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International Tax Planning After Check-the-Box

Monica Gianni examines the international tax planning and structuring opportunities generated by the check-the-box regulations and evaluates the federal revenue authorities' attempts to curb the resultant "abuses."

By Monica Gianni

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The check-the-box regulations opened up a vast array of tax planning opportunities in the international arena by increasing the simplicity of organizing foreign passthrough entities ("PE"). United States taxpayers implemented new techniques following the issuance of these regulations to take advantage of tax savings made possible by using PEs for conducting foreign operations. The IRS followed quickly on the heels of the exploitation of these tax reduction opportunities and took action to curb what it perceived to be abuses. The extent to which the IRS will succeed in curtailing international tax planning opportunities in this area is not yet known, as United States multinationals and tax practitioners loudly objected to the IRS's actions. In spite of this uncertainty, however, opportunities abound for United States taxpayers to reduce their overall taxes by utilizing PEs, particularly single-member entities, for their foreign business operations. This article discusses the check-the-box regulations as applied to foreign entities, sets forth some basic principles of United States international taxation, outlines foreign structuring opportunities made possible by the regulations and summarizes the IRS's attempts to curb perceived abuses in this area.

Check-the-Box Regulations

The IRS issued the check-the-box regulations under Code Sec. 7701[1] on December 17, 1996, effective January 1, 1997.[2] The regulations specify how an entity can be classified as a PE for United States federal income tax purposes. Prior to the issuance of these regulations, classification as an entity was based on four factors: free transferability of interests, limited liability, centralized management and continuity of life.[3] If an entity with more than one owner possessed no more than two of the listed factors, it was taxed as a partnership; if three of the factors were

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present, an entity was taxed as a corporation. For single-member entities, it was unclear how the entity would be regarded. Under these prior rules, taxpayers were normally able to obtain the desired classification for an entity with careful planning, but the process resulted in numerous problems. For the classification of foreign entities, the taxpayer had to consult with local counsel, because local law determined whether a particular characteristic was present for foreign entities.[4] In addition, appropriate provisions had to be included in the foreign entity's governing documents, and the applicable documentation had to be translated into English.

The IRS eliminated [the] complicated, uncertain process of obtaining entity classification when it issued the check-the-box regulations.

The IRS eliminated this complicated, uncertain process of obtaining entity classification when it issued the check-the-box regulations. In the international area, the check-the-box regulations provide a list of entities that are always taxable as corporations, *i.e., per se* corporations.[5] One type of entity that is a *per se* corporation is generally listed for each country, *e.g.*, the *societe anonyme* in France and Belgium and the public limited company in Australia, South Africa and the United Kingdom. These *per se* entities cannot utilize the check-the-box election procedures; they are considered to be corporations by the IRS without exception. "Eligible entities" that are not on the list can choose to be taxed either as corporations or as PEs.[6] If no election is made for the entity, the entity is classified by default based on the liability protection provided to the owners under local law.[7] If all of the owners of an entity have limited liability, the entity is a corporation; if any owner has unlimited liability, it is a PE.[8] An owner has "unlimited liability" if the owner has personal liability for the debts of, or claims against, the entity by reason of being an owner, based solely on the law under which the entity is organized.[9] If protection from liability is optional under local law, the entity's organizational documents are relevant in determining whether there is limited liability.[10] Entities that are treated as PEs are taxed as partnerships if they have more than one owner; single-member PEs are disregarded.[11]

If a taxpayer wants an entity to have a classification other than that provided by the default rules, the taxpayer must file IRS Form 8832, Entity Classification Election, with the appropriate IRS Service Center.[12] It is generally advisable to file Form 8832 for all foreign eligible entities to ensure the desired classification is obtained, because the liability limitations for owners under local law, which determine the default classification, may not be known with certainty. An entity that elects to change its classification generally is precluded from changing its classification again during the 60-month period following the effective date of the election.[13] An election must be signed by each owner of the entity at the time that the election is filed, or by any officer, manager or member who is authorized to make the election and who represents that he or she possesses such authorization under penalties of perjury.[14] The classification election is effective on the date specified on Form 8832.[15] The effective date cannot be more than 75 days prior to, or 12 months after, the date on which the election is filed.[16]

Transitional rules apply to entities in existence on January 1, 1997.[17] A foreign eligible entity can keep its prior classification if its classification was relevant to any person for United States federal tax purposes at any time during the 60-month period prior to January 1, 1997.[18] Foreign *per se* entities that were in existence on May 8, 1996 and that were taxable as partnerships may continue to be classified as partnerships, if: (1) the classification was relevant to any person for United States federal tax purposes on May 8, 1996; (2) no person for whom the entity's classification was relevant on May 8, 1996 treats the entity as a corporation for federal tax purposes for the tax year including May 8, 1996; (3) any change in the entity's classification within 60 months prior to May 8, 1996 occurred solely because of changes in the entity's organizational documents, and the entity and all owners recognized the federal tax consequences of any change in the entity's classification in such 60-month period; (5) the entity had a reasonable basis for claiming partnership classification on May 8, 1996; and (6) neither the entity nor any owner was notified in writing on or before May 8, 1996 that the entity's classification was under examination.[19]

The tax classification of a foreign entity as either a corporation or a PE applies for United States tax purposes and does not, of course, apply to classification of the entity under foreign law for purposes of any foreign income tax ("FIT"). United States taxpayers may thus own foreign entities that are taxed as PEs for United States tax purposes but as corporations for FIT purposes (hybrid entities), or foreign entities that are taxed as corporations for United States tax purposes and as PEs for purposes of FIT (reverse hybrid entities).

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International Tax Concepts

A number of provisions in the Internal Revenue Code affect tax planning with PEs for United States companies doing business in foreign countries. The general concepts of these laws are summarized below.

Deferral of U.S. Income Tax

Foreign corporations ("FCs") are not normally subject to United States income tax on their income, unless the income is from United States sources.[20] Income earned by FCs is taxed in the United States only if the FC has a United States shareholder, in which case the FC's earnings are taxed when the United States shareholder receives a dividend from the FC. A United States shareholder may thus be able to defer payment of United States income tax on the FC's earnings until the FC distributes dividends.

Several anti-deferral regimes, however, prevent United States taxpayers from obtaining this deferral benefit in certain circumstances. Because of these far-reaching anti-deferral rules, a key part of international tax planning involves avoiding these regimes, so that United States income taxation of foreign income is deferred. The most important of the anti-deferral regimes are the foreign personal holding company rules, the controlled foreign corporation ("CFC") rules and the passive foreign investment company rules, with the CFC rules generally being those most commonly applied.[21]

Under the CFC rules, if United States shareholders[22] own more than 50 percent of an FC by vote or by value, certain types of tainted income earned by the CFC, primarily consisting of "Subpart F" income, are taxed to the United States shareholders as deemed dividends at the time that the CFC earns the income. The main categories of tainted income are foreign personal holding company income ("FPHCI"), composed of passive income such as dividends, interest, rents or royalties; foreign base company sales income, involving sales or purchases of goods from a related party for use outside the CFC's country of incorporation; and foreign base company services income, for services provided for a related party outside of the CFC's country of incorporation.

A number of special rules apply to deemed dividends from the Subpart F income of CFCs. The ability to come within, or to avoid, as applicable, the scope of these rules are important tax planning techniques.

- **Same-Country Exception.** Dividends received by a CFC from a related corporation incorporated in the same country as the CFC, and a substantial part of the assets of which are used in its trade or business in such country, are not FPHCI.[23]
- **Full-Inclusion Rule.** If more than 70 percent of the gross income of a CFC is tainted income, all of the income of the CFC is taxable currently to the CFC's United States shareholders.[24]
- ***De Minimis* Rule.** If the tainted gross income is less than the lesser of five percent or $1 million of the CFC's total gross income, then none of the income of the CFC is considered to be tainted income.[25]
- **High-Tax Exception.** If a foreign country's effective income tax rate is greater than 90 percent of the maximum United States corporate tax rate, then the income is not Subpart F income.[26]
- **Earnings and Profit Limit.** Subpart F income cannot exceed the CFC's current-year earnings and profits.[27]

Direct Foreign Tax Credit

When the earnings of an FC are repatriated as dividends to a United States shareholder, the dividend may be subject to a foreign withholding tax. This tax is generally eligible for the foreign tax credit ("FTC"), which allows the United States owner to credit the FIT against the United States income tax on the income.[28] The FIT imposed on a United States entity operating directly in a foreign country through a branch, rather than through a separate FC, is also creditable by the United States person because it is a direct tax on the United States person.

The creditability of the FIT against the United States income tax is limited in such a way that the FIT may be credited only up to the amount of the United States income tax imposed on the income.[29] If the FIT is imposed at a rate higher than the United States income tax rate, a credit can be taken only up to the amount of tax imposed at United States rates. This limitation is expressed as a formula that determines the portion of United States tax applicable to foreign-source income and sets the maximum amount of the FTC that may be claimed by a United States taxpayer:[30]

(United States tax (pre-credit)) multiplied by (Foreign-source taxable income divided by Worldwide taxable income)

For purposes of simplicity in the discussion that follows, it is assumed that the United States corporate income tax rate is a flat 35 percent. In such a case, the FTC limitation will be the relevant foreign-source income times 35 percent, *e.g.*, for $100 of foreign-source income, the FTC limitation will be $100 times 35 percent, or $35. If the FIT exceeds the FTC limitation, then the excess can be carried back two years and forward five years.[31]

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The FTC limit is computed separately for each of ten specified "baskets" of income,[32] including baskets for passive income, high withholding tax interest, financial services income and shipping income. Dividends from each FC with a level of ownership by a C corporation between 10 percent and 50 percent ("10/50 corporations") also are in separate baskets for each such corporation. Note that the Taxpayer Relief Act of 1997 ("TRA 97")[33] removes this separate basket limitation for 10/50 corporations for tax years beginning after 2002. Distributions after 2002 from pre-2003 earnings will be placed in one basket for all 10/50 corporations. For the earnings of 10/50 corporations after 2002, the dividends will be placed in separate baskets based on the character of the income earned by the corporations under a look-through rule. This post-2002 treatment for 10/50 corporations is the same as that currently in effect for dividends from CFCs which are placed in baskets based on the earnings of the CFC even though dividends would otherwise be in the passive income basket.[34] Income that does not fall into any of the baskets goes into a "general limitation" basket.

The income within each basket is added together, and the FTC limitation formula is applied separately to each basket. This system allows foreign-source income with high effective tax rates to be blended with foreign-source income with low effective tax rates for income within the same basket. This blending can result in foreign-source income taxed at rates higher than the United States income tax rate to be creditable for FTC purposes if the income is combined with low-taxed income in the same basket.

Indirect Foreign Tax Credit

The FIT paid by an FC is not generally creditable by a United States owner because the FIT is not a tax imposed on the United States owner. If the United States shareholder is a C corporation that owns at least 10 percent of the voting stock of an FC, however, part of the FIT is deemed paid by the United States corporate shareholder when the corporation pays a dividend.[35] The United States C corporation can, therefore, get an indirect credit for the FIT paid by the FC, subject to the FTC limitations described above. (United States non-corporate investors can obtain an indirect credit only if they make an election under Code Sec. 962(a)(2) to be taxed as a corporation.) The computation of the deemed FIT is as follows:

(Post-1986 FIT) multiplied by (Dividend divided by Post-1986 undistributed earnings)

Deemed dividends under the CFC rules described above also can pull out deemed FIT of the FC to a C corporation shareholder,[36] as can deemed dividends arising when a United States shareholder sells stock in a CFC or receives a liquidating distribution from the CFC.[37]

Prior to TRA 97, the indirect credit could only be claimed for certain FCs through the third tier of ownership. Under current law, a United States corporate shareholder can claim the indirect credit for the FIT of FCs up to the sixth tier, provided that the United States shareholder owns at least five percent of the voting stock of the lower-tier corporation indirectly through a chain of FCs connected through stock ownership of at least 10 percent of their voting stock.[38] Corporations below the third tier must be CFCs in which the United States corporation claiming the credit is a United States shareholder.

Allocation of Expenses

Only the FIT paid on foreignsource income is eligible for the FTC. A United States entity must therefore allocate and apportion its expenses between income from United States and foreign sources in order to compute foreign-source income under the procedures prescribed in regulations.[39] One particularly important expense is interest expense, which generally must be apportioned based on the relative basis or value of assets generating the income, with certain exceptions.[40] Because of the operation of the FTC limitation formula, the greater the foreign-source income, the larger the potential FTC. For example, if a United States person has $100 of gross income from foreign sources, the FTC limitation will be $31.50 if only $10 of expenses are allocated to the income (35% times ($100 minus $10)). If, instead, $50 of expenses are allocated to the foreign-source income, the FTC limitation is only $17.50 (35% times ($100 minus $50)).

Transfers to Foreign Corporations

The excess of the fair market values and adjusted bases of assets transferred to FCs is generally subject to United States income tax at the time of the transfer in spite of the nonrecognition rules of Code Sec. 351.[41] Gains on transfers of assets that are used outside of the United States in an active trade or business are not subject to United States income tax, however, except for gains on certain types of assets, such as inventory and accounts receivable.[42] Before TRA 97, transfers of appreciated property to a foreign partnership generally resulted in a 35 percent excise tax on the built-in gain under Code Sec. 1491. TRA 97 repealed Code Sec. 1491 and gave the Treasury Department ("Treasury") the authority to deny nonrecognition under Code Sec. 721 for transfers to partnerships if the realized gain on the transfer would be

taxable to a non-United States person.[43] Treasury has the authority under Code Sec. 721(c) to issue regulations to tax transfers to foreign partnerships. No such regulations have been issued to date, and the rules of Code Sec. 704(c) that tax appreciated assets to a contributing partner upon their sale should adequately cover gain recognition without the need for an additional gain recognition event.

Planning Opportunities with PEs

The check-the-box regulations opened the door for many United States taxpayers operating in foreign countries to reduce their total taxes by using PEs. The following sets out some of the opportunities available.

Use of the FIT Paid by a Foreign Entity

As described above, the FIT paid by an FC is not creditable against United States income tax except to the extent that the FIT is deemed paid by a United States owner of an FC under the indirect credit provisions. For taxpayers not eligible for the indirect credit, such as individuals and limited liability companies, creditability for the FIT can be obtained by utilizing a PE to do business in a foreign country rather than an FC. In such a case, the FIT paid by the PE is considered paid directly by the United States owner, with the result that the FIT can be credited against United States income tax paid on the income. The advantages of using a PE to obtain an FTC for the FIT paid by a foreign entity, however, may be offset by the elimination of deferral of United States taxes because the income of the PE becomes taxable in the United States as it is earned. If the effective rate of the FIT imposed on a PE is less than the United States tax rate, it may be more advantageous to use an FC structure so that United States income tax deferral is achieved until the repatriation of the earnings.

Example. Assuming that the FIT rate is 20 percent and that the FC's income is not taxable currently to United States owners under the anti-deferral rules, using a PE instead of an FC will result in an immediate additional tax of 15 percent, the difference between the United States tax and the FIT rates. If, on the other hand, the effective rate of the FIT is equal to or greater than the United States tax rate, the FIT will generally be fully creditable against United States income tax with no additional United States tax incurred on the immediate inclusion of foreign-source income in the United States person's taxable income. Assuming that a foreign PE earns $100 of income, the United States owner will be subject to a United States income tax of $35 on these earnings. If the $100 of income is subject to a $50 FIT, and this is the only foreign-source income of the United States person, $35 of the FIT will be creditable, i.e., the entire United States income tax will be offset by the FIT through the FTC mechanism.

Flow-Through of Losses

If a United States taxpayer does business in a foreign country through an FC, losses of the FC will not flow through to the United States shareholder. However, if the foreign entity is a PE, losses will flow through to the owners and will be available to offset other income of the United States owner, including United States-source income.[44] There may be negative consequences from loss flowthroughs if foreign-source income is thereby reduced. Reduction of foreign-source income may result in a decrease in the FTC limitation, because the numerator of the formula will be reduced. For example, if a United States corporation has $100 of foreign source income and pays $35 of FIT on that income, the corporation will typically be able to fully utilize the FIT as an FTC. If , in addition, the corporation has a $100 foreign-source loss, the corporation will have no foreign-source income, and the $35 FIT will not be currently creditable.

Elimination of the 10/50 Basket

As described above, dividends received by United States corporate shareholders from each 10/50 corporation are currently placed in separate FTC limitation baskets for each 10/50 corporation. The effect of this restriction is that the income of each 10/50 corporation cannot be mixed with the income from other FCs for purposes of rate averaging. For instance, if the effective United States tax rate is less than the effective foreign tax rate on the income of an FC, then the United States shareholder will not be able to claim an FTC for the excess FIT paid. If, on the other hand, income and FIT of the 10/50 corporation could be grouped with other foreign-source income that has a low foreign tax rate, more of the FIT of the highly taxed FC may be creditable.

The 10/50 basket limitation can be avoided by using a PE. In such a case, the character of the income earned by the PE will determine the basket to which it is added, and rate averaging within each basket will be allowed. If a United States corporation owns several 10/50 entities that are treated as PEs, any deferral benefits will be lost because the income will be taxed to the United States owner as it is earned. In order to avoid losing the benefits of deferral, a wholly owned FC could be formed to be the owner of the 10/50 entities. The income of the 10/50 entities then would flow up to the FC, where any distribution from the

FC would be taxed under look-through rules for purposes of the FTC. This planning technique will cease to be of importance after 2002 because, as described above, TRA 97 changed the separate 10/50 basket limitation to a look-through rule for post-2002 earnings of 10/50 corporations.

Indirect Credit for Lower-Tier Subsidiaries

The indirect credit can only be claimed for subsidiaries meeting certain ownership requirements through the sixth tier of ownership. If these ownership requirements are not met, or if a tier beyond the sixth is needed, a foreign PE can be used to eliminate these restrictions. If the ownership requirements cannot be met at the first tier, the first-tier entity could be a PE, which would cause the United States shareholder of the entity to be treated as paying directly the FIT of the first-tier entity. If the ownership requirements cannot be met at a lower tier, *e.g.*, the first-tier CFC owns less than 10 percent of the second-tier entity, then the lower-tier entity could be a PE and be taxed with the first-tier entity.

Avoidance of Subpart F Income from Lower-Tier Subsidiaries

A CFC generally has FPHCI when it receives income from a foreign subsidiary corporation, *e.g.*, dividend, interest or royalty payments. This income is thus taxable to the United States shareholders of the CFC as Subpart F income. However, if the subsidiary is a single-member PE instead of an FC, the subsidiary's income will be considered earned by the CFC for United States tax purposes. Thus, distributions from the subsidiary will not be taxable as FPHCI to the CFC and will not otherwise subject the CFC's United States shareholders to United States income taxation.

Example. USCo is the sole owner of F1, a *per se* corporation. F1 is the sole owner of F2, which is not a *per se* entity. F2 makes royalty payments to F1 under a license agreement. If F2 is a corporation, and the same-country exception does not apply, the payments to F1 will be Subpart F income as FPHCI to F1 and thus taxable currently to USCo. If F2 is a PE, the royalty payments are disregarded as inter-company payments, and F1 has no Subpart F income. Even though the royalty payments by F2 are disregarded for United States tax purposes, the royalty payments generally will be deductible for purposes of computing F2's FIT, thus reducing F2's FIT.

Payments between subsidiaries of a CFC can also be disregarded if the subsidiaries are organized as PEs.

Example. F1, from the previous example, has two more wholly owned subsidiaries, F2 and F3. If F2 paid interest to F3 and F3 is a corporation, the income will be FPHCI to USCo because USCo is a United States shareholder under the indirect ownership rules.[45] If F2 and F3 are PEs, however, the interest payment will be disregarded, and there will be no Subpart F income inclusion to USCo. Again, as in the preceding example, the interest payment by F2 will likely reduce F2's FIT.

Although Subpart F income can be avoided by operating foreign businesses in PEs, as illustrated by the above two examples, care must be taken so as not to cause the use of a PE as a lower-tier subsidiary to actually create Subpart F income.

Example. USCo owns FC1, a *per se* corporation, which owns subsidiaries in various other countries that act as buy-sell distributors for products purchased from and manufactured by USCo in the country in which they are each incorporated. The subsidiaries do not generate Subpart F income as foreign base company sales income because they sell the products for use in their country of incorporation. If the subsidiaries are PEs, however, they will be disregarded, and FC1 will be treated as the selling entity. Income from USCo's products sold outside of FC1's country of incorporation will, therefore, be foreign base company sales income and taxable to USCo as Subpart F income.

Blending Income for Lower-Tier Subsidiaries

If the income of a lower-tier foreign subsidiary is subject to a higher effective tax rate than the income of a higher-tier subsidiary, PEs can be used for the lower-tier subsidiaries in such a way that their higher tax rates are blended with the lower rate of the higher-tier owner. This could result in FIT from high-tax-rate countries being creditable. Further, if one lower-tier subsidiary has losses, this loss could be used to offset the income of another subsidiary if the subsidiaries are PEs. If the subsidiaries are FCs, the losses of one subsidiary cannot offset the income from the other subsidiary. An offset of income with losses will reduce the earnings and profits of the upper-tier subsidiary, and thus the Subpart F income potential, because, as described above, Subpart F income is limited to earnings and profits. This consolidation of the income and losses of several entities may also cause the *de minimis* exception to apply, thus eliminating any Subpart F income inclusion.

It may also be possible to avoid the full-inclusion rule for a CFC holding company that has a number of foreign corporate subsidiaries from which it receives dividends. The dividends would generally be Subpart F income as FPHCI, unless the same-country exception applied. If the CFC has its own non-Subpart F income, the United

States shareholders of the CFC may be taxable on all of the CFC's income because of the full-inclusion rule. To avoid the application of this rule, the CFC could operate one or more of the subsidiaries with active businesses as PEs. The PEs' income would then be mixed with the CFC's dividend income from its other corporate subsidiaries such that the full-inclusion rule at the CFC holding company level would not apply. It may also be possible, through income blending, to cause the effective FIT rate to be raised to the point where the high-tax exception applies, making all of the earnings of the combined entities non-Subpart F income.

Allocation of Expenses

As described above, the expenses of a United States entity must be allocated and apportioned between United States and foreign-source income. For purposes of computing the maximum FTC, the less the expenses allocated to the foreign-source income, the greater the FTC limitation. The allocation of expenses can be affected by using FCs or PEs for the foreign entities.

Example. If a first-tier foreign entity has a significant debt, then it will have a large interest expense that will reduce only its income. If the foreign entity is a PE, part of this interest expense will reduce United States-source income based on the assets of the United States parent group, including the foreign PE. This allocation will generally result in foreign-source income being greater, and hence the FTC limitation, because part of the interest expense is allocated to United States-source income.

Transfers to Foreign Entities

Built-in appreciation in assets is generally subject to United States income tax upon the transfer of assets by a United States person to a FC. If the foreign entity is instead a PE, there is no United States income tax on the transfer. If the PE is a single-member entity, the transfer is disregarded; if the PE is a partnership, TRA 97 repealed the 35-percent excise tax of Code Sec. 1491, and no regulations that would tax such a transaction have been issued to date.

Attempts to Curb Abuse

As can be seen from the above, the check-the-box regulations made possible a number of tax savings opportunities through the ease of using PEs for foreign operations. The Treasury recognized this possibility when the check-the-box regulations were issued, stating in the preamble to the proposed regulations: "In the light of the increased flexibility under an elective regime for the creation of organizations classified as partnerships, Treasury Department and the IRS will continue to monitor carefully the uses of partnerships in the international context and will issue appropriate substantive guidance when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of United States tax treaties."[46] Since the issuance of the regulations and the increased use of PEs for foreign operations of United States taxpayers, Treasury and the IRS have made a number of attempts to limit the uses of PEs in the international context and thus curb certain planning opportunities.

Partnership Anti-Abuse Regulations

Even before the check-the-box regulations, the IRS was concerned about abusive uses of partnerships when it issued the partnership anti-abuse regulations in 1994. These regulations permit the IRS to recharacterize a transaction if a partnership is formed or availed of for a principal purpose of substantially reducing the present value of the partner's aggregate tax liability in a manner inconsistent with the intent of Subchapter K.[47] To avoid the reach of these regulations, the partnership must have a substantial business purpose, the substance of the transaction must be in accordance with its reporting form and the partnership's operations and transactions must reflect the partners' economic agreement.[48] If a transaction is inconsistent with Subchapter K, the IRS may disregard the partnership, treat partners as parties who are not partners, adjust the partnership's method of accounting, reallocate taxable items among the partners or treat a partnership as an aggregate of its partners.[49] The anti-abuse regulations contain examples that specifically authorize the use of partnerships in international tax planning, including using a partnership to avoid the 10/50 basket limitation.[50] The reach of these regulations in other international planning areas, however, is uncertain.

IRS Notices

Treasury issued two notices to address perceived abuses with check-the-box entities. Notice 98-5,[51] issued December 23, 1997, addresses transactions designed to generate FTCs in situations considered to be abusive. Less than one month following the release of this notice, Treasury announced its intention to issue regulations to eliminate certain hybrid branch arrangements that are inconsistent with Subpart F in Notice 98-11,[52] issued January 16, 1998. According to the latter Notice, Treasury and the IRS believe that taxpayers are using hybrid branches to get around the purposes of

Subpart F, the use of which was facilitated by the check-the-box regulations. Uses inconsistent with Subpart F include 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."[53] The Notice recognizes that United States international tax policy seeks to balance neutrality of taxation between domestic and foreign enterprises with the need to keep United States businesses competitive, but finds that hybrid transactions "upset that balance." Treasury and the IRS, therefore, decided that it was appropriate to prevent taxpayers from using hybrid branches to reduce the FIT while avoiding the creation of Subpart F income. The Notice gives two examples of the types of transactions that the IRS considers to be abusive.

The check-the-box regulations opened the door for many [US] taxpayers operating in foreign countries to reduce their total taxes by using [pass-through entities].

Example. CFC1 owns all of the stock of CFC2. CFC1 and CFC2 are both incorporated in Country A. CFC1 also has a branch, BR1, in Country B, a low-tax jurisdiction. Countries A and B all classify CFC1, CFC2 and BR1 as separate taxable entities. BR1 transfers cash to CFC2 that is treated as a loan in Countries A and B for computing the FIT, and CFC2, therefore, receives a deduction for the interest payments that it makes to BR1. If BR1 is a PE for United States tax purposes, the loan is considered as made between CFC1 and CFC2. There is, therefore, no Subpart F income under the "same country exception." If BR1 were considered to be a separate entity for United States tax purposes, the interest income would be Subpart F income. Under regulations to be issued, this non-Subpart F income will be recharacterized as Subpart F income.

Example. CFC3 is incorporated in Country A. CFC3 has a branch, BR2, in Country B. CFC3 and BR2 are treated in Country A and B as separate taxable entities. BR2 transfers cash to CFC3 that is considered to be a loan by both Country A and B. CFC3, which earns only non-subpart F income, pays interest to BR2, which CFC3 credits against its taxable income. Little or no tax is paid by BR2 on the interest income. If BR2 is disregarded, the loan and interest payments are ignored. If this transaction were between two CFCs, however, the interest income would be Subpart F income. For transactions meeting these requirements, the payor and payee would be treated as separate CFCs in future regulations when determining whether the income is Subpart F income.

Regulations

On March 23, 1998, Treasury issued temporary and proposed regulations under Code Sec. 954 to implement Notice 98-11.[54] The regulations were to apply to transactions in which: (1) a payor makes a deductible payment to a hybrid branch that reduces the payor's FIT; (2) a payee is taxed at a FIT rate of 90 percent or less of what the FIT rate is to the payor; and (3) the payment would have been FPHCI to the payee if the payee were a CFC. If these requirements are met, non-subpart F income is recharacterized as Subpart F income. The amount recharacterized is the gross amount of the hybrid branch payment up to the CFC's earnings and profits.

Post-Notice Actions

Treasury's authority to issue regulations under Notice 98-11 was immediately widely contested by United States multinationals, which challenged the legal authority of Treasury to issue the regulations. Substantial lobbying efforts with Congress by the multinationals quickly paid off. The Senate included a provision in the Senate version of the 1998 IRS reform bill[55] that imposed a moratorium on enforcement of the regulations under Notice 98-11. The Senate bill also included a Sense of the Senate that the regulations should be withdrawn and that Congress, and not Treasury or the IRS, should determine the policy issues for the treatment of hybrid transactions and Subpart F.

As a compromise, and to prevent Congress from passing legislation that would prohibit hybrid branch regulations, Treasury and the IRS adjusted their approach on June 19, 1998 with the issuance of Notice 98-35.[56] Notice 98-35 withdrew Notice 98-11 and its implementing temporary and proposed regulations. Notice 98-35 did not bring an end to the assault on hybrid branches, however, but merely deferred the attack. Notice 98-35 states that the temporary regulations issued under Notice 98-11 would be reissued as proposed regulations and would not be finalized before January 1, 2000. Furthermore, the regulations issued under Notice 98-35 would not apply to arrangements in place before June 19, 1998, unless the arrangements are substantially modified. If the arrangement is entered into on or after June 19, 1998, but before the regulations are finalized,

certain "qualifying hybrid branch payments" would not be subject to the regulations until five years from the date that the regulations are final. Senators Connie Mack (R-Florida) and John Breaux (D-Louisiana), still not satisfied with the approach in Notice 98-35, sponsored legislation, S. 572, on March 10, 1999, that would forbid Treasury from issuing hybrid branch regulations.

On July 9, 1999, Treasury and the IRS once again backed off from their aggressive hybrid branch position. This time they withdrew the temporary and proposed regulations on the use of hybrid entities to avoid Subpart F income and issued the new proposed regulations promised in Notice 98-35. The re-proposed regulations are essentially a restatement of the withdrawn March 1998 proposed regulations, except that the effective date is changed to tax years commencing five years after the regulations become final. The grandfather relief provisions of Notice 98-35 remain in effect, but the complicated transitional rules have been eliminated.

Treasury Study

While the debate regarding hybrid branches continues, Treasury is undertaking a major study of the taxation of United States income earned by foreign subsidiaries of United States corporations. A "white paper" is scheduled to be released in the near future. United States multinational corporations complain that the current United States tax rules on offshore investment are among the most complex and strict in the world, which puts the United States corporations at a significant tax disadvantage that makes them less competitive. Treasury believes that concerns with competitiveness must be balanced against concerns about "capital export neutrality," which requires that foreign subsidiaries of United States corporations be taxed at the same rates as United States corporations. Treasury will need to consider fundamental principles of international tax policy in its study. It will have to analyze the competitiveness versus capital export neutrality considerations and reach some sort of compromise between the two competing positions. It will also need to explain why reducing the FIT, the concern of Notice 98-11, is something with which the United States should even be concerned. Once the study is complete, the direction that the Treasury and the IRS will take for PEs used for the foreign operations of United States companies should be much clearer.

Until the policy paper is released, United States taxpayers still can benefit from many of the planning techniques discussed above. While payments involving hybrid branches are clearly suspect at this point, other planning possibilities are still available, such as: converting an FIT into a creditable tax; passing through losses; eliminating the 10/50 basket; blending tax rates; allocating expenses to maximize foreign-source income; and eliminating income tax upon the transfer of assets to a foreign entity. The check-the-box regulations have made these planning opportunities relatively simple to implement, and, until the use of PEs to operate foreign businesses is prohibited by United States law, will likely be a necessary consideration for every tax advisor assisting clients in planning foreign operations.

Wolters Kluwer

ENDNOTES

1 All references to Code Sec., unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended.
2 T.D. 8697, 1997-1 CB 215.
3 Former Reg. §301.7701-2(a).
4 Rev. Rul. 73-254, 1973-1 CB 613.
5 Reg. §301.7701-2(b)(8).
6 Reg. §301.7701-3(a).
7 Reg. §301.7701-3(b)(2).
8 Reg. §301.7701-3(b)(2).
9 Reg. §301.7701-3(b)(2)(ii).
10 *Id.*
11 Reg. §§301.7701-3(b)(2)(i)(A) and (C).
12 Reg. §301.7701-3(c)(1)(i).
13 Reg. §301.7701-3(c)(1)(iv).
14 Reg. §301.7701-3(c)(2)(i).
15 Reg. §301.7701-3(c)(1)(iii).
16 *Id.*
17 Reg. §§301.7701-2(e) and -3(b)(3).
18 Reg. §§301.7701-3(b)(3) and -3(d).
19 Reg. §301.7701-2(d)(1).
20 Code Secs. 881 and 882.
21 See Code Secs. 551-558, 951-964 and 1291-1298.
22 U.S. shareholders, for purposes of the CFC rules, are U.S. persons who own, or are considered to own, at least 10 percent or more of the voting power of all classes of voting stock. Code Sec. 951(b).
23 Code Sec. 954(c)(3).
24 Code Sec. 954(b)(3)(B).
25 Code Sec. 954(b)(3)(A).
26 Code Sec. 954(b)(4).
27 Code Sec. 952(c)(1)(A).
28 Code Sec. 901.
29 Code Sec. 904.
30 Code Sec. 904(a).
31 Code Sec. 904(c).
32 Code Sec. 904(d).
33 P.L. 105-34, 105th Cong., 1st Sess.
34 Code Sec. 904(d)(3)(D).
35 Code Sec. 902.
36 Code Secs. 902 and 960.
37 Code Secs. 1248 and 367(b).
38 Code Secs. 902(a) and (b).
39 See the allocation rules in Reg. §§1.861-8T through 1.861-14T.
40 Reg. §1.861-9T.
41 Code Sec. 367(a).
42 Code Sec. 367(a)(3).
43 Code Sec. 721(c).
44 The deductibility of foreign losses is subject to various Code provisions that limit deductibility, such as the dual consolidated loss rules of Code Sec. 1503(d) and the loss recapture rules of Code Secs. 904(f) and 367(a)(3)(C).
45 Code Sec. 958(a)(2).
46 61 Fed. Reg. 21989, 21990.
47 Reg. §1.701-2(b).
48 Reg. §1.701-2(a).
49 Reg. §§1.701-2(b) and -2(g).
50 Reg. §§1.701-2(d), Ex. (3), and –2(f), Ex. (3).
51 IRB 1998-3, 49.
52 IRB 1998-6, 18. Notice 98-11 also indicated Treasury's intention to issue regulations addressing the use of partnerships and trusts to avoid Subpart F.
53 *Id.*
54 T.D. 8767, IRB 1998-16,4.
55 H.R. 2676, §3713(a), 105th Cong. (1998).
56 IRB 1998-27, 35.

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