New York State Bar Association
Tax Section

Report On Administration Proposals Regarding Deferral Of Deductions Related To Deferred Foreign Income, Foreign Tax Credit Pooling, And Entity Classification Rules

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New York State Bar Association
Tax Section

Report On Administration Proposals Regarding Deferral Of Deductions Related To Deferred Foreign Income, Foreign Tax Credit Pooling, And Entity Classification Rules

This report (the "Report")[1] addresses three of the international tax reform proposals made by the Obama Administration this spring.[2] Two of these proposals, requiring the deferral of deductions relating to deferred foreign source income and the pooling of foreign tax credits allowable under Section 902 of the Internal Revenue Code of 1986, as amended (the "Code"),[3] are similar to proposals made in legislation introduced by House Ways and Means Committee Chairman Charles Rangel on October 25, 2007.[4] We prepared a report commenting on the Rangel Bill proposals last year.[5] The Green Book proposals raise many of the same

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1. The Report was prepared by a working group consisting of K. Eli Akhavan, Alan I. Appel, Kimberly S. Blanchard, Andrew H. Braiterman, Patrick J. Brown, Douglas L. Bryan, Joseph J. Czajkowski, Christopher K. Fargo, Stephen E. Fiamma, Joshua A. Gordon, David R. Hardy, Michael Hirschfield, Bobbe Hirsh, Joel Karp, Charles I. Kingson, Susan F. Klein, Mary Anne Mayo, Stephen G. Mills, Erika W. Nijenhuis, Deborah L. Paul, Richard Reinhold, Josephine Robinson, Michael L. Schler, Fadi Shaheen, Judy Shen, Gretchen Sierra, Eric Solomon, Willard Taylor, Bonnie Teligmann, Jeffrey Trey, Jeffrey M. Trinklein, and Philip Wagman. The principal drafter was Andrew H. Braiterman. Helpful comments were received from Peter H. Blessing, Andrew W. Needham, David R. Sicular, and Diana L. Wollman. The assistance of Meredith M. Stead is gratefully acknowledged.
   Opinions expressed herein are those of the Tax Section of the New York State Bar Association, and do not represent those of the New York State Bar Association unless and until they have been adopted by the Association's House of Delegates or its Executive Committee.

2. The Administration proposals are set forth in DEPARTMENT OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS (May 2009) (hereinafter; the "Green Book"). The Staff of the Joint Committee on Taxation has prepared a detailed description of the Green Book proposals that relate to cross-border income and investment. JCS-4-09, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL, PART THREE: PROVISIONS RELATED TO THE TAXATION OF CROSS-BORDER INCOME AND INVESTMENT (September 2009) (hereinafter, the "JCT Description").
3. Unless otherwise indicated, all "Section" references herein are to the Sections of the Code.
4. Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. (2007) (hereinafter, the "Rangel Bill"). The Rangel Bill, unlike the Green Book, coupled these proposals with a proposed reduction in corporate tax rates.
5. New York State Bar Association Tax Section, *Report on International Provisions of H.R. 3970 and Effects of Reduction in Corporate Tax Rates* (Report No. 1173, December 24, 2008), 2008 TAX NOTES TODAY 249-24

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issues. Part I of the Report discusses those proposals. The Report's comments on these portions of the Green Book are directed largely at the differences between the Green Book proposals and the corresponding provisions of the Rangel Bill. The third proposal addressed in the Report would change the entity classification rules (the so-called "check-the-box" regulations) to provide that a foreign entity cannot be treated as a disregarded entity for U.S. federal income tax purposes unless the entity is created or organized in, or under the law of, the same foreign country in which, or under the law of which, its single owner is created or organized, or, except in cases of U.S. tax avoidance, is a first-tier foreign eligible entity wholly owned by a U.S. person. Part II of the Report discusses the entity classification proposal.

All three of the Green Book proposals raise the broad question of their effect on the U.S. economy. On the one hand, it can be argued that current law provides inappropriate incentives for U.S. taxpayers to earn and keep profits offshore rather than investing in the U.S. On the other hand, many taxpayers are of the view that the proposals would put U.S. multinationals at a competitive disadvantage relative to their foreign counterparts based in countries that have a territorial system of taxation. Aside from these considerations, the proposals are driven by the administration's perceived need to raise revenue, and as such must be compared to other means of raising revenue. These fundamental policy aspects of the proposals are more properly addressed as economic and political matters, rather than being the proper subject for technical legal analysis. The Report is not intended to express views on the merits of the underlying policies reflected in the proposals. Our comments are generally directed toward

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(Document 2008-27152) (December 29, 2008) and available at www.nysba.org (Tax Section/Tax Section Reports/Tax Section Reports 2008) (hereinafter, the "Rangel Bill Report").

whether the Green Book proposals would be effective in achieving what appear to be their intended objectives.

I. Deferral of Deductions and Foreign Tax Credit Pooling

A. Description of Proposals

1. Deduction Deferral

The Green Book proposal would require deferral of deductions for a U.S. taxpayer's expenses (other than research and experimentation expenditures) that are attributable to deferred foreign source income. The pertinent portion of the proposal reads as follows:

> "The proposal would defer a deduction for expenses (other than research and experimentation expenditures) of a U.S. person that are properly allocated and apportioned to foreign-source income to the extent the foreign-source income associated with the expenses is not currently subject to U.S. tax. The amount of expenses properly allocated and apportioned to foreign-source income generally would be determined under current Treasury regulations. The amount of deferred expenses for a particular year would be carried forward to subsequent years and combined with the foreign-source expenses of the U.S. person for such year before determining the impact of the proposal in such year."[6]

Under the analogous provision of the Rangel Bill, a U.S. taxpayer would be required to determine its total currently-taxed and deferred foreign source income for the year. The current year's deduction for otherwise deductible expenses allocated or apportioned to foreign source income would be limited to the total amount of such expenses multiplied by a fraction, the numerator of which is the currently-taxed foreign source gross income for the year and the denominator of which is the total currently-taxed and deferred foreign income (defined as the taxpayer's share of undistributed non-subpart F earnings and profits ("E&P") of its

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6. Green Book, p. 29.

controlled foreign corporation ("CFC") subsidiaries) for the year. Deferred deductions would be taken into account in later years as deferred foreign income is repatriated.[7]

The Green Book deduction deferral proposal differs from the Rangel Bill in a number of respects. In addition to the exclusion of research and experimentation expenditures, the Green Book proposal apparently does not affect deductions that are directly allocable to a U.S. taxpayer's foreign branch income or other foreign source income that is earned directly by the U.S. taxpayer. In addition, the Green Book, unlike the Rangel Bill, does not include a provision repealing the worldwide interest expense allocation rules of Section 864(f), which originally were scheduled to become effective for taxable years beginning after December 31, 2010. As discussed in the Rangel Bill Report, repeal of Section 864(f) would increase the impact of the deduction deferral proposal. The JCT Description states that, based upon the Green Book's silence on Section 864(f), "it can reasonably be concluded that the proposal assumes that the worldwide interest allocation rules would take effect as provided in present law."[8] However, subsequent to release of the Green Book proposal and the JCT Description, the effective date of Section 864(f) was delayed until taxable years beginning after December 31, 2017,[9] and the health care reform bill passed by the House of Representatives would repeal Section 864(f).[10]

2. <u>Foreign Tax Credit Pooling</u>

The Green Book proposal would require a U.S. taxpayer to determine the deemed paid foreign tax credit under Section 902 by pooling the foreign taxes and E&P of all direct and

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7. Proposed Section 975 under the Rangel Bill is described in more detail in the Rangel Bill Report at pp. 3-5.
8. JCT Description, p. 18.
9. The Worker, Homeownership, and Business Assistance Act of 2009, H.R. 3548, 111th Cong., 1st Sess. § 15 (2009).
10. The Affordable Health Care for America Act, H.R. 3962, 111th Cong., 1st Sess. § 554 (2009).

indirect foreign subsidiaries with respect to which the U.S. taxpayer meets the Section 902 ownership test.

The Green Book proposal reads as follows:

> "Under the proposal, a U.S. taxpayer would determine its deemed paid foreign tax credit on a consolidated basis by determining the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit (including lower tier subsidiaries described [in] section 902(b)). The deemed paid foreign tax credit for a taxable year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year."[11]

The analogous provision of the Rangel Bill would operate in a manner similar to the Rangel Bill's deduction deferral proposal. A U.S. taxpayer's current year's foreign tax credit would be based on the total foreign taxes paid or accrued by the U.S. taxpayer and its CFC subsidiaries during the year multiplied by the percentage of total currently-taxed and deferred foreign income that is currently taxed. Deferred credits would be allowed as deferred foreign income is repatriated.[12]

The Green Book foreign tax credit pooling proposal is narrower than the Rangel Bill insofar as it would apply only to Section 902 credits and not to Section 901 credits. Another key difference between the Green Book proposal and the Rangel Bill is that it appears that the Green Book would preserve the basic structure of current Section 902, in which foreign subsidiaries maintain E&P and foreign tax pools (albeit with the Section 902 credit determined on an aggregated pooling basis rather than on a subsidiary-by-subsidiary basis). By contrast,

11. Green Book, p. 30.
12. Proposed Section 976 under the Rangel Bill is described in more detail in the Rangel Bill Report at pp. 5-6.

proposed Section 976 under the Rangel Bill would provide that undistributed E&P of, and foreign taxes paid by, a foreign subsidiary would be reflected in pools of deferred foreign income and foreign taxes maintained by the U.S. taxpayer that owned the foreign subsidiary at the time the E&P was earned and the foreign taxes paid.

B. Summary of Comments and Recommendations

The following is a summary of our comments and recommendations relating to the Green Book deduction deferral and foreign tax credit pooling proposals:

1. The Green Book deduction deferral proposal represents an improvement over the analogous provision of the Rangel Bill insofar as the Green Book proposal would not affect the timing of deductions for expenses directly allocable to branch and other foreign source income earned directly by a U.S. taxpayer (as opposed to through a foreign subsidiary). The Rangel Bill formula, by taking such expenses and directly earned foreign source income into account for purposes of determining current allowable deductions, is inherently distortive. We are unsure why the Green Book proposal's express exclusion from application to research and experimentation expenditures is necessary.

2. The Green Book proposal is unclear as to the definition of deferred foreign income with respect to which allocable deductions must be deferred. We recommend that deferred foreign income include a taxpayer's share of undistributed non-subpart F E&P of 10%-or-more owned foreign subsidiaries.

3. Rules are needed for allocating and apportioning foreign source expenses between currently taxed and deferred foreign income. We believe that such expenses should first be allocated between foreign source income directly earned by the U.S. taxpayer and income earned through its foreign subsidiaries based upon the general principles of the current Section

861 regulations (including the asset value based rules applicable to interest expense). The deductions allocable to the foreign subsidiaries' income should then be allocated between currently taxed and deferred foreign income based upon the percentage of the taxpayer's share of the foreign subsidiaries' E&P that is currently distributed or included under subpart F. We continue to believe that deferral or repeal of Section 864(f) is inappropriate, especially in the context of the deduction deferral proposal.

4. The Green Book proposal should incorporate rules similar to the Rangel Bill proposal for allowance of deferred deductions as deferred foreign income is repatriated.

5. We approve of the Green Book proposal's approach of limiting foreign tax credit pooling to Section 902 (as opposed to Section 901) credits for taxes imposed directly on U.S. taxpayers. Although we recognize that this would permit U.S. taxpayers to benefit from conducting high-tax operations in branch form and low-tax activities in subsidiary form, taking directly earned foreign source income such as interest and export income that is subject to little or no foreign tax into account in the pooling formula would have the potential to result in inappropriate acceleration of credits for taxes paid by foreign subsidiaries on their undistributed income. In addition, the six-tier limitation of Section 902 should be eliminated, as it could permit taxpayers to avoid including low-taxed income in the blended tax rate by conducting low-tax foreign country activity in seventh or lower tier subsidiaries.

6. The foreign tax credit pooling proposal should not apply to low-taxed subpart F income, and the Section 954(b)(4) high-tax exception should not be applied on the basis of the blended rate for all the U.S. taxpayer's subsidiaries.

7. The taxability of distributions from foreign subsidiaries should continue to be governed by the company-by-company rules of Section 316, rather than being determined on a pooled basis.

8. In order for the foreign tax credit pooling and deduction deferral rules to work properly, where a taxpayer's foreign subsidiaries have different functional currencies, a provision similar to the Rangel Bill provision for translating foreign subsidiaries' E&P into dollars based upon exchange rates in the year earned is necessary. An adjustment mechanism to take into account subsequent changes in exchange rates is also needed.

9. Consideration should be given to excluding foreign subsidiaries with cumulative E&P deficits from the aggregate E&P and foreign tax pools in order to avoid potentially distortive results in the timing of credits.

10. Consideration should be given to the effect of changes in a U.S. taxpayer's ownership in a foreign subsidiary on the application of the foreign tax credit pooling proposal to both the original owner and the new owner.

11. Although we believe that the foreign tax credit pooling proposal is consistent with U.S. tax treaty obligations, Congress should clarify that the proposal overrides treaties in the event it is asserted that there is a conflict. This is necessary in order to avoid the uncertainty created by the possibility of protracted litigation.

12. Transition rules are needed to address the application of the foreign tax credit pooling proposal to pre-enactment E&P and foreign taxes. Including pre-enactment E&P and taxes in the aggregate pools has the advantage of providing less opportunity for manipulation.

C. Discussion

1. Scope of Deduction Deferral Provision

The Green Book proposal represents an improvement over the Rangel Bill insofar as it does not require deferral of expenses that are directly attributable to foreign branches or other foreign source income earned directly by U.S. taxpayers. Deferral of such deductions does not advance the purpose of the proposal. As discussed in the Rangel Bill Report, taking such expenses and directly earned foreign source gross income into account in the formula for determining currently allowable deductions is inherently distortive.[13] Under the formula embodied in the Rangel Bill, a portion of foreign branch expenses would be allocated to deferred foreign income and therefore would be deferred, but there would be no corresponding current allowance of a portion of similar expenses incurred by a foreign subsidiary that does not distribute its earnings. On the other hand, the Rangel Bill formula would overstate the currently allowable portion of deductions for expenses such as interest that are subject to apportionment, because currently taxed foreign income would include all directly earned foreign source income such as branch income on a gross basis, while deferred foreign income would be determined by reference to the E&P (essentially net income) of CFCs. Similarly, it is appropriate to provide for complete deferral of deductions directly allocable to deferred foreign income (*e.g.*, stewardship expenses), rather than formulaically allocating such expenses between currently taxed and deferred foreign income as under the Rangel Bill. The Green Book proposal properly limits deduction deferral to expenses that are either directly allocable to deferred foreign income or apportionable to such income under rules such as those applicable to interest expense.

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13. Rangel Bill Report, pp. 11-13.

We are uncertain as to the reason for the Green Book proposal's specific exclusion of research and experimentation expenditures from the deduction deferral proposal. As a general matter, any such expenditures that are properly deductible by a U.S. taxpayer should be attributable to income that is directly earned by the U.S. taxpayer in the form of either income from the U.S. group's operations or royalties from foreign affiliates or third parties. It seems unlikely that such deductions would be deferred under the Green Book proposal even absent the explicit carve-out for research and experimentation expenditures.[14]

2. Definition of Deferred Foreign Income

The Green Book proposal is unclear as to what constitutes non-currently taxed foreign source income. We believe that it is appropriate to treat a U.S. taxpayer's share of undistributed non-subpart F E&P of its foreign subsidiaries with respect to which the taxpayer meets a specified ownership percentage as deferred foreign income. The Section 902 threshold (possibly substituting a 10% vote or value test for the Section 902 vote test) is appropriate in our view. The Rangel Bill, by looking only to E&P of CFCs, tends to understate the amount of expenses attributable to deferred foreign income because the undistributed income of other foreign subsidiaries is not included in calculating the ratio of currently taxed foreign income to total foreign income; it is particularly anomalous that a 50% owned subsidiary of a U.S. taxpayer is not taken into account if none of the other shareholders is a 10% U.S. shareholder with the result that the subsidiary is not a CFC.[15] We recognize that a lower ownership threshold

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14. Although U.S. taxpayers may develop intangible property in the U.S., deduct the related research and experimentation expenditures for U.S. income tax purposes, and move the intangible property offshore without charging adequate royalties, the issue presented is one of transfer pricing. We do not see how this type of issue can be addressed by deferral of deductions.

15. *See* Rangel Bill Report, p. 20.

potentially makes it more difficult for the taxpayer to obtain the necessary information about the subsidiary's E&P. Income earned through a foreign corporation in which a U.S. taxpayer owns a less-than-10% interest can also be viewed as deferred foreign income if the income is not currently distributed, but we believe that such treatment would cause more of an administrative burden than it is worth.

3. Allocation and Apportionment of Expenses between Currently Taxed and Deferred Foreign Source Income

(a) Generally

The Green Book proposal contemplates that current Treasury Regulations would generally apply for purposes of allocation and apportionment of expenses between domestic and foreign source income. These rules do not, however, address how to further apportion deductions allocable to foreign source income between currently taxed and deferred foreign source income.

As a general matter, we believe that otherwise deductible foreign source expenses (as determined under current law) should first be allocated and apportioned between foreign source income earned directly by the U.S. taxpayer and income earned through its foreign subsidiaries based upon the general principles of the current Section 861 regulations. Expenses allocated to directly earned foreign source income should be currently deductible. A percentage of expenses allocable to income earned by foreign subsidiaries equal to the amount of the U.S. taxpayer's dividends from foreign subsidiaries (including dividends paid out of E&P accumulated in a prior year by a particular foreign subsidiary) and subpart F inclusions for the year divided by the U.S. taxpayer's share of the foreign subsidiaries' current year E&P determined on a pooled basis (or, if less, 100%) should also be currently deductible; the remainder should be deferred. Making this determination on an aggregate basis for the taxpayer's foreign subsidiaries, rather than by allocating deductible expenses to investments in particular foreign subsidiaries and making determinations on a subsidiary-by-subsidiary basis based upon which subsidiaries distribute their income, is preferable for two reasons. First, it is more consistent with the Green Book's foreign tax credit proposal, under which it generally does not matter which foreign subsidiaries distribute their earnings. Second, the aggregate approach is substantially simpler from an administrative standpoint in most cases.

If a taxpayer's foreign subsidiaries have no current year E&P (or have a deficit in current year E&P), it is unclear how much of the current year's expenses allocable to investments in the foreign subsidiaries' activities should be deductible. In our view, the best approach is to provide for full deductibility of the expenses. The purpose of the proposal is to deny current deductions for expenses attributable to deferred income, and, in the absence of E&P, no income is being deferred. In theory, expenses such as interest allocable to investments in foreign subsidiaries that generate no E&P could be viewed as properly capitalizable, especially in situations in which the expenses would have to be capitalized if the foreign subsidiary were a branch of the U.S. taxpayer and the expenses were incurred by the branch. However, tracing expenses of a U.S. taxpayer to particular activities of its foreign subsidiaries in order to determine whether the expenses should be capitalized would be impractical. Assuming that expenses should be capitalized because the foreign subsidiaries have no current year E&P would not properly account for situations in which the subsidiaries' activities are simply unprofitable and would create an artificial distinction between situations where there is no E&P and situations in which there is minimal E&P that can be distributed at little U.S. tax cost.

(b) Application to Interest Expense

Allocation and apportionment methodology is particularly important in the case of interest expense. In implementing the general recommended approach described above, we believe that the current year's foreign source interest expense (other than interest expense directly allocable to particular items of income under Temp. Treas. Reg. § 1.861-10T(b), (c) or (e)) should first be allocated between investments in foreign subsidiaries that potentially produce deferred foreign income and investments in other foreign income-producing assets based upon relative asset values, using the same methodology as the current rules for apportioning interest expense between domestic and foreign source income (taking into account the principles of Section 864(f) if and when it becomes effective). The portion of the interest expense allocable to investment in foreign subsidiaries that is currently deductible would be based on the percentage of the taxpayer's share of their current year E&P that is currently distributed or includible under subpart F. This effectively represents a hybrid asset value/net income approach to apportionment of interest expense. Although a pure asset value methodology might be more appropriate as a conceptual matter, we do not see how it could easily be implemented for purposes of apportioning interest expense between currently distributed income of foreign subsidiaries and income that is not currently distributed.

Our suggested approach can be illustrated by the following example[16]:

> Example 1: Assume that the assets of U.S. corporation P consist of domestic source income producing assets with a value of 1500, foreign branch assets with a value of 500 and the stock of a wholly-owned foreign subsidiary, X, which has assets with a value of 1000 and no liabilities. P incurs interest expense of 120 and X has current year E&P of 100, of which 50 is distributed.

16 The mathematics in examples 1 and 2 is set out in more detail in an Appendix.

Based upon current allocation and apportionment rules, 60 in interest expense (half of P's total interest expense) would be apportioned to foreign source income. Under our recommended approach, 40 in foreign source interest expense (*i.e.*, two-thirds of the total foreign source interest expense) would be allocated to P's investment in X. Because half of X's E&P is distributed, 20 of the interest expense allocable to P's investment in X would be allowable in the current year and the remaining 20 interest expense allocable to P's investment in X would be deferred.

We continue to believe, as indicated in the Rangel Bill Report, that the worldwide interest allocation rules of Section 864(f) appropriately allocate interest expense to the income that it supports.[17] Repeal of Section 864(f), by ignoring foreign subsidiaries' interest expense, overstates the amount of a U.S. taxpayer's interest expense allocable to its foreign subsidiaries' income. As noted in the Rangel Bill Report, the impact of this distortion is magnified if allocation of interest expense affects timing of deductions in addition to foreign tax credits. The JCT Description acknowledges this point, stating that "the overallocation of interest expense to foreign source income under the present 'water's edge' allocation rules would result in overstatement of the amount of interest expense subject to deferral - an effect that could be more costly than understatement of the foreign tax credit limitation if the taxpayer's offshore investments are located in relatively low-tax countries."[18]

If Section 864(f) were to become effective, under our recommended two step approach to apportioning interest expense, foreign subsidiaries' interest expense that reduces the U.S. taxpayer's foreign source interest expense should be applied to reduce the interest expense

17. *See* Rangel Bill Report, pp. 16-18.
18. JCT Description, p. 18.

that is allocable to the U.S. taxpayer's investment in its foreign subsidiaries included in its worldwide affiliated group and thus potentially subject to deferral.

> Example 2: Same facts as Example 1, except that X has assets with a value of 2,000, liabilities of 1,000, and interest expense of 60.

Under Section 864(f), P's worldwide group would have assets with a value of 4,000 (of which 1,500 produces domestic source income and 2,500 produces foreign source income) and interest expense of 180. Total foreign source interest expense of the worldwide group would be 112.50 (total interest expense of 180 multiplied by foreign assets of 2,500 divided by total assets of 4,000), of which 90 (half of the worldwide group's total interest expense) would be allocable to X's assets. P's foreign source interest expense would be 52.50 (total foreign source interest expense of the worldwide group less X's interest expense). Under our suggested approach to the deduction deferral proposal, 30 of P's interest expense (total worldwide interest expense of 90 allocable to X's assets less X's interest expense) would be allocated to P's investment in X and 15 of this interest expense would be deferred, since half of X's E&P is distributed. By contrast, absent Section 864(f), the result would be the same as Example 1 -- 20 in interest expense would be deferred.

4. Timing of Allowance of Deferred Deductions

The Green Book proposal states that "[t]he amount of deferred expenses for a particular year would be carried forward to subsequent years and combined with the foreign-source expenses of the U.S. person for such year before determining the impact of the proposal in such year."

It is not clear how this carryforward mechanism is intended to operate. Combining the deferred expenses with the subsequent year's current foreign source expenses does not appear to be a workable solution, since prior years' deferred expenses do not relate to the currently taxed or deferred income earned in the subsequent year.

We believe that the most logical approach would be one similar to the Rangel Bill, under which deferred expenses would be allowed as deductions as the deferred foreign income is repatriated. This should be done on the basis of multiyear pooling (similar to the Section 902 rules) rather than attempting to tie the allowance of expenses incurred and deferred in a particular year to the year in which that year's deferred income is distributed. As discussed in the Rangel Bill Report,[19] these rules should be refined so that subsequent reductions in the foreign subsidiaries' E&P pools do not result in permanent disallowance of deferred expenses.

> <u>Example 3</u>: Assume that U.S. corporation P owns all the stock of foreign corporation X. In Year 1, X has E&P of 100, none of which is distributed. In Year 2, X has an E&P deficit of 50.

At the end of Year 2, X no longer has sufficient E&P to pay a dividend in the full amount of the Year 1 deferred income. Accordingly, it is appropriate to permit P to deduct a percentage of its Year 1 deferred expenses equal to the percentage of X's remaining 50 in E&P that is distributed. If X's deficits in E&P are sufficient to eliminate its accumulated E&P, all remaining deferred expenses should be deductible as there is no longer any deferred income. It should also be clarified that accumulated E&P and deficits in E&P of a foreign subsidiary that arise prior to a taxpayer's acquisition of stock in the subsidiary should not affect the amount of E&P that must be repatriated in order to permit the taxpayer to fully deduct its previously

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19. *See* Rangel Bill Report, p. 33.

deferred expenses. In Example 3, if P acquires all the stock of Y at the beginning of Year 2, Y's pre-Year 2 accumulated E&P or deficit should not be viewed as a component of P's deferred foreign income; Y's pre-Year 2 accumulated E&P or deficits should not affect the deferred earnings pool that must be repatriated for P to be allowed to deduct the full amount of its deferred Year 1 expenses.[20]

5. Limitation of Foreign Tax Credit Pooling Rules to Section 902 Credits

The Green Book foreign tax credit proposal, unlike the Rangel bill, applies only to Section 902 credits for taxes paid by a U.S. taxpayer's foreign subsidiaries, and not to Section 901 credits for taxes imposed directly on a U.S. taxpayer (or imposed by means of withholding on payments to the U.S. taxpayer). Limiting the pooling rules to Section 902 credits and foreign subsidiaries' E&P can be viewed as subverting the apparent purpose of the proposal, which is preventing taxpayers from maximizing their foreign tax credits by recognizing high-taxed foreign income on a current basis while deferring low-taxed foreign income.[21] A U.S. taxpayer would still be able to maximize foreign tax credits by conducting operations in high-tax foreign countries in branch form and in low-tax foreign countries through subsidiaries. This is mitigated, however, by the fact that taxpayers would be limited in their ability to decide which country's foreign source income on which to pay current U.S. tax and claim a current Section 901 credit on a year-by-year basis.

20. On the other hand, because the foreign tax credit pooling proposal retains the basic structure of Section 902, it is appropriate to include pre-acquisition E&P and foreign taxes in the combined pools for purposes of that proposal.

21. The "Reasons for Change" portion of the relevant section of the Green Book refers to a concern about enhanced ability of taxpayers to reduce residual U.S. tax on foreign-source income by "cross-crediting" as a result of the reduction in the number of foreign credit limitation categories from nine to two under the American Jobs Creation Act of 2004. Green Book, p. 30.

Limiting the pooling rules to Section 902 credits and foreign subsidiaries' E&P largely avoids the potential under the Rangel Bill for acceleration of foreign tax credits by reason of U.S. taxpayers' inclusion of foreign source interest, royalty or rental income that is exempt from foreign taxes, as illustrated by the following example:

> Example 4: Assume that U.S. corporation P owns all the stock of foreign corporation X, all the income of which is general limitation income. P receives 100 in interest income from X, which is not subject to foreign withholding tax, and X has E&P of 100 (after deducting the interest payment) which is not currently distributed. Assume further that P has no other foreign activities or foreign source income.

Under the Rangel Bill, P would have currently taxed foreign income of 100 and deferred foreign income of 100. As a result, P could claim a current year credit for half the foreign taxes paid by X in the current year on its undistributed income.[22] A similar acceleration of credits for X's foreign taxes would result if P has export income (possibly unrelated to its investment in X) that attracts no foreign tax and is treated as partly foreign source under Treas. Reg. § 1.863-3(b). The Green Book proposal avoids this result by limiting pooling to foreign subsidiaries' E&P and foreign taxes, although, as discussed at Section I.C.6 below, similar results potentially can be achieved in the case of subpart F income.

It can be argued that the result reached in Example 4 under the Rangel Bill is appropriate on the theory that P's entitlement to a foreign tax credit with respect to income generated by X's business activities should not be affected by whether income is brought back to the U.S. in the form of interest (or rents or royalties) rather than dividends; it is in the interest of the U.S. to encourage taxpayers to bring back funds to the U.S. and to bring income within the

22. *See* Rangel Bill Report, p. 23.

U.S. tax net, regardless of the form which the repatriation takes.[23] Arguably, the result in Example 4 (as well as situations involving export income) under the Rangel Bill is less problematic than the ability under current law to selectively repatriate high-taxed income and generate surplus credits to shelter U.S. tax on low-taxed or untaxed foreign source interest or export income. However, in our view the result reached by the Green Book proposal is preferable. As a general matter, we do not think it is appropriate to permit taxpayers to generate foreign tax credits by recognizing income that is not subject to foreign tax without recognizing any of the foreign source income that generates the foreign tax. Moreover, from a practical standpoint, we believe that part of the justification for taking on the considerable complexity inherent in pooling of foreign tax credits is raising revenue; acceleration of foreign tax credits in Example 4 cuts against this objective.[24]

One potential anomaly should be noted with respect to the limitation of pooling to Section 902 subsidiaries. It appears that under the Green Book proposal, US. taxpayers could avoid blending of high-taxed and low-taxed foreign source income while preserving deferral by conducting low-tax foreign country activities in seventh (or lower) tier foreign subsidiaries, dividends from which do not result in Section 902 credits. We recommend eliminating the six-tier limitation of Section 902.

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23. Regardless of whether a current foreign tax credit is allowed in Example 4, the amount of the credit is less (and the net U.S. tax liability is higher) than would be the case under current law if there were no intercompany indebtedness and repatriation took the form of dividends.

24. Of course, the Green Book proposal would allow higher foreign tax credits than current law when distributions are made from low-tax rather than high-tax foreign subsidiaries. However, this is inherent in the proposal's pooling approach.

6. Application of Foreign Tax Credit Pooling to Subpart F Income

It appears that subpart F income would be treated under the Green Book proposal in the same manner as other income earned through foreign subsidiaries for purposes of the pooling rules. This can lead to results similar to those applicable under the Rangel Bill in Example 4 above.

> Example 5: Same facts as Example 4, except that the interest is paid to foreign corporation Y, a tax-haven subsidiary of P, rather than to P itself.

Assuming that Section 954(c)(6) expires,[25] Y's income generally would be subpart F income currently includible by P. Because X's and Y's E&P and foreign taxes would be pooled, it appears that P would be entitled to a current credit for a portion of X's foreign taxes under the Green Book proposal.

Similar issues are posed by the interaction of the foreign tax credit pooling rules and the Section 954(b)(4) high-taxed income exception to the subpart F inclusion rules. Under Treas. Reg. § 1.954-1(d)(3), the determination of whether an item of income that is otherwise currently includible under subpart F is excludible under this exception is made by reference to the amount of foreign taxes that would be creditable under Section 960 if the income were taxable under subpart F. If the blending approach of the Green Book proposal is adopted, it appears that the high-taxed income exception would effectively be applied by reference to the blended foreign tax rate of all the U.S. taxpayer's foreign subsidiaries, rather than by reference to the tax rate imposed on the subsidiary receiving the income. As a result, the high-taxed income

25. Although the Green Book proposes extending Section 954(c)(6) through 2010 (Green Book, p. 19), we assume that it would not survive the enactment of the proposed changes in the entity classification rules. *See* Section II.B, below.

exception potentially would be unavailable for income received by a CFC that is a tax resident of a high-tax jurisdiction but could be available to a CFC organized in a tax haven, depending upon the blended foreign tax rate of the foreign subsidiaries in the group.

We believe that these results are inconsistent with the basic purpose of subpart F, which is to treat low-taxed foreign personal holding company income ("FPHCI") earned by a CFC in essentially the same manner as income earned directly by its U.S. shareholder.[26] It is difficult to justify reaching different results in Examples 4 and 5. Assuming that it is concluded that P should not be entitled to a credit for a portion of X's taxes in Example 4, consistency suggests that the rules of current law should be retained for purposes of determining foreign tax credits associated with subpart F inclusions of low-taxed interest, royalty and rental income, as well as application of the Section 954(b)(4) exception; the credit would be determined by looking solely to the foreign tax paid by the particular subsidiary receiving the income rather than on a pooling basis. These rules should possibly be refined so as to look solely to the foreign taxes paid by the CFC with respect to the subpart F income, as opposed to the current rules which combine the subpart F income and associated foreign taxes with the rest of the CFC's E&P and foreign tax pool. Similarly, the Section 954(b)(4) high-tax exception should be applied by reference to the foreign tax actually paid by the CFC with respect to the income in question.[27]

Application of the foreign tax credit pooling rules and Section 954(b)(4) high-tax exception to foreign base company sales and services income poses issues similar to those

26. This, of course, assumes that repeal of Section 954(c)(6) and treatment of Y's income in Example 4 as subpart F income is deemed appropriate in the first place, which poses broader issues similar to those posed by the Green Book entity classification proposal.

27. The change in the Section 954(b)(4) test could be effected by changing the regulations without amending the Code.

discussed above. On the other hand, subpart F income in the form of dividends between foreign subsidiaries (assuming expiration of Section 954(c)(6)), including deemed dividend income under Section 964(e), does not involve diversion of active foreign income to low-tax jurisdictions. Application of the foreign tax credit pooling rules to such income is therefore appropriate.

7. Taxability of Distributions

It is not clear whether the foreign tax credit pooling proposal is intended to affect the determination of whether a distribution to a U.S. taxpayer from a foreign subsidiary is taxable as a dividend. Under a pure pooling approach, the taxability of a distribution from a foreign subsidiary would not be affected by whether the particular subsidiary has E&P. This issue can be illustrated by the following example:

> Example 6: U.S. corporation P has two wholly-owned foreign subsidiaries, X and Y. Neither X nor Y has current year E&P. X has accumulated E&P of 110, and Y has an E&P deficit of 100.

Under current law, up to 110 in distributions by X are taxable as dividends, while distributions by Y are not taxable as dividends. Under a pure pooling approach, up to 10 in distributions from either X or Y would be taxed as dividends; additional distributions would reduce basis, and, if in excess of basis, result in capital gain. The Rangel Bill, which included actual statutory language, did not make any changes in this regard.

Although it can be argued that a pure pooling approach is more consistent conceptually with the Green Book proposal, we believe that respecting separate E&P pools for individual foreign subsidiaries for purposes of determining the taxability of distributions is preferable. The current rules of Section 316 are consistent with the principle that taxability of distributions (and adjustments to basis when distributions exceed E&P) should reflect the profitability of the subsidiary making the distribution. In addition, maintaining separate company E&P calculations for purposes of Section 316 avoids the possibility of distributions being taxable to some shareholders and not to others in the case of a foreign corporation with more than one shareholder. The current law approach is also simpler to apply in situations where ownership of a foreign subsidiary changes, as discussed at Section I.C.10, below.

8. Foreign Currency Issues

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.[28] The Rangel Bill would amend Section 986(b)(2) to provide that a foreign corporation's E&P is translated into dollars at the average exchange rate in the year in which earned. The Rangel Bill would further 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. In the case of a U.S. taxpayer that owns foreign subsidiaries with different functional currencies, a similar provision for translation of E&P into dollars in the year earned is needed in order to make the Green Book deduction deferral and foreign tax credit pooling proposals workable. Otherwise, it would not be possible to maintain a combined E&P pool for foreign subsidiaries with different functional currencies. Where a foreign subsidiary's E&P is distributed in a year after it is earned, determining the later year's Section 902 credit under the Green Book pooling proposal (as well as the allowance of previously deferred deductions under our recommended approach) requires a mechanism for taking into account

28. Section 986(b).

changes in exchange rates between the year in which the E&P is earned and the year in which it is distributed. The simplest approach is probably to retranslate the accumulated E&P of all foreign subsidiaries into dollars on an annual basis to reflect changes in exchange rates.

9. Effect of Foreign Subsidiary E&P Deficits

Maintaining E&P and foreign tax credit pools for all of a U.S. taxpayer's U.S. subsidiaries on an aggregate basis for purposes of Section 902 produces possibly unintended results with respect to the timing of foreign tax credits in cases where one or more subsidiaries has E&P deficits. This can be illustrated by the following example:

> Example 7: Assume U.S. corporation P has two wholly-owned foreign subsidiaries, X and Y. X has current and accumulated E&P of 101 and has paid foreign taxes of 40. Y has an accumulated E&P deficit of 100 and has paid foreign taxes of 10.

Under current law, P is entitled to claim credits for taxes paid by X in proportion to the amount of X's E&P that is distributed. Y's foreign taxes are "trapped" and cannot be claimed as credits until Y has positive E&P on a cumulative basis and pays a dividend.

Under a Section 902 pooling approach, however, X and Y would have an aggregate E&P pool of 1 and an aggregate foreign tax pool of 50. If X were to pay a dividend of 1, P would be entitled to a foreign tax credit for all 50 in foreign taxes paid by X and Y.[29] If the facts were changed so that X had only 99 in E&P, there would be an aggregate E&P deficit of 1, and the foreign taxes paid by both X and Y would be trapped until X and Y have positive E&P on an aggregate, cumulative basis.[30]

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29. The credit, however, would be subject to the Section 904 limitation rules, which might make this result unfavorable to the taxpayer.

30. Proposed Section 976 under the Rangel Bill would pose similar issues. *See* Rangel Bill Report, pp. 30-32.

A possible alternative approach would be to exclude foreign subsidiaries that have cumulative E&P deficits from the aggregate E&P and foreign tax pools until the deficits are eliminated. This would help to avoid the distortions discussed in the preceding paragraph. A further argument in favor of excluding subsidiaries with E&P deficits from the aggregate pool arises in situations where the ownership of foreign subsidiaries changes, as discussed at Section I.C.10, below. However, this would be inconsistent with the general principle under the pooling proposal that a taxpayer that brings back all its foreign subsidiaries' aggregate E&P is entitled to a credit for all the foreign taxes paid by the subsidiaries. In addition, even if subsidiaries with E&P deficits were excluded from the pool, the results described in the preceding paragraph would still be possible (as they are under current law) if Y in Example 7 were a hybrid disregarded entity subsidiary of X.[31] It should also be noted that taking into account subsidiaries with E&P deficits for purposes of the deduction deferral proposal does not pose the same problems as it does for the foreign tax credit pooling proposal.

10. Changes in Ownership of Foreign Subsidiary

Application of the FTC pooling and (depending upon the approach taken to the allowance of deferred deductions) the deduction deferral rules in cases where the ownership of a foreign subsidiary changes poses difficult issues for both the old and new owners, as illustrated by the following examples:

> Example 8: U.S. corporation A owns all the stock of two foreign corporations, X and Y. X and Y each has accumulated E&P of 100 through the end of Year 1. X has paid foreign taxes of 100, and Y has paid no foreign taxes. At the beginning of Year 2

31. Even if the proposed changes in the entity classification rules were enacted, similar results would be possible if Y were a hybrid partnership substantially all the interests in which were owned by X.

unrelated U.S. corporation B acquires 50% of the stock of X in the form of newly issued equity.

Example 9: Same facts as Example 8, except that at the end of Year 1 X pays a dividend of 100 to A.

Example 10: Same facts as Example 8, except that instead of acquiring 50% of the stock of X, B acquires 50% of the stock of Y in the form of newly issued equity.

Example 11: Some facts as Example 9, except that instead of acquiring 50% of the stock of X, B acquires 50% of the stock of Y in the form of newly issued equity.

Example 12: Same facts as Example 8, except that instead of acquiring 50% of the stock of X as newly issued stock, B purchases 50% of the stock of X from A.

Under the Green Book foreign tax credit pooling proposal, these examples raise the question of what effect the stock acquisition by B has on the E&P and foreign tax pools of A's and B's subsidiaries going forward.[32] In Examples 8 and 9, half of X's (and, in Examples 10 and 11, half of Y's) accumulated E&P presumably would be transferred from A's foreign subsidiaries' aggregate E&P pool to B's foreign subsidiaries' aggregate E&P pool. The more difficult question is the effect on A's and B's foreign subsidiaries' aggregate foreign tax pools.

One approach would be to provide that if a U.S. taxpayer's ownership interest in a foreign subsidiary (and therefore in the subsidiary's accumulated E&P) is reduced, a percentage of the U.S. taxpayer's aggregate foreign tax pool equal to the transferred percentage of its aggregate E&P pool would be transferred. In Examples 8 and 10, this would result in 25 in

32. Proposed Sections 975 and 976 under the Rangel Bill pose similar issues. Under proposed Section 976, deferred foreign tax credits would be taken into account based upon a U.S. taxpayer's repatriation of its previously deferred foreign income; Section 902 principles would no longer apply as such. However, as discussed in the Rangel Bill Report, pp. 29-30, dilution of a U.S. taxpayer's ownership of foreign subsidiaries could affect whether the U.S. taxpayer's foreign subsidiaries have adequate E&P out of which to repatriate its deferred foreign income and enable it to claim the full amount of deferred deductions and credits.

potential future foreign tax credits (*i.e.*, 25% of A's subsidiaries' total foreign taxes) being transferred from A to B. In Examples 9 and 11, the Year 1 distribution by X would permit A to claim 50 in foreign tax credits (*i.e.*, credits equal to half the foreign taxes paid by X). In Example 9, because X would not have any remaining E&P, B would not succeed to any foreign tax credits. In Example 11, because B would succeed to half of the A group's remaining E&P, B would succeed to 25 in future foreign tax credits (*i.e.*, half the remaining foreign taxes in the A group's pool).

A second possible approach would be to maintain separate company E&P and foreign tax pools in addition to the aggregate pools and to attempt to leave the theretofore uncredited foreign taxes with the subsidiary that generated them. Under this second approach, in Example 8, in which B acquires an interest in X, half of the foreign taxes paid by X (*i.e.*, 50 in foreign taxes) would go over to the B group, while in Example 10, in which B acquires an interest in Y, all the foreign taxes would remain with the A group. This result is in our view preferable to the result reached under the first approach in Examples 8 and 10. This second approach breaks down, however, in situations where distributions have previously been made to the U.S. taxpayer whose interest in the foreign subsidiary is diminished. In Example 9, no interest in E&P is transferred and it is hard to see how any of the foreign taxes paid by X could shift from A's pool to B's pool. Conversely, in Example 11, even though no foreign taxes were paid by Y, it is hard to see how none of the foreign taxes would be transferred to B when X has no remaining E&P. Similarly, if the facts of Example 9 were changed so that the amount of the Year 1 dividend paid by X to A was 90, entitling A to a foreign tax credit of 45 (because 45% of the aggregate E&P pool was distributed), it seems anomalous that B should succeed to half of the remaining foreign tax pool by reason of succeeding to half of X's remaining E&P of 10. The second approach could be refined to address these issues, possibly by providing that if a dividend from one subsidiary results in a greater foreign tax credit under the pooling regime than would result under the separate company approach of current law, the excess credit would reduce the foreign tax pools of higher-taxed subsidiaries; conversely, if pooling resulted in a lower foreign tax credit, foreign taxes would be shifted to the foreign tax pools of lower-taxed subsidiaries. Under this modified approach, a dividend of 50 from X to A in the examples would result in a foreign tax credit of 25 (*i.e.*, 25% of the aggregate foreign tax pool) and a transfer of 25 in taxes from X's separate pool to Y's separate pool; a dividend of 50 from Y to A would also result in a foreign tax credit of 25, which would reduce X's separate foreign tax pool. If B were then to acquire stock in X or Y, B would succeed to a portion of X's or Y's remaining foreign tax pool.

There are reasonable arguments in favor of both the approaches discussed above, as well as other possible approaches. However, there is no readily apparent perfect (much less simple) solution; under the second approach, matters become more complicated where there are multiple foreign subsidiaries subject to different foreign tax rates. A possible alternative, which would go beyond the scope of the Green Book proposal and raise issues of its own, would be to provide that a new shareholder of a foreign corporation is neither subject to tax nor eligible for foreign tax credits with respect to distributions of pre-acquisition E&P.

Further complications are posed where a foreign subsidiary in a taxpayer's group has a deficit in E&P. Assume, for example, that in Example 8 the facts are changed so that Y has an E&P deficit of 50. If, as discussed at Section I.C.9, above, subsidiaries with E&P deficits are taken into account in determining the aggregate E&P pool, A's foreign subsidiaries' aggregate E&P pool would be 50 prior to B's acquisition of the interest in X. If B succeeds to 50% of X's 100 in E&P (representing all of the aggregate E&P) it does not seem right for B to succeed to A's foreign subsidiaries' entire aggregate E&P pool and therefore to become entitled to future credits for all the foreign taxes paid by X. This supports the position that it is appropriate to exclude subsidiaries with E&P deficits from the aggregate E&P and foreign tax pools.

Example 12 raises the further issue of the interaction between Section 1248 and the foreign tax credit pooling proposal. We believe that any gain recognized by A on the sale to B of stock in X that is taxed as a dividend under Section 1248 should be treated as a dividend for purposes of determining A's foreign tax credits in the year of sale in accordance with the pooling rules. The previously taxed income rules of current Section 959 should continue to apply to post-sale dividends from X to B, and the foreign taxes otherwise transferred from the A group to the B group should be reduced by A's foreign tax credits generated by the Section 1248 inclusion.

11. <u>Treaty Issues</u>

U.S. income tax treaties generally require the United States to provide a U.S. corporation that owns at least a specified amount of stock (typically a 10% voting interest) in a foreign corporation with a credit against its U.S. tax liability for taxes paid by the foreign corporation on profits from which it pays a dividend to the U.S. corporation.[33] U.S. taxpayers and treaty partners may argue that the Green Book foreign tax credit pooling proposal is inconsistent with treaty provisions because U.S. taxpayers would no longer be entitled to Section 902 credits tied directly to the foreign taxes paid by the dividend-paying subsidiary.[34] Where the

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33. *See* United States Model Income Tax Convention of November 15, 2006, Article 23.
34. *See* Robert H. Dilworth, *Proposed Multilateral FTC Pooling and U.S. Bilateral Tax Treaties*, 124 TAX NOTES 1227, 1231 (2009).

treaty country subsidiary pays foreign taxes at a higher rate than the U.S. taxpayer's other foreign subsidiaries and dividends are paid only by the treaty country subsidiary, the pooling proposal would result in diminution of the foreign tax credit. On the other hand, it can be argued that the Green Book proposal would not deny the foreign tax credit in contravention of the treaty rule, but would merely affect the timing of the credit. It is generally understood that treaties do not restrict application by the U.S. of its foreign tax credit limitation rules, which generally look to a U.S. taxpayer's total foreign source income and foreign taxes paid.

On balance, we believe that the Green Book foreign tax credit pooling proposal is consistent with U.S. treaty obligations. However, we recognize that some taxpayers and possibly courts may take a different view. If the foreign tax credit pooling proposal is enacted, we recommend that Congress expressly provide that, although it believes that the proposal is consistent with U.S. treaty obligations, the legislation is intended to override any treaty obligations that a treaty partner or a court may determine to be conflicting. Neither taxpayers nor the government would be well served by the protracted litigation that would likely result in the absence of such an express statement.

12. <u>Transition Rules</u>

The Green Book deduction deferral and foreign tax credit pooling proposals would be effective for taxable years beginning after December 31, 2010.

The Green Book proposal does not specify how pre-effective date E&P and foreign taxes are to be treated. There are two basic possibilities. Pre-enactment E&P and foreign taxes of a U.S. taxpayer's foreign subsidiaries could be included in the aggregate pools. Alternatively, the current Section 902 rules (*i.e.*, company by company treatment) could apply to post-effective date dividends paid out of pre-effective date E&P; this would presumably be coupled with a rule providing that dividends are treated as paid first out of post-effective date E&P to the extent thereof and then out of pre-effective date E&P, similar to the rules introduced in 1986 when the multi-year pooling rules for purposes of Section 902 were enacted.

We believe that the first approach, under which pre-effective date E&P and foreign taxes are included in the aggregate pools, is preferable. This approach provides less opportunity for taxpayer manipulation and is probably simpler to administer.

II. Changes in Entity Classification Rules

A. Background

Since the promulgation of the check-the-box rules,[35] taxpayers have had essentially complete flexibility in the determination of the classification for federal income tax purposes of domestic and foreign entities, other than those entities classified as "per se" corporations under Treas. Reg. § 301.7701-2(b) and entities subject to the publicly traded partnership rules of Section 7704. In addition to making it easier to structure entities with more than one owner as partnerships or corporations for U.S. taxpayers, the check-the-box rules introduced a new concept of a single-owner entity that is disregarded as an entity separate from its owner.[36] One of the principal effects of such an election is that transactions between the entity and its owner are ignored for U.S. tax purposes.

Beginning shortly after the check-the-box rules became effective, the Treasury Department and the IRS have from time to time expressed concerns that taxpayers can use disregarded entities to avoid subpart F. A particular source of concern has been the ability of CFCs to reduce their foreign tax burden by means of payments between CFCs and their hybrid

35. Treas. Dec. 8697, 1997-1 C.B. 215, effective January 1, 1997.
36. Treas. Reg. § 301.7701-3(b)(1)(ii) (domestic entities) and -3(b)(2)(i)(C) (foreign entities).

disregarded entity subsidiaries (or between disregarded entities with a common owner) that are deductible for foreign tax purposes. Such payments, while potentially reducing foreign tax liability by shifting income from high-tax jurisdictions to low-tax jurisdictions, escape subpart F because they are ignored for U.S. tax purposes, but (prior to the enactment or after the expiration of Section 954(c)(6) and absent application of the Section 954(c)(3) same country/related party exception or another applicable exception) would be treated as FPHCI if the disregarded entities were treated as separate CFCs. Similar issues are posed by transactions in which a CFC pays interest to a disregarded entity organized in a different country that is owned by a related CFC organized in the same country as the first CFC; if the disregarded entity is treated as a separate corporation for foreign tax purposes, the payment can reduce foreign taxes but escape subpart F under Section 954(c)(3).

In Notice 98-11,[37] Treasury and the IRS addressed this issue not by proposing to change the entity classification rules generally, but instead by making a limited change restricted to treatment for purposes of subpart F. The Notice announced plans to issue regulations that would recharacterize certain payments between hybrid branches and CFCs as subpart F income by treating the branch and the CFC as separate corporations for purposes of subpart F. Treasury then issued temporary regulations (the "Hybrid Branch Regulations") under Sections 904 and 954 to this effect on March 23, 1998.[38] The regulations provided that (1) if a "hybrid branch payment"[39] was made between a CFC and its hybrid branch or between hybrid branches of the

37. 1998-1 C.B. 433.
38. Treas. Dec. 8767, 1998-1 C.B. 875, effective March 23, 1998. Proposed regulations relating to the treatment under subpart F of certain partnership transactions were issued at the same time (REG-104537-97, 63 Fed. Reg. 14613 (Mar. 26, 1998)).
39. That is, a payment that was regarded as a payment between the two entities under local law but that was not income to the recipient under U.S. tax law.

same CFC (or between hybrid branches and partnerships with CFC partners) and (2) the payment successfully reduced foreign tax to a significant degree,[40] then the non-subpart F income of the CFC would be recharacterized as subpart F income to the extent necessary to increase the CFC's subpart F income to the amount that it would have been had the hybrid branch been a separate CFC. Treatment of hybrid branches as separate corporations would apply only for purposes of recharacterizing non-subpart F income as subpart F income and not for any other purpose, including the Section 952(c) E&P limitation on subpart F income.

The regulations met with strong resistance from Congress[41] and practitioners,[42] and were withdrawn later that same year.[43] The regulations were then reissued the following year in substantially the same form as proposed regulations,[44] but with the caveat that they

40. Whether the reduction was significant depended on whether there was a "significant disparity" between the effective rate of tax on the payment in the hands of the payee and the hypothetical rate of tax that would have applied if the income had been taxed in the hands of the payor. The regulation provided that there was a "significant disparity" if the payment was taxed at an effective rate that was less than 90% of, and at least 5 percentage points less than, the hypothetical effective rate of tax. The hypothetical effective rate was equal to the amount of tax that would have been paid by the payor if the payment had not been made, minus the amount of taxes actually paid by the payor, divided by the amount of the payment. Temp. Treas. Reg. § 1.954-9T(a)(5)(iv).

41. The Senate Finance Committee's report on the legislation that would become Public Law 105-206 included a Sense of the Senate Resolution requesting the IRS to withdraw Notice 98-11 and the T.D. 8767 regulations. S. Rep. No. 105-174, *as reprinted in* 1998-3 C.B. 537, at 646. However, the IRS issued Notice 98-35 prior to passage of the final version of that legislation, so the bill as enacted by Congress (Pub. L. 105-206) did not include the Resolution.

42. *See*, *e.g.*, New York State Bar Association Tax Section, *Notice 98-11: Tax Treatment of Hybrid Entities*, 79 TAX NOTES 877 (May 18, 1998) (expressing concerns that Notice 98-11 exceeded Treasury's authority).

43. Treasury and the IRS announced their intention to withdraw the proposed regulations in Notice 98-35, 1998-2 C.B. 34. Formal withdrawal (effective March 23, 1998) was made in Treas. Dec. 8827, 1999-2 C.B. 120.

44. REG-113909-98, 64 Fed Reg. 37727, 37729-37733 (Jul. 13, 1999).

would not be effective until five years after being finalized.[45] Although the proposed regulations were never formally withdrawn, there is no indication that they will ever be finalized.[46]

Congress subsequently moved in the opposite direction of Notice 98-11 and the temporary and proposed regulations by enacting Section 954(c)(6) as part of the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA").[47] Section 954(c)(6) generally excludes dividends, interest, rents, and royalties received or accrued from a related CFC from FPHCI, except to the extent that the amount is attributable or properly allocable to subpart F income or effectively connected income ("ECI") of the related CFC.[48] This permits a U.S. taxpayer owning multiple CFCs to achieve deferral and foreign tax reduction benefits that are largely equivalent to those that could be achieved under current law (and the law in effect prior to the enactment of TIPRA) by owning a single CFC with multiple disregarded entity subsidiaries.

In another attempt to address perceived abuses involving the check-the-box rules, Treasury proposed regulations in 1999 to address "check-and-sell" transactions, in which the sole owner of a CFC makes an election prior to sale of the CFC to treat the CFC as a disregarded entity. The effect of the election is to treat the sale as a sale of assets for U.S. tax purposes, which generally permits the gain on the sale to be treated as foreign source general limitation income for foreign tax credit limitation purposes. In addition, where the election is made for a

45. REG-113909-98, above at note 44. In addition, special grandfather rules would have precluded application of the final regulations for payments made under hybrid arrangements entered into before June 19, 1998, provided that those arrangements had not been substantially modified (as defined in the proposed regulations) on or after that date.

46. The history of Notice 98-11 and the Hybrid Branch Regulations is discussed in the JCT Description, pp. 106-109. *See also* David R. Sicular, *The New Look-Through Rule: W(h)ither Subpart F*?, 115 TAX NOTES 349, 361-62 (April 23, 2007).

47. Pub. L. 109-222, 120 Stat. 345 (2006).

48. The legislative history of TIPRA, in explaining the rationale for Section 954(c)(6), referred to facilitating the reinvestment of active foreign earnings, while making no reference to the ability to reduce foreign taxes through payment of interest, rent, and royalties. H.R. Rep. No. 109-304, at 45 (2005).

second (or lower) tier CFC, FPHCI treatment of the selling CFC's gain is generally avoided.[49] The proposed regulations,[50] unlike Notice 98-11 and the Hybrid Branch Regulations, would have directly addressed entity classification by providing that an entity would not be treated as disregarded if, within twelve months of making a check-the-box election, the entity engaged in an "extraordinary transaction" (defined as a sale, exchange, transfer, or other disposition of a 10%-or-greater interest in the entity). The rule would have applied only if the foreign entity had been taxable as a corporation at any time twelve months before commencement of the extraordinary transaction. After much criticism,[51] the Service withdrew the extraordinary transaction rule in Announcement 2003-78.[52] The IRS has also been unsuccessful in challenging the treatment of check-and-sell transactions in litigation.[53]

B. Description of Proposal

The Green Book proposal would require that a foreign eligible entity with a single owner be treated as a corporation rather than as a disregarded entity, subject to two exceptions. First, a foreign eligible entity with a single owner that is created or organized in the same country as the eligible entity could still elect to be treated as a disregarded entity (the "Same Country

49. Check-the-box elections also have the potential to affect the treatment of an outbound transaction under Section 367.
50. REG-110385-99, 64 Fed. Reg. 66591-66595 (Nov. 29, 1999).
51. *See*, *e.g.*, New York State Bar Association Tax Section, *Report on Proposed Entity Classification Regulations* (Report No. 974, May 15, 2000), 2000 Tax Notes Today 97-20 (Document 2000-13899) (May 18, 2000), available at www.nysba.org (Tax Section/Tax Section Reports/Tax Section Reports 2000) (expressing no view on whether rule should be adopted, but concern that it was overly broad); Association of the Bar of the City of New York, Committee on Taxation of Business Entities, *Comment on Changes in Entity Classification: Special Rule for Certain Foreign Eligible Entities Under Section 7701 of the Internal Revenue Code*, 2000 Tax Notes Today 72-18 (Document 2000-10295) (April 13, 2000) (strongly disapproving of both the characterization of check-and-sell transactions as abusive and of the proposed regulations as a means to discourage such transactions).
52. 2003-2 C.B. 1172.
53. *Dover Corp. v. Commissioner*, 122 T.C. 324 (2004) (where CFC holding company elected to treat its wholly-owned subsidiary as disregarded entity, subsequent sale was treated as sale of assets, and gain on sale did not constitute FPHCI to U.S. parent corporation under Section 954(c)(1)(B)(iii)).

Exception"). Second, a "first tier" foreign eligible entity wholly owned by a U.S. person could still elect to be treated as a disregarded entity "[e]xcept in cases of U.S. tax avoidance" (the "First-Tier Entity Exception").[54] The Green Book goes on to provide that the tax treatment of conversion of a foreign eligible entity from a disregarded entity to a corporation as a result of enactment of the proposal "would be consistent with current treasury regulations and relevant tax principles."[55]

The Green Book proposal would be effective for taxable years beginning after December 31, 2010. The Green Book would also extend Section 954(c)(6), which currently applies only to taxable years beginning before January 1, 2010, for another year.[56] We assume that Section 954(c)(6) would be allowed to expire at the end of 2010 if the Green Book entity classification proposal is enacted.

C. Impact of Entity Classification Proposal and General Policy Considerations

1. Stated Intent of Proposal

The entity classification proposal appears to have as its principal objective the limitation of the ability of U.S. taxpayers to defer foreign income in certain cases in which they have taken steps to reduce their foreign tax liability. The "Reasons for Change" section reads as follows:

> "As applied to foreign eligible entities, the entity classification rules may result in the unintended avoidance of current U.S. tax, particularly if a foreign eligible entity elects to be treated as a disregarded entity. In certain cases, locating a foreign disregarded entity under a centralized holding company (or partnership) may permit the migration of earnings to low-taxed jurisdictions without

54. There is no U.S. tax avoidance exception to the Same Country Exception.
55. Green Book, p. 28.
56. Green Book, p. 19.

> a current income inclusion of the amount of such earnings to a U.S. taxpayer under the subpart F provisions of the Code."[57]

2. Effect on Foreign Personal Holding Company Income

One of the principal effects of the proposal would be to limit the ability of U.S. taxpayers to reduce the effective foreign tax rate on their foreign subsidiaries' income without triggering inclusions of FPHCI under subpart F.

> Example 13: U.S. corporation USP owns all the stock of a foreign corporation, FX1, which is organized in low-tax Country X. FX1 in turn has two wholly-owned subsidiaries, FX2, a Country X company, and FY, a company organized in high-tax Country Y. FX2 and FY, but not FX1, elect to be treated as disregarded entities for U.S. tax purposes. FY pays interest or royalties to FX2; the payments are deductible by FY for Country Y tax purposes and are not subject to Country Y withholding tax.

Under current law, FY and FX2 would be disregarded as entities separate from FX1. As a result, the interest or royalty payments from FY to FX1 would be disregarded for U.S. tax purposes and would not result in recognition by USP of subpart F income. Under the Green Book proposal, FY would be required to be treated as a corporation for U.S. tax purposes,[58] and the interest or royalty income would be includible by USP as FPHCI under subpart F. The effect of the Green Book proposals would be similar in this case to Notice 98-11 and the Hybrid Branch Regulations.

The basic policy question posed by Example 13 is whether USP should be permitted to reduce its foreign tax liability on active income earned by FY without triggering a current U.S. tax liability. On the one hand, it can be argued that it is appropriate for a U.S.

57. Green Book, p. 28.
58. FX2 could continue to be treated as a disregarded entity for U.S. tax purposes under the Same Country Exception.

taxpayer to be able to defer active foreign income even if it reduces the foreign tax burden on such income by shifting it among foreign subsidiaries. The taxpayer's financing structure is intended to and has the effect of reducing foreign tax liability, not U.S. tax liability. On the other hand, it can be argued that the ability to defer active foreign income should be preserved only to the extent that the income is taxable in the jurisdiction in which it is earned.

The application of the Green Book proposal to dividends poses somewhat different considerations from those posed by its application to interest, rents and royalties. In Example 13, dividends paid from FY to FX1 would be disregarded under current law but would be includible by USP as subpart F income under the Green Book proposal, absent applicability of the high-tax exception. As a general matter, the payment of dividends, in contrast to interest, rents, and royalties, does not result in a reduction in foreign tax liability. It is not clear to us whether the Green Book proposal's concern, expressed in the "Reasons for Change," with "migration of earnings to low-taxed jurisdictions" extends to situations in which there is no avoidance of taxation in the jurisdiction in which the income-producing activities take place. The principal effect of permitting dividends between foreign subsidiaries without triggering subpart F inclusions is the facilitation of redeployment of foreign earnings from active businesses among foreign operations. We believe that the case for subpart F income treatment of intercompany dividends is generally weaker than the case for such treatment of interest, rents and royalties.[59] Even without the ability to avoid subpart F income inclusions from dividends through check-the-box elections or Section 954(c)(6), a CFC can redeploy its earnings without attracting U.S. tax liability by reinvesting them directly or through a lower-tier subsidiary.

59. Notice 98-11 and the Hybrid Branch Regulations did not affect the treatment of intercompany dividends.

Another impact of the proposal on FPHCI determinations would be the elimination of the ability to avoid subpart F income on the sale by a CFC of a lower-tier wholly-owned foreign subsidiary.

> Example 14: U.S. corporation USP owns all the stock of a CFC, F1, which in turn owns all the stock of a second-tier foreign eligible entity, F2. F1 sells the stock of F2 to an unrelated third party.

Under current law, if a check-the-box election is made to treat F2 as a disregarded entity, the sale will not result in subpart F income except to the extent that F2's assets are FPHCI-producing assets. Under the Green Book proposal, F2 would be treated as a corporation. Subject to possible application of the high-taxed income exception, F1's gain would be subpart F income. The gain would give rise to a deemed dividend under Section 964(e) to the extent of F2's E&P,[60] with the remaining gain treated as FPHCI under Section 954(c)(1)(B)(i) (and generally in the Section 904 passive limitation category). As in the case of dividends, the ability under current law to avoid subpart F income on a sale by a CFC of stock of a lower-tier foreign subsidiary does not entail issues posed by reduction of foreign tax, but instead simply facilitates redeployment of foreign earnings.

Finally, the entity classification proposal could affect the applicability of exceptions to FPHCI treatment that require a CFC to perform certain functions using its own employees.[61] Because a foreign eligible entity owned by a CFC would not be treated as a

60. Under current law, the deemed dividend would be excluded under Section 954(c)(6). *See* Notice 2007-9, 2007-1 C.B. 401, Section 3.

61. *See* Treas. Reg. § 1.954-2(f)(2)(iii) (relating to active conduct of a commodities business); Treas. Reg. § 1.954-2(c)(1)(ii) & (iv) (active rental income); Treas. Reg. § 1.954-2(d)(1)(ii) (active royalty income).

disregarded entity, the foreign eligible entity's employees would not be treated as employees of the CFC.

3. Effect on Foreign Base Company Sales and Service Income

The Green Book proposal would also expand the reach of the foreign base company sales and service income rules because transactions between commonly-owned related entities could no longer be ignored as a result of disregarded entity elections.[62]

> Example 15: USP owns all the stock of FA, a CFC organized as a holding company in Country A. FA in turn owns all the stock of FB, a company organized and carrying on manufacturing operations in Country B, and FC, a company organized in Country C which buys finished goods from FB and sells them to unrelated customers outside of Country C. The effective tax rate on FB's income in Country B is the same as the effective tax rate on FC's income in Country C.

Under current law, assuming that FB and FC are disregarded entities for U.S. tax purposes, the US tax consequences for USP in Example 15 would be governed by the branch rules of Section 954(d)(2) and the regulations issued thereunder, which address cases where a CFC has one or more branches outside the CFC's country of incorporation. Broadly speaking, the Section 954(d)(2) regulations require an analysis of the manufacturing and sales activities performed by each of FA's branches, as well as a comparison of the effective tax rates imposed on the income attributable to each branch; sales income that is relatively low-taxed is treated as foreign base company sales income.[63]

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62. In the case of foreign base company sales income, expansion of the branch rules promulgated pursuant to Section 954(d)(2) could achieve essentially the same effect as the Green Book proposal without the need for legislation.

63. The regulations address a number of different possible fact patterns. If a CFC has a branch outside its country of incorporation through which it conducts sales activities, then the branch is generally treated as a separate corporate subsidiary of the CFC for purposes of Section 954(d), and is deemed to transact business with the CFC (*e.g.*, purchasing from the CFC for resale to customers), if income attributable to the branch is taxed at an

(Footnote continued on next page)

Under these regulations, USP would not be required to treat FC as a separate corporation for purposes of Section 954(d), due to the lack of a disparity between the effective tax rates in Country B and Country C.[64] By comparison, under the Green Book proposal, FB and FC would be treated as separate corporations; as a result, FC's sales income would be treated as foreign base company sales income absent application of the Section 954(b)(4) high-taxed income exception, which would compare the Country C tax rate with U.S. tax rates rather than Country B tax rates. The result under the Green Book proposal would be different, however, if FA, FB, and FC all were organized under the laws of the same country. In that case, the current rules under Section 954(d) would continue to govern, and FB and FC would be treated as corporations for purposes of applying Section 954(d) only if the Country C effective tax rate is sufficiently low compared to the effective tax rate in Country B. The rate disparity test in the Section 954(d) regulations also would continue to govern in a case involving natural branches of FA in Countries B and C.

Even if FC is treated as a CFC under the Green Book proposal, FC's income would not be treated as foreign base company sales income if its employees make a "substantial

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(Footnote continued from prior page)
effective rate that is less than 90% of, and at least 5 percentage points less than, the effective tax rate at which such income would be taxed if the CFC was taxed on the income in the country where the CFC is incorporated. *See* Treas. Reg. §§ 1.954-3(b)(1)(i)(a)-(b). In addition, if a CFC conducts manufacturing activity through a branch outside the CFC's country of incorporation, the manufacturing branch is treated as a separate corporation, which is deemed to transact business with the CFC (*e.g.*, selling manufactured goods to the CFC for resale to customers) if the CFC is subject to tax on the income allocable to its operations (excluding the manufacturing branch) at an effective rate that is less than 90% of, and at least 5 percentage points less than, the effective rate of tax that would be imposed if such income were taxed in the country where the manufacturing branch is located. *See* Treas. Reg. § 1.954-3(b)(1)(ii)(b), Temp. Treas. Reg. § 1.954-3T(b)(1)(ii)(a). The regulations provide detailed rules, which take the same basic approach of comparing the effective tax rates imposed on sales and manufacturing income earned in different locations, to the case of a CFC that has multiple branches outside its country of incorporation through which it conducts sales and/or manufacturing operations. *See* Temp. Treas. Reg. §§ 1.954-3T(b)(1)(i)(c) & (b)(1)(ii)(c).

64. *See* Temp. Treas. Reg. § 1.954-3T(b)(1)(ii)(c).

contribution" to the manufacture of personal property (*e.g.*, by providing oversight and direction of the manufacturing process).[65] The regulations under Section 954(d) relating to the substantial contribution test and the manufacturing exception envision the possibility that a CFC might have multiple branches, none of which in isolation makes a substantial contribution to the manufacturing process, but all of which taken together do make a substantial contribution; under the regulations, the CFC may satisfy the manufacturing exception in such a case.[66] If the Green Book proposal were enacted, then a CFC that had satisfied the manufacturing exception due to the combined activity of multiple disregarded entities would now be required to treat each disregarded entity as a separate CFC, with none of these CFCs qualifying for the manufacturing exception. By comparison, a CFC with multiple subsidiaries treated as disregarded entities under the Same Country Exception, or with multiple true branches, would continue to be subject to the Section 954(d) regulations dealing with branches.

In addition to affecting the application of the foreign base company sales rules, the Green Book proposal would cause intercompany service arrangements between disregarded entities owned by the same CFC to be taken into account. In Example 15, if FC performs services for FB outside of Country C, any fees received by FC for providing those services generally would be foreign base company services company income under Section 954(e) as a result of treating FB and FC as separate corporations.

65. *See* Treas. Reg. § 1.954-3(a)(4)(iv), as amended by Treas. Dec. 9438, 2009-5 I.R.B. 387 (effective July 1, 2009).
66. *See* Temp. Treas. Reg. § 1.954-3T(b)(1)(ii)(c)(3)(iii).

4. Effect on Foreign Taxpayers

Although the entity classification proposal's impact is primarily on foreign activities of U.S. taxpayers, it would also affect the taxation of U.S. activities of certain foreign taxpayers.

> Example 16: Foreign corporation FP has a subsidiary, FS, organized in a different foreign jurisdiction. FS performs management or other services in the United States for, or engages in research activities in the United States to develop intangible property which it licenses to, FP and FP's other foreign subsidiaries, which have no activities in the United States and earn foreign source income from unrelated foreign parties. FS and FP's other foreign subsidiaries elect to be treated as disregarded entities.

Under current law, all the activities of FS and FP's other subsidiaries would be attributed to FP. Because the transactions between FS and its affiliates are disregarded for U.S. tax purposes and FP's income is foreign source and therefore generally not ECI, it is unlikely that FP would be subject to U.S. income tax, even if FS's U.S. activities contribute substantially to the group's income. Under the Green Book proposal, FS would be treated as a corporation and would have to charge arm's length service fees and royalties to its affiliates (or have such fees and royalties imputed under Section 482). FS's income from intercompany services performed in the U.S. generally would be treated as U.S. source income and subject to U.S. tax as ECI.[67]

D. Summary of Comments and Recommendations

The following is a summary of our comments and recommendations relating to the Green Book proposal to change the entity classification rules.

67. Foreign source royalty income received by FS from its affiliates would not be taxed as ECI or otherwise subject to U.S. tax, even if there are substantial U.S. activities involved in the production of such income. Section 864(c)(4)(D)(i).

1. As a general matter, we believe that the objectives of the entity classification rules could be better achieved by directly changing subpart F and other substantive rules rather than requiring foreign eligible entities to be treated as corporations for U.S. tax purposes.

2. The Same Country Exception generally would be appropriate if the entity classification rules are adopted. However, the exception should be based upon the countries in which the entities are resident for tax purposes, rather than the countries in which, or under the laws of which, they are organized.

3. The First-Tier Entity Exception should apply to multiple tiers of foreign disregarded entities. Application of the First-Tier Entity Exception to foreign eligible entities that are wholly-owned by U.S. or foreign partnerships poses serious issues insofar as the appropriate treatment may depend on the status of the partners (*e.g.* as U.S. persons or CFCs), resulting in conflicts where a partnership has different types of partners. The anti-avoidance exception to the First-Tier Entity Exception should be clarified as to its intended scope, and its objectives would probably be better served by the inclusion of specific rules addressing specific potentially abusive situations.

4. If the entity classification proposal is adopted, it should be extended to domestic eligible entities in situations where their use presents the same issues as the use of foreign eligible entities.

5. The rationale behind the entity classification proposal applies equally to third country natural branches of foreign corporations that do not tax foreign branch income. As a practical matter, such situations are probably easier to address through changes to subpart F and other substantive rules rather than by reclassifying such branches as corporations.

6. Many of the concerns raised by the use of disregarded entities apply to partnerships as well. However, requiring reclassification of partnerships as corporations raises additional problems. Issues involving partnerships can be addressed more appropriately by changing the subpart F rules.

7. The conversion of a disregarded entity to a corporation upon the effective date of the entity classification proposal potentially results in adverse tax consequences, including the possible creation of Section 367 gain, subpart F income, and E&P, that do not appear to be germane to the purpose of the proposal. We have several recommendations for ameliorating these adverse consequences.

E. <u>Discussion</u>

1. <u>Appropriateness of Proposal for Achieving Its Objectives</u>

We do not believe that the entity classification proposal is the most effective or appropriate means of accomplishing its apparent objectives. As discussed in more detail below, the effect of the proposal is too narrow in some cases and too broad in others. In addition, the proposal would have a number of undesirable collateral consequences that do not advance the proposal's objectives.

The entity classification proposal's objectives could be achieved by a more direct approach targeted at the relevant substantive provisions of the Code rather than changing the entity classification rules. For example, avoidance of FPHCI taxable under subpart F by use of disregarded entities could be addressed through rules similar to those of Notice 98-11 and the Hybrid Branch Regulations.[68] Rules along the lines of the Hybrid Branch Regulations, unlike

68. In light of the prior controversy discussed at Section II.A, above, this should be effected legislatively.

changing the classification of the disregarded entity to a corporation, would avoid the creation of E&P where none would otherwise exist. Although, as discussed above, dividends provide a less compelling case for subpart F income than do interest, rents, and royalties, such rules could be extended to intercompany dividends. To the extent that check-and-sell transactions are viewed as problematic, Section 954(c) could be amended to provide that gain on sale of a disregarded entity is treated as FPHCI.

Similarly, if the current foreign base company sales income rules are thought to produce inappropriate results in situations involving multiple disregarded entity subsidiaries, the regulations relating to branches under Section 954(d)(2) could be amended, probably without the need for any legislative change. Section 954(e) could be amended to provide rules applicable to service transactions involving branches similar to those of Section 954(d)(2).

Foreign corporations' ability to avoid U.S. tax on income attributable to their U.S. activities in situations similar to that illustrated in Example 15 could be addressed by changing the ECI rules so that income can be attributed to a U.S. branch based upon an arm's-length measure of income.[69] Such changes would not have to be limited to situations in which the U.S. activities are conducted through a foreign eligible entity.

The remainder of our discussion of the entity classification proposal addresses ways in which the entity classification proposal's objectives could be achieved by other means,

69. This would be consistent with treaties that permit taxation of business income attributable to permanent establishments. *See also* REG-208299-90, 63 Fed. Reg. 11177, 11195-11197 (Mar. 6, 1998) (proposing new Treas. Reg. § 1.863-3(h) for sourcing income from global dealing operations); Treas. Reg. § 1.482-9 (providing methods for determining the arm's length amount charged in a controlled services transaction) (finalized by Treas. Dec. 9456, 2009-33 I.R.B. 188).

as well as recommendations as to how the proposal could be improved and elaborated upon if Congress decides to adopt the general approach of the proposal.

2. Same Country Exception

Under the Same Country Exception, a foreign eligible entity could be treated as a disregarded entity as long as it is organized in or created under the laws of the same country as its owner. The rationale for this exception presumably is that payments between two companies resident in the same jurisdiction generally do not have the potential for shifting income between high tax and low tax jurisdictions or avoiding tax in the jurisdiction in which the income producing activity takes place.

As a general matter, we approve of the Same Country Exception. However, we recommend that its applicability be determined not by reference to the country under the laws of which the entities are organized, but instead by reference to the country in which the entities are taxed on a residence basis. For example, we do not see why an entity that is formed under Country X law and treated as a resident of Country X for tax purposes should not be eligible for disregarded entity status if it is owned by an entity organized under Country Y law that is managed and controlled in Country X and treated as a Country X resident for Country X tax purposes. Conversely, applying the Same Country Exception to a Country X company that is wholly owned by another Country X entity that is treated as a pass-through for Country X tax purposes would be contrary to the purpose of the proposal, unless the owner is itself wholly-owned by tax residents of Country X.[70]

70. Note that similar issues are posed by the current law same country exception of Section 954(c)(3)(A)(i).

3. First-Tier Entity Exception

(a) Generally

As a general matter, we think that the First-Tier Entity Exception is appropriate. The general intent of the Green Book entity classification proposal is to limit the opportunity for U.S. taxpayers to defer foreign income. As long as the U.S. owner of a foreign eligible entity is subject to current U.S. tax on the entity's income, there is no potential for deferral of the entity's income; in fact, prohibiting disregarded entity treatment generally would result in increased deferral. The fact that a foreign eligible entity may be able to reduce its foreign tax liability by means of payments to the U.S. owner that are disregarded for U.S. tax purposes does not seem to be relevant, except in cases similar to that described in Example 17 below.

We assume that the First-Tier Entity Exception is intended to apply to multiple tiers of disregarded entities with an ultimate U.S. owner. As long as the income of every entity in the chain is currently taxable to the U.S. owner, there is no deferral opportunity.

However, if the First-Tier Entity Exception were to apply to foreign eligible entities owned by U.S. partnerships, the intended effect of the entity classification proposal could readily be subverted by interposing a U.S. partnership between a CFC and its lower-tier foreign subsidiaries.[71] On the other hand, if a U.S. partnership (or, for that matter, a foreign partnership) has U.S. citizens, resident individuals, or corporations as its partners, application of the First-Tier Entity Exception to foreign eligible entities owned by the partnership is appropriate, since there would be no deferral of the U.S. partners' income. In principle, where a foreign eligible entity is

71. *See* Notice 2009-7, 2009-3 I.R.B. 312 (treating as a "transaction of interest" the use of a domestic partnership composed of two CFCs to block the taxation to the ultimate U.S. shareholder of the CFCs of the subpart F income of a third CFC owned by the partnership).

wholly-owned by a U.S. partnership which in turn is owned 50% by a U.S. corporation and 50% by an unrelated CFC, the entity classification proposal should apply to the foreign eligible entity for purposes of determining the U.S. tax liability of the CFC's U.S. shareholders but not for purposes of determining the U.S. tax liability of the U.S. corporate partner. However, a foreign eligible entity with a single owner is either a disregarded entity or a corporation for U.S. tax purposes; unlike Schrödinger's cat, it cannot be both. Applying the First-Tier Entity Exception only if none of the partners is a CFC (or no more than a specified percentage of the partnership is owned by CFCs) would also be problematic. If all the initial partners in a partnership are U.S. persons, a sale by one partner of an interest to a CFC resulting in a deemed incorporation of the foreign eligible entity would result in adverse tax consequences to continuing U.S. partners, including recognition of gain under Section 367. Changing the subpart F rules rather than changing the entity classification rules would permit appropriate treatment of both CFC and non-CFC partners.

(b) Anti-Avoidance Rule

The U.S. tax avoidance exception to the First-Tier Entity Exception raises serious concerns. We are uncertain as to the circumstances in which it is meant to apply. Because a check-the-box election has no purpose or effect other than its U.S. tax consequences, the anti-avoidance rule could swallow up the entire First-Tier Entity Exception. We recommend that the anti-avoidance rule be clarified as to its intended scope and limited to circumstances described in regulations promulgated pursuant to a legislative grant of authority.

Certain U.S. tax benefits that are associated with treating first-tier foreign eligible entities as disregarded entities clearly should not be within the scope of the anti-avoidance rules.

Examples of such benefits are the ability of a U.S. taxpayer to use losses of a first-tier disregarded entity and to claim credits on a current basis for foreign taxes imposed on a disregarded entity doing business in a high tax jurisdiction, notwithstanding the possible enactment of the Green Book foreign tax credit pooling proposal. Such benefits are clearly contemplated by general U.S. tax principles.

To the extent that the anti-avoidance rule is intended to address foreign eligible entities owned by U.S. partnerships, we believe that it would be very difficult to clearly distinguish between situations where application of the First-Tier Entity Exception would or would not result in inappropriate "avoidance." Many other potential avoidance opportunities associated with disregarded entity status for first-tier foreign eligibility entities are (or can be) adequately addressed by other means. For example, the dual consolidated loss regulations prevent use of a first-tier foreign disregarded entity's losses against its U.S. parent's income for U.S. tax purposes and a CFC subsidiary's losses for foreign tax purposes. Similarly, the result in *Guardian Industries Corp. v. United States*,[72] in which the U.S. taxpayer was able to claim credits for foreign taxes paid by a first-tier disregarded entity on income earned by lower-tier subsidiaries that was deferred for U.S. tax purposes, is adequately addressed by the Green Book proposal relating to separation of foreign tax credits from related income[73] and the proposed regulations modifying the technical taxpayer regulations.[74]

72. 477 F. 3d 1368 (Fed. Cir. 2007).
73. Green Book, p. 31.
74. REG-124152-06, 71 Fed. Reg. 44, 240 (Aug. 4, 2006). *See* New York State Bar Association Tax Section, *Report on Regulation Section 1.901-2(f)(3) and the Allocation of Foreign Taxes Among Related Persons* (Report No. 1083, Apr. 4, 2005), 2005 TAX NOTES TODAY 64-26 (Document 2005-6881) (Apr. 4, 2005), available at www.nysba.org (Tax Section/Tax Section Reports/Tax Section Reports 2005).

One situation in which the application of antiavoidance rules may be appropriate is where the first-tier disregarded entity is entitled to a deduction for foreign tax purposes for interest paid or accrued to its U.S. owner and is able to use the interest expense to shelter income of a CFC subsidiary for foreign tax purposes.

> Example 17: U.S. corporation USP owns all the stock of a foreign eligible entity, FX1, which is organized under the laws of Country X and treated as a disregarded entity for U.S. tax purposes. FX1 in turn owns all the stock of FX2, another Country X company, which is a CFC. FX1 and FX2 file consolidated Country X tax returns. FX1 has indebtedness owing to USP, interest on which is deductible for Country X tax purposes.

Under current law, if FX1 has no gross income for U.S. tax purposes, the deductibility for Country X tax purposes of interest paid or accrued by FX1 to USP provides benefits similar to those derived in Example 13. Although there is no shifting of income to a low-tax jurisdiction, the group is able to take advantage of differences in U.S. and foreign tax law in order to reduce its foreign tax liability without incurring incremental U.S. tax liability. Of course, no such benefit is achieved if FX1 funds its interest payments with dividends from FX2, and, if FX1 has other income, denying disregarded entity status for FX1 may result in increased deferral of U.S. tax liability. [75] It is very difficult to fashion and apply an antiavoidance rule under the entity classification proposal that appropriately distinguishes between situations where it is and is not appropriate to deny disregarded entity status to FX1. A more appropriate approach would be to expand the dual consolidated loss regulations to reach this situation,

75. This technique is most likely to be effective where the foreign jurisdiction permits deductions for accrued but unpaid interest or interest that is funded through circular flows of cash from the U.S. shareholder.

possibly by imputing a portion of USP's interest expense to FX1 for this purpose or by treating the otherwise disregarded loan as a regarded loan.[76]

4. Possible Extension of Entity Classification Proposal to Domestic Eligible Entities

Assuming that the entity classification proposal is adopted, we believe that at least in some circumstances the proposal should preclude disregarded entity status for domestic eligible entities rather than being limited to foreign eligible entities.

> Example 18: U.S. corporation USP owns all the stock of FX1, a Country X CFC. FX1 has two wholly-owned subsidiaries, FX2, a Country X company, and DS, a Delaware limited liability company. FX2 and DS are treated as disregarded entities for U.S. tax purposes. DS is not treated as a pass-through entity for Country X tax purposes. FX2 pays interest or royalties to DS.

The entity classification proposal would not affect the disregarded entity status of DS. Assuming that DS's interest or royalty income is not ECI, treatment of DS as a disregarded entity has the same effect as such treatment of a foreign tax haven subsidiary. We believe that it would be appropriate to require DS to be treated as a corporation for U.S. tax purposes if the approach of the entity classification proposal is enacted. Similarly, in Example 16, we do not see any basis for having different results based on whether a foreign corporation conducts its U.S. activities through a foreign eligible entity or a domestic eligible entity.

Application of the entity classification proposal to domestic eligible entities should be limited to situations, such as those described in Example 17 and those involving

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76. In a prior report we recommended changing the dual consolidated loss regulations along these lines. *See* New York State Bar Association Tax Section, *Report on Final Dual Consolidated Loss Regulations* (Report No. 1144, Jan. 23, 2008), 2008 TAX NOTES TODAY 17-17 (Document 2008-1461) (January 25, 2008), available at www.nysba.org (Tax Section/Tax Section Reports/Tax Section Reports 2008).

domestic entities that are treated as foreign residents for foreign tax purposes, which present a potential for abuse. On the other hand, a domestic LLC wholly-owned by a domestic partnership, where all activities are U.S. business activities, appears to be a clear case for allowing disregarded entity treatment, regardless of who owns the partnership.

Avoidance of subpart F through domestic eligible entities could be addressed by changes to the subpart F rules rather than changes to the entity classification rules. In fact, the Hybrid Branch Regulations would have applied to hybrid entities organized under U.S. law.

5. <u>Possible Extension of Entity Classification Proposal to "Natural" Branches</u>

The Green Book proposal would not affect the treatment of "natural" branches that are located outside a foreign corporation's home country but are not organized as separate legal entities, even if the foreign country does not tax the branch's income. However, natural branches of CFCs have the same potential for avoidance of subpart F as do hybrid disregarded entities. For example, if a CFC has a branch in a country outside its country of residence and the branch receives interest payments from a related CFC organized in the same jurisdiction as the first CFC and the CFC's country of residence does not tax income earned by branches in the other country, applying Section 954(c)(3)(A)(i) to exclude the interest payment from FPHCI poses the same issues as does a payment to a hybrid disregarded entity owned by a CFC. Similarly, the ability of a foreign corporation to avoid U.S. tax on U.S. branch activities as illustrated by Example 16 applies to natural branches as well as to hybrid disregarded entities.

In principle, if the entity classification proposal were to be adopted, it would be appropriate to apply it to natural branches. However, this would pose technical difficulties, especially with respect to the ability to properly define the income and assets of the "deemed" corporation. This is another illustration of why we believe that directly addressing the substantive subpart F and ECI rules is preferable to the entity classification proposal.[77]

6. Possible Extension of Entity Classification Proposal to Partnerships

The Green Book entity classification proposal would not change the classification of foreign eligible entities with more than one owner. Such entities could continue to be treated as partnerships for U.S. tax purposes, regardless of the tax residence of their owners.

Mandating corporate classification for single-owner but not multiple-owner foreign eligible entities can be justified on the basis that transactions between partnerships and their owners, unlike transactions between disregarded entities and their owners, are not ignored for U.S. tax purposes, and that partnerships therefore create less of an opportunity for tax avoidance. Nonetheless, at least some of the same planning opportunities offered by the use of disregarded entities that the entity classification proposal is intended to prevent are available through the use of partnerships. These opportunities are most readily apparent where a CFC owns substantially all the equity in a partnership.

> Example 19: U.S. corporation USP owns all the stock of FX, a CFC organized in Country X. FX in turn owns 99% of FY, a company organized in Country Y that is treated as a corporation for Country X and Country Y tax purposes and as a partnership for U.S. tax purposes.

Distributions of earnings from FY to FX would not give rise to dividend or other income includible under subpart F, except to the extent that the distributions exceed FX's basis in its FY interest. This result is no more or less appropriate than it would be if FY were a

77. Although the Hybrid Branch Regulations would only have applied to hybrid entities, they could readily be expanded to cover true branches of CFCs resident in countries that do not tax branch income.

disregarded entity rather than a partnership. Similarly, under the look-through rules of Section 954(c)(4), gain on sale by FX of its interest in FY is treated for purposes of subpart F in essentially the same manner as if FY were a disregarded entity.

Payments of interest or royalties from FY to FX generally would be treated as FPHCI. However, because 99% of FY's interest or royalty expense would be allocated to FX, the actual subpart F inclusion would generally be less than if FY were treated as a corporation for U.S. tax purposes.[78] Moreover, if FX uses a substantial part of its assets in a trade or business in Country X, the same country exception could apply to 99% of any interest that FY pays to a related Country X CFC under Section 954(c)(3) and Treas. Reg. § 1.954-2(b)(4)(i)(B).

This suggests that it may be appropriate to apply the entity classification proposal to foreign eligible entities with more than one owner, at least in the case of hybrid entities. However, requiring classification as a corporation may be overly draconian, especially in the case of a foreign eligible entity that is a true joint venture between or among unrelated parties or that has direct U.S. partners. Such situations present many of the same issues discussed at Section II.E.3, above, with respect to foreign eligible entities that are wholly-owned by partnerships, where the "correct" result is different for differently situated partners. In theory, rules could attempt to distinguish between "true" partnerships involving unrelated parties and partnerships such as FY in Example 19 that are essentially indistinguishable from wholly-owned subsidiaries. It is very hard, however, to make such distinctions without running the risk of under-inclusiveness, over-inclusiveness, or uncertainty (or a combination of the three). Accordingly, we believe that it would be preferable to tighten up the application of the subpart F

78. *See* Treas. Reg. § 1.954-1(c)(1)(i) and Treas. Reg. § 1.904-5(c)(2)(ii).

rules to partnerships rather than changing the entity classification rules for entities with more than one owner, even if the entity classification rules were adopted for single owner entities. In this regard, it should be noted that the Hybrid Branch Regulations also included provisions applicable to partnerships that would have prevented interest and other expenses from being allocated to the FPHCI from which the expense arises and would have limited the application of Section 954(c)(3) in cases where the partnership is a hybrid entity resident for tax purposes in a different jurisdiction from the CFC.

7. Transition Issues

Under the Green Book proposal, the deemed incorporation of a disregarded entity as a result of enactment of the changes in the entity classification rules is treated in the same manner as an actual incorporation of the entity's assets. This could have a number of adverse tax consequences for taxpayers.

In the case of a foreign eligible entity that is directly owned by a U.S. taxpayer (or is owned by a partnership in which a U.S. taxpayer is a partner), deemed incorporation could result in recapture of losses under the dual consolidated loss regulations, gain recognition under Section 367(a), and ongoing income recognition under the "super-royalty" provisions of Section 367(d).[79] The potential severity of these consequences presents a strong argument for limiting (if not eliminating) the anti-avoidance exception to the First-Tier Entity Exception.

In the case of a foreign eligible entity that is owned by a CFC, the situations of most concern are those in which the foreign eligible entity that is deemed to be incorporated has

79. Another Green Book proposal would expand the scope of intangible assets subject to Section 367(d). *See* Green Book, p. 32.

indebtedness owing to its owner (or to another disregarded entity with the same owner) which is disregarded for U.S. tax purposes but is deemed to "spring" into existence upon the deemed incorporation.

> Example 20: U.S. corporation USP owns all the stock of FX, a CFC organized in Country X. FX has a wholly-owned Country Y subsidiary, FY, that is treated as a disregarded entity. FY has assets with a basis of 100 and fair market value of 200. FY has indebtedness of 50 owing to FX, which is recognized for Country X and Country Y tax purposes but disregarded for U.S. tax purposes.

Because the intercompany indebtedness would be treated for U.S. tax purposes as coming into existence only at the time of the deemed incorporation of FY resulting from enactment of the entity classification proposal, FX would be treated as transferring all the assets of FY in exchange for stock of FY and an FY note. Under Section 351(b), FX would recognize gain of 50 (*i.e.*, the lesser of the realized gain of 100 and the amount of boot represented by the intercompany note). To the extent that FY's assets are passive, this would result in recognition by USP of subpart F income. If FY's assets are active, USP would have no current income inclusion, but FX's E&P would be increased by the recognized gain, with the result that foreign tax credits on future dividends would be diluted.[80]

We think that the requirement of gain recognition under Section 351(b) in this situation, although logically consistent with the deemed incorporation construct, is not essential to the purposes of the entity classification rules and is unduly punitive. It would be appropriate in our view to treat the springing indebtedness in the same manner as pre-existing indebtedness

80. To the extent that the increased basis in assets reduces future E&P, this effect would only be a timing difference as opposed to a permanent difference.

owed to a third party, at least in cases where the previously disregarded intercompany indebtedness was created (for legal and foreign tax purposes) prior to enactment of, and not in anticipation of, the entity classification proposal. Under this approach, gain recognition would be required under Section 357(c) only to the extent, if any, that the indebtedness “assumed” by the newly created FY exceeded the basis in its assets.

Further issues arise when the converted foreign eligible entity owns stock of a foreign subsidiary.

> Example 21: Same facts as Example 20, except that FY’s sole asset is the stock of FZ, a CFC organized in Country Z.

In Example 21, FX would have a deemed distribution of 50 under Section 304. Under Section 304(b)(3)(A), this result would apply even if our suggested Section 357(c) approach were adopted, unless the indebtedness was incurred by FX to acquire the stock of FZ.[81] Assuming that Section 954(c)(6) remains in effect through the end of the year prior to the first year to which the entity classification proposal applies, we believe that it would be appropriate to permit taxpayers to apply Section 954(c)(6) to the deemed incorporation under the entity classification proposal, so that any portion of the Section 304 distribution treated as a dividend would be excluded from subpart F, even if the deemed incorporation is treated as occurring on the first day of the first taxable year for which the entity classification rule and the expiration of Section 954(c)(6) are effective.

More broadly, we do not think that any of the potential consequences associated with deemed incorporation are germane to the purposes of the entity classification proposal. Our

81. *See* Section 304(b)(3)(B).

preferred approach of changing subpart F and other substantive rules rather than changing the entity classification rules would have the advantage of avoiding these collateral consequences.

Appendix – Calculations for Examples 1 and 2

> Example 1: Assume that the assets of U.S. corporation P consist of domestic source income producing assets with a value of 1500, foreign branch assets with a value of 500 and the stock of a wholly-owned foreign subsidiary, X, which has assets with a value of 1000 and no liabilities. P incurs interest expense of 120 and X has current year E&P of 100, of which 50 is distributed.

Step 1 – Allocate interest expense between U.S. and foreign assets

Assets		Interest Expense
US	1500	60
F	1500	**60**
Total	3000	120

Step 2 – Allocate foreign source interest expense between foreign subs and other assets

Foreign Assets		Interest Expense
Subs	1000	**40**
Other	500	20
Total	1500	60

Step 3 – Allocate foreign-sub interest expense between deferred and distributed E&P

40 x 50/100 = **20** interest expense to be deferred

Example 2: Same facts as Example 1, except that X has assets with a value of 2,000, liabilities of 1,000, and interest expense of 60.

Step 1 – Allocate interest expense between U.S. and foreign assets

Assets		WW Interest Expense	P's Interest Expense*
US	1500	67.50	67.50
F	2500	**112.50**	52.50
Total	4000	180	120

*P's interest expense is allocated by (i) first allocating worldwide interest expense, and then (ii) reducing the 112.50 foreign source interest expense by the 60 amount of X's interest expense. This gives a result different from allocating P's 120 of interest expense by reference to U.S. and foreign assets. Technically, there is no need to allocate P's interest expense until step 2.

Step 2 – Allocate foreign source interest expense between foreign subs and other assets

Foreign Assets		WW Interest Expense	P's Interest Expense*
Subs	2000	90	**30**
Other	500	22.50	22.50
Total	2500	112.50	52.50

*P's interest expense is allocated by (i) first allocating worldwide interest expense, and then (ii) reducing the 90 foreign source interest expense allocated to X by the 60 amount of X's interest expense. This gives a result different from allocating P's 52.50 of interest expense by reference to foreign subs and other assets.

Step 3 – Allocate foreign-sub interest expense between deferred and distributed E&P

30 x 50/100 = **15** interest expense to be deferred