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Check-the-Box Reform: (Subpart F)ishing with Dynamite

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INTRODUCTION

Check-the-box (CTB) reform is both a timely and timeless topic. It is timely because it was on the short(ish) list of international tax proposals included in the Obama Administration's Fiscal Year 2010 revenue proposals (the "Greenbook"),[2] on May 13, 2009, and it is timeless because it implicates a debate regarding the strength of Subpart F's anti-deferral rules that has been ongoing since 1962. The Administration intended the proposal to limit a U.S.-parented multinational's ability to shift the income earned by its controlled foreign corporations (CFC) from high- to low-tax foreign jurisdictions through transactions that are disregarded for U.S. tax purposes and, therefore, do not trigger current Subpart F inclusions.[3] Thus, the proposal would shift policy toward capital export neutrality, or the idea that U.S. multinationals should be subject to the same tax rates abroad as they are in the United States, and away from capital import neutrality, the idea that U.S. multinationals should be subject to the same tax rates abroad as their foreign competitors.

In this article, we analyze the Administration's proposal and several other recent CTB reform proposals that may gain political traction. Indeed, each of the proposals we discuss is noted as a potential alternative to the Administration's proposal in the Joint Committee on Taxation's (JCT) "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" (the "JCT White-

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[2] Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (2009) [hereinafter Greenbook]. Some experts expect some variation on the proposal to be enacted. *See, e.g.,* Lee A. Sheppard, "Check-the-Box Repeal Likely to be Enacted," 2009 *TNT* 128-1 (7/8/09).

[3] Greenbook at 28.

book''), issued on September 14, 2009.[4] We seek to show that these CTB reform proposals miss the mark: they are overbroad, may not achieve the intended results, are likely to result in costly collateral tax consequences to U.S. multinationals, and raise troublesome transition issues. We also discuss proposed and temporary Subpart F regulations that Treasury previously issued to target the same issues following its now-infamous Notice 98-11,[5] but which Treasury subsequently withdrew.

We prefer the Notice 98-11 approach of Subpart F-specific rules. This approach can be better tailored to the identified problems than the CTB proposals. It also has the significant advantage of not altering the entity classification rules, the core building block of international tax planning. And while not without the complexity that we have come to expect in international tax, the Notice 98-11 approach is relatively mechanical and based on bright-line tests. In contrast, the CTB proposals, while mechanical to a degree, at times resort to ill-defined standards or notions such as ''tax avoidance.'' In a world with FIN 48 and Sarbanes-Oxley, good tax policy requires the entity classification rules to be predictable and clear in all cases. There are simply too many collateral tax consequences at stake.

Finally, we have not found a reason why a Subpart F-specific approach would be less effective in achieving the Administration's goals, however interpreted. Of course, the Notice 98-11 approach also involves some difficult line-drawing issues, the most salient of which is that a Notice 98-11 approach requires one to determine whether an entity is ''fiscally transparent'' under foreign law. The point, however, is that the stakes that are implicated by any uncertainty created under a Notice 98-11 approach are limited to the Administration's stated aims, which is whether a payment gives rise to Subpart F income. Most importantly, no uncertainty arises regarding the fundamental attribute of entity classification. We worry that the negative response to Notice 98-11 may still haunt policymakers, sending them in search of dynamite— when we think a rod, a reel, and a few nightcrawlers would do the trick.

[4] JCT Whitebook at 113-14.

[5] 1998-1 C.B. 433.

BACKGROUND

CTB Regulations

In December 1997, Treasury issued the CTB entity classification regulations.[6] The CTB regulations adopted a mostly elective regime for classifying business entities. Generally, the CTB regulations divide business entities into two categories: per se corporations and eligible entities.[7] An eligible entity may elect to be taxed as either a corporation or as a passthrough entity.[8] If an eligible entity does not make a classification election, default rules determine its classification.[9]

This ''choice of entity'' principle represented a dramatic change in policy, through which Treasury intended to simplify business entity classification, while providing taxpayers with flexibility and certainty. Under prior regulations, a multi-factor test, based on a corporate resemblance test set forth by the Supreme Court in *Morrissey v. Comr.*,[10] applied to determine whether an unincorporated business entity was classified as a corporation or partnership. A business entity that had three of the following four characteristics was classified as a corporation: (i) continuity of life, (ii) centralized management, (iii) limited liability to the owners, and (iv) transferability of ownership interests.[11] Otherwise, the entity was classified as a partnership. In effect, entity classification was elective in many cases, because well-advised taxpayers could usually arrange for an entity to possess characteristics that would result in the desired classification. This exercise, however, often required significant time and expense, and, particularly in the international context, the desired classification was not always easily achievable due to the vagaries of foreign law.

International CTB Planning

The CTB regulations introduced the concept of a disregarded entity (''DRE''), a concept that previously had been mostly academic.[12] U.S. policymakers have become concerned that U.S. multinationals are using

[6] T.D. 8697 (12/17/96). For a discussion of the history of the entity classification rules, see the JCT Whitebook at 93-95.

[7] *See* Regs. §301.7701-2, -3 (as amended by T.D. 9433 (11/26/08)).

[8] Regs. §301.7701-3(a).

[9] Regs. §301.7701-3(b).

[10] 296 U.S. 344 (1935).

[11] Regs. §301.7701-2 (prior to amendment by T.D. 8697 (12/17/96)).

[12] *See, e.g.,* PLR 7743060 (7/28/77) (concluding that the entity in question need not file tax returns and that its income, gains, losses, deductions, and credits against tax could be accounted for by its parent). Before the CTB regulations, almost all business

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foreign DREs to circumvent Subpart F in several ways.

First, U.S. multinationals can use DREs to shift cash and property between foreign entities in different jurisdictions through payments that are disregarded for U.S. tax purposes and, as a result, do not trigger Subpart F inclusions.[13] Such disregarded payments may take various forms for foreign tax purposes, including interest, dividends, and royalties. Arguably, such payments of what would be foreign personal holding company income (FPHCI) if made between regarded entities circumvent the general Subpart F policy of currently taxing a U.S. parent on the mobile income of its foreign subsidiaries.

This concern may seem anachronistic in light of the 2006 enactment of §954(c)(6). That provision, originally intended to be effective for three years, explicitly excluded most payments of passive income between CFCs from the definition of Subpart F income.[14] We anticipate that the Administration, with its renewed focus on capital export neutrality, will allow §954(c)(6) to expire.

As it currently applies, §954(c)(6) generally exempts from Subpart F income certain passive types of income received from related CFCs, to the extent the payments are attributable to non-Subpart F income of the payors. Section 954(c)(6) is a more flexible and uniform planning tool than CTB. For example, §954(c)(6) applies to cross chain payments between CFCs, whereas DRE planning is limited to entities within a single chain (although, notably, ''chain'' could, and often does, include most of the U.S. multinational's foreign operations).[15] Moreover, §954(c)(6) applies to payments between per se corporations and payments involving multiple-member entities and joint ventures.[16] Section 954(c)(6) is also more fine-tuned. It does not provide look-through treatment to the extent a payment is attributable to effectively connected income (ECI) (in addition to Subpart F income),[17] whereas DRE planning can be used to strip ECI out of a CFC.

The JCT Whitebook notes that a U.S. multinational's ability to shift earnings between its foreign entities without current Subpart F inclusions through CTB and §954(c)(6) planning has the additional consequence of allowing it to separate its relatively high-taxed from its low-taxed foreign-source income, thereby facilitating FTC limitation planning through the selective repatriation of high- or low-tax foreign income.[18] This is claimed to have the effect of further deterring the repatriation of foreign earnings.[19]

The second, and related, concern with CTB raised by U.S. policymakers is that a multinational can use foreign DREs to reduce the foreign taxes paid by its CFCs through earnings stripping transactions that are disregarded for U.S. tax purposes and, therefore, do not give rise to Subpart F income. According to some, this ''foreign base erosion,'' which allows earnings invested abroad to be subject to artificially low foreign tax rates, violates the policies underlying Subpart F by creating greater incentives for U.S.-parented multinationals to invest abroad and to avoid repatriating the earnings of foreign subsidiaries.[20] This, it is argued, reduces tax revenue *and* economic activity in the U.S.

''entities'' would have been treated as either a corporation or a partnership. It would have been oxymoronic to speak of an *entity* that was *disregarded* for U.S. tax purposes.

[13] Greenbook at 28.

[14] Congress enacted §954(c)(6) to permit U.S.-parented multinationals to reinvest foreign earnings without additional taxes, making them more competitive. The House Report to P.L. 109-222, the Tax Increase Prevention and Reconciliation Act of 2005, which introduced §954(c)(6), defended the policy as follows:

> Most countries allow their companies to redeploy active foreign earnings with no additional tax burden. The Committee believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries. By allowing U.S. companies to reinvest their active foreign earnings where they are most needed without incurring the immediate additional tax that companies based in many other countries never incur, the Committee believes that the provision will enable U.S. companies to make more sales overseas, and thus produce more goods in the United States.

Thus, the Congress that enacted §954(c)(6) favored tipping the scale toward more permanent deferral, in the interest of ensuring that U.S. multinationals competing in foreign markets bear the same rate of tax as their competitors and therefore do not suffer a competitive disadvantage. This is in contrast with the Obama Administration's focus on ensuring that tax is not a differentiator for a U.S. multinational presented with investment opportunities around the world. The deferral currently permitted for active business income is consistent with capital import neutrality, whereas Subpart F is geared toward achieving capital export neutrality for certain categories of income thought to be more mobile.

It is also possible that, in enacting §954(c)(6), Congress was influenced by the preexisting ability of U.S.-parented multinationals to effectively shift earnings through CTB planning. Thus, Congress may have intended to legitimize and simplify current practice. Finally, §954(c)(6) was enacted by a ''business-friendly'' Congress during a Republican administration.

[15] David R. Sicular, ''The New Look-Through Rule: W(h)ither Subpart F?'' 115 *Tax Notes* 349 (4/23/07).

[16] *Id.* at 15.

[17] The Tax Relief and Health Care Act of 2006, P.L. 109-432, Div. A, §426(a) (2006).

[18] JCT Whitebook at 110-11.

[19] JCT Whitebook at 111.

[20] In enacting Subpart F, Congress acknowledged that earnings stripping transactions could be used to reduce the foreign taxes owed by U.S. multinationals. H.R. 10650, 87th Cong., 2d Sess. (1962). *See also* JCT Whitebook at 106-07.

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An example illustrates a classic earnings-stripping transaction.

Example 1. Assume a domestic corporation, P, wholly owns a Country S manufacturer, S, which is subject to a 30% income tax in Country S. In Year 1, S has 100x of pre-tax earnings and pays 30x of foreign taxes.

Now assume that S wholly owns a Country T entity, T, which is subject to a 0% income tax in Country T. T owns the intellectual property that S uses in its manufacturing operations. S annually pays T 100x of royalties, and Country S imposes a 10% withholding tax on royalties. Thus, S's 100x of pre-tax earnings is reduced by its 100x of royalty expense, and S has no income tax liability in Country S. T has 100x of Country S-source royalties and 10x of withholding tax liability in S. However, T is not subject to income tax in Country T. Thus, P's overall foreign tax liability relating to S's operations is reduced from 30x to 10x. If T elects to be treated as a DRE for U.S. tax purposes, S's royalty payments to T are disregarded and, thus, do not give rise to Subpart F income to T.[21]

A third concern raised by U.S. policymakers is that if a CFC owned by a multinational intends to sell the stock of a subsidiary, it can avoid recognizing Subpart F income on the sale by electing to treat the target as a DRE prior to the sale. The transaction is then treated as a sale of business assets, which unlike a sale of stock does not give rise to Subpart F income.[22] This objection may be unjustified, because the check-and-sell result could be achieved without the CTB rules, albeit less efficiently. A selling CFC could liquidate the target CFC under foreign corporate law and sell the assets of the liquidated CFC to the acquiring corporation or a newly organized subsidiary or passthrough entity owned by the acquiror. Moreover, this planning technique was explicitly permitted in *Dover v. Comr.*[23]

On November 29 1999, Treasury issued proposed regulations that would have governed CTB elections in check-and-sell transactions.[24] Under the proposed regulations, an election to classify a foreign eligible entity as a DRE would be disregarded, and the entity would instead be classified as a corporation, if (i) at least 10% of the ownership interest in the entity was sold in one or more transactions (collectively called an ''extraordinary transaction'') during the period beginning one day before and ending 12 months after the effective date of the classification election, and (ii) the entity was classified as a corporation at any time during the 12 months preceding the commencement of the extraordinary transaction.[25]

Commentators voiced numerous technical and policy concerns regarding the proposed check-and-sell regulations. The policy-oriented critiques of the proposed regulations included the following: (i) the proposed regulations adopted bright-line rules, abandoning the more appropriate and substantive approach to check-and-sell transactions previously espoused by the Service in CCA 199937038 (6/28/99); (ii) an entity's classification would be affected by events occurring after its classification election was made (this highlights the broader principle that an entity's activities and transactions should not affect its tax classification); and (iii) the proposed regulations would apply to certain non-abusive transactions.[26] In response to the criticisms, Treasury withdrew the proposed regulations.[27] It is sufficient to note that the objections to the regulations are evidence that addressing substantive Subpart F issues through changes to the CTB rules is awkward and imprecise.

A fourth concern raised by U.S. policymakers is that hybrid entities and reverse hybrid entities can be used improperly to ''split'' or decouple foreign taxes from the foreign income to which they relate, permitting a U.S. parent to claim foreign tax credits (FTCs) without necessarily including the corresponding income.[28] In addition to artificially increasing or accelerating foreign tax credits, the separation of the for-

[21] For a discussion of several DRE planning methods under Subpart F, see Phillip R. West, ''Re-Thinking Check-the-Box; Subpart F,'' 83 *TAXES* 29 (2005).

[22] Regs. §1.954-2(e)(1)(i)(A).

[23] 122 T.C. 324 (2004).

[24] Former Prop. Regs. §301.7701-3(h) (2003).

[25] Former Prop. Regs. §301.7701-3(h)(1)(i). The proposed regulations also would have disregarded an election to classify a foreign eligible entity as a DRE, if (i) the entity acquired, in one or more related non-recognition transactions, the assets of one or more foreign business entities that were classified as corporations at any time during the year preceding the beginning of the acquisition (ii) after the acquisition, the acquired assets comprised more than 80% of the value of the total assets held by the entity, and (iii) the entity was involved in an extraordinary transaction within one year of the completion of the acquisition. Former Prop. Regs. §301.7701-3(h)(2)(i). This rule was intended to prevent a multinational from circumventing the proposed regulations by using a ''shelf'' DRE to acquire the assets of an existing foreign corporation and then checking the shelf entity before selling its assets.

An election to treat a foreign eligible entity as a DRE would not be disregarded, however, if the taxpayer could satisfy the Service that the classification did not materially change the tax consequences of the extraordinary transaction, including the sourcing, §367, foreign tax credit, and Subpart F consequences.

[26] Andrew H. Braiterman, ''Attorneys Urge Treasury to Abandon Proposed Check-the-Box Regs.,'' 2000 *TNT* 72-18 (4/13/00) (writing on behalf of the Association of the Bar of the City of New York Committee on Taxation of Business Entities); Armando Gomez, ''Attorney Raises Concerns About Proposed Check-the-Box Regs.,'' 2000 *TNT* 62-38 (3/30/00).

[27] Notice 2003-46, 2003-2 C.B. 53.

[28] A hybrid entity is a foreign entity that is classified as a passthrough entity for U.S. tax purposes but is subject to entity-

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eign taxes from the foreign income also reduces the U.S. parent's incentive to repatriate the income, because any actual or deemed dividends received by the parent from the relevant CFC or 10/50 company would carry up fewer §902 indirect FTCs.[29] CTB facilitates such splitting structures by making it easier and less costly to establish hybrid and reverse hybrid entities.

Example 2. Consider the following example loosely inspired by the structure in CCA 200920051 (5/15/09).[30] A domestic corporation, P, wholly owns two Country S entities, S and T, which are treated as corporations for Country S tax purposes and DREs for U.S. tax purposes (thus, they constitute hybrid entities). S wholly owns U, and T wholly owns V. U and V are Country S entities, and each of U and V is treated as a passthrough entity for Country S tax purposes but as a corporation for U.S. tax purposes (thus, they constitute reverse hybrid entities).

Non-Subpart F income earned by U and V flows up to S and T for Country S tax purposes, and S and T are therefore liable for Country S taxes on the income. However, the income is treated as earned by U and V for U.S. tax purposes. P claims FTCs under §901 on the Country S taxes, because even though S and T are taxable entities for Country S purposes, they are DREs and, thus, branches of P for U.S. tax purposes. The related income is retained by U and V for U.S. tax purposes and is deferred until it is repatriated.[31]

The proposed ''technical taxpayer'' regulations, if finalized, would address most of the abusive splitter transactions, though the JCT Whitebook identifies several ways in which the proposed regulations create new distortions.[32] Under the proposed regulations, if foreign tax is paid by a hybrid DRE, its owner is treated as the technical taxpayer entitled to claim FTCs.[33] If foreign tax is paid by a hybrid partnership, the partnership is treated as liable for the foreign tax, and the foreign tax generally is allocated among its partners in accordance with their ''interests in the partnership.'' [34] Finally, if foreign tax is paid by a reverse hybrid entity, any foreign tax imposed on an owner's share of the reverse hybrid's income is aggregated with any other foreign taxes imposed on other income of the owner. This aggregated amount is then allocated between the owner and the reverse hybrid entity based on their respective portions of the combined tax base.[35] This means that if the owner pays no foreign taxes on income other than its share of the reverse hybrid entity's income, the foreign tax is entirely allocated to the reverse hybrid entity.[36] Notably, the Greenbook included among its international tax proposals a proposal to address splitter transactions by adopting a ''matching rule.'' [37] We understand this proposal may simply implement the proposed technical taxpayer regulations, as amended to address some of their known deficiencies.[38]

Example 3. Returning to the previous example, assume the proposed technical taxpayer regulations apply. U and V are reverse hybrid entities, and their respective owners, S and T, have no income other than that earned through U and V. Thus, U and V are treated as the technical taxpayers with respect to the foreign taxes actually paid by S and T. Accordingly, P may not claim FTCs under §901 with respect to the foreign taxes. It may, however, claim FTCs under §902 if and when U and V distribute the income to S and T (and therefore to P for U.S. tax purposes).

level income tax in its country of tax residence, and a reverse hybrid entity is a foreign entity that is classified as a corporation for U.S. tax purposes but is treated as a passthrough entity in its country of tax residence. For a discussion of FTC splitter transactions, see the JCT Whitebook at 96-99.

[29] ABA Task Force, ''Report of the Task Force on International Tax Reform,'' 59 *Tax. Law.* 649, 739.

[30] For a discussion of the CCA, see Dirk J.J. Suringa, ''Voluntary Payments, Italian Style,'' 38 *Tax Mgmt. Int'l J.* 524 (2009).

[31] Interestingly, the Service chose to challenge the domestic corporation's eligibility to the FTCs under the compulsory payment rules, but some believe that the proposed ''technical taxpayer'' regulations or the enactment of the Greenbook's 2010 budget proposal on splitter transactions offer better solutions. *Id.*

[32] JCT Whitebook, at 100-05.

[33] Prop. Regs. §1.901-2(f)(3).

[34] *Id.*; Regs. §1.704-1(b)(4)(viii).

[35] Prop. Regs. §1.901-2(f)(2)(iii).

[36] In the case of a foreign ''consolidated group,'' the group's foreign tax is considered paid by the group members based on their respective shares of the group's tax base. Prop. Regs. §1.901-2(f)(2). This rule was adopted to overrule the outcome reached in *Guardian Industries v. U.S.*, 65 Fed. Cl. 50 (2005). In *Guardian Industries*, the parent company of a Luxembourg ''consolidated group'' was classified as a DRE for U.S. tax purposes. *Id.* at 52. The court held that the DRE parent was liable for the *full* amount of taxes paid by the group, and, thus, the owner of the DRE could claim FTCs for the full amount of the group's foreign taxes, under §901. *Id.* at 55.

[37] Greenbook at 31. For a discussion of the proposal, see the JCT Whitebook at 96-106.

[38] The JCT discusses alternative ways the Administration could establish matching between creditable foreign taxes and the earnings on which the taxes are imposed, including finalizing or enacting as legislation the proposed technical taxpayer regulations. *See* JCT Whitebook at 100-06.

Importantly, the adoption of the blending regime for §902 credits contained in the Administration's Greenbook would appear to eliminate the distortions created by splitter transactions that do not utilize first-tier DREs. An alternative foreign tax credit blending regime contained in H.R. 3970, introduced on Oct. 25, 2007, by House Ways and Means Committee Chairman Charles Rangel, would average a taxpayer's §§901 and 902 foreign tax credits and, thus, would also eliminate the benefits of splitter transactions that rely on first-tier DREs, as in *Guardian Industries*.

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ADMINISTRATION'S CTB REFORM PROPOSAL

The Obama Administration's proposal would preclude a U.S. taxpayer from electing to treat certain lower-tier foreign entities as DREs under the CTB regulations. Specifically, a single-member foreign eligible entity, other than a first-tier foreign eligible entity, could not elect to be classified as a DRE, unless it is created or organized under the laws of the foreign country in which its single member is organized.[39] Such entities would be treated as per se corporations. The proposal thus would limit the choice of entity flexibility currently provided by the CTB rules in the foreign context. The Administration's proposal would not apply to a ''first-tier foreign eligible entity'' wholly owned by a U.S. person, ''except in the case of tax avoidance,'' an unfortunately vague standard.[40]

The Greenbook provided only a skeletal description of the proposal. As originally formulated, however, it may contain several holes.[41] First, the proposal would apply only to *foreign* eligible entities. Thus, a multinational potentially could engage in foreign base erosion by substituting domestic eligible entities (such as Delaware LLCs) in place of its lower-tier foreign eligible entities.

Second, a multinational potentially could adopt a similar planning strategy using foreign eligible entities organized under the laws of the foreign countries in which their respective single owners are organized. For example, arbitrage would still be possible if the foreign countries in which the eligible entities were organized used a management and control test for tax residence.[42]

Example 4. Assume a domestic corporation, P, wholly owns a CFC, S, which is organized under the laws of, and is managed and controlled in, Country S. Country S is a high-tax foreign jurisdiction that determines residency by applying a management and control test. S wholly owns T, an entity also organized under the laws of Country S but with its management and control in Country T, a low-tax foreign jurisdiction. If T were eligible for reduced withholding rates under the Country S-Country T income tax treaty as a resident of Country T, it could be used to strip earnings out of Country S.

Third, the proposal would not apply to foreign eligible entities with more than one owner. Thus, a multinational could avoid the provision by causing each of its lower-tier foreign eligible entities to issue ownership interests to related persons, transforming the DREs into partnerships (although it is not clear that partnerships could be successfully used in foreign base erosion transactions).[43]

Each of these holes could be plugged with ad hoc rules or anti-avoidance spackle.[44] However, they illustrate the clumsiness of using entity classification rules to address the substantive Subpart F issues with

[39] Greenbook at 28.

[40] The ostensible rationale behind excluding most first-tier foreign eligible entities from the proposal is that income earned by a U.S. parent through a first-tier DRE is already subject to tax in the U.S. It is unclear, however, whether only the top member or each member in a chain of DREs would qualify as a first-tier foreign eligible entity. It appears consistent with the policy underlying the proposal to permit a taxpayer to disregard a chain of DREs, as all of the chain's activities are taxable in the U.S.

Also important, the meaning of ''tax avoidance'' needs to be clarified. *See* Robert B. Stack, Danielle E. Rolfes, Joshua T. Brady, and John D. Bates, ''Recent International Tax Proposals Raise Technical Issues,'' 124 *Tax Notes* 451, 465 (8/3/09) (hereinafter ''Technical Issues''). The JCT suggests that U.S. tax avoidance may include mere foreign base erosion transactions. JCT Whitebook at 112. Policymakers' concern with foreign earnings stripping is understandable, but this suggestion is troubling. The relationship between foreign base erosion and a taxpayer's U.S. tax liability is indirect, at best, especially because higher foreign taxes typically would result in a higher foreign tax credit in the U.S. Simply put, contorting the concept of U.S. tax avoidance to include the reduction of foreign taxes is unsupported by tax law authority.

[41] For a discussion of these potential issues, see the JCT Whitebook at 112-13.

[42] In order to be eligible for reduced withholding under a treaty, the same-country DRE would need to be subject to tax as a resident in a low-tax foreign country, possibly as a result of being managed and controlled, having its principal place of business, or being organized as a dual chartered entity, in the country. Technical Issues at 464-65. Alternatively, there are also a few high-tax countries with low or no withholding tax under domestic law. Sweden, for example, does not impose withholding tax on interest payments.

[43] Also, the conversion of a DRE to a partnership would not necessarily be tax-free. A taxpayer would need to consider whether the new partnership is deemed to assume from a contributing partner liabilities in excess of basis (determined under the special partnership rules of §752) and whether the resulting partnership constitutes an investment company under §721(b) (an unlikely outcome in the multinational structuring context).

[44] The proposal could be modified to eliminate the domestic eligible entity and same-country foreign eligible entity planning opportunities. For example, the proposal could treat as a per se corporation any lower-tier, single-member domestic eligible entity owned by a CFC that is not currently taxable in the foreign country in which its single owner is a tax resident. Also, the proposal could treat as a per se corporation any lower-tier, single-member, same-country foreign eligible entity that is taxable on the basis of its residence in a foreign country other than the foreign country in which its single owner is a tax resident. *See generally* JCT Whitebook at 112-13. However, it still might be possible to structure a disregarded loan or otherwise strip earnings out of a foreign jurisdiction using a contractual or juridical arrangement that is treated as a taxable entity under foreign tax law but as a ''non-entity'' for purposes of U.S. tax law. The term ''entity'' is not defined in the entity classification regulations and there exists surprisingly little authority as to what constitutes an entity.

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which policymakers are concerned.[45] More importantly, to cause entity classification — the building block of tax structuring — to turn on poorly defined anti-avoidance concepts is bad tax policy. Also important, transitioning to the Administration's proposal would have significant collateral tax consequences, including §304, treaty eligibility, §987, §367, branch loss recapture (BLR), §904(f)(3) recapture, and dual consolidated loss (DCL) recapture transition issues, as discussed in Part F, below, thus forcing U.S. multinationals to undertake costly restructurings.

JOINT COMMITTEE ON TAXATION'S CTB PROPOSAL

In 2005, the JCT issued a report,[46] which contained, among other international tax reform proposals, a proposal to reform the CTB rules as they apply to foreign entities.[47] The proposal was intended to preclude the avoidance of Subpart F through CTB planning,[48] while preserving the simplicity and certainty of the CTB entity classification regulations.

Under the JCT proposal, a foreign business entity would be treated as a corporation for U.S. tax purposes if it were a separate legal entity organized under foreign law and had only a single member. Thus, the JCT proposal would not apply to a branch that does not constitute a separate entity under foreign law, and as under the Administration's proposal, domestic entities and multiple-member foreign entities would not be subject to the proposal. However, Treasury would have authority to issue anti-abuse regulations, extending the proposal's application to (i) a multiple-member foreign business entity, if a membership interest were issued to a person related to another member with a principal purpose of avoiding the proposal, and (ii) a domestic business entity with a CFC as its single member.[49]

Unlike the Administration's proposal, the JCT proposal would not uniformly have provided an exception for same-country foreign eligible DREs, and it would have applied to *all* first- and lower-tier foreign DREs. Particularly as a result of its application to first-tier DREs, the JCT proposal would raise greater collateral transition issues than the Administration's proposal, including the §304, treaty eligibility, §987, §367, BLR, §904(f)(3) recapture, and DCL recapture issues, discussed below.

ABA TASK FORCE'S CTB PROPOSAL

In 2006, a task force commissioned by the American Bar Association issued a report,[50] which included, among a number of international tax reform proposals, an alternative CTB reform proposal [51] to the JCT proposal. The ABA Task Force sought to align United States and foreign entity classification in order to simplify the application of U.S. tax laws and reduce opportunities for tax planning through the use of inconsistent treatment.[52] The ABA Task Force asserted that although the check-the-box regulations embody a ''choice of tax entity'' principle, such principle does not provide a U.S. taxpayer the right to elect inconsistent classification of an entity for U.S. and foreign tax purposes.[53] The proposal was intended to address FTC splitter transactions, in addition to Subpart F issues.[54]

The ABA Task Force proposal would treat a foreign entity that is subject to entity-level income taxation in its country of tax residence as a per se corporation and would treat an entity that is not subject to entity-level income tax in its country of tax residence as a per se passthrough entity.[55] Whether a foreign entity is subject to ''income tax'' in a foreign country would be determined by applying §901 principles. The ABA Task Force asserted that the proposed system would

[45] For a more detailed discussion of these issues, including examples, see note 40, above.

[46] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (1/27/05) (hereinafter ''JCT Options'').

[47] JCT Options 182-85.

[48] JCT Options at 183.

[49] *Id.*

[50] Stephen E. Shay et al., ''Report of the Task Force on International Tax Reform,'' 59 *Tax Law.* 649 (2006) (hereinafter ABA Task Force Report).

[51] We discuss this proposal in significant detail, because we think a subject-to-tax standard for entity classification may gain traction with policymakers as the CTB reform debate evolves.

[52] For a discussion of another proposal that attempts to align U.S. and foreign entity classification, see Lawrence Lokken, ''Whatever Happened to Subpart F? U.S. CFC Legislation after the Check-the-Box Regulations,'' 7 *Fla. Tax Rev.* 185, 207-09 (2005). Under Professor Lokken's proposal, an existing hybrid entity would be treated as a corporation for U.S. tax purposes, unless (i) U.S. persons own less than or equal to 10% of the interests in the entity, directly or indirectly, or (ii) the entity is fiscally transparent under the laws of the country in which it is organized, each country in which it conducts business, and each country that allows a deduction for any payment to the entity. An existing reverse hybrid would be treated as a fiscally transparent entity for U.S. tax purposes with respect to each U.S. person who would be a U.S. shareholder if the entity were fiscally transparent under the laws of the country in which it is organized, a country in which it carries on business, or a country that allows a deduction for payment to the entity.

[53] ABA Task Force Report at 745.

[54] *Id.* at 744.

[55] *Id.* The ABA Task Force anticipated that it would be difficult to treat entities that are not subject to entity-level tax as passthroughs in certain circumstances, such as if an entity is publicly traded. It proposed that in such circumstances the entity could elect to be treated as a corporation, or its U.S. owners could elect to treat it as a corporation, subject to an agreement to include their share of the entity's earnings in income. *Id.*

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be relatively simple to administer and apply, because it would be based on U.S. tax principles.[56]

Unlike the Administration and JCT proposals, the ABA Task Force proposal would apply to multiple-member foreign entities. Thus, it would more comprehensively reduce entity classification electivity and inconsistent tax treatment between the U.S. and foreign countries. Another major difference between the ABA Task Force proposal and the Administration and JCT proposals is that the ABA Task Force proposal is a two-way reclassification street: like the Administration and JCT proposals, the ABA proposal would turn some passthrough entities into corporations, but the ABA proposal also would turn some corporations into passthrough entities. Moving from corporate to passthrough status would raise a whole new set of collateral transition issues.

As under the JCT proposal, the ABA Task Force proposal would apply to both first- and lower-tier foreign eligible entities. Thus, it would raise all of the §304, treaty eligibility, §987, §367, BLR, §904(f)(3) recapture, and DCL recapture transition issues as the Administration and JCT proposals, as described below, but in both the single-member and multiple-member foreign eligible entity contexts.[57] The remainder of this section considers whether the proposal would achieve the Administration's goals, and discusses technical issues raised by the proposal.

Foreign Base Erosion Transactions

Most significantly, the ABA Task Force proposal would not comprehensively address foreign base erosion transactions, because it would not only permit, but require, that a foreign entity in a zero-tax foreign country be treated as a passthrough entity. This would permit certain foreign base erosion arrangements to continue, though earnings-stripping would be more difficult than it is under the CTB rules. Illustrating this, the earnings-stripping transaction described in Example 1, above, would continue to be possible under the proposal. Because zero-tax countries rarely, if ever, have strong income tax treaty networks, earnings stripping arrangements under the ABA Task Force proposal primarily would rely on low withholding taxes. However, it is not hard to imagine a foreign country with a strong treaty network creating a special entity or system in order to take advantage of such a rule. Thus, we believe the proposal as currently formulated would not achieve the Administration's objectives.

Zero-Tax Standard

The ABA Task Force acknowledged that its proposal did not conclusively address the treatment of entities in countries with nominal entity-level income taxes.[58] This would require line drawing and could raise uncertainty and complexity. For example, would the rule turn on an entity's *effective* tax rate, taking into account deductions, credits, tax holidays, and other tax preferences? If so, could an entity's classification change from year to year? Also, would the determination be made uniformly across all industries, despite special tax preferences?

Treaty Eligibility Issues

If applied literally, the ABA proposal could cause certain entities that explicitly qualify as treaty residents under various U.S. income tax treaties to cease to be eligible for treaty benefits. This would be relevant particularly with respect to foreign tax-exempt entities, pensions, and foreign special investment vehicles that are effectively exempt from entity-level tax.

Example 5. Assume a French *fonds commun de placement* (FCP) receives U.S.-source dividend and interest income. An FCP is an investment vehicle that is treated as a passthrough entity for French tax purposes, but is nonetheless explicitly treated as a resident of France for purposes of the U.S.-France income tax treaty.

If the proposal were applied literally, the FCP would be treated as a passthrough for U.S. tax purposes. Consequently, it would not be entitled to reduced withholding rates under the treaty, because it would not be the ''beneficial owner'' of the interest and dividend income (a source-state determination). Thus, we believe the proposal should be modified to treat as a corporation any business entity that qualifies as a resident of a foreign country under a U.S. income tax treaty. This, however, leaves open the treatment of tax-exempt entities, pensions, and special investment vehicles in non-treaty counties.

Section 901 Income Tax Standard

We are not certain that the §901 ''income tax'' standard is appropriate for determining an entity's classification, given the Administration's stated goals. An income tax standard would be appropriate if the Administration were seeking to eliminate FTC-splitter transactions through CTB reform, as the ABA Task Force had as one of its goals. The Administration,

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[56] *Id.*

[57] A partnership does not recognize any gain or loss upon liquidating, but a partner recognizes gain on the liquidation of a partnership if the partner receives cash in excess of its outside basis in its partnership interest. §§731(b) and 731(a)(1).

[58] *Id.* at 745.

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however, addresses FTC-splitter transactions in a separate proposal.[59]

Despite the ABA Task Force's claim that applying §901 principles would simplify the administration of the entity classification rules, whether an entity is subject to entity-level income tax within the meaning of Regs. §1.901-2(a)(1) can be a complicated and fact-intensive inquiry that requires an understanding of foreign tax law. This raises an important policy question: how much certainty is enough? Is it sufficient that *some* or *most* multinationals could structure their operations without doubt? Would the Service issue a ''white list'' of entities that it deems subject to entity-level income tax or countries that it deems to have an income tax?

We believe the proposal would not provide sufficient certainty in fringe cases, requiring taxpayers and their domestic and foreign tax advisers to undertake costly analysis. For example, in order for a tax to constitute an income tax, it must be likely to reach net gain in normal circumstances.[60] TAM 200719011 (5/11/07) demonstrates the potential complexity of this analysis. In TAM 200719011, the Service took the position that a U.K. windfall tax on company appreciation did not constitute an income tax, despite the taxpayer's argument that the tax could be algebraically reformulated to reflect net gain. As another example, in *Texasgulf, Inc. v. U.S.*,[61] the court held that the Ontario Mining Tax satisfied the net gain requirement because its alternative cost recovery system typically permitted ''deductions'' in excess of actual expenses. But to reach this conclusion, the court found it necessary to statistically analyze tax returns.

Also, under the income tax standard, an entity's classification could change from one year to the next based on external events unrelated to U.S. taxation. We believe that regardless of the reform adopted, an entity's classification should not be subject to change, absent some action by the taxpayer.

Section 903 ''In Lieu of'' Taxes

The proposal also raises the issue of whether an entity subject to a §903 ''in lieu of'' tax would be treated as a corporation or a passthrough. Generally, §903 provides FTCs for certain taxes imposed as substitutes, but not in addition to, income taxes.[62] In lieu of taxes should be treated as income taxes for purposes of the proposal, because the proposal broadly seeks to harmonize U.S. entity classification with foreign entity classification, not to determine whether a foreign tax to which the entity is subject is akin to a net income tax.

It also could be appropriate in limited circumstances for the proposal to adopt a standard that includes payments that are not technically ''taxes'' under §901 principles, such as a levy paid to a foreign government for a ''specific economic benefit'' (i.e., a benefit provided by a foreign government that is not generally available to all companies on substantially the same terms).[63] We have in mind situations in which a non-tax levy is imposed as a substitute for an income tax; as a general matter, non-tax levies should not form a basis of entity classification. This would be relevant for natural resource companies that pay foreign governments for the right to access government-owned resources but are not otherwise subject to a generally applicable foreign income tax.

UBTI Blocker Structures

The ABA Task Force acknowledged that the proposal would affect the structures (so-called ''blocker structures'') through which tax-exempt entities, such as pensions and foundations, invest in hedge funds and private equity funds, which typically are classified as partnerships for U.S. tax purposes. A tax-exempt entity generally is taxable on its unrelated business taxable income (UBTI),[64] which equals its net income from ''any trade or business, the conduct of which isn't substantially related to the exercise or performance by the organization of its exempt purpose.'' [65] Because hedge funds typically use leverage, income from a hedge fund is typically characterized as ''debt financed income'' thereby producing UBTI to a tax-exempt investor under §514. Thus, if a tax-exempt entity invests directly in a fund as a partner, it is taxable on its share of the fund's income that constitutes UBTI. However, if the tax-exempt entity invests through a blocker corporation, the blocker corporation is treated as the partner in the fund, and the tax-exempt investor receives its return in the form of dividends, which do not constitute UBTI.

Most blocker corporations are established in zero-tax foreign countries. Thus, the proposal would treat these entities as passthrough entities. Nevertheless, the ABA Task Force noted that ''it is difficult to jus-

[59] Greenbook at 31.

[60] Regs. §1.901-2(a)(3). This requires the tax to be triggered by realization-like events and to be applied to gross receipts less deductions. Regs. §1.901-2(b)(1).

[61] 84 AFTR 2d 99-6642 (Fed. Cl. 1999), *rev'g* 17 Cl. Ct. 275 (1989).

[62] Regs. §1.903-1(b).

[63] Regs. §1.901-2(a)(2)(ii)(B).

[64] §511(a).

[65] §§512(a)(1), 513.

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tify an alternative approach for these cases.''[66] We agree that it seems wrong to contort the entity classification rules — whatever they may be — to accommodate blocker structures. But as a tax policy matter, it is worth asking why a proposal concerned with Subpart F issues should affect long established methods for tax-exempt entities to invest in the private equity markets.

CTB REFORM TRANSITION ISSUES

Transitioning to any of the proposals described above would require reclassifying certain entities. The Greenbook provides that the collateral tax consequences of the transition would be determined ''consistent with current Treasury regulations and relevant tax principles.''[67] This would prove costly and time-consuming for most U.S. multinationals with more than a de minimis number of foreign DREs. We describe below some of the transition issues, which, admittedly, are of greater consequence in the first-tier foreign DRE context, but, as we note, there exist significant transition issues in the lower-tier foreign DRE context as well.

Section 351 Issues

Many deemed incorporations would constitute nontaxable contributions to capital under §351(a).[68] Several major complications could arise, however. Previously disregarded liabilities owed by a DRE to its owner would be treated as ''other property'' received by the owner in the exchange (sometimes referred to as ''springing boot''), causing the owner to recognize gain on the transaction if the fair market value of the springing boot exceeds the basis in the contributed property.[69] To the extent the DRE's assets include stock in lower-tier subsidiaries, springing boot could give rise to §304(a)(1) transactions.[70] Also, it is unclear whether a chain of multiple DREs (or cross-chain DREs) would be deemed to be incorporated from the ''bottom up'' or ''top down'' or based on a different ordering system, each potentially leading to different tax results. We believe the best approach would be to permit taxpayers to determine the ordering, as is the case under Regs. §301.7701-3(g)(3)(iii) for simultaneous elections to treat a chain of DREs as corporations under the CTB rules.[71] Even under this flexible approach, it could be very challenging to manage the web of intercompany payables and receivables that exist in most multinational groups. While certain notes owed between parents and subsidiaries could be terminated easily, cross-chain intercompany payables and receivables could prove much more difficult to move, terminate, or offset.

Foreign-to-Foreign §304 Issues

To the extent a deemed incorporation of a DRE constitutes a §304 transaction, the resulting foreign-to-foreign deemed dividend could constitute Subpart F income.

Example 6. Assume a domestic corporation, P, wholly owns a Country S corporation, S, which wholly owns Country T entity, T, which is treated as a DRE for U.S. tax purposes. T's sole asset is all of the stock of a Country U corporation, U. S and U are classified as corporations, and S is treated as owning all of the stock of U, with a value of 200x and a basis of 50x, for U.S. tax purposes. U has current and accumulated E&P of 100x. T's sole liability, which is disregarded for U.S. tax purposes, is a note owed to S with an outstanding principal amount and value of 100x.

If the proposal were enacted, S would be treated as contributing the stock of U to T in exchange for 100x of T stock and the 100x note, which would ''spring'' into existence for U.S. tax purposes. The transfer would constitute a partial §304(a)(1) transaction.[72] S's receipt of the 100x note would be treated as a dividend of 100x (because U has E&P of 100x).[73] If the §954(c)(6) look-through rule no longer applied, the deemed dividend likely would constitute Subpart F income, which would carry with it §902 FTCs. To minimize the adverse impacts of the transition, we recommend that any CTB reform legislation explicitly provide that §954(c)(6) remains effective for purposes of determining the tax consequences of the deemed incorporations of DREs.

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[66] ABA Task Force Report at 745.

[67] Greenbook at 28. The JCT Whitebook confirms this interpretation, noting that this could result in arbitrary and unfair tax consequences and suggesting that transition relief may be appropriate. *See* JCT Whitebook at 114-15.

[68] Generally, if a DRE changes its classification to be taxed as a corporation, its owner is deemed to contribute all of the DRE's assets to a new corporation in exchange for stock of the new corporation and the new corporation's assumption of the DRE's liabilities. Regs. §301.7701-3(g)(1)(iv).

[69] §351(b).

[70] §304(b)(3).

[71] For a detailed discussion of the issues raised by these deemed transactions, see Robert B. Stack, Danielle E. Rolfes, Joshua T. Brady, and John D. Bates, ''Recent International Tax Proposals Raise Technical Issues,'' 124 *Tax Notes* 451, 465 (8/3/09).

[72] Under §304(b)(3), the transaction is bifurcated into a §351(a) transfer of 100x of U stock in exchange for 100x of T stock, and a §304(a)(1) transfer of 100x of U stock in exchange for the 100x note.

[73] §304(b)(2).

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Treaty Eligibility Issues

The incorporation of lower- or first-tier foreign eligible entities could create reverse hybrid entities, raising treaty eligibility issues.

Example 7. Assume a domestic corporation, P, wholly owns a Country S entity, S, which is treated as a corporation for U.S. tax purposes. S owns a Country T entity, T, which is treated as a DRE for U.S. tax purposes and as a passthrough entity for Country S and Country T purposes. For example, T may have a second owner for foreign law purposes, but which does not have an economic interest and therefore does not constitute a member for U.S. purposes. The U.S. has an income tax treaty with Country S but not with Country T.

T loans money to P, and P makes interest payments on the loan to T. The interest payments are treated as made to S for U.S. tax purposes, because T is a DRE. S should be entitled to claim a reduced rate of withholding under the U.S.-Country S tax treaty, because the interest income would likely be treated as ''derived by'' S,[74] a fiscally regarded entity for Country S tax law purposes, and S should be treated as the ''beneficial owner'' of the interest income.

Now suppose T were reclassified as a corporation for U.S. tax purposes under one of the CTB reform proposals. It is possible that neither S nor T would be entitled to a reduced rate of withholding on the interest payments. S may not be entitled to a reduced withholding rate, because S may not be treated as the ''beneficial owner'' of the interest income, and T would not be entitled to a reduced withholding rate because the U.S. does not have a treaty with Country T. Moreover, T may not be entitled to a reduced rate of withholding even if the U.S. did have a treaty with Country T, because it may not ''derive'' the interest income, as determined by reference to Country T tax law.[75]

Branch Foreign Currency Issues

Each of the CTB proposals would raise issues under §987, which governs foreign currency gains or losses from branch activities. Proposed regulations issued under §987 in 2006, which set forth the method of accounting under §987 currently favored by the Service, require a corporation to identify its §987 qualified business units (''§987 QBUs''). Generally, a §987 QBU is a trade or business that maintains separate books and records and has a functional currency that differs from that of its ''owner.'' [76]

Under the 2006 proposed regulations, a taxpayer must annually determine its ''net unrecognized [§]987 gain or loss'' for each of its §987 QBUs.[77] Net unrecognized §987 gain or loss is intended to reflect the change in value resulting from currency exchange rate fluctuations of the §987 QBU's financial assets that are denominated in its functional currency.[78] Net unrecognized §987 gain or loss is triggered ratably as the §987 QBU makes net remittances to its owner.[79] However, a taxpayer's net unrecognized §987 gain or loss is fully recognized if the §987 QBU terminates, which would occur if, *inter alia*, the trade or business that comprises the §987 QBU is contributed to another corporation in a §351 transfer.[80]

Example 8. Assume a domestic corporation, P, wholly owns N, a CFC that is organized under the laws of the Netherlands. P's functional currency is the U.S. Dollar, and N's functional currency is the Euro. P also directly operates a Brazilian business through B, a DRE, which uses the Real as its functional currency. B's activities constitute a §987 QBU with respect to P.

In addition, N operates Swedish and U.K. businesses through S and U, respectively. S and U are treated as DREs for U.S. tax purposes and have functional currencies of the Kroner and British Pound, respectively. S's and U's activities each constitute §987 QBUs with respect to N.

Now, assume that S and U must be reclassified as corporations. N is treated as contributing S's and U's assets to newly formed corporations, terminating N's Swedish and U.K. §987 QBUs. Thus, for E&P purposes, N must recognize any previously unrecognized §987 gain or loss with respect to the S and U QBUs. N's §987 gain or loss would be Subpart F income to the extent S's and U's assets produce Subpart F income.

Moreover, if the enacted proposal applied to first-tier foreign eligible entities, or if B's status as a DRE were determined to have a tax avoidance purpose un-

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[74] Regs. §1.894-1(d)(1).

[75] *Id.*

[76] Prop. Regs. §1.987-2(b)(2).

[77] Prop. Regs. §1.987-4(a).

[78] Prop. Regs. §1.987-4(d).

[79] Prop. Regs. §1.987-5(a), (b). A net remittance occurs in any year to the extent the basis of the property transferred by the §987 QBU to its owner exceeds the basis of the property transferred by the owner to the §987 QBU. The amount of net unrecognized gain or loss recognized by a taxpayer on a remittance is calculated by multiplying the net unrecognized §987 gain or loss by a fraction, the numerator of which is the remittance, and the denominator of which is the total adjusted basis of the gross assets of the §987 QBU as of the end of the year (adding back the amount of the remittance).

[80] *See, e.g.,* Prop. Regs. §1.987-8(e), *Ex. (2)*.

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der the Administration's proposal, P also would be treated as contributing B's assets and liabilities to a newly formed corporation, triggering all of P's previously unrecognized §987 gain or loss with respect to its Brazilian QBU.

Section 367 Issues and Branch Loss Recapture

Absent tax avoidance, the Administration's CTB proposal would not apply to first-tier foreign eligible entities. Thus, §367(a)'s outbound transfer rules generally would not apply to most deemed incorporations, because the transferor would be foreign. Although §367(b) would apply, in most cases it would not cause adverse tax consequences.[81] The collateral tax consequences would be more significant if the enacted proposal applied to first-tier DREs, as would be the case under the Joint Committee and ABA Task Force proposals.

A U.S. transferor's outbound transfer of assets in what would otherwise qualify as a §351(a) transaction generally is taxable under §367(a)(1). An exception applies if the assets are used in a foreign trade or business that is actively managed and operated by the foreign acquiring corporation after the contribution.[82] This exception does not apply, however, to outbound transfers of inventory, intellectual property (other than foreign goodwill and going concern value),[83] accounts receivable, and certain other assets.[84] Moreover, a U.S. transferor's outbound transfer of stock in a foreign corporation would be taxable unless the U.S. transferor entered into a five-year gain recognition agreement with respect to the stock.[85] Thus, a U.S. transferor could be subject to substantial gain upon the incorporation of a first-tier DRE.

Moreover, the incorporation of a first-tier eligible entity could trigger the BLR rules. Under the BLR rules, a U.S. corporation recognizes gain on an outbound transfer of assets used in a foreign trade or business, equal to the lesser of (i) the gain realized but not recognized in the §351(a) exchange on the transferred assets,[86] or (ii) ''branch losses'' not previously recaptured.[87] A taxpayer's branch losses with respect to a foreign branch generally equal the excess of previously deducted losses with respect to the branch over the taxable income of the branch in prior years, plus any §904(f)(3) recapture, as discussed below.[88] BLR is determined on a branch-by-branch basis.

Example 9. Assume a domestic corporation, P, wholly owns a Country S entity, S, which is treated as a DRE for U.S. tax purposes. P is thus treated as the owner of S's assets for U.S. tax purposes. P's basis in the assets is 100x, and the fair market value of the assets is 300x. In each of Years 1 through 3, S incurs a net loss of (100x). In Years 4 and 5, S has net taxable income of 100 and 50, respectively.

Now assume one of the proposals is enacted in Year 6, and P is treated as transferring S's business assets to a newly formed corporation in a §351(a) transaction. P would recognize 150x of gain (the lesser of (i) the gain realized by P of 200x, and (ii) S's prior branch losses of 300x, reduced by its 150x of branch income).

Section 904(f)(3) Recapture

The incorporation of a first-tier DRE also could trigger gain under the §904(f)(3) ''overall foreign loss'' (OFL) recapture rules. A taxpayer's current-year OFL equals the excess of its foreign-source deductions over its foreign-source income.[89] Under §904(f)(3), a U.S. multinational recognizes gain if it ''disposes'' of property predominantly used in a foreign trade or business, including through the incorporation of a foreign branch, in an amount equal to the lesser of (i) the gain realized but not recognized in the disposition, or (ii) any cumulative OFL of the U.S. parent not previously recaptured.[90] Most importantly, a ''disposition'' for this purpose includes a nonrecognition transfer or exchange, with the result that a

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[81] As the proposals primarily would apply to single-member, lower-tier foreign DREs, in most cases the U.S. shareholders indirectly would own the same percentage of stock of the newly formed foreign corporations as they owned, directly or indirectly, in the foreign transferor corporations. Thus, the transition would not trigger §1248 dividends in most cases. Regs. §1.367(b)-4(b).

[82] §367(a)(3); Regs. §1.367(a)-2T.

[83] Regs. §1.367(d)-1T(b). The Greenbook included a proposal to include all goodwill, workforce in place, and going concern value in the definition of intellectual property in §367(d), removing these exceptions to gain recognition in outbound transfers. Greenbook at 32.

[84] Regs. §1.367(a)-5T. With respect to any intellectual property (IP) transferred, the U.S. transferor would be treated as receiving contingent payments for the useful life of the IP, up to 20 years, based on the productivity of the IP.

[85] Regs. §1.367(a)-3(b).

[86] Although the amount of gain recognized is limited to the built-in-gain in the transferred assets, the built-in-gain is computed by taking into account goodwill, going concern value, and other intangibles.

[87] §367(a)(3)(C).

[88] *Id.*

[89] §904(f)(2). Under the general OFL recapture rule, if a U.S. corporation has an OFL, it is required to re-source foreign-source income in an amount equal to the lesser of (i) the OFL or (ii) 50% of its foreign-source taxable income. §904(f)(1). Any OFL that is not recaptured is carried forward.

[90] Section 904(f)(3) is not applied on a branch-by-branch basis. Thus, the amount recaptured is not limited to the cumulative OFL generated by the incorporated branch.

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taxpayer with an OFL would be required to recognize gain on the incorporation of a foreign branch, even if the transfer otherwise qualifies for non-recognition treatment under §367(a).

Example 10. Returning to Example 9, also assume that P has a cumulative OFL that was not previously recaptured of 50x, and S's assets were used predominantly in a foreign trade or business. In Year 6, P would still recognize 150x of gain. This time, however, 50x of the gain constitutes §904(f)(3) OFL recapture and 100x of the gain constitutes BLR (a taxpayer's BLR is decreased by its §904(f)(3) recapture, but a taxpayer can have §904(f)(3) recapture without BLR).

Dual Consolidated Loss Recapture

An incorporation of a first-tier foreign DRE also could trigger DCL recapture. A DCL includes a net loss attributable to a ''separate unit,'' [91] which includes a business operated through a foreign branch of a U.S. corporation within the meaning of Regs. §1.367(a)-6T(g)(1) (unless the foreign branch does not constitute a permanent establishment in a country with which the U.S. has an income tax treaty) or an interest in a hybrid entity.[92] Thus, a net loss of a first-tier foreign DRE often would constitute a DCL.

Under the ''domestic use limitation'' rule, a DCL cannot be used to reduce the taxable income of a ''domestic affiliate,'' including the domestic owner of a separate unit,[93] regardless of whether the DCL actually offsets income in a foreign country.[94] There are, however, a number of exceptions to the domestic use limitation rule, including when there is no possibility of foreign use of the DCL or the domestic corporation makes a ''domestic use election,'' certifying that there will be no foreign use of the DCL for a five-year period.[95]

However, even if one of the exceptions applies and, therefore, the loss is used to offset income of a domestic affiliate, the domestic corporation is required to recapture the DCL as income, with an interest charge, if a triggering event occurs.[96] The conversion of a separate unit into a foreign corporation or a transfer of at least 50% of the assets or interest in a separate unit is a triggering event.[97] Thus, a U.S. corporation would be required to recapture any DCLs of a first-tier DRE that was required to be treated as a corporation under one of the proposals.

[91] §1503(d)(3); Regs. §1.1503(d)-1(b)(5)(ii).

[92] Regs. §1.1503(d)-1(b)(4).

[93] Regs. §1.1503(d)-4(b).

[94] Regs. §1.1503(d)-2.

[95] Regs. §1.1503(d)-6(c), (d).

[96] Regs. §1.1503(d)-6(h)(1)(i).

[97] Regs. §1.1503(d)-6(e)(1)(iv), (vi).

Example 11. Assume a domestic corporation, P, wholly owns a hybrid entity, S, which is subject to tax in Country S on the basis of its residence and is treated as a DRE for U.S. tax purposes. Thus, S constitutes a separate unit. In Year 1, S incurs a loss of 100x, which is a DCL.[98] P makes a domestic use election.

If one of the proposals became effective beginning in Year 3, with the result that P were treated as incorporating S, P would be required to recognize 100x of DCL recapture in income, plus interest.[99]

Tax Issues Relating to Liquidations of Foreign Entities

Transitioning to the ABA Task Force proposal could cause reverse hybrid entities to be treated as passthrough entities. In the case of a single-member reverse hybrid entity, the corporation would be treated as distributing all of its assets and liabilities to its sole shareholder in liquidation.[100] A multiple-member reverse hybrid entity would be treated as distributing in liquidation all of its assets and liabilities to its shareholders, who, in turn, would be treated as immediately contributing all such assets and liabilities to a newly formed partnership.[101]

Foremost, because the ABA Task Force proposal is not limited to single-member foreign entities, some U.S. corporate shareholders may not own the requisite 80% of the stock of the liquidating corporation to qualify for tax-free treatment under §332. Such minority shareholders would recognize gain or loss on their stock in the liquidating corporation,[102] and the liquidating corporation would recognize gain or loss on the assets distributed to shareholders that do not meet the 80% ownership test.[103]

Moreover, an inbound liquidation can result in significant collateral tax consequences, even if it otherwise qualifies for non-recognition treatment under §§332 and 337. In a §332 liquidation, a domestic corporation that is a ''United States shareholder'' within the meaning of §951(b) with respect to a foreign liquidating corporation is required to include in income

[98] The DCL rules could apply even if S does not have a Country S affiliate, because a foreign use of the DCL might theoretically be possible if, for example, a Country S corporation subsequently acquired S.

[99] P's DCL recapture would be reduced to the extent P takes into account any BLR or §904(f)(3) recapture. *See* Preamble to T.D. 8434, 1992-2 C.B. 240-46; FSA 199947011.

[100] Regs. §301.7701-3(g)(1)(iii).

[101] Regs. §301.7701-3(g)(1)(ii).

[102] §331(a).

[103] §336(a).

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a deemed dividend equal to its ''all E&P amount'' [104] (i.e., the previously untaxed earnings of the liquidating foreign corporation attributable to the stock held by the shareholder).[105] In addition, a domestic shareholder is required to reduce its basis with respect to any built-in loss assets received in the liquidation to the fair market value of the assets.[106]

Example 12. Domestic corporation, P, wholly owns a foreign reverse hybrid entity, S. S has 100x of previously untaxed earnings. S's stock has a fair market value of 300x, and P has a 100x basis with respect to the stock.

If S is treated as liquidating, P would be deemed to receive a dividend of 100x (and would be entitled to any indirect FTCs carried up by the deemed dividend).

HYBRID BRANCH PAYMENT REGULATIONS UNDER NOTICE 98-11

In January 1998, Treasury issued Notice 98-11,[107] announcing that it would issue regulations governing the treatment of payments by and between CFCs and hybrid branches. The Treasury followed the Notice with temporary and proposed regulations in March 1998.[108] In June 1998, however, Treasury issued Notice 98-35,[109] withdrawing the regulations and Notice 98-11 in response to strong criticism from the business community and members of the Congressional tax-writing committees, who charged that Treasury had infringed on Congress's legislative turf.[110] Notice 98-35 effectively served as a compromise, or at least a detente. Treasury announced its intent to issue similar final regulations no earlier than January 1, 2000, providing Congress an opportunity to address the issues in the interim, and promised generous transition relief.[111] Nevertheless, Treasury never issued the final regulations.

Although the proposed and temporary ''hybrid branch payment'' regulations issued under Notice 98-11 were complicated, the underlying principle was simple. The regulations would have caused a CFC to recognize Subpart F income if the CFC used disregarded payments to or from a hybrid branch to significantly reduce its foreign taxes. Thus, the regulations, in effect, treated the payment as between regarded CFCs, but solely for purposes of Subpart F.

A ''hybrid branch'' was defined as an entity that (i) had a single owner that was either a CFC or a partnership in which a CFC was a partner, (ii) was fiscally transparent for U.S. tax purposes, and (iii) was not fiscally transparent in the country in which the payor corporation, any owner of the fiscally transparent payor entity, the CFC, or any intermediary partnership was created, organized, or had substantial assets.[112] A ''hybrid branch payment'' was defined as a payment that was regarded as made between separate entities under the tax laws of any jurisdiction in which the payor was subject to tax, but that was treated as a disregarded payment made between two parts of a single entity for U.S. tax purposes.[113] Thus, a hybrid branch payment could take the form of a payment between (i) a CFC and its hybrid branch, (ii) two hybrid branches of a CFC, (iii) a partnership in which a CFC is a partner and a hybrid branch of the partnership, or (iv) two hybrid branches of a partnership in which a CFC is a partner.[114] However, a payment made by a hybrid branch of a CFC to another CFC or to a hybrid branch of another CFC would not constitute a hybrid branch payment, because the payment would be regarded for

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[104] Regs. §1.367(b)-3(b)(3)(i).

[105] Regs. §1.367(b)-2(d)(1).

[106] §362(e).

[107] 1998-1 C.B. 433. For a discussion of the issuance and withdrawal of the Notice 98-11 regulations and the subsequent issuance in 1999 and withdrawal in 2003 of substantially similar proposed regulations, see the JCT Whitebook at 107-108.

[108] T.D. 8767, 1998-1 C.B. 875.

[109] 1998-2 C.B. 34.

[110] *See, e.g.,* ''Archer's Call for No New Regs on Hybrid Entities Goes Unheeded,'' 98 *TNT* 59-44 (3/27/98).

[111] A grandfather rule would have permanently exempted an arrangement entered into before June 19, 2008 (the date the notice was issued), so long as the arrangement was not subsequently substantially modified. Moreover, it would have exempted an arrangement entered into before Jan. 1, 2000, from the rules for five years, so long as the arrangement satisfied certain requirements and was not substantially modified. Perhaps this is evidence that Treasury acknowledged that it was unfair policy to compel U.S. multinationals to unwind their existing foreign arrangements in short order, or, more likely, it reflected a political concession.

[112] Former Regs. §1.954-9T(a)(6).

[113] Former Regs. §1.954-9T(a)(6).

[114] Former Regs. §1.954-9T(a)(2)(i). With respect to a hybrid branch payment involving a partnership that is fiscally transparent under the tax laws of the payor's country, the partnership would be disregarded for purposes of applying the hybrid branch rules. Former Regs. §1.954-9T(a)(2)(ii)(A). Thus, if the hybrid branch payment was between the partnership and its hybrid branch, the payment would be treated as made directly between the CFC partner and the hybrid branch; if the payment was between hybrid branches of the partnership, the payment would be treated as made between hybrid branches of the CFC.

In contrast, with respect to a hybrid branch payment involving a partnership that is not fiscally transparent under the tax laws of the payor's country, the partnership itself would be treated as a CFC for purposes of applying the hybrid branch payment rules. Former Regs. §1.954-9T(a)(2)(ii)(B).

The proposed regulations also would have limited a CFC's ability to offset Subpart F income with expenses resulting from a payment between the CFC and a hybrid partnership in which the CFC was a partner. Former Regs. §1.954-1T(c)(1)(i)(B).

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U.S. tax purposes as between separate entities (namely, the two CFCs).[115]

Under the regulations, non-Subpart F income of a CFC would be recharacterized as Subpart F income to the extent of the gross amount of a hybrid branch payment, if (i) the hybrid branch payment reduced the CFC's foreign tax liability, (ii) the hybrid branch payment would have been FPHCI if it had been made between separate CFCs, and (iii) the branch payment was taxed at an effective rate (including both withholding and income taxes) that was less than 90% of, and at least five percentage points less than, the hypothetical effective tax rate that would have been paid or accrued if the hybrid branch payment had not been made (the ''tax disparity'' requirement).[116] Under a high-tax exception, however, a payment would not constitute a hybrid branch payment if it were subject to foreign tax at greater than 90% of the maximum U.S. rate for the tax year of the CFC.[117] The amount of non-Subpart F income recharacterized as Subpart F income would equal the gross amount of the hybrid branch payment, limited by the CFC's non-Subpart F earnings.[118]

Example 13. Domestic corporation, P, wholly owns a CFC, S, which is organized in Country S. S wholly owns a foreign eligible entity, T, which is organized and taxed on the basis of its residency in Country T. T is treated as a DRE for U.S. tax purposes but recognized as a separate entity from S for Country S purposes. T would constitute a hybrid branch because (i) its single owner is a CFC, (ii) it is fiscally transparent for U.S. tax purposes, and (iii) it is not fiscally transparent in Country S, the country in which its single member is organized.

Now assume that Country S imposes an entity-level income tax of 35% but imposes no withholding tax, and Country T imposes an entity-level income tax of 10%. In Year 1, S earns 50x of net non-Subpart F income and pays 100x of deductible royalties to T, which are unrelated to T's business activities. S's 100x royalty payment to T would constitute a hybrid branch payment because (i) it would be treated as a payment between separate legal entities in Country S, the country in which the payor is organized, and (ii) the payment would be disregarded for U.S. tax purposes as made between S and its branch. Thus, under the regulations, S's 50x of non-Subpart F income would be recharacterized as Subpart F income because (i) the royalty payment reduces S's foreign tax liability (because it is deductible for Country S purposes), (ii) the royalty payment would have been FPHCI under Regs. §1.954-2(a)(1)(i) if made between separate CFCs (assuming §954(c)(6) were repealed), and (iii) the income tax rate in Country T (10%) is less than 90% of, and at least five percentage points less than, the income tax rate in Country S (35%), thereby satisfying the tax rate disparity test.[119]

The intricacies of, and particular technical issues raised by, the hybrid branch payment regulations are beyond the scope of this article. Nevertheless, we believe a similar approach could achieve the Obama Administration's goals. As they were formulated, the Notice 98-11 regulations target foreign base erosion, but would not apply to passive income payments (i.e., payments that would constitute FPHCI if made between related CFCs in the absence of §954(c)(6)) between a CFC and a hybrid branch, so long as the payments do not substantially reduce the CFC's foreign taxes. If the Administration concluded that all FPHCI-type payments between CFCs and branches should trigger Subpart F inclusions, the hybrid branch payment rules easily could be modified to target all such payments among foreign entities. For example, the definition of a hybrid branch payment could be expanded by eliminating (i) the requirement that the payment reduce the foreign tax liability of the payor and (ii) the tax disparity requirement.

CONCLUSION

Entity classification rules should not be tweaked or twisted to achieve substantive tax ends that are otherwise attainable. CTB has been in place for over 10 years and has brought needed certainty to entity classification in both the domestic and international spheres. Moreover, as shown above, transitioning to a new system would involve complexity and collateral tax consequences that largely could be avoided under a Subpart F-specific approach. Finally, the CTB reform proposals might not even solve the problems perceived by policymakers without requiring as yet unidentified layers of complexity and ambiguity in addition to those set forth above.

In the event, however, that we fail to convince policymakers that transforming the entity classification

[115] In the case of a payment by a CFC to a hybrid branch of a related CFC, the related-person exceptions under Subpart F would have applied only if the payment would have qualified for the exception if the hybrid branch had been a separate CFC incorporated in the jurisdiction in which the payment was subject to tax. Former Regs. §1.954-2T(a)(6).

[116] Former Regs. §1.954-9T(a)(1)(ii)-(iii), (5)(iv).

[117] Former Regs. §1.954-9T(a)(1)(5)(v).

[118] Former Regs. §1.954-9T(a)(5)(i). The regulations would not have required the CFC to carry forward or backward the excess of the hybrid branch payment over the CFC's non-Subpart F earnings (i.e., the CFC would not be required to recharacterize non-Subpart F income in prior or future years as Subpart F income). Former Regs. §1.954-9T(a)(5)(vi).

[119] Notably, S would not carry forward to the subsequent year (or carry back to a prior year) the 50x excess of the amount of the hybrid branch payment over its non-Subpart F income.

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regime in order to plug perceived holes in Subpart F is akin to fishing with dynamite, we hope that the litany of transition issues set forth in Part F, above, will at least persuade them to provide a generous deferred effective date and/or grandfathering rules, in order to provide taxpayers with sufficient opportunity to revamp their foreign structures.

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