Recent International Tax Proposals Raise Technical Issues

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This report discusses select technical international tax issues raised by the foreign-related expense deferral, indirect foreign tax credit, and entity classification reforms recently proposed by the Obama administration among its fiscal year 2010 revenue proposals. It highlights potential transition issues and proposes solutions to unresolved aspects of the proposals. In particular, it compares the administration expense deferral and foreign tax credit proposals with proposals included in H.R. 3970, a bill introduced by House Ways and Means Chairman Rangel in 2007.

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I. Introduction

When asked why he robbed banks, Willie Sutton simply replied, "Because that's where the money is."[1] While it is hotly contested whether increased tax revenue can or should be wrung from U.S.-parented multinationals in the current economic climate, that has not stopped the Obama administration from seeking nearly $210 billion[2] over 10 years through what it calls "reform of the international tax system," much of which is designed to increase the tax bills of those multinationals. The impetus no doubt arises from a confluence of factors, including the increasing deficit, the need to fund health-care reform, and, not to be discounted, a sense among some policymakers that current U.S. international tax policy skews economic decisions in favor of investing and keeping earnings offshore. In realpolitik terms, such reform may well succeed for a reason no more complicated than that offered by George Bernard Shaw: "A government that robs Peter to pay Paul can always depend on the support of Paul."

This report does not delve into the economic or political wisdom of the current menu of international tax reform proposals or the likelihood that any particular proposal will emerge as law, but focuses on technical issues raised by the following proposed reforms: (i) deferral of deductions for expenses that relate to unrepatriated foreign-source income; (ii) changes to the foreign tax credit provisions intended to either defer credits for foreign taxes related to unrepatriated foreign-source income or limit a U.S.-parented multinational's ability to selectively repatriate high- or low-taxed foreign earnings; and (iii) changes to the check-the-box regulations intended to limit a multinational's ability to shift income among its foreign entities without recognizing corresponding subpart F inclusions.

The administration did not begin with a clean slate. On October 25, 2007, House Ways and Means Committee Chair Charles B. Rangel, D-N.Y., introduced H.R. 3970, which proposed to add new sections 975 and 976 to the code, addressing foreign-related expense deferral and FTC deferral, respectively. Because these provisions may well form the basis of future legislative action, we compare the Rangel proposals with the description of the

[1]Federal Bureau of Investigations, "FBI History, Famous Cases: Willie Sutton," *available at* http://www.fbi.gov/libref/historic/famcases/sutton/sutton.htm.

[2]On June 11, 2009, the Joint Committee on Taxation reduced the revenue estimate of these provisions to approximately $150 billion. JCX-28-09, *Doc 2009-13321, 2009 TNT 111-11*.

administration's proposals in the Treasury green book.[3] Our analysis of the Rangel proposals was greatly aided by the New York State Bar Association (NYSBA) Tax Section's December 2008 report on the international provisions of the bill.[4] As described in detail below, the Rangel proposals would fundamentally alter both the timing of deductions for expenses allocable to foreign-source income and the timing of FTCs, whereas the administration's proposals are less sweeping and, in the FTC area, build on the existing systems in sections 902 and 960.

Regarding check-the-box reform, in January 2005 the staff of the Joint Committee on Taxation provided an antecedent to the administration's check-the-box proposal in its report titled ''Options to Improve Tax Compliance and Reform Tax Expenditures.'' Further, the 2006 report of the American Bar Association Section of Taxation Task Force on International Tax Reform[5] also considered how the check-the-box regime might be changed to, in effect, increase repatriation. This check-the-box reform movement follows efforts begun by the IRS with Notice 98-11, 1998-1 C.B. 433, which would have minimized the impact of check-the-box on subpart F by effectively treating disregarded payments as regarded solely for purposes of subpart F. The issues we raise below regarding the various check-the-box proposals invite further inquiry into whether a more targeted approach to these subpart F issues may be more appropriate.[6]

II. Foreign-Source Expense Deferral Proposals

A. Rangel Expense Deferral Proposal

The Rangel proposal would defer a taxpayer's ability to deduct some foreign-source expenses. To distinguish between currently deductible expenses and expenses that must be deferred, it would first divide a taxpayer's worldwide, foreign-source income (including earnings and profits of controlled foreign corporations owned by the taxpayer) into two categories: currently taxed foreign income and deferred foreign income.[7] Currently taxed foreign income would include any foreign-source income earned directly by the taxpayer (reduced by any foreign taxes paid directly by the taxpayer) and any subpart F income of the taxpayer's CFCs (because that subpart F income would give rise to current income inclusions by the taxpayer).[8] It would not include a foreign-source dividend received from a CFC to the extent the dividend was paid out of the CFC's previously deferred income but would include other foreign-source dividends.[9] Thus, currently taxed foreign income would appear to include all dividends received from non-CFC foreign entities, including 10/50 companies. Also, currently taxed foreign income would include nondividend payments made by a CFC, such as interest or royalty payments.

Deferred foreign income would include any non-subpart F earnings of the taxpayer's CFCs that are not paid out as dividends in the current year. It would be defined as the additional amount that would be includable under subpart F if all of the taxpayer's CFCs were treated as a single, mega-CFC and all of the E&P of the mega-CFC were subpart F income.[10] Any section 78 gross-up amount (the gross income deemed received by a taxpayer as a result of being treated as paying foreign taxes indirectly under section 902 or 960) would not be includable in either currently taxed foreign income or deferred foreign income (and foreign earnings would be reduced by the foreign taxes paid on those earnings).[11]

The proposal would then allocate the taxpayer's foreign-related deductions (deductions allocable to foreign-source gross income) proportionally to its currently taxed foreign income and deferred foreign income. The taxpayer could only currently deduct the foreign-related deductions allocable to its currently taxed foreign income. In effect, any deductions allocable to the taxpayer's deferred foreign income would be deferred until those earnings were paid by CFCs as dividends (the proposal would call the dividends ''repatriated foreign income''). Conceptually, each dividend paid by one of the taxpayer's CFCs in a future year could come out of the taxpayer's aggregate deferred foreign income and, as a result, would ''release'' a proportionate amount of the taxpayer's aggregate deferred foreign-related deductions. It appears that the taxpayer could carry forward any deferred foreign-related deductions indefinitely.

These general rules can be illustrated by an example. Suppose a domestic corporation, P, owns all the stock of two CFCs, S and T. In year 1, P earns 100x of foreign-source income (after foreign taxes) directly through a foreign branch and incurs foreign-related expenses of 50x. S has 20x of subpart F income and 10x of non-subpart F earnings, and T has 20x of non-subpart F earnings (each after foreign taxes).

Overall, P has 120x of currently taxed foreign income (P's 100x of foreign-source income earned though its foreign branch plus S's 20x of subpart F income) and 30x of deferred foreign income (S's 10x of non-subpart F earnings and T's 20x of non-subpart F earnings). Thus, P could currently deduct the 40x of its foreign-related

[3]Treasury Department, ''General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals,'' May 11, 2009 (the green book), *Doc 2009-10664, 2009 TNT 89-44*.

[4]NYSBA Tax Section, ''Report on the International Provisions of H.R. 3970 and the Effects of Reductions in Corporate Tax Rates,'' Dec. 24, 2008 (NYSBA report), *Doc 2008-27152, 2008 TNT 249-24*.

[5]''Report of the Task Force on International Tax Reform,'' 59 *The Tax Lawyer* 649 (Spring 2006).

[6]We have not considered and express no opinion on whether a more radical change to the international tax system, such as the end of deferral or the adoption of a complete exemption system, might be preferable to the tax reform proposals discussed herein.

[7]Proposed section 975(c)(2) and (3).

[8]Proposed section 975(c)(2).

[9]Proposed section 975(c)(2). As discussed below, it is not clear how dividends from CFCs would be sourced, as being paid from current CFC earnings or previously deferred earnings.

[10]Proposed section 975(c)(3).

[11]Proposed section 975(c)(7)(A).

expenses allocable to currently taxed foreign income (calculated by multiplying P's 50x of foreign-related expenses by a fraction the numerator of which is P's 120x of currently taxed foreign income, and the denominator of which is P's 150x of currently taxed foreign income plus deferred foreign income). Its remaining 10x of foreign-related expenses would be allocable to its deferred foreign income and carried forward as previously deferred foreign-related deductions.

In year 2, S and T have no current earnings, and T pays a dividend of 20x. The dividend is treated as repatriated foreign income (i.e., paid out of P's aggregate deferred foreign income) and releases 6.67x of P's previously deferred foreign-related deductions (10x multiplied by a fraction the numerator of which is the repatriated earnings of 20x, and the denominator of which is P's previously deferred foreign earnings of 30x). It is also worth noting that the 20x of repatriated foreign income would not be treated as currently taxed foreign income for purposes of applying the expense deferral regime in year 2.

B. Issues Regarding the Rangel Proposal

1. Income of non-CFC foreign subsidiaries. Economically, it is unclear why the proposal would not take the undistributed foreign earnings of non-CFC foreign subsidiaries into account as either currently taxed or deferred foreign income. A U.S. person's foreign-related expenses could just as well relate to earnings of a non-CFC foreign subsidiary, such as a 10/50 corporation. This omission could represent a rule of convenience or administrability. As a matter of policy, it is unclear how foreign income of a non-CFC foreign subsidiary should be treated if it were taken into account. Economically, the income is deferred. However, its exclusion from the subpart F regime suggests the deferral is not abusive because U.S. shareholders lack control over the entity and therefore cannot determine the timing of distributions. Thus, it could be more appropriate to add the undistributed earnings of non-CFC foreign subsidiaries to currently taxed foreign income.

2. Dividends from CFCs. The proposal would need to clarify when a dividend paid by a CFC constitutes currently taxed foreign income and when it constitutes repatriated foreign income. The obvious approach would be to treat a dividend paid by a CFC as currently taxed foreign income to the extent of the CFC's current-year earnings and to treat the remainder as repatriated foreign income (that is, a last-in, first-out sourcing rule). This would be consistent with the proposal's treatment of subpart F inclusions, which effectively are current-year deemed dividends, as currently taxed foreign income.

This determination should be made on a CFC-by-CFC basis.[12] An alternative, however, would be for each dividend to be treated as paid out of current earnings (and therefore to represent currently taxed foreign income) and prior-year accumulated earnings (and therefore to represent repatriated foreign income) on a pro rata basis.

3. CFC losses. The Rangel proposal's definition of deferred foreign income (again, the additional amount that would be includable under subpart F if all the taxpayer's CFCs were treated as a single, mega-CFC and all the E&P of the mega-CFC were subpart F income) leaves unclear how to treat a CFC's net operating losses. Excluding a CFC's losses, which are effectively negative earnings, would overstate the taxpayer's foreign-related expenses economically allocable to non-subpart F earnings of the taxpayer's CFCs. Thus, the proposal could clarify that deferred foreign income is the additional net positive amount that would be includable under subpart F if the aggregate earnings of all the taxpayer's CFCs were netted against the aggregate losses of the taxpayer's CFCs and treated as subpart F income of the mega-CFC.

If this suggestion were adopted, it would raise the issue of whether a taxpayer could carry forward an overall loss of its hypothetical mega-CFC (that is, negative deferred foreign income) for purposes of applying the Rangel expense deferral and FTC proposals (discussed below). An aggregate loss could not be effectively taken into account in the current year because it would cause the numerator (currently taxed foreign income) to exceed the denominator (currently taxed foreign income plus deferred foreign income) in both the expense deferral and FTC fractions.

If, for purposes of applying the fractions, the taxpayer were allowed to carry forward an overall loss of its hypothetical mega-CFC, the carryforward would reduce the denominator of the taxpayer's deferral fraction in subsequent years. Depending on the size of the loss, it could eliminate all deferred foreign income from the deferral fraction in one or more of the immediately following years, allowing the taxpayer to avoid deferring any of its foreign-source deductions in those years. To the extent the loss related to, for example, start-up activities or other investments by the foreign subsidiaries, the carryforward approach might produce better matching.

Alternatively, instead of permitting a taxpayer to carry forward an overall loss, the loss could be subtracted from the taxpayer's aggregate previously deferred income pool, thereby permitting future repatriations to carry up a greater proportion of the taxpayer's previously deferred foreign-related expenses and foreign taxes. In this case, a carryback would reduce the denominator of the taxpayer's *repatriation* fraction, increasing the amount of expenses that could be taken into account on a repatriation.

C. Administration's Expense Deferral Proposal

The administration's 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 Treasury regulations. The amount of deferred expenses for a particular year would be carried forward

[12]Thus, in the example in Part II.A above, it should not matter whether S had current-year earnings in year 2, because it was T that paid the dividend.

to subsequent years and combined with the foreign-source expenses of the U.S. person for that year before determining the impact of the proposal in that year.

Thus, the administration's proposal would apply the current expense allocation and apportionment rules and defer the deductibility of expenses (other than research and experimentation expenses) allocated to foreign-source income not currently subject to tax.

It is not totally clear from the brief explanation provided in the green book when a U.S. person may take previously deferred expenses into account. The green book indicates that a U.S. person would carry forward any deferred expenses to the subsequent year. This suggests that taxpayers would be required to keep track of two rolling snowballs: previously deferred expenses and previously deferred income. Each year, the taxpayer would apply the deferral test by combining the taxpayer's current-year foreign-source expenses with its previously deferred expenses and its previously deferred income with current-year deferred income.

D. Differences Between Proposals

1. Branch income. As drafted, the Rangel proposal would not distinguish between a U.S. person's foreign-related deductions allocable to its foreign branch operations and those allocable to its foreign subsidiaries, potentially subjecting both to deferral.[13] In contrast, it is understood that the administration's proposal would spare foreign branch expenses from potential deferral.[14]

The disparate treatment of branch and CFC expenses was illustrated in the NYSBA report with the following example:

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

Under the Rangel proposal, P would have foreign-related deductions of 60, currently taxed foreign income of 85 (its 100 of branch gross income, reduced by its 15 of directly incurred foreign taxes), and deferred foreign income of 25. P could currently deduct 46.36 of its foreign-related expenses (calculated by multiplying P's 60 of foreign-related deductions by a fraction the numerator of which is P's 85 of currently taxed foreign income, and the denominator of which is P's 110 of currently taxed foreign income plus deferred foreign income). Its remaining 13.64 of foreign-related deductions would be deferred. In effect, the presence of non-subpart F income in P's CFC would reduce P's ability to deduct expenses related to its currently taxed branch income. In contrast, the administration's proposal could exclude expenses allocable to foreign-source income earned directly and taxed currently, thereby enabling P to deduct its full 60 of foreign-related expenses.

2. Worldwide expense allocation. Unlike the Rangel proposal, which explicitly would repeal section 864(f), the administration's proposal apparently would retain the worldwide interest allocation regime in section 864(f), providing an important benefit to taxpayers.[16] Under current law, a domestic corporation's interest expense is generally allocated between domestic- and foreign-source income by reference to the relative values of its domestic- and foreign-source income-producing assets.[17] In effect, this tends to overstate a domestic parent's foreign-source interest expense because it does not take into account any interest expense incurred by the parent's foreign subsidiaries but does take into account the value of the subsidiaries' stock. In other words, it assumes that the entire group's interest expense is borne by the domestic parent corporation. Section 864(f) would eliminate this distortion by applying the interest expense allocation rules on a group basis.

The following example illustrates how the worldwide interest allocation rules would operate. Assume a domestic corporation, P, has 100x of U.S.-source income-producing assets and wholly owns stock of a foreign subsidiary, S. P also has liabilities of 50x. S has assets of 100x and liabilities of 50x. Assume P's and S's liabilities each annually generate 5x of interest expense. Without section 864(f), S's interest expense would be ignored for purposes of allocating P's interest expense to U.S.- and foreign-source income. Two-thirds of P's interest expense would be allocable to U.S.-source income (calculated by dividing P's 100x of U.S.-source income-producing assets by its total assets of 150x, which includes the value of its stock in S of 50x). If, however, section 864(f) were applicable, all of P's interest expense would be allocable to U.S.-source income (because P's interest expense would be allocated only to foreign-source income in an amount equal to the excess of (i) the P worldwide group's interest expense (10x) multiplied by the percentage of the P worldwide group's assets that produce foreign-source income (50 percent), over (ii) S's interest expense to the extent it would be allocated to foreign-source income (5x)).

E. Other Issues Raised in the NYSBA Report

The NYSBA report raised several other issues regarding the Rangel proposal's definition of deferred foreign income, and we mention some of the more salient issues here. First, the NYSBA report argued that a CFC's effectively connected income should not constitute deferred foreign income (which the Rangel proposal effectively defines as any non-subpart F income of a CFC). ECI

[13]We understand that the drafters of the Rangel proposal may have intended to exclude deductions allocable to income earned directly by the U.S. person.

[14]This was recommended in the NYSBA report. NYSBA report, *supra* note 4, at 7.

[15]*Id.* at 12.

[16]The American Jobs Creation Act of 2004 added section 864(f) to the code. Section 864(f), as originally enacted, would have applied to tax years beginning on or after January 1, 2009, but was later changed to apply only to tax years beginning on or after January 1, 2011. Section 864(f)(6).

[17]Reg. section 1.861-9T(f)(1) and (g).

could either be treated as currently taxed foreign income or, more appropriately, as U.S.-source income for purposes of applying the expense deferral provision.[18]

Second, the NYSBA report noted that deferred foreign income is the amount of income that would be included under subpart F if ''all controlled foreign corporations were treated as one controlled foreign corporation.'' This language may cause confusion if read to treat all of a taxpayer's CFCs as a single CFC for all purposes. This would, for example, require all inter-CFC transactions to be eliminated. The NYSBA report recommended that the treatment of all CFCs as a single CFC be limited to aggregating the taxpayer's share of E&P of the CFCs in which it owns an interest and that transactions between CFCs not be eliminated. This seems like the conceptually correct, and clearly more administrable, interpretation.[19] Inter-CFC transactions would not result in perfectly offsetting expense and income if the U.S. person owns differing percentages in the CFCs involved (or if a loss deferral provision were to apply), but this is economically appropriate.

Finally, the NYSBA report noted that rules for determining a taxpayer's share of a CFC's earnings would be necessary. The current rules for determining a U.S. shareholder's pro rata share of a CFC's subpart F income would be appropriate when a CFC has positive earnings.[20]

III. FTC Reform[21]

A. Rangel Bill's FTC Proposal

The Rangel bill would replace the current FTC system, which distinguishes between foreign taxes paid directly by a taxpayer (creditable under section 901) and foreign taxes paid by some CFCs and 10/50 companies (creditable under section 902). Under the proposal, a taxpayer would be entitled to credit a portion of its total foreign income taxes — the aggregate of the foreign taxes paid directly by the taxpayer and the foreign taxes that would be deemed paid or accrued under sections 902 and 960 if all the taxpayer's CFCs were treated as a single, mega-CFC, and all the E&P of the mega-CFC were subpart F income.[22] Notably, total foreign income taxes would exclude foreign income taxes paid by 10/50 companies with which a taxpayer would otherwise satisfy the section 902(a) or (b) ownership requirements.

The taxpayer could currently claim FTCs only in an amount that bears the same ratio to its total foreign income taxes as its currently taxed foreign income bears to the sum of its currently taxed foreign income and deferred foreign income in that year.[23] This provision would parallel the Rangel expense deferral proposal, which, as explained above, would permit a taxpayer to currently deduct foreign-related expenses only to the extent allocable to currently taxed foreign income.

To illustrate the application of this rule, assume a domestic corporation, P, wholly owns a CFC, S. In year 1, P earns 100x (after foreign taxes) of foreign-source income through a branch and pays 50x of foreign taxes. S has 50x of subpart F income (after foreign taxes) and 50x of non-subpart F earnings (after foreign taxes) and pays 50x of foreign taxes. P's total foreign income taxes would equal 100x (the 50x paid by P and the 50x paid by S), its currently taxed foreign income would equal 150x (the 100x of foreign-source income earned directly by P and the 50x of subpart F income earned by S), and its deferred foreign income would equal 50x (the 50x of non-subpart F earnings of S). In year 1, P could claim 75x of FTCs (the amount that bears the same ratio to P's total foreign income taxes of 100x as P's 150x of currently taxed foreign income bears to its 200x of currently taxed foreign income plus deferred foreign income).

The Rangel proposal would permit a taxpayer to carry forward any deferred foreign income taxes to future years, indefinitely.[24] If a CFC were to pay a dividend in a future year out of previously deferred foreign income (the payment would constitute repatriated foreign income), the payment would release a portion of the taxpayer's previously deferred foreign income taxes.[25] The amount of foreign income taxes allocated to the repatriated foreign income would bear the same ratio to the taxpayer's previously deferred foreign income taxes as the repatriated foreign income bears to the taxpayer's previously deferred foreign income.[26] Any foreign income taxes released by the repatriated foreign income would not be included in the taxpayer's total foreign income taxes for that year.

Returning to the prior example, P would carry forward to year 2 its remaining 25x of total foreign income taxes from year 1 as previously deferred foreign income taxes, and P would have 50x of previously deferred foreign income (S's 50x of non-subpart F earnings in year 1). Assume that in year 2 S pays a 20x dividend to P out of its previously deferred foreign income. The 20x would constitute repatriated foreign income and P could claim a credit of 10x out of its previously deferred foreign income taxes (calculated by multiplying P's 25x of previously deferred foreign income taxes by a fraction the numerator of which is P's 20x of repatriated foreign income, and the denominator of which is P's 50x of previously deferred foreign income).

[18]NYSBA report, *supra* note 4, at 15.

[19]*Id*.

[20]*Id*. at 15-16.

[21]For simplicity's sake, and because section 904 would continue to apply as it does under current law to both the Rangel and administration's FTC proposals, this report does not specify the section 904(d) category of income in the discussion or examples provided.

[22]Proposed section 976(c)(2).

[23]Proposed section 976(a).

[24]Proposed section 976(b).

[25]Previously deferred foreign income taxes would be defined as the aggregate amount of total foreign income taxes not taken into account for all prior tax years, reduced by any foreign income taxes released by repatriated foreign income. Proposed section 976(c)(1).

[26]Proposed section 976(b)(2).

B. The Administration's FTC Proposal

Under the administration's proposal, a domestic corporation would determine its indirect FTCs on a worldwide consolidated basis. This means that the taxpayer would aggregate the foreign taxes and accumulated earnings of the CFCs and 10/50 corporations for which it satisfies the ownership requirements of section 902(a) or (b), as applicable, into a single set of consolidated earnings and foreign tax pools.[27] Each dividend actually or deemed paid by a CFC or 10/50 corporation would carry up foreign taxes in an amount that bears the same ratio to the taxpayer's consolidated foreign tax pool as the dividend bears to its consolidated earnings pool.

As an example, assume a domestic corporation, P, wholly owns two CFCs, S and T. In year 1, S has 50x of subpart F income (after foreign taxes) and pays 30x of foreign taxes, and T has 50x of non-subpart F earnings (after foreign taxes) and pays 10x of foreign taxes. P's consolidated earnings pool would equal 100x and its consolidated foreign tax pool would equal 40x. Thus, in year 1, P could claim indirect FTCs of 20x (P's 40x balance in its consolidated foreign tax pool, multiplied by a fraction the numerator of which is P's 50x dividend deemed paid by S, and the denominator of which is P's 100x balance in its consolidated earnings pool).

Thus, the mechanics of the proposal would parallel the mechanics of current section 902 but use a weighted average foreign tax rate of the taxpayer's various CFCs and 10/50 companies. The administration's proposal would not incorporate the Rangel proposal's concept of deferred foreign income or foreign taxes, and it would not affect the amount of section 901 credits a taxpayer could claim.

One issue under the administration's proposal is whether it would depart from current law and take into account the earnings and foreign taxes of seventh-tier and lower CFCs and 10/50 corporations. If not, before the proposal were to go into effect, a domestic corporation could drop its foreign subsidiaries subject to low or no foreign tax below the sixth tier. This would effectively remove the earnings and foreign taxes of those corporations from the taxpayer's consolidated earnings and foreign tax pools, thereby increasing the FTCs it could claim on each dividend. This would involve a trade-off, however. The domestic corporation would lose the right to claim indirect foreign credits for foreign taxes paid by those foreign corporations.

C. Differences Between Proposals

The Rangel proposal would more fundamentally change the FTC system. It would not distinguish between foreign taxes paid directly by a taxpayer and foreign taxes paid by CFCs. Thus, it would affect the amount and timing of both direct and indirect FTCs that a taxpayer could claim. It is unclear whether the Rangel proposal would narrow the class of creditable foreign taxes by excluding foreign taxes paid by 10/50 corporations from the definition of total foreign income taxes, or whether it simply would exclude those foreign taxes from the proposed section 976 regime, such that they would remain creditable under section 902 as under current law. In contrast, the administration's proposal would work within the current FTC framework, affecting only the amount and timing of indirect credits. Notably, neither proposal would repeal or amend the section 904 limitation and basketing rules.

As an example that partially illustrates these differences, assume that a domestic corporation, P, wholly owns a CFC, S. In year 1, P earns 100x of foreign-source income (after foreign taxes) through a branch and pays 30x of foreign taxes, and S has 100x of non-subpart F income (after foreign taxes) and pays 20x of foreign taxes. Under the Rangel proposal, P could claim 25x of FTCs (calculated by multiplying P's 50x of total foreign income taxes by a fraction the numerator of which is P's 100x of currently taxed foreign income, and the denominator of which is P's 200x of currently taxed foreign income plus deferred foreign income). In contrast, the administration's proposal would operate similarly to current law. P could claim FTCs of 30x for the foreign taxes it paid directly, but could not claim any indirect credits for the 20x of foreign taxes paid by S.

There are situations, however, in which the Rangel proposal would provide accelerated credits, particularly when the foreign-source income earned directly by the taxpayer is subject to a lower effective tax rate than the foreign-source income earned by its CFCs. As an example, assume a domestic corporation, P, wholly owns a CFC, S. P earns 100x of foreign-source income (after foreign taxes) through a branch and pays 30x of foreign tax. It also has 100x of foreign-source section 863(b) income on which it pays no foreign taxes. S has 100x of non-subpart F earnings (after foreign tax) and pays 20x of foreign taxes. Under the Rangel proposal, P would be entitled to a credit of 33.33x (calculated by multiplying P's 50x of total foreign income taxes by a fraction the numerator of which is P's 200x of currently taxed foreign income, and the denominator of which is P's 300x of currently taxed foreign income plus deferred foreign income), whereas under current law or the administration's proposal, P could claim a credit of only 30x (the amount of foreign taxes paid directly). This situation could arise when a domestic corporation receives foreign-source passive income that is subject to low or no withholding (such as under a treaty), and it may accentuate the importance of the section 904 limitation and basketing rules.[28]

D. Foreign Currency Issues

Both proposals raise foreign currency translation issues. Current law requires a foreign corporation to maintain its earnings in its functional currency, including for purposes of its section 902 post-1986 earnings pool.[29] Those earnings are translated into U.S. dollars only when they are actually or deemed distributed.[30] In contrast, a

[27]Green book, *supra* note 3, at 30.

[28]NYSBA report, *supra* note 4, at 6.

[29]Section 986(b)(1).

[30]Section 986(b)(2). If the foreign corporation makes a distribution of previously taxed E&P, section 986(c) requires the

(Footnote continued on next page.)

foreign corporation's post-1986 foreign tax pool is maintained in U.S. dollars.[31] Foreign taxes paid by the foreign corporation are generally translated into U.S. dollars at the average exchange rate for the year in which they are paid or accrued. Thus, if the foreign corporation's functional currency appreciates or depreciates substantially against the U.S. dollar between the time income is earned and the time it is actually or deemed distributed in the form of a dividend, the distribution will carry up a disproportionately low or high percentage, respectively, of its post-1986 foreign tax pool in dollar terms.

For example, assume a domestic corporation, P, wholly owns a CFC, S, with the euro as its functional currency. In year 1, S has €100 of non-subpart F earnings (after foreign taxes) and pays €50 of foreign taxes. During year 1, the average U.S. dollar-euro exchange rate is 1 to 1. In year 2, S again has €100 of non-subpart F earnings (after foreign taxes) and pays €50 of foreign taxes. During year 2, the euro appreciates, such that the average U.S. dollar-euro exchange rate is 2 to 1. During year 2, S pays a dividend of €150 euros to P. At the end of year 2, S's post-1986 earnings pool is €200 (it is not reduced for dividends paid in the current year) and its post-1986 foreign tax pool is $150 (S's €50 of year 1 foreign taxes translated at the 1-1 exchange rate plus S's €50 of year 2 foreign taxes translated at the 2-1 exchange rate). Thus, S's €150 dividend to P, worth $300, carries up $112.50 of FTCs (calculated by multiplying S's post-1986 foreign tax pool of $150 by a fraction, the numerator of which is the €150 dividend, and the denominator of which is S's post-1986 earnings pool of €200). Because of the exchange rate difference, the grossed-up dividend of $412.50 carries out foreign taxes of $112.50, resulting in a foreign effective tax rate for U.S. purposes of approximately 27.3 percent, rather than the 33.3 percent for foreign law purposes.

If, however, S's post-1986 earnings pool had been maintained in U.S. dollars, at the end of year 2, the pool would have a balance of $300 (S's year 1 earnings of €100 translated into U.S. dollars at the 1-1 exchange rate plus S's year 2 earnings of €100 translated into U.S. dollars at the 2-1 exchange rate). S's distribution would have been $300 in dollar terms (the €150 dividend translated into U.S. dollars at the 2-1 exchange rate), and thus would have carried up the full $150 of FTCs (calculated by multiplying S's post-1986 foreign tax pool of $150 by a fraction the numerator of which is the $300 dividend, and the denominator of which is S's post-1986 earnings pool of $300).

Such a system would be suboptimal because it would decouple the amount of earnings (or cash) actually left in a CFC and the balance of the CFC's earnings pool (in the prior example, it would leave €50 of earnings in S, but S's post-1986 earnings pool would be zero). Yet it would minimize the effects of exchange rate fluctuations on a foreign corporation's post-1986 earnings and foreign tax pool. Perhaps the best system would be to (i) keep the taxpayer's post-1986 earnings pool in U.S. dollars (only for section 902 purposes), (ii) trace a distribution out of the pool to earnings from a particular year (such as by maintaining annual layers within the pool and having distributions come out first-in, first-out, or LIFO), and (iii) translate that distribution at the historical exchange rate for purposes of determining the numerator of the section 902 fraction.

Both proposals would aggregate the earnings of a taxpayer's CFCs (and 10/50 corporations in the case of the administration's proposal) for FTC purposes. The Rangel proposal would require the taxpayer to translate each CFC's earnings and foreign taxes into U.S. dollars annually to determine its currently taxed and deferred foreign income and total foreign income taxes.[32] This would be done at the average exchange rate for the year.[33]

However, repatriated foreign income (which is the numerator for the fractions used to determine how much of a taxpayer's previously deferred foreign-related expenses and previously deferred foreign income taxes are carried up with a dividend) is translated at the exchange rate at the time of distribution.[34] Thus, a distribution of highly appreciated currency could carry up more than the full amount of the previously deferred foreign income in dollar terms. As explained above, one solution would be to trace repatriated foreign income to the CFC's earnings for a particular year and translate the repatriated foreign income at the appropriate historical exchange rate for purposes of determining the amount of previously deferred foreign-related expenses and previously deferred foreign income taxes that are released.

Addressing foreign currency issues may be more complicated under the administration's proposal. It would be possible to adopt a system of translation similar to current law, in which a CFC's earnings are maintained in its functional currency. However, this would require maintaining the taxpayer's consolidated earnings pool in the various functional currencies of its CFCs and 10/50 corporations. Each distribution of earnings from a particular foreign corporation (the section 902 fraction's numerator) would be translated at the appropriate exchange rate at the time of the distribution, and the entire consolidated earnings pool (the section 902 fraction's denominator) would be translated at the relevant exchange rates at the time of the distribution to determine what fraction (in dollar terms) of the consolidated earnings pool is distributed. This would be administratively burdensome but would be the economically pure method of determining a taxpayer's indirect credits.

Alternatively, the consolidated earnings pool could be maintained in U.S. dollars. Again, this would involve translating the earnings of each of the taxpayer's CFCs and 10/50 corporations into U.S. dollars at the average annual exchange rate in the year earned. Solely for

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domestic corporation that receives the distribution to recognize foreign currency gain or loss on any movement in the exchange rates between the time the E&P was deemed distributed and actually received.

[31]Section 986(a).

[32]Proposed section 986(b)(2).

[33]*Id.*

[34]Proposed section 975(c)(5).

purposes of determining the portion of the consolidated earnings pool distributed in a single dividend (and therefore the associated FTC), the distribution would need to be translated into U.S. dollars at the historical exchange rate (that is, the average exchange rate for the year in which the distributed earnings were earned). This would require tracing rules, such as a FIFO or LIFO convention, which could also prove administratively burdensome. This system would represent a departure from the current system, under which exchange rate movements between the time a foreign corporation earns income and the time it distributes the income affect the foreign effective tax rate for U.S. tax purposes.

E. FTC Redeterminations

Under current law, if a U.S. taxpayer pays foreign taxes directly and those foreign taxes are redetermined in a later year (for example, if the foreign taxing authority rejects a position taken by the taxpayer), the taxpayer is required to adjust any FTCs taken.[35] In contrast, generally if a taxpayer claims indirect FTCs for foreign taxes paid by a CFC or 10/50 corporation and those foreign taxes are adjusted in a later year, the taxpayer is required to adjust the FTCs claimed only if the redetermination, if taken into account in the year to which the foreign tax relates, would reduce the indirect FTCs taken by the taxpayer on any distribution by at least 10 percent.[36] Otherwise, the taxpayer is only required to adjust the post-1986 earnings and foreign tax pools of the relevant foreign corporation prospectively.[37]

The administration's proposal could incorporate a system similar to the current redetermination rules because it would maintain the distinction between direct and indirect credits. Thus, an adjustment could be required for all redeterminations of foreign taxes taken into account under section 901 and all significant redeterminations of foreign taxes taken into account under section 902. The 10 percent rule would be less likely to require a U.S. redetermination because any foreign tax adjustment would less likely be material in the context of the entire tax pool.

The current redetermination rules would need to be amended if the Rangel proposal were adopted, because the proposal would not distinguish between foreign taxes paid directly by a domestic corporation and foreign taxes paid by its CFCs, and it would eliminate the current pooling system for indirect credits. Alternatively, a taxpayer could be required to make an adjustment for any foreign tax redetermination (if it affects the credits taken into account in that year or a later year through a repatriation), regardless of whether it is of a foreign tax paid by the taxpayer or a CFC. Or, a taxpayer could be required to adjust its credits only for a substantial redetermination by providing a threshold as under the current indirect credit rule. If the redetermination did not exceed the threshold, the taxpayer could be required to adjust its aggregate previously deferred foreign income and aggregate previously deferred foreign income taxes, thereby increasing or decreasing (depending on the direction of the redetermination) the previously deferred foreign income taxes and previously deferred foreign-related expenses carried up with future repatriated foreign income.

F. CFC Losses, E&P, and M&A Issues

The Rangel proposal would define a taxpayer's total foreign income taxes as including ''the increase in foreign income taxes that would be paid or accrued during the taxable year under sections 902 and 960 if all controlled foreign corporations were treated as one controlled foreign corporation, and all earnings and profits of all controlled foreign corporations were Subpart F income.'' As mentioned above, this definition does not address the treatment of earnings deficits in a taxpayer's CFCs. If a taxpayer cannot take into account CFC earnings deficits, its deferred foreign income (which is included in the denominator of the FTC fraction) could be overstated, thereby reducing its FTCs and potentially trapping forever some previously deferred foreign taxes (because the taxpayer's CFCs could never pay dividends in an amount sufficient to exhaust the taxpayer's previously deferred foreign income).

For example, assume a domestic corporation, P, wholly owns two CFCs, S and T. In year 1, P earns 100x of foreign-source income (after foreign taxes) and pays 50x of foreign taxes, S has 50x of non-subpart F earnings (after foreign taxes) and pays 25x of foreign taxes, and T has an earnings deficit of -50x and pays zero foreign taxes. If P cannot take T's earnings deficit into account, it could claim 50x of foreign taxes in year 1 (calculated by multiplying P's 75x of total foreign income taxes by a fraction the numerator of which is P's 100x of currently taxed foreign income, and the denominator of which is P's 150x of currently taxed foreign income plus deferred foreign income). P would carry forward the remaining 25x of foreign income taxes as previously deferred foreign income taxes along with its 50x of deferred income.

Alternatively, if P is allowed to net its CFCs' positive deferred foreign income and earnings deficits, it could claim 75x of credits in year 1 (calculated by multiplying P's 75x of total foreign income taxes by a fraction the numerator of which is P's 100x of currently taxed foreign income, and the denominator of which is P's 100x of currently taxed foreign income plus zero net deferred foreign income). This approach could accelerate a taxpayer's credit compared with current law.

Another alternative is that a taxpayer may take a CFC's earnings deficit into account on a CFC-by-CFC basis, similar to an NOL carryforward. Returning to the previous example, assume P is allowed to carry T's year 1 earnings deficit forward. In year 2, assume P earns 100x of foreign-source income (after foreign taxes) and pays 50x of foreign taxes, S has zero earnings and pays zero foreign taxes, and T has 50x of non-subpart F income and pays 25x of foreign taxes. Moreover, S pays a dividend to P of 50x. In Year 2, P could claim 100x of credits. This would equal P's 75x foreign income taxes (calculated by multiplying P's 75x of total foreign income taxes in year 2 by a fraction the numerator of which is P's 100x of currently taxed foreign income, and the denominator of

[35]Prop. reg. section 1.905-3T(d)(1).
[36]Prop. reg. section 1.905-3T(d)(3)(ii).
[37]Prop. reg. section 1.905-3T(d)(2)(i) and (ii).

which is P's 100x of currently taxed foreign income plus zero of net deferred foreign income, taking into account the deficit carryforward), plus 25x of previously deferred foreign income taxes (calculated by multiplying P's previously deferred foreign income taxes of 25x by a fraction the numerator of which is P's 50x of repatriated foreign income from the dividend from S, and the denominator of which is P's 50x of previously deferred foreign income).

Another issue to consider is whether the Rangel proposal would include a CFC's foreign taxes in a taxpayer's total foreign income taxes if the CFC has an accumulated earnings deficit. Current law precludes a taxpayer from claiming indirect credits for a CFC or 10/50 corporation that has an accumulated earnings deficit. The Rangel proposal defines total foreign income taxes as those taxes that would be deemed paid under sections 902 and 960 if all the taxpayer's CFCs were a single, mega-CFC and all its earnings were subpart F income.[38] This suggests that the accumulated deficit rule may apply only on a consolidated basis to the mega-CFC and could permanently disallow any credits for foreign income taxes paid by CFCs in the year of the aggregate deficit of the mega-CFC (because those foreign taxes would not constitute part of the taxpayer's total foreign income taxes).

This harsh rule would exacerbate the effect of timing differences between U.S. and foreign tax law compared with current law. Under the current pooling regime for post-1986 earnings and taxes, foreign taxes paid by a CFC with an accumulated deficit are not permanently lost because the foreign taxes would regain their utility as potential FTCs as soon as the CFC has at least one dollar of positive accumulated earnings. To ameliorate this impact of the Rangel proposal, an alternative rule could provide that the foreign taxes paid by each CFC that has an accumulated earnings deficit would be excluded from the consolidated foreign tax pool until the CFC has positive accumulated earnings.

It is also unclear how the Rangel proposal would address section 381 transactions involving CFCs. Under current law, a target CFC's or 10/50 corporation's post-1986 earnings and foreign tax pools and pre-1987 annual layers are generally aggregated with the acquiring CFC's or 10/50 company's earnings and foreign tax pools (subject to the hovering deficit rules of reg. section 1.367(b)-7). The Rangel proposal, however, would abandon the pooling and layering approach. Thus, it would be necessary under the Rangel proposal to devise new rules to ensure that a U.S. transferor's previously deferred foreign income taxes and previously deferred foreign income attributable to a target CFC is transferred to the U.S. transferee's (looking up the chain from the acquiring CFC) aggregate previously deferred foreign income taxes and previously deferred foreign income. This likely would require complex rules for tracing a U.S. transferor's previously deferred income and previously deferred taxes to particular CFCs.

[38]Proposed section 956(c)(2).

Earnings deficit issues would arise under the administration's proposal. Would a CFC's or 10/50 corporation's annual earnings deficit be taken into account in calculating the balance of a taxpayer's consolidated earnings pool? Under current law, an annual earnings deficit of a CFC or 10/50 corporation is taken into account in its post-1986 earnings pool. This suggests that an annual earnings deficit would be taken into account in determining the balance of the consolidated earnings pool.

But this leads to the question of how a CFC or 10/50 corporation with an aggregate earnings deficit should be taken into account. Taking an aggregate earnings deficit (and the related foreign taxes) into account would be more generous than current law, as would applying the aggregate deficit rule on a consolidated basis (that is, prohibiting a taxpayer from claiming credits only if the balance of its consolidated earnings pool is a deficit).

To help answer that question, the current hovering deficit rules could provide guidance (and also provide guidance on how acquisitions of CFCs, either in the form of stock or asset acquisitions, could be addressed). Under current law, if (i) a CFC or 10/50 corporation acquires the assets of another CFC or 10/50 corporation in an asset reorganization to which section 381 applies, and (ii) one of the corporations has an aggregate post-1986 earnings deficit, the hovering deficit rules provide that the deficit may be used only to offset postacquisition accumulated earnings of the surviving corporation. Thus, the surviving corporation's post-1986 earnings pool is higher than it would be if the acquirer's and target's post-1986 earnings pools were simply netted (and thus each dividend paid by the surviving corporation carries up a lower percentage of its post-1986 foreign tax pool). Moreover, any foreign taxes relating to the earnings deficit (that is, foreign taxes paid by the corporation on the deficit) are trapped outside the surviving corporation's post-1986 foreign tax pool.[39] Those foreign taxes are released into the surviving corporation's post-1986 foreign tax pool on a pro rata basis only as the hovering earnings deficit is offset by future accumulated E&P of the surviving corporation.[40]

The administration's proposal could incorporate similar hovering deficit rules in the mergers and acquisitions context but, more interestingly, could apply similar rules to existing CFCs with aggregate post-1986 earnings deficits. Illustrating this, assume a domestic corporation, P, wholly owns two CFCs, R and S. In year 1, R's post-1986 earnings pool has a balance of 100x, and R's post-1986 foreign tax pool has a balance of 50x. S's post-1986 earnings pool has a deficit of -50x, and S's post-1986 foreign tax pool has a balance of 10x. P's consolidated post-1986 earnings pool would be 100x and its post-1986 foreign tax pool would be 50x. It would have a hovering earnings deficit for S of -50x and would have trapped foreign taxes of 10x on that hovering deficit.

Assume that in year 2, R has no earnings and pays no foreign taxes, and S has non-subpart F earnings of 100x (after foreign taxes) and pays foreign taxes of 50x. At the

[39]Reg. section 1.367(b)-7(d)(2).
[40]*Id.*

beginning of year 3, S's 100x of accumulated E&P would more than offset its hovering deficit of -50x and release the 10x of trapped taxes. Thus, P's consolidated post-1986 earnings pool would have a balance of 150x (the 100x of R's year 1 earnings plus the 50x of S's net year 1 and 2 earnings) and its consolidated foreign tax pool would have a balance of 110x (R's 50x of year 1 foreign taxes plus the 60x of foreign taxes paid by S in years 1 and 2). However, applying a hovering deficit-type rule to non-acquired foreign corporations may be inappropriate because one of the purposes of the hovering deficit rules is to discourage FTC-motivated acquisitions.

G. Transition Issues

Transitioning to either proposal would add complexity and may create planning opportunities. The first issue is whether the proposals would apply to earnings recognized and foreign taxes paid in prior years (pre-2011 earnings and foreign taxes) or future years only (post-2010 earnings and foreign taxes). These approaches would further different policy objectives. Applying a proposal to pre-2011 earnings and foreign taxes would increase revenues, whereas applying it only to post-2010 earnings and foreign taxes could be viewed as fairer to taxpayers that planned and structured their operations under current law. The latter approach would be consistent with the 1986 transition to the aggregate earnings and foreign tax pool system from the annual layering system. Moreover, the latter, prospective approach is more administrable in that it would give taxpayers advance notice that accurate records would henceforth be required for each CFC's earnings and tax pools to determine the FTC effect of a dividend from *any* of the taxpayer's CFCs. It is an understatement to say that many taxpayers would struggle to reconstruct accurate earnings and tax pools going back a number of years for CFCs for which records were neglected because of the unlikelihood of repatriations from those CFCs.

To implement a prospective approach under the administration's proposal, a CFC's post-1986 earnings and foreign tax pools and annual layers could be maintained for pre-2011 tax years. A LIFO ordering rule for sourcing dividends would be consistent with the 1986 transition rules. That rule would deem a distribution by a CFC to come first out of the particular CFC's contribution to the taxpayer's consolidated post-2010 earnings pool (until it is exhausted), then out of the CFC's post-1986 earnings pool, and, only if that is exhausted, out of the CFC's pre-1987 annual layers.

To illustrate the application of this rule, assume a domestic corporation, P, wholly owns three CFCs, R, S, and T. In 2011, R, S, and T have non-subpart F earnings of 50x, 10x, and 50x (all after foreign taxes) and foreign taxes of 40x, 5x, and 12x, respectively. In 2012, R, S, and T have zero earnings and zero foreign taxes. Thus, the balance of P's consolidated post-2010 earnings pool would be 110x and the consolidated tax pool would be 57x (resulting in a medium-taxed pool). Moreover, R's post-1986 earnings pool has a balance of 100x, and its post-1986 foreign tax pool has a balance of 75x (a high-taxed pool); S's post-1986 earnings pool has a balance of 200x, and its post-1986 foreign tax pool has a balance of 100x (a medium-taxed pool); and T's post-1986 earnings pool has a balance of 100x, and its post-1986 foreign tax pool has a balance of 25x (a low-taxed pool).

In 2012 P seeks to repatriate 150x of previously deferred foreign earnings. To maximize FTCs, P should cause R to pay the entire dividend of 150x. The first 50x of R's dividend would be treated as out of R's share of P's consolidated post-2010 earnings pool, which would carry out 25.91x of FTCs (calculated by multiplying the balance of P's consolidated foreign tax pool of 57x by a fraction the numerator of which equals R's share of P's post-2010 earnings pool of 50x, and the denominator of which equals the balance of R's post-1986 earnings pool of 110x), and the remaining 100x as out of R's high-taxed post-1986 earnings pool, carrying out 75x of FTCs (calculated by multiplying the balance of R's post-1986 foreign tax pool of 75x by a fraction the numerator of which equals the residual amount of the dividend paid by R to P of 100x and the denominator of which equals the balance of R's post-1986 earnings pool of 100x). Alternatively, if the consolidated earnings pool were low taxed, it may be more advantageous to have S pay the 150x of dividend, because in that case only 10x of the dividend would be sourced from the low-taxed consolidated earnings pool and the remainder would be sourced from S's medium-taxed pool.

Under a variation of this approach, a dividend distribution by any CFC or 10/50 company could be sourced first out of the consolidated post-2010 earnings pool until it is completely exhausted. This approach would eliminate some of the high-low tax planning that would continue to be possible under the transition rule described above, in which taxpayers could limit the extent to which a dividend was sourced from the consolidated earnings pool by manipulating which foreign entity paid the dividend.[41] Thus, in theory, this alternative might be considered more consistent with the policy behind the administration's proposal.

This approach should be rejected, however, because it raises a host of complex issues. Foremost, without a complex regime for shifting pre-2011 E&P between CFCs whenever a CFC's distribution was sourced from the consolidated earnings pool in excess of the CFC's share of that pool, this alternative would risk decoupling the CFC's E&P used for purposes of determining whether a distribution qualifies as a dividend under sections 301

[41]Under this alternative, assuming P is in an excess limitation position, one might think that it would be beneficial, in the example above, for P to cause T to pay the first 100x of dividends in 2012, thereby exhausting P's consolidated post-2010 earnings pool, and to cause R to pay the remaining 50x, to take advantage of R's high-taxed post-1986 earnings pool. However, if the administration pursued this alternative, under which dividends from any CFC first would be sourced to the entire consolidated earnings pool (and not just to the CFC's share of that pool) until that pool is exhausted, the administration also should impose a rule similar to that in section 316(a)(2) for nimble dividends to prevent such planning opportunities. Under that rule, all dividends paid by CFCs during the tax year would be sourced pro rata from the consolidated earnings pool, regardless of the order in which the dividends actually were paid.

and 316 from its E&P pools used for FTC purposes. If so, it also would have the potential to permanently trap pre-2011 foreign taxes of entities whose dividends were disproportionately sourced from the consolidated earnings pools, because those entities never could pay sufficient dividends under section 316 to reach all those taxes. Thus, the administration should reject any transition rule that would source a CFC's distribution to the post-2011 consolidated earnings pool in excess of the CFC's share of that pool.

Similarly, applying the Rangel proposal only to post-2010 earnings and foreign taxes could be accomplished by maintaining each CFC's post-1986 earnings and foreign tax pools, but similar ordering issues and planning opportunities would arise. Would a dividend paid by a CFC of repatriated foreign income be treated first as coming out of the taxpayer's previously deferred foreign income (until it is exhausted) and then out of the particular CFC's post-1986 earnings pool, or first out of that CFC's share of the taxpayer's previously deferred foreign income (until the share is exhausted) and then out of the CFC's post-1986 earnings pool?

Applying either proposal to pre-2011 earnings and foreign taxes would raise mechanical issues. Transitioning to the administration's proposal would be simpler. A taxpayer's starting consolidated earnings and foreign tax pools could equal the aggregate of the post-1986 earnings and foreign tax pools (and possibly pre-1987 annual layers) of all its CFCs and 10/50 corporations. However, this would still raise serious compliance and administrability issues because, for example, a taxpayer may be unable to determine the historical earnings and foreign tax pools of its CFCs and 10/50 companies.

Applying the Rangel proposal to all of a taxpayer's pre-2011 earnings and foreign taxes would be even more difficult, because taxpayers historically have not calculated or tracked the items introduced in the proposal, such as currently taxed or deferred foreign income or deferred foreign taxes. Perhaps a more appropriate approach would be to aggregate the post-1986 earnings and foreign tax pools (and possibly pre-1987 annual layers) of a taxpayer's CFCs, but not 10/50 companies, to calculate the taxpayer's beginning balances for previously deferred foreign income and previously deferred foreign taxes.

IV. Check-the-Box Reform

A. Administration's CTB Reform Proposal

The administration's proposal would restrict a U.S. taxpayer's ability to treat some lower-tier foreign entities as disregarded entities under the check-the-box regulations. Specifically, a foreign eligible entity (other than a first-tier foreign eligible entity) with a single owner could not elect to be classified as a disregarded entity unless it is created or organized under the laws of the foreign country in which its single owner is organized.[42] Those foreign ineligible entities would effectively be per se corporations.

The administration's stated rationale for the proposal is to limit a U.S.-parented multinational's ability to shift the income earned by its CFCs from high- to low-tax foreign jurisdictions through transactions that are disregarded for U.S. tax purposes and that therefore do not trigger current subpart F inclusions.[43] For example, assume a domestic corporation, P, wholly owns a country X CFC, S, which is subject to a 33.3 percent tax rate in X. Suppose also that S wholly owns a country Y foreign eligible entity, T, that elects to be treated as a disregarded entity and is subject to a 10 percent tax rate in Y. In year 1, S has 100x of non-subpart F earnings (after foreign taxes) from business activities and pays 50x of foreign taxes.

Now assume that T lends S 2000x in year 1, such that S annually pays T 150x of interest, and the X-Y income tax treaty reduces withholding on interest in the source state to 0 percent. If X's domestic tax law does not contain anti-earnings-stripping rules, S's 150x of interest expense offsets its 150x of pretax earnings, and, thus, S is subject to zero tax in X. T has 135x of interest income in Y (after

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[42]The green book describes the proposal as follows:

> Under the proposal, a foreign eligible entity may be treated as a disregarded entity only if the single owner of the foreign eligible entity is created or organized in, or under the law of, the foreign country in, or under the law of, which the foreign eligible entity is created or organized. Therefore, a foreign eligible entity with a single owner that is organized or created in a country other than that of its single owner would be treated as a corporation for federal tax purposes. Except in cases of U.S. tax avoidance, the proposal would generally not apply to a first-tier foreign eligible entity wholly owned by a United States person. The tax treatment of the conversion to a corporation of a foreign eligible entity treated as a disregarded entity would be consistent with current Treasury regulations and relevant tax principles.

Green book, *supra* note 3, at 28.

[43]The green book sets forth the following policy rationale for the proposal:

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

Id.

The ability of U.S. taxpayers to reduce foreign taxes through disregarded lending transactions between disregarded entities is often cited as a reason for reform. For example, the ABA task force report explained as follows:

> Disregarded foreign entities are routinely used to issue debt to a U.S. shareholder and thereby achieve a foreign interest deduction without a U.S. income inclusion. If the disregarded borrower is the parent of a foreign consolidated group and the interest may be used to reduce foreign tax on a "regarded" affiliate under a consolidation regime (such as group relief in the U.K. or an *organschaft* in Germany), the result is to lower the effective rate of tax on income eligible for deferral.

ABA task force report, *supra* note 5, at 738.

foreign taxes) and is subject to 15x of taxes in Y. Yet, T's loan to S and S's interest payments to T are disregarded for U.S. tax purposes and thus do not give rise to subpart F inclusions. Thus, P's overall effective foreign tax rate is reduced from 33.3 percent to 10 percent and P is not required to currently recognize subpart F inclusions.

It is important to distinguish between the objections that have been raised to check-the-box planning. The first objection is that income shifting through check-the-box planning creates disincentives for a multinational to repatriate the earnings of its foreign subsidiaries (in other words, it creates incentives to invest abroad), because the multinational can reinvest those earnings abroad subject to a low effective foreign tax rate. According to the proponents of this view, this generally results in lower tax revenue in the United States (and less domestic economic activity).[44]

The second objection, and the one emphasized in the green book, is that this type of income shifting permits a multinational to move income among its foreign entities without triggering subpart F inclusions.[45] This emphasis on shoring up subpart F's antideferral rules, which are somewhat inherently arbitrary to begin with, runs counter to the recent trend. Indeed, section 954(c)(6), passed by Congress in 2005 and scheduled to sunset in 2010, permits a CFC to exclude interest, dividends, rents, and royalties paid by a related CFC from subpart F income to the extent those payments are attributable to non-subpart F earnings (and non-ECI) of the paying CFC. The Congress that passed section 954(c)(6) believed scaling back subpart F would enhance the ability of U.S. multinationals to compete in overseas markets.[46] It is also understood that Congress intended section 954(c)(6) to permit for CFCs what the check-the-box regulations permitted for foreign disregarded entities. In contrast, the Obama administration has emphasized the negative impact on U.S. workers of U.S. multinationals' ability to defer their foreign earnings while enjoying low foreign effective tax rates. Given these differing views of what is best for the American worker, it is not surprising that the administration, through the expected sunsetting of section 954(c)(6) along with the proposed check-the-box reform, would return the U.S. tax system to the pre-check-the-box *status quo ante*, when movements of cash among CFCs triggered subpart F inclusions.

A third objection, which was not raised in the green book but which has been otherwise raised in the context of check-the-box reform, is that the check-the-box rules permit a CFC to at least partially avoid subpart F gain on the sale of stock of another CFC by having the target CFC elect disregarded entity status before the sale, thereby causing the selling CFC to be treated as selling business assets.[47] This objection may be misplaced, because the ''check and sell'' result could be achieved without the check-the-box rules, albeit less efficiently. The selling CFC could liquidate the target CFC and sell the assets of the liquidated CFC to the acquiring corporation or a newly organized subsidiary or passthrough entity owned by the acquirer. Moreover, section 954(c)(4) provides that a sale of a 25 percent partnership interest by a CFC is treated as the sale of the CFC's share of the partnership assets. This treatment, however, is arguably more appropriate in the partnership context because a partnership is often treated as the aggregate of its partners under subpart F.

Finally, some international tax practitioners question whether check-the-box reform primarily would generate foreign tax revenue by limiting a multinational's incentive to engage in foreign earnings stripping transactions,

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[44]Preamble to the proposed regulations in Notice 98-11, 1998-1 C.B. 433, (*Doc 98-2983, 98 TNT 12-8*) (later withdrawn by Notice 98-35, 1998-2 C.B. 34, *Doc 98-20115, 98 TNT 119-6*); Notice 98-11 states:

> Related person transactions can be more easily manipulated to reduce both United States and foreign taxes. One of the purposes of Subpart F is to prevent CFCs (including those engaged in active businesses) from structuring transactions designed to manipulate the inconsistencies between foreign tax systems to inappropriately generate low- or non-taxed income on which United States tax might be permanently deferred.

See also George Yin, ''Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers,'' *Tax Notes*, Jan. 7, 2008, p. 173, *Doc 2007-27163,* or *2008 TNT 5-22.* (''The check-the-box rules that took effect in 1997 increased the attraction of foreign investment and the advantage of delayed repatriations by providing taxpayers with an easy way to shift their foreign income to low-tax countries without U.S. tax consequences. This practice was essentially codified for three years in 2006 [in section 954(c)(6)].'')

[45]Green book, *supra* note 3, at 28; JCT report, *supra* note 2, at 184.

[46]The House report to the Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222, which introduced section 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.

H.R. Rep. No. 109-304, *Doc 2005-23623, 2005 TNT 224-18*.

Thus, the Congress that enacted section 954(c)(6) favored tipping the scale toward more permanent deferral, in the interest of better achieving ''capital import neutrality.'' Capital import neutrality refers to the policy objective 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 capital export neutrality, the goal of which is to ensure 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 some categories of income that are thought to be more mobile.

[47]*See, e.g.*, JCT report, *supra* note 2, at 183-184; *see also Dover v. Commissioner*, 122 T.C. 324 (2004), *Doc 2004-9660, 2004 TNT 88-15*.

and they question whether the protection of foreign fiscs is a legitimate goal of U.S. international tax policy. However, the above discussion demonstrates that policymakers' motivation is the ultimate increase of U.S. tax revenues through increased subpart F inclusions and the removal of incentives to invest abroad (and avoid repatriations) that are created by the low foreign effective tax rates made possible under check the box.[48]

B. Domestic Eligible Entities

As described in the green book, the administration's proposal would apply only to some foreign eligible entities. A multinational may be able to substitute domestic eligible entities (such as Delaware limited liability companies (LLCs)) in place of its lower-tier foreign eligible entities to achieve the same tax benefits. Generally, a business entity is domestic if it is created or organized under the laws of the United States or any state; it is foreign if it is not domestic; and a business entity created or organized in both the United States and a foreign country is domestic.[49] Thus, the proposal would not prohibit a multinational from placing domestic disregarded entities under its CFCs.

To achieve the same tax benefits as are possible under the check-the-box regulations, a domestic disregarded entity would need to be subject to tax as a resident in the foreign countries in which it operates (that is, constitute a reverse hybrid entity). This could be satisfied in a number of foreign countries by causing the domestic disregarded entity to be managed and controlled and to have its principal place of business in the country, and it could be satisfied in other countries by having the domestic disregarded entity be organized under the laws of the foreign country as well (that is, constitute a dual chartered entity).[50]

To illustrate this idea, assume a domestic corporation, P, wholly owns a first-tier holding CFC, R, which is organized under the laws of country W, a low-tax foreign country. R, in turn, owns two CFCs, S and T, organized under the laws of country X and Y, respectively, two high-tax foreign jurisdictions. S and T each own a Delaware LLC with its management and control and principal place of business in country Z, a low-tax foreign country. Under the domestic tax law of Z, each LLC is taxable as a resident of Z. P may be able to reduce its overall effective foreign tax rate by stripping any active business income out of X and Y and into Z through loans issued by the LLCs to S and T. Under this strategy, it would be important to ensure that an LLC is eligible for benefits under the S-Z and T-Z income tax treaties as residents of Z to reduce withholding tax in S and T on any interest.

C. Same-Country Foreign Eligible Entities

A multinational could adopt a similar planning strategy using foreign eligible entities organized under the laws of the foreign country in which their single owners are organized, rather than domestic eligible entities. Returning to the previous example, P could instead place foreign eligible entities organized in X and Y underneath S and T, respectively. Each entity could have its management and control and principal place of business in country Z. Again, it would be important to ensure that the foreign eligible entities were eligible for benefits under the S-Z and T-Z income tax treaties.

It would not be difficult to modify the administration's proposal to eliminate the domestic eligible entity and same-country foreign eligible entity loopholes. For example, the proposal could treat a lower-tier domestic eligible entity that is taxable in a foreign jurisdiction on the basis of its residence as a per se corporation. Similarly,

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[48]The technical and transition issues, discussed below, that would arise under the administration's check-the-box reform proposal suggest that a simpler solution may exist. Differing solutions have been proposed to combat the same perceived abuses. For example, Notice 98-11, which was very controversial and ultimately withdrawn by Notice 98-35, would have permitted the IRS to regard some transactions between disregarded entities as if the transactions were entered into between corporations.

The ABA task force report considered a proposal that would have treated a foreign business entity as a corporation for U.S. tax purposes if it were subject to an entity-level income tax (determined under principles of section 901) in its country of tax residence. If not, the entity would have been treated as a passthrough. Further, a foreign business entity subject to an entity-level income tax integrated with the tax on the entity's owners would have been treated as a corporation, and a foreign business entity organized in a jurisdiction without an income tax would have been treated as a passthrough. ABA task force report, *supra* note 5, at 244.

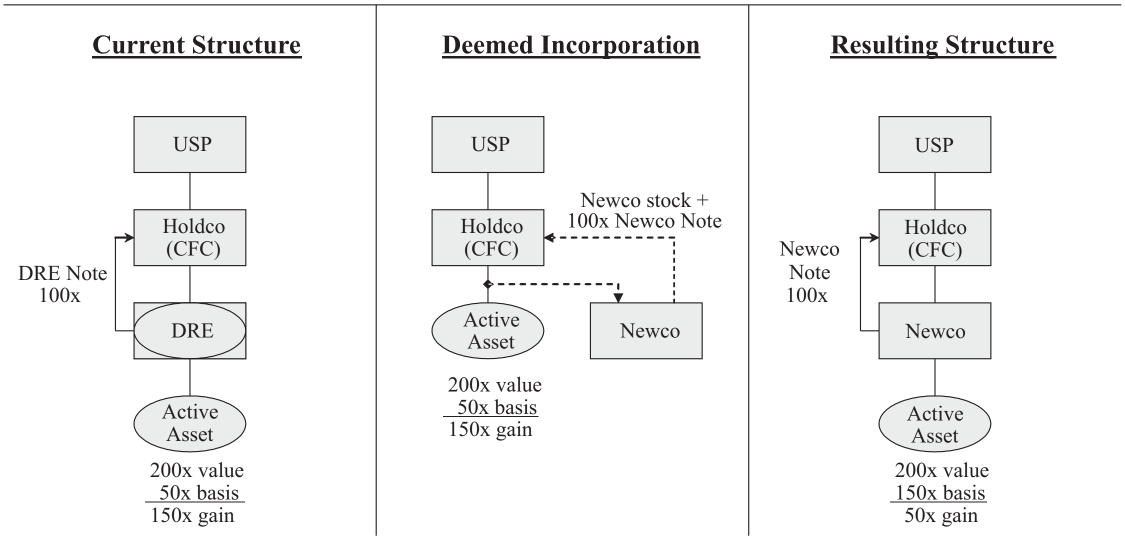
While this proposal would reduce arbitrage opportunities by harmonizing U.S. and foreign tax treatment of some entities, it leaves open a number of nettlesome issues. For example, like the administration's proposal, this proposal would apply to foreign business entities, thus leaving open planning opportunities using domestic eligible entities. Also, establishing the minimum necessary foreign income tax would require line-drawing and antiabuse rules. Finally, from a policy perspective, it is unclear whether per se passthrough status is appropriate for entities established in no-tax jurisdictions. A disregarded entity in a low-tax or no-tax jurisdiction can be used by a multinational to reduce its overall effective foreign tax rate through disregarded loans and other earnings stripping arrangements. This is one of the practices targeted by the administration's proposal.

Finally, under the JCT report, a foreign business entity would have been treated as a corporation for U.S. tax purposes if it is a separate legal entity organized under foreign law and has only a single member. Domestic business entities and multiple-member foreign entities would not have been subject to the rule. However, Treasury would have been authorized to issue regulations applying the rule 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 rule, and (ii) a domestic business entity with a CFC as its sole member.

[49]Section 7701(a)(4); reg. section 301.7701-5.

[50]The JCT report anticipated that domestic entities might be able to achieve what is currently achieved with foreign disregarded entities, and its proposal concerning single-member foreign entities (which was similar to the administration's proposal) granted the Treasury secretary authority to issue regulations extending the application of its proposal to a domestic business entity that has a CFC as its sole member. JCT report, *supra* note 2, at 183. This approach would create a host of technical issues in the mergers and acquisitions context.

Example 1. Deemed Incorporation of DRE Holding Active Assets



the same-country exception could be narrowed to include only a foreign eligible entity that is organized under the laws of the same foreign country in which its single owner is located and is also subject to tax on the basis of its residence in the same country in which its single owner is a resident (after applying any relevant income tax treaties). This way, any interest expense for a disregarded loan would be offset by interest income in the same foreign country. However, it still could 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 nonentity for purposes of U.S. tax law.[51] However, the treatment of that entity would vary from country to country, and it may be difficult to structure a foreign arrangement that is not an entity for U.S. tax purposes but is a tax resident of a foreign jurisdiction. Thus, the administration's proposal, at a minimum, would make it harder to achieve the benefits currently provided by the check-the-box rules.

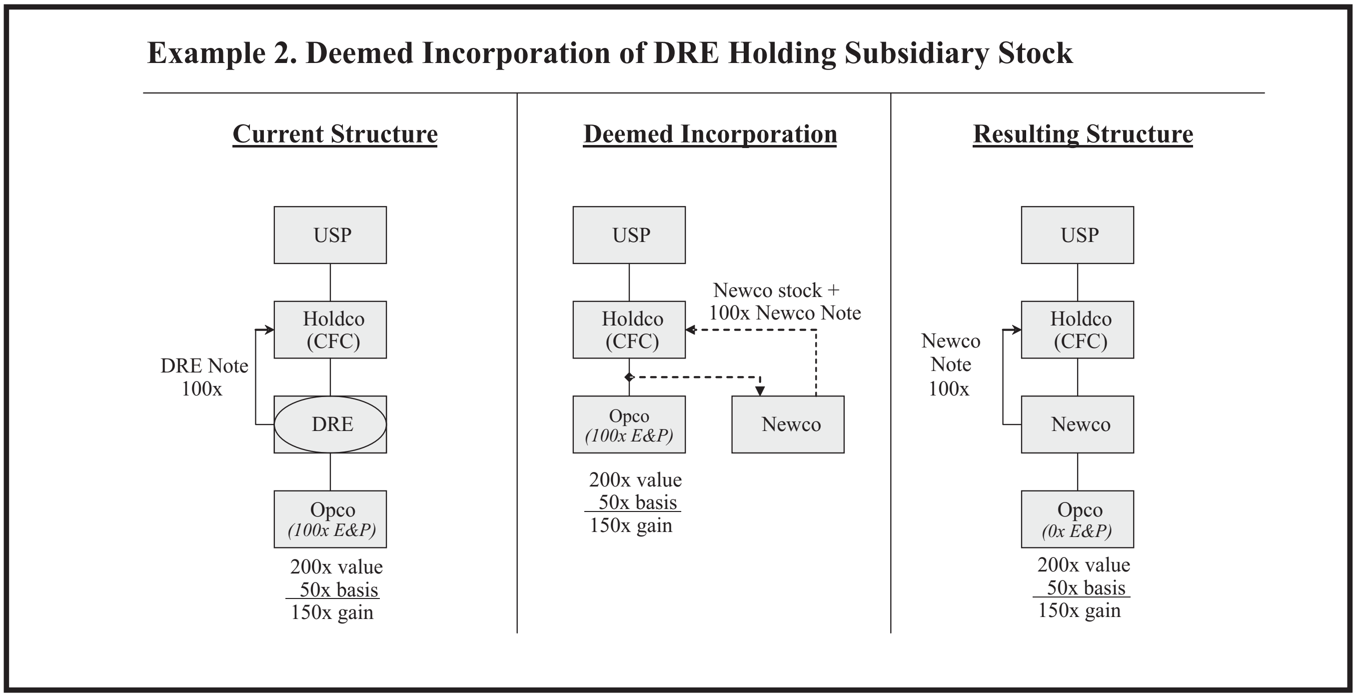
D. Multiple-Owner Foreign Eligible Entities

The proposal would not apply to foreign eligible entities with more than one owner. Thus, a multinational could add a second owner to each of its foreign hybrid disregarded entities to avoid per se corporate status. For example, assume a domestic partnership wholly owns a CFC, S, organized in country X, a low-tax jurisdiction. S wholly owns a second-tier CFC, T. S owns 99 percent of a foreign eligible entity, K, and T owns the remaining 1 percent of K. K operates an active business that earns 100x of non-subpart F income annually in country Z, a high-tax jurisdiction. K is treated as a partnership for U.S. tax purposes but as a corporation for Z tax purposes. S and T lend K 990x and 10x, respectively, on which loan K must make annual interest payments of 99x and 1x to S and T, respectively.

In year 1, K earns 100x of income and has interest expenses of 100x for Z tax purposes and, thus, would not be subject to tax in Z. It would appear that S should be able to deduct its 99x distributive share of interest expense against its 99x distributive share of interest income for purposes of determining its net foreign personal holding company income (FPHCI) (which would equal the amount of its subpart F income) under section 954(b)(5) and reg. section 1.954-1(c).[52] But even if S's distributive share of interest expense could not be used to offset its share of interest income, that interest income may avoid being FPHCI under the related-person, same-country interest exception of section 954(c)(3). Under section 954(c)(3)(A), a payment made by a partnership with corporate partners is treated as made by those partners in proportion to their interest in the partnership. Thus, S would be treated as making 99 percent of the interest payment to itself, possibly qualifying for the related-person exception or possibly causing the interest

[51]The term "entity" is not defined in the entity classification regulations, and there is surprisingly little authority on what constitutes an entity. A Cayman Islands partnership, for example, with a 0 percent general partner (essentially a contractual relationship under Cayman Islands law) would likely not constitute an entity for U.S. tax purposes.

[52]Generally, a partner's distributive shares of interest income from a partnership in which it owns a 10 percent or greater interest is allocated at the partner level. Reg. section 1.861-9T(e)(1). Related-person interest expense first reduces passive FPHCI. Reg. section 1.954-1(c)(1)(i)(C). Proposed regulations, if ever finalized, would prevent some expenses arising from a payment of interest by a partnership to a CFC partner from reducing FPHCI. Prop. reg. section 1.954-1(c)(1).



payment to be disregarded in whole. Under any of these theories, P would have effectively shifted K's high-tax foreign income into a low-tax foreign jurisdiction without triggering commensurate subpart F income.

The administration's proposal could be tweaked to preclude such partnership planning. Providing a model, the JCT report suggests providing Treasury the authority to issue regulations treating a multiple-member foreign eligible entity as a per se corporation if a member that is related to another member was added with a principal purpose of avoiding corporate status. That arrangement would depart from the existing entity classification rules, which permit a taxpayer to choose between a partnership and corporate form of business based on tax considerations.

E. First-Tier Foreign Eligible Entities

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." The rationale behind this exception is presumably that a first-tier disregarded entity is already subject to tax in the United States. It is unclear from the language of the description, however, whether only the top member or each member in a chain of disregarded entities would qualify as a first-tier eligible entity. It appears consistent with the policy underlying the proposal to permit a taxpayer to disregard an entire chain of disregarded entities, since the chain's activities would be taxable in the United States. Thus, the proposal should clarify that the term "first-tier foreign eligible entity" refers to any foreign eligible entity that is not owned by a regarded foreign entity.[53]

The proposal would preclude a taxpayer from treating a first-tier foreign eligible entity as a disregarded entity in the case of "U.S. tax avoidance." The scope of this exception would need to be clarified. If the primary motivation of the proposal is to limit a taxpayer's ability to move funds among CFCs, it is difficult to see how a first-tier disregarded entity could ever involve *U.S.* tax avoidance. On the other hand, if the primary motivation for the proposal relates to the reduction of a taxpayer's foreign effective rate, it is possible that a first-tier foreign eligible entity would be treated as a corporation under this tax avoidance exception if it is used to reduce a taxpayer's foreign effective rate through disregarded payments. Even on those facts, however, it is not clear when and whether this constitutes U.S. tax avoidance. Given the high stakes — the determination of an entity's classification for federal income tax purposes — this is not an area in which ambiguity can be tolerated.

F. Transition Issues

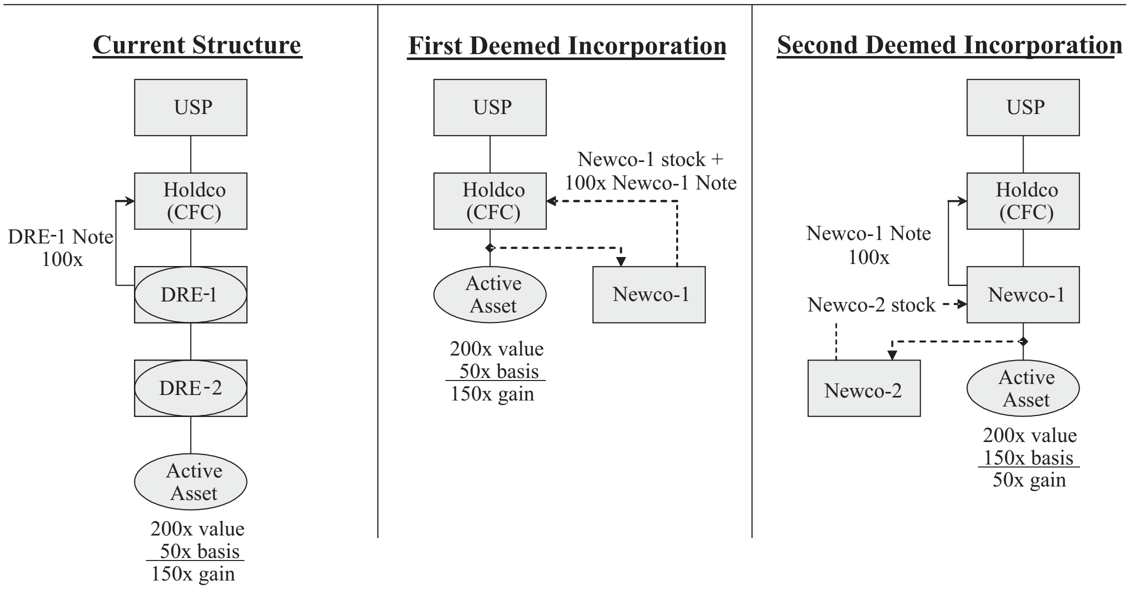
The administration's proposal provides that "the tax treatment of the conversion to a corporation of a foreign eligible entity treated as a disregarded entity would be consistent with current Treasury regulations and relevant tax principles."[54] This statement suggests that all disregarded entities subject to the new rules would be deemed to be incorporated on January 1, 2011. As explained below, this statement's simplicity belies tremendous complexity.

Under reg. section 301.7701-3(g)(1)(iv), if a disregarded entity changes its classification to be taxed as a corporation, the owner of the disregarded entity is deemed to contribute all the disregarded entity's assets to

[53]Reg. section 301.7701-3(b)(2).

[54]Green book, *supra* note 3, at 28.

Example 3. Deemed Incorporation of Tiered DREs, "Top Down"



a new corporation in exchange for the stock of the new corporation and the new corporation's assumption of the disregarded entity's liabilities. Generally, that transaction will be treated as a section 351 transaction. However, several major complications arise. First, if the disregarded entity owes outstanding liabilities to its owner and those liabilities are not extinguished in the incorporation, the liabilities likely will be treated as other property received by the owner (sometimes referred to as "springing boot"). Second, to the extent the assets of the disregarded entity consist of stock of lower-tier subsidiaries, any springing boot would give rise to a section 304(a)(1) transaction. Third, it is unclear whether a chain of multiple disregarded entities (or cross-chain disregarded entities) would be deemed to be incorporated from the "bottom up" or "top down" or based on a different ordering system. These issues are explored in the following examples.

1. Incorporation of disregarded entity with active assets and 'springing' liabilities in excess of basis. As a first example, assume a domestic corporation, USP, owns all the stock of a CFC, Holdco. Holdco owns all the stock of a foreign eligible entity, DRE, that is incorporated in a different country and that has elected to be treated as a disregarded entity. DRE is an operating company, and DRE's sole asset has a value of 200x and a basis of 50x, and is used in the active conduct of a trade or business. DRE's sole liability is a note to Holdco with an outstanding principal amount and value of 100x. Under current law, the existence of the note (and payments of principal and interest thereon) is disregarded.

On January 1, 2011, Holdco would be deemed to contribute DRE's asset to a new corporation, Newco, in exchange for Newco stock and the note, which would be treated as "springing" into existence once both parties to the note are "regarded." Under general section 351 principles, the note would be treated as boot received by Holdco, which would cause Holdco to recognize gain on the transfer under section 351(b).[55] Thus, Holdco would recognize 100x of gain on the transfer (the lesser of the built-in gain in DRE's asset or the value of the note deemed received). That gain would generally not be subpart F income because DRE's asset would be used in the active conduct of a trade or business.[56]

2. Incorporation of disregarded entity that holds stock and springing liabilities in excess of basis. Now assume the same facts as above except that DRE is a holding company whose sole asset is the stock of a CFC, Opco, with a value of 200x and a basis of 50x. Assume that Opco has current and accumulated E&P of 100x. On January 1, 2011, Holdco would be deemed to contribute the stock of Opco to Newco for 100x of Newco stock and the 100x note. The transfer would be treated as a partial section 304(a)(1) transaction under section 304(b)(3).[57] In that case, the deemed receipt of the 100x note would be treated as a dividend to the extent of T's E&P of 100x, under section 304(b)(2)(B). If, as expected, the look-through rule of section 954(c)(6) is no longer in effect on January 1, 2011, the deemed dividend received by Holdco would be subpart F income to P. P may be able to avoid this result by causing Holdco to contribute the note to the capital of DRE (causing the note to terminate), having DRE repay the note, or offsetting the note with another

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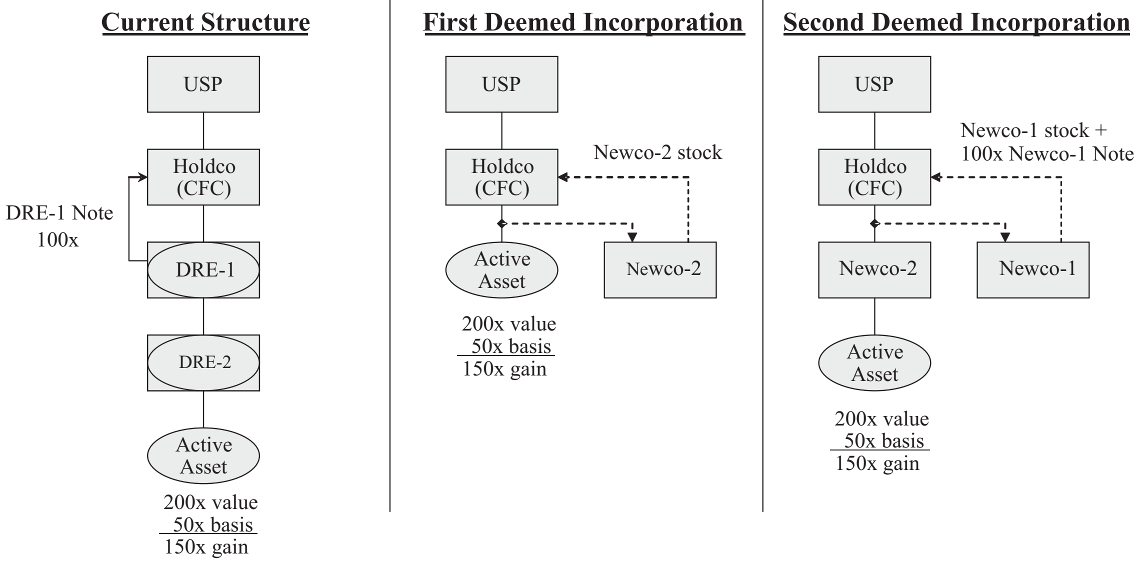
[55] *See* Rev. Rul. 80-228, 1980-2 C.B. 115 (IRS will not follow *Wham Construction Co. v. United States*, 37 AFTR 2d 76-950 (D. S.C. 1976), *aff'd*, 600 F.2d 1052 (4th Cir. 1979)).

[56] Reg. section 1.954-2(e)(3)(ii).

[57] Under section 304(b)(3), the transaction is split between (i) a section 351(a) transfer of 100x of Opco stock for 100x of Newco stock and (ii) a section 304(a)(1) transfer of 100x of Opco stock for the 100x note.

Example 4. Deemed Incorporation of Tiered DREs, "Bottom Up"



note owed by Holdco to DRE before January 1, 2011. However, if such a section 304 transaction would be unavoidable (for example, if P could not eliminate the note for foreign tax reasons), P may want to undertake the section 304 transaction before the expiration of section 954(c)(6) to get look-through treatment on the deemed dividend.[58]

3. Deemed top-down incorporation of tiered disregarded entities. Assume a domestic corporation, USP, owns all the stock of a CFC, Holdco, which in turn owns all of a foreign eligible entity, DRE-1, which is disregarded for U.S. tax purposes. DRE-1's sole asset is the stock of another foreign eligible entity, DRE-2, which is disregarded for U.S. tax purposes. DRE-1's sole liability is a note owed to Holdco with a principal amount and value of 100x. DRE-2's sole asset has a value of 200x and a basis of 50x and is used in the active conduct of a trade or business.

On January 1, 2011, assume that DRE-1 and DRE-2 are deemed incorporated from the top down.[59] First, DRE-1 would be treated as incorporated as a newly formed corporation, Newco-1, and second, DRE-2 would be treated as incorporated as a newly formed corporation, Newco-2. In the incorporation of DRE-1 as Newco-1, Holdco would be deemed to contribute DRE-2's asset (worth 200x) to Newco-1 in exchange for 100x of Newco-1 stock and the 100x note previously owed by DRE-1 to Holdco. The note would be treated as boot received by Holdco, which would cause Holdco to recognize 100x of gain on the transfer under section 351(b) (the lesser of the built-in gain in DRE-2's asset, which is treated as transferred to Newco-1, or the value of the note deemed received). That gain would generally not be subpart F gain because DRE-2's asset is used in the active conduct of a trade or business. Newco-1 would also increase the basis of DRE-2's asset to 150x under section 362(b). In the incorporation of DRE-2 as Newco-2, Newco-1 would be deemed to contribute the asset received from Holdco (worth 200x) to Newco-2 in exchange for 200x of Newco-2 stock. Because no boot is deemed to be received by Newco-1 in the second incorporation, Newco-1 would not recognize any gain on the transfer under section 351(a).

4. Deemed bottom-up incorporation of tiered disregarded entities. In contrast, if DRE-1 and DRE-2 are deemed to be incorporated from the bottom up,[60] section 304 could apply. First, in the incorporation of DRE-2 as Newco-2, Holdco would be deemed to contribute the asset previously held by DRE-2 (worth 200x) to Newco-2 in exchange for 200x of Newco-2 stock in a section 351(a) transaction. Holdco's basis in the Newco-2 stock would be 50x under section 358. Second, in the incorporation of DRE-1 as Newco-1, Holdco would be deemed to contribute the Newco-2 stock to Newco-1 stock in exchange for 100x of Newco-1 stock and the 100x note previously owed by DRE-1 to Holdco. The transfer would be treated as a partial section 304(a)(1) transaction under section 304(b)(3).[61] Neither Newco-1 (acquiring) nor Newco-2

[58]Trying to undo these arrangements in foreign jurisdictions could also have tax consequences, such as cancellation of indebtedness income in those jurisdictions.

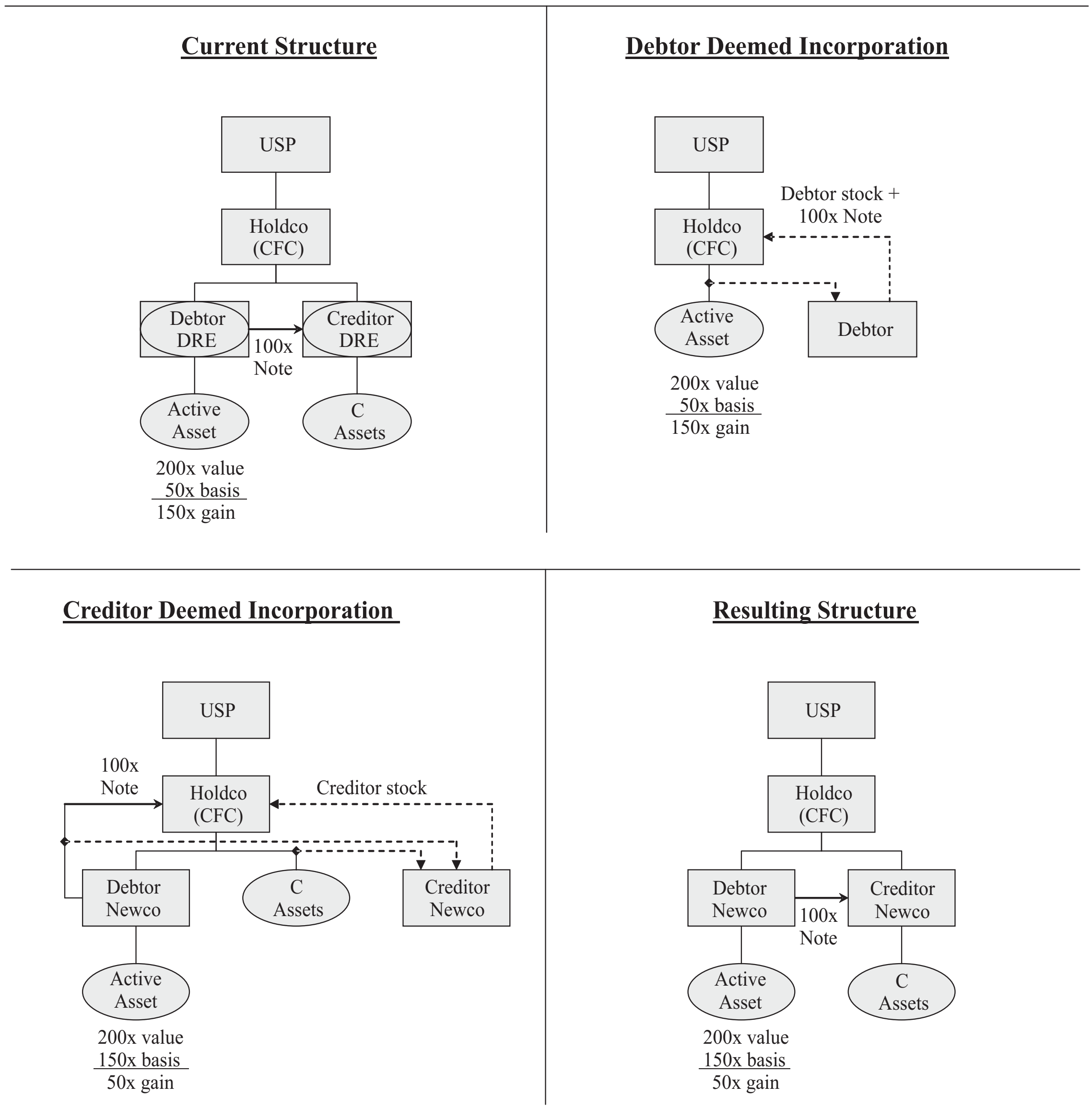
[59]*See* Rev. Rul. 77-449, 1977-2 C.B. 110.

[60]*See* Rev. Rul. 2003-51, 2003-1 C.B. 938, *Doc 2003-11263, 2003 TNT 87-16*. *See also* reg. section 301-7701-3(g)(3)(iii).

[61]Under section 304(b)(3), the transaction is split between (i) a section 351(a) transfer of 100x of Newco-2 stock for 100x of

(Footnote continued on next page.)

Example 5. Deemed Incorporation of Brother-Sister DREs, Debtor First



(issuing) would have any E&P. Thus, Holdco should (i) apply 50x of the deemed distribution to offset the aggregate basis in the Newco-1 stock deemed to be received in the transfer under section 301(c)(2),[62] and (ii) recognize 50x of capital gain under section 301(c)(3). That gain

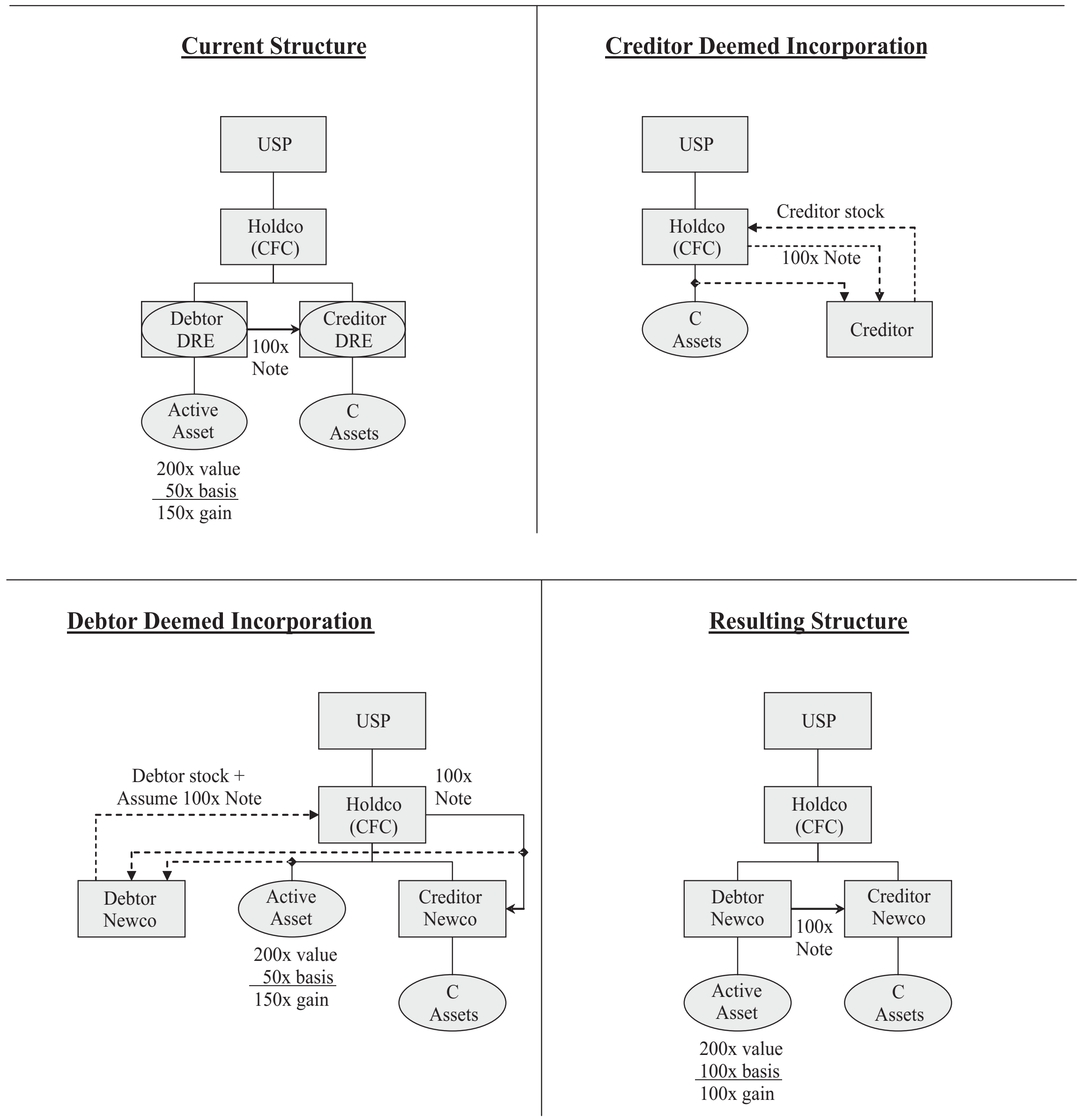
Newco-1 stock and (ii) a section 304(a)(1) transfer of 100x of Newco-1 stock for the 100x Newco-1 note.

[62]In the bifurcated transaction, Holdco would be deemed to receive (1) Newco-1 stock with a 25x basis in the section 351(a) transfer and (2) Newco-1 stock with a 25x basis in the section 304(a)(1) transfer. The portion of the Newco-1 stock deemed issued in the section 304(a)(1) transfer is first deemed issued in a section 351(a) transfer and then is deemed to be redeemed for

(Footnote continued in next column.)

the 100x Newco-1 note. Under recently proposed regulations, Holdco should be able to recover its 25x basis in the hypothetically redeemed Newco-1 shares issued in the section 304(a)(1) transfer as well as its 25x basis in the Newco-1 shares deemed to be issued in the section 351(a) transfer. *See* prop. reg. section 1.304-2(a)(4) (2009). Previously, the IRS had proposed regulations under which only the basis of the hypothetically redeemed shares (here, 25x) could be recovered under section 301(c)(2). *See* former prop. reg. section 1.304-3, Example 3 (2002).

Example 6. Deemed Incorporation of Brother-Sister DREs, Creditor First



would be treated as subpart F income under section 954(c)(1)(B), and P's corresponding subpart F inclusion would carry up FTCs.

5. Deemed incorporation of brother-sister DREs, debtor first. Assume that a domestic corporation, USP, owns stock of a CFC, Holdco. Holdco in turn owns all of the stock of two foreign eligible entities: Debtor DRE and Creditor DRE, both of which are disregarded for U.S. tax purposes. Debtor DRE's sole asset has a value of 200x and a basis of 50x, and is used in the active conduct of a trade or business. Debtor DRE's sole liability is a note owed to Creditor DRE with a principal amount and value of 100x. On January 1, 2011, Debtor DRE and Creditor DRE are deemed incorporated as two newly formed corporations, Debtor Newco and Creditor Newco, respectively.

If Debtor DRE is deemed incorporated first, Holdco will be deemed to transfer Debtor DRE's asset (worth 200x) to Debtor Newco in exchange for 100x of Debtor Newco stock and the 100x note. The note would be treated as boot received by Holdco, which would cause Holdco to recognize 100x of gain on the transfer under section 351(b) (the lesser of the built-in gain in Debtor DRE's asset, which is treated as transferred to Debtor Newco, or the value of the note deemed received). That gain would generally not be subpart F gain because

Debtor DRE's asset is used in the active conduct of a trade or business. Debtor Newco would increase the basis of Debtor DRE's asset to 150x under section 362(b).

Next, in the deemed incorporation of Creditor DRE, Holdco would be deemed to transfer Creditor DRE's assets and the 100x Debtor Newco note to Creditor Newco in exchange for Creditor Newco stock of equivalent value. Holdco would not recognize any gain on the transfer under section 351(a).

6. Deemed incorporation of brother-sister DREs, creditor first. Assume the same facts except that Creditor DRE is deemed incorporated first. In the deemed incorporation of Creditor DRE, Holdco would be deemed to transfer Creditor DRE's assets and 100x note payable to Creditor Newco in exchange for Creditor Newco stock of equivalent value. Holdco would not recognize any gain on the transfer under section 351(a).

Next, in the deemed incorporation of Debtor DRE, Holdco would be deemed to Debtor DRE's asset (worth 200x) to Debtor Newco in exchange for 100x of Debtor Newco stock and Debtor Newco's assumption of the 100x note payable to Creditor Newco. Holdco would recognize 50x of gain on the deemed transfer under section 357(c) (equal to the excess of the 100x liability assumed over the 50x basis of the assets transferred). That gain would generally not be subpart F gain because Debtor DRE's asset is used in the active conduct of a trade or business. Debtor Newco would increase the basis of the Debtor DRE's asset to 100x under section 362(b).