclusive insofar as it would not apply where the foreign common parent corporation is organized in a treaty country that has a broad participation exemption under its domestic law, even though such situations can produce similar results to structures where the parent is organized in a tax haven jurisdiction with no treaty. This could severely undermine the effectiveness of the proposed provision.[55] In addition, proposed Section 894(d) would apply only if the U.S. payor and the foreign recipient are controlled by a foreign common parent corporation. The proposal would not apply if the affiliated entities are controlled by one or more nonresident alien individuals or by a foreign entity that is treated as a partnership for U.S. tax purposes (even if it is treated as a corporation for foreign tax purposes).

III. EFFECTS OF THE REDUCTION OF THE CORPORATE INCOME TAX RATE

A. Overview

The United States currently has the second highest combined statutory rate of corporate income tax among the OECD countries, and there appears to be a global trend toward reductions in corporate tax rates.[56] The Bill would reduce the federal income tax rate for corporations from 35% to 30.5% (and possibly further, based upon comments by Chairman Rangel).[57]

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55. In this connection, we understand that several publicly-traded multinational companies that had previously undergone inversion transactions have recently announced that they are changing their place of incorporation from traditional tax haven jurisdictions to Switzerland.

56. KPMG's Corporate and Indirect Tax Rate Survey 2008 (Aug. 2008), *available at* http://www.kpmg.com/SiteCollectionDocuments/Corporate-and-Indirect-Tax-Rate-Survey-2008v2.pdf.

57. Section 3001 of the Bill. *See* note 1, *supra*. The rate of 30.5% (and even the suggested rate of 28%) would still be higher than the OECD average of 26.7% for 2008.

Economists have been studying whether the high corporate tax rate undermines U.S. global competitiveness and whether a rate cut, such as the one proposed by Chairman Rangel, would stimulate domestic corporate activities, attract foreign investments and keep jobs in the United States.[58] From their work, one could conclude that the relationship between the statutory corporate income tax rate of a country and the global competitiveness of that country's economy is by no means simple, and one must at a minimum take into account the availability of tax credits, accelerated depreciation, amortization and depletion that narrow the corporate tax base, the ability of businesses to operate in a form not subject to corporate income tax (*e.g.*, limited liability companies and S corporations) and the possibility of reducing overall tax liabilities, deferring income recognition or shifting income through tax planning (with tools such as a check-the-box election, debt financing, foreign tax credits and transfer pricing).[59]

B. Abuse of the Corporate Form

One aspect of a corporate tax reduction that appears to be uncontroversial is that there is a limit to how much the corporate tax rate can be reduced relative to individual tax rates before a corporation potentially becomes attractive as a device for wealthy individuals to escape the imposition of current income tax on their investments. In 1913, the year the individual income tax was (re)introduced after the ratification of the Sixteenth Amendment, legislators recognized this possibility and enacted a provision that imposed a penalty tax on shareholders of a

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58. *See, e.g.*, DEP'T OF THE TREASURY, TREASURY CONFERENCE ON BUSINESS AND GLOBAL COMPETITIVENESS, BACKGROUND PAPER (2007); Jane G. Gravelle & Thomas L. Hungerford, Congressional Research Service, CORPORATE TAX REFORM: ISSUES FOR CONGRESS (2008); James R. Hines Jr., *Corporate Taxation and International Competition*, *in* TAXING CORPORATE INCOME IN THE 21ST CENTURY 268-295 (Alan J. Auerbach *et al.* eds., 2007).

59. *Id.*

corporation that was created or used to defer income tax at the individual shareholder level.[60] Both the accumulated earnings tax[61] and personal holding company tax provisions[62] in today's law have their origins in this 1913 provision.

From 1913 to 1982, the highest marginal income tax rates for individuals were considerably higher than the highest corporate tax rates. This disparity, as well as structural features such as the *General Utilities* doctrine, encouraged individuals to exploit the corporate form to defer, or avoid altogether, imposition of individual tax on their income. The deferral of individual tax alone was advantageous. This remained true even when the combination of the corporate tax and the individual income tax on dividends became greater than the highest individual income tax rate applicable to direct investments if the individual taxpayer could keep his or her investments in a corporation and let the corporation reinvest any income or gain therefrom with a single level of taxation. The introduction of a preferred rate for long-term capital gain[63] and a basis step-up provision for acquisitions from decedents[64] in 1921 presented individual investors with greater incentives to form or utilize a corporation for a tax-avoidance purpose, particularly if the individual was able to take advantage of the *General Utilities*

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60. Revenue Act of 1913, Ch. 16, Section II(A)2, 38 Stat. 114 (1913) (the "1913 Act").

61. Sections 531-537.

62. Sections 541-547.

63. Revenue Act of 1921, Ch. 136, Section 206(a) & (b), 42 Stat. 227 (1921) (the "1921 Act") (allowing a reduced tax rate if assets were held for at least two years).

64. The 1921 Act, Section 202(a)(3) (the predecessor to Section 1014).

doctrine[65] to avoid corporate-level tax on unrealized gains in investment assets. The capital gain preference provided an individual investor with an option to sell the appreciated stock of a corporation that was formed as a tax shelter at a preferred long-term capital gain rate, thereby transforming dividends and interest that would have been taxed as ordinary income into capital gain. An investor could also choose to hold the stock of the corporation until his or her death and pass on to his or her heirs the appreciated stock of the corporation with a stepped-up basis, thereby avoiding all taxation on gain and profits from investments that had accumulated prior to the investor's death.

The introduction of individual tax rates that were more aligned with the corporate tax rates in 1982,[66] and the complete repeal of the *General Utilities* doctrine in 1986,[67] greatly diminished the incentive to form corporations for a tax-avoidance purpose, and the accumulated earnings tax and personal holding company tax, two mechanisms to prevent such tax avoidance, have become somewhat of a dead letter. If the proposed rate reduction is enacted, however, the corporate income tax rate would again fall below the highest individual tax rate, and corporations could become vehicles for wealthy individuals to shelter their income, particularly if the rate

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65 *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). In its fullest form, the *General Utilities* doctrine permitted a corporation to distribute appreciated assets either as dividends or in liquidation without recognizing the gain inherent in the distributed asset. *See also* Internal Revenue Code of 1954, Sections 311, 336 & 337 (1954) (codifying the *General Utilities* doctrine).

66. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981) (reducing the highest individual income tax rate to 50%, only 4% higher than the highest corporate income tax rate).

67. Tax Reform Act of 1986, Section 631, 100 Stat. 2085 (1986).

differential becomes sufficiently large.[68] Consequently, the accumulated earnings tax and the personal holding company tax may become relevant once again.

C. Accumulated Earnings Tax

1. In General

The accumulated earnings tax is a corporate-level penalty tax imposed on the "accumulated taxable income" of a corporation, currently at a rate of 15%.[69] The accumulated earnings tax applies to every corporation that is not a personal holding company, a tax-exempt corporation, a passive foreign investment company[70] or an S corporation[71] and that is formed or availed of for the purposes of avoiding the income tax with respect to its shareholders or the shareholders of another corporation by permitting earnings and profits to accumulate instead of being distributed.[72]

Unlike the personal holding company tax, discussed below, the accumulated earnings tax is not self-assessed and arises only on a deficiency assessment.[73] Because it requires the IRS to

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68. With respect to investment income, a small difference between the highest individual tax rate and the corporate tax rate (4.5%) probably would not revive much interest in so-called "incorporated pocketbooks" unless the tax base of the corporation is narrower than the tax base of an individual investor in a meaningful way. It may, therefore, make more sense in many circumstances for individuals to make investments through a pass-through entity.

69. Section 531. This rate applies only to taxable years beginning after December 31, 2002 and before January 1, 2011. Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 102, 120 Stat. 345. For taxable years beginning before 2003 and after 2010, accumulated taxable income is taxed at the rate for individuals in the highest income tax bracket.

70. Section 532(b).

71. Section 1363(a).

72. Section 532(a).

73. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.1 (7th Ed., 2006 & supp. 2008).

show (i) accumulated earnings and profits during the taxable year beyond the reasonable needs of the business or (ii) an intent on the part of the corporation to avoid the income tax on its shareholders by accumulating earnings and profits instead of distributing them,[74] the accumulated earnings tax is not easily enforceable, and thus presumably less effective than it otherwise could be. Although the accumulated earnings tax is generally imposed on closely-held corporations, its application is determined without regard to the number of the shareholders,[75] and publicly-held corporations are not immune from this tax.[76]

2. History

The history of the provisions of the Code (and its predecessors) governing the accumulated earnings tax shows a series of changes that were intended, for the most part, to simplify its enforcement. Under the 1913 Act, the accumulated earnings tax was imposed on individual shareholders of a corporation that was "formed or *fraudulently* availed of" for the purpose of avoiding the imposition of individual income tax on its shareholders.[77] The fact that the corporation was a "mere holding company" or that its gain and profits were permitted to accumulate "beyond the reasonable needs of the business" was "prima facie evidence of a *fraudulent purpose* to escape" individual income tax, but it also required that the Treasury Secretary certify that in his opinion a corporation's accumulation was "unreasonable for

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74. INTERNAL REVENUE MANUAL HANDBOOK § 4233, *Tax Audit Guidelines, Audit Technique – Accumulated Earnings Tax*, Ch. 600 (*withdrawn in* 2005).

75. Section 532(c).

76. *Trico Prods. Corp. v. Comm'r*, 137 F.2d 424 (2d Cir. 1943) *cert. denied*, 320 U.S. 799 (1943), *reh'g denied*, 321 U.S. 801 (1944) (holding that a publicly-traded corporation that invested its profits in securities rather than distributing was subject to surtaxes (*i.e.*, accumulated earnings tax) where a comparatively small group of shareholders was "in control of the dividend policy").

77. The 1913 Act, Section II(A)2 (emphasis added).

purposes of the business"[78] before imposing any penalty tax on the corporation's shareholders. With the highest individual income tax rate at 7% and the corporate income tax rate at 1%,[79] legislators in 1913 clearly saw a need to prevent an individual with "an income as large as Mr. Carnegie's income" "from organizing a holding company and passing his income from year to year up to undivided profits" for the purpose of evading the tax.[80] However, because of the subjective "intent" standard, enforcing this law soon proved difficult, if not impossible.

Since 1913, the accumulated earnings tax provisions have seen numerous revisions and amendments, largely in order to make enforcement practical. In 1918, the necessity of proving fraud was eliminated based on the observation that it was difficult for the Treasury Secretary to secure evidence to establish fraud.[81] In 1921, a change was made to impose the penalty tax on an offending corporation itself, rather than its shareholders.[82] In 1924, an "investment company" was added as prima facie evidence of tax avoidance, and the requirement that the Treasury Secretary first find evidence of evasion was eliminated.[83] In an attempt to discourage exploitation of the corporate form for a tax avoidance purpose, Congress also doubled the rate of

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78. *Id.* (emphasis added).

79. The 1913 Act, Section II(A)1 & 2.

80. 50 CONG. REC. 3774-75, 4380 (1913) (statement by Sen. Williams), *reprinted in* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861, 985 (1938) [hereinafter SEIDMAN'S LEGISLATIVE HISTORY].

81. Revenue Act of 1918, Ch. 18, Section 220, 40 Stat. 1057 (1918); *see also* 57 CONG. REC. 253 (1918) (statement by Sen. Simmons), *reprinted in* SEIDMAN'S LEGISLATIVE HISTORY, *supra* note 80, at 926.

82. The 1921 Act, Section 220. This amendment was made not to improve enforceability of the accumulated earnings tax but to deal with a Supreme Court decision in *Eisner v. Macomber*, 252 U.S. 189 (1920) that raised considerable doubt about the constitutionality of taxing shareholders on the undistributed income of corporations. H.R. REP. NO. 350 at 12-13 (1921).

83. Revenue Act of 1924, Ch. 234, Section 220(b), 43 Stat. 253 (1924) (the "1924 Act").

the penalty tax.[84] These changes apparently were not sufficient to make the accumulated earnings tax effective, however. In 1928, the House Ways and Means Committee proposed an objective standard that would have allowed automatic applications of the penalty tax whenever a corporation's undistributed profits exceeded 30% of net income,[85] but this proposal did not survive the Senate Finance Committee.[86]

In 1934, Congress identified a special class of corporations that were closely held and utilized primarily for passive investments and personal services as the most prevalent form of tax avoidance practiced by individuals with large income.[87] Congress termed such corporations "personal holding companies," removed them from the reach of the general accumulated earnings tax provisions, and created new anti-deferral provisions just for them. Under the personal holding company provisions, if a corporation satisfied certain objective ownership and income tests, the penalty tax was automatically levied without the necessity of proving any tax avoidance purpose.[88] The 1934 Act also amended the general accumulated earnings tax provisions to prevent taxpayers from using tiered corporate structures to escape from the application of the accumulated earnings tax by providing that a corporation would be subject to

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84. *Id.*

85. H.R. REP. NO. 2 at 17-18 (1928). *See also* 69 Cong. Rec. 519-21 (1928), *reprinted in* SEIDMAN'S LEGISLATIVE HISTORY, *supra* note 80, at 528.

86. 69 CONG. REC. 7976-77 (1928), *reprinted in* SEIDMAN'S LEGISLATIVE HISTORY, *supra* note 80, at 529.

87. H.R. REP. NO. 704 at 11 (1934).

88. Revenue Act of 1934, Ch. 277, Section 351, 48 Stat. 680 (1934) (the "1934 Act"). *See also* H.R. REP. NO. 704, at 11 (1934); S. REP. NO. 558, at 13-14 (1934). Note that the Revenue Act of 1937, Ch. 815, Section 201, 50 Stat. 813 (1937) created yet another anti-deferral regime with an objective standard to prevent U.S. individuals' use of "foreign personal holding companies" for a tax avoidance purpose.

the accumulated earnings tax if it was "formed or availed of for the purpose of preventing the imposing of surtax upon . . . the shareholders of *any other* corporation."[89]

In 1938, after the government's defeats in *National Grocery Co.*[90] and *Cecil B. DeMille Productions, Inc.,*[91] Congress made further attempts to remove barriers to effective enforcement of the accumulated earnings tax provisions.[92] One such attempt was shifting of the burden of proof to the taxpayers. Having concluded that the prima facie presumption of intent arising from the fact that the corporation had accumulated surplus beyond the reasonable needs of the business did not render much aid to the government, Congress amended the provisions to require the corporate taxpayer to prove the absence of any purpose to avoid surtaxes upon its shareholders by a clear preponderance of the evidence after it had been determined that the earnings and profits had been unreasonably accumulated.[93]

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89. The 1934 Act, Section 102(a) (emphasis added.) *See also* H.R. REP. NO. 704 at 26 (1934); 78 CONG. REC. 2662 (1934) (statements by Rep. Hill), *reprinted in* SEIDMAN'S LEGISLATIVE HISTORY, *supra* note 80, at 328.

90. *Nat'l Grocery Co. v. Helvering,* 92 F.2d 931 (3d Cir. 1937), *rev'd* 304 U.S. 282 (1938) (holding that the government did not prove unreasonable accumulation of profits by a corporation wholly owned by a single individual where the corporation represented that it required a large amount of liquid assets to purchase additional grocery stores and to protect itself against emergencies).

91. *Comm'r v. Cecil B. DeMille Productions, Inc.,* 90 F.2d 12 (9th Cir. 1937) (holding that the taxpayer's accumulation of earnings were reasonable where the taxpayer stated that its earnings were allowed to accumulate "so that the company might be able to produce its own pictures").

92. H.R. REP. NO. 1860 at 72 (1938); S. REP. NO. 1567 at 4-5, 16 (1938). *See also* H.R. REP. (REPORT OF SUBCOMM. OF H. COMM. ON WAYS & MEANS, TAX REVISION, 1938), Jan. 14, 1938 (Jan. 14, 1938), *reprinted in* SEIDMAN'S LEGISLATIVE HISTORY, *supra* note 80, at 44-45.

93. *Id.*

With this amendment, the test for the accumulated earnings tax liability assumed its present form.[94] The statute still required a finding of a corporation's intent to avoid income tax on its shareholders; such intent, however, was now presumed when the corporation accumulated earnings and profits beyond the reasonable needs of its business unless the corporation could prove by a preponderance of the evidence that such accumulation was not motivated by a tax-avoidance purpose.[95] Theoretically, the government could prevail on an accumulated earnings tax claim even without showing accumulations in excess of the reasonable needs of a business, if it could prove that a corporation had intent to avoid income tax on its shareholders. However, as Judge Learned Hand said, "a statute which stands on the footing of the participants' state of mind may need the support of presumption, indeed be practically unenforceable without it."[96] Therefore, the determination of whether a corporation's accumulation was in excess of reasonable needs of its business became the most critical and most contentious issue for any accumulated earnings tax case.

The 1938 Congress, which provided presumption of tax-avoidance intent upon a showing of an accumulation in excess of reasonable business needs, was also aware that there was no workable evidentiary test of unreasonable accumulations.[97] On the House floor, it was suggested that "reasonable needs of business" be limited to the amount necessary to pay "outstanding

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94. A later amendment shifted the burden of proof back to the government under certain limited circumstances. *See* Section 534.

95. Another significant development with respect to the "intent" standard is the decision by the Supreme Court in *United States v. Donruss Co.*, 393 U.S. 297, 307-308 (1969), holding that as long as tax avoidance constituted a purpose for an unreasonable accumulation of earnings, the penalty tax could be imposed whether or not tax avoidance constituted "the" primary motive.

96. *United Business Corp. v. Comm'r*, 62 F.2d 754, 755 (2d Cir. 1933).

97. 83 CONG. REC. 2940, 3001-03 (1938), *reprinted in* SEIDMAN'S LEGISLATIVE HISTORY, *supra* note 80, at 46-47.

debts, current operating expenses and existing contractual obligations" to prevent the taxpayers from prevailing in courts by declaring speculative projects at some indefinite time in the future as a legitimate business needs.[98] However, this attempt to define the reasonableness of accumulations did not succeed.[99] Ultimately, in 1954, a new provision was added to clarify that "reasonable needs of a business" included "reasonably anticipated needs of the business"[100] to make clear that there was no requirement that the accumulated earnings and profits be invested immediately in the business so long as the corporation had specific and definite plans for acquisition of buildings or equipment for use in the business.[101]

Since 1954, statutory,[102] regulatory,[103] and case law[104] guidelines have been developed to clarify what constitutes the "reasonable needs of business" and what does not. Even so, there is no definite, objective standard for determining the reasonable needs of a business, and each individual case must be decided based on all facts and circumstances. It is likely that this is unavoidable in a diverse and dynamic economy. Since 1986, when individual ordinary income tax rates were reduced to less than those applicable to corporations, it is likely that the incentive

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98. *Id.*

99. *Id.*

100. Internal Revenue Code of 1954, Section 537 (1954).

101. H.R. REP. NO. 1337, 52-53 (1954).

102. *See* Section 537 (providing, among other things, that the accumulation of the amount needed or reasonably anticipated to be needed for a Section 303 redemption and the amount of reasonably anticipated product liability losses are considered the reasonable needs of business).

103. *See, e.g.,* Treas. Reg. § 1.537-2(b) & (c).

104. *See, e.g., Bardahl Int'l Corp. v. Comm'r,* T.C. Memo 1966-182; *Bardahl Mfg. Corp. v. Comm'r*, T.C. Memo 1965-200 (establishing a mathematical formula used to determine the amount of working capital reasonably needed for a taxpayer's operating cycle).

to accumulate income in a corporation was eliminated. Consequently, there has been little recent development in the law regarding the accumulated earnings tax.

With respect to investment income, even if individual ordinary income tax rates are higher than the tax rates applicable to corporations, it is unlikely that there will be substantial incentives to accumulate earnings in a corporation, unless such rate differential is significant (much more than 4.5%, assuming no increase in individual rates) or the tax base of the corporation is narrower than the tax base of an individual investor in a meaningful way. First, since the repeal of the *General Utilities* doctrine, the ability to sell stock of the corporation and avoid tax on the inherent gain in its investment assets has been eliminated. Second, the individual tax rate on capital gains and dividends is currently substantially lower than the rate of tax on corporations; so long as that remains the case, there is an incentive to realize capital gains outside of a corporation. Finally, partnerships and other pass-through entities have become the vehicle of choice for holding investments, in part because they preserve these benefits. Thus, although Congress likely would wish to retain the accumulated earnings tax provisions, it does not appear that substantial changes to these provisions would be warranted merely because of a decrease in corporate tax rates relative to individual rates.

We note that for an individual operating a business, a corporation may become an attractive form in comparison to a pass-through entity, because ordinary income from business operations would be taxed at a rate lower than the individual rate. This would be particularly true if the earnings of the business were likely to be reinvested in the growth of the business rather than distributed to the owners. Therefore, the proposed reduction in corporate tax rates, particularly if accompanied by an increase in individual income tax rates, may discourage to

some extent the use of pass-through entities for operating businesses.[105] In any event, presumably this sort of choice of entity would not be viewed as abusive.[106] On the other hand, this fact pattern would presumably cause Congress to desire to retain the accumulated earnings tax rules.

D. Personal Holding Company Tax

The personal holding company tax is also a penalty tax designed to discourage individuals from using closely-held corporations to defer the individual level taxation on their investments or personal services income. A U.S. corporation is a personal holding company if more than 50% of the stock (by value) of such corporation is owned, directly, indirectly or constructively, by five or fewer individuals at any time during the last half of the corporation's taxable year and not less than 60% of adjusted ordinary income is "personal holding company income."[107] A personal holding company is subject to a 15% tax[108] on its undistributed personal holding company income, which includes, among other things, dividends, interest, royalties, certain rents and other passive-type income, amounts received for use of its property by its

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105. Of course, for an individual, operating in the corporate form would eliminate the possibility of selling assets (either directly or through the use of a Section 338(h)(10) election) in an exit transaction. The associated cost would continue to encourage operations in pass-through entities. The ability of a corporation to be acquired on a tax-free basis in a corporate reorganization would have the opposite effect.

106. *Cf.* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 14.41[2][c] (7th Ed., 2006 & supp. 2008) (noting that Section 269 should not apply to the incorporation of an existing sole proprietorship or partnership to take advantage of any disparity between the bottom corporate tax rate and the top personal tax rate because Congress intended to provide such a benefit).

107. Section 542(a).

108. Section 541. This rate applies only to taxable years beginning after December 31, 2002 and before January 1, 2011. Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 102, 120 Stat. 345. For taxable years after 2010, the rate will return to the highest individual rate absent further legislation.

shareholder, and compensation under personal service contracts.[109] Tax-exempt organizations, life insurance companies, certain lending or financing companies, foreign corporations and S corporations are not subject to the personal holding company tax.[110] Unlike the accumulated earnings tax, the personal holding company tax liability is generally self-assessed.[111]

As discussed above, the 1934 Congress singled out "personal holding companies" as the most prevalent form of tax avoidance by wealthy individuals and subjected them to the new anti-deferral regime that did not require a proof of tax-avoidance intent. Because the personal holding company tax is automatic and self-assessed, it probably is easier to administer than the accumulated earnings tax. On the other hand, because of the objective, mechanical nature of the ownership and income tests, it is relatively easy for a corporation to structure its ownership or its income producing activities in order to escape the personal holding company rules. If a corporation successfully avoids qualification as a personal holding company, any accumulation of such corporation's earnings must be tested under the much less effective regime of the accumulated earnings tax.

The potential for abuse through the use of personal holding companies has almost certainly been reduced since the enactment of the provision largely in its current form in 1934. As with the accumulated earnings tax, the repeal of the *General Utilities* doctrine increased the tax cost of exit from a corporate deferral vehicle by ensuring that a corporate level tax would be paid on any unrealized gain inherent in the corporation's assets. The preferential rates for capital

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109. Section 543(a).

110. Sections 542(c) & 1363(a).

111. Treas. Reg. § 1.541-1(a).

gains (and, currently, dividend income) of individuals, which are below and proposed to remain below the corporate rate, further increase the potential cost of a corporate deferral vehicle, with respect to investment income. Accordingly, while Congress may wish to retain the personal holding company provisions in their current form, it does not seem likely that they will see substantially increased application merely because of a reduction in corporate tax rates.[112]

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112. However, since, as discussed above, lower corporate tax rates would encourage conducting operating businesses in corporate form, the personal holding company rules would be necessary to discourage such a corporation from selling the business for cash and reinvesting in investment assets, in order to avoid shareholder-level tax.