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Incremental International Tax Reform: A Review of Selected Proposals

David L. Cameron¹ and Philip F. Postlewaite²

I. INTRODUCTION

Business people, tax practitioners, and legal academics generally agree that the United States' international tax regime is broken. Criticisms abound that the system is overly complicated, disadvantageous to American businesses competing in a global economy, and frequently subject to manipulation and abuse. In the recent past, individuals and groups across the political spectrum have proposed numerous reforms to address these problems, some of which seek simply to modify current requirements while others jettison the current system in favor of dramatic alternatives.

The current United States international tax regime is frequently referred to as a "worldwide" tax system because United States taxpayers, including corporations formed in the United States, are subject to tax on their worldwide income.³ However, the income of a foreign subsidiary of a United States corporate parent is generally not taxable by the United States until the earnings are returned to the United States, typically through the payment of a dividend from the subsidiary to the parent.⁴ Thus, the incorporation of a foreign subsidiary to engage in foreign business activities allows the deferral of foreign income from United States tax. Nevertheless, certain types of income of a foreign subsidiary that fall within the definition of a Controlled Foreign Corporation may be taxable by the United States under Subpart F of the Internal Revenue Code.⁵ From this perspective, the

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³ PHILIP F. POSTLEWAITE & STEPHANIE R. HOFFER, INTERNATIONAL TAXATION §§ 1.01 and 1.02 (5th ed. forthcoming 2010) (manuscript on file with authors). Foreign taxes paid on foreign income are generally creditable against the income taxes imposed by the United States under I.R.C. § 901. See *infra* notes 87–102 and accompanying text.

⁴ *Id.* at § 1.02. Such foreign taxes paid on foreign income by the subsidiary are creditable against taxes imposed by the United States under § 902. See *infra* notes 103–116 and accompanying text.

⁵ *Id.* at ch. 7. Other so-called "anti-deferral" provisions may also be applicable to other types of income earned by a foreign corporation satisfying certain ownership requirements by United States persons, such as Passive Foreign investment Companies. *Id.* at ch. 9.

United States international tax regime is more accurately referred to as a hybrid between a pure worldwide system and a territorial or exemption system, under which income earned outside the United States would not be subject to tax currently by the United States.⁶

Two of the more ambitious proposals regarding international tax reform have centered on implementing changes that would significantly modify the current international tax regime. The first proposal would move the current regime closer to an exemption or territorial system and provide that foreign income, whether earned directly or through a foreign subsidiary, would not be subject to United States taxation. Both the 2005 President's Advisory Panel on Federal Tax Reform and the Treasury Department under the Bush Administration proposed reforms that would implement an exemption or territorial system.⁷ Proponents of a territorial or exemption system claim that such an approach is necessary in order to ensure that United States businesses are able to compete effectively with foreign businesses in foreign markets. Moreover, these proponents point to recent reforms adopted by the United Kingdom and Japan that move these countries closer to such a system.⁸ However, critics of an exemption or territorial system suggest that the benefits of deferral available under the current United States international tax regime allow United States businesses to avoid United States taxation of foreign income until the income is repatriated to the United States sometime in the future, if ever, thus undermining the asserted claims of exemption proponents.

The second proposal would move the current regime closer to a pure worldwide tax system, sometimes referred to as a "full inclusion" system,

⁶ Countries with territorial systems are also more accurately referred to as adopting hybrid systems because such systems typically do not exempt all earnings by foreign subsidiaries from home-country taxation in order to prevent tax avoidance, particularly earnings derived from mobile financial assets. PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 103 (2005) [hereinafter PRESIDENT'S ADVISORY PANEL].

⁷ PRESIDENT'S ADVISORY PANEL, *supra* note 6, at 102–05, 132–35; OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY 54–63 (2007) [hereinafter APPROACHES TO IMPROVE COMPETITIVENESS]. See also U.S. DEP'T OF THE TREASURY, TREASURY CONFERENCE ON BUSINESS TAXATION AND GLOBAL COMPETITIVENESS BACKGROUND PAPER (2007); STAFF OF THE JOINT COMM. ON TAXATION, 110TH CONG., ECONOMIC EFFICIENCY AND STRUCTURAL ANALYSIS OF ALTERNATIVE U.S. TAX POLICIES FOR FOREIGN DIRECT INVESTMENT 21–49 (Comm. Print 2008) [hereinafter, JOINT COMMITTEE, ECONOMIC EFFICIENCY AND STRUCTURAL ANALYSIS] (discussing the principal features and structural issues presented by a territorial system).

⁸ Although a worldwide tax system was once prevalent among developed countries, less than half of the members of the Organization for Economic Cooperation and Development (OECD) have such a system. APPROACHES TO IMPROVE COMPETITIVENESS, *supra* note 7, at 57; PRESIDENT'S ADVISORY PANEL, *supra* note 6, at 103. For a discussion of the British and Japanese reform proposals, see APPROACHES TO IMPROVE COMPETITIVENESS, *supra* note 7, at 46–49.

under which the foreign income of foreign subsidiaries would be attributed to the United States parent.⁹ Proponents of such a system maintain that exemption systems include their own set of incentives that distort investment decisions by taxpayers that are more problematic than those that exist under a properly designed full inclusion system.¹⁰ As examples of such inefficiencies, proponents of a full inclusion system point to incentives under an exemption system to create tax haven finance subsidiaries, engage in aggressive transfer pricing tactics, transform interest and royalty payments into exempt dividends, and invest in low-tax foreign countries rather than in their residence country or high-tax foreign countries despite superior pre-tax returns in the latter countries.¹¹ Proponents also point to a lack of empirical evidence that a territorial system is necessary to allow the United States multinationals to compete in a global economy.¹² Finally, proponents of full inclusion systems cite fairness considerations because, under a territorial system, residents who earn foreign-source income are allowed to avoid the tax burden borne by other residents who earn primarily domestic-source income.¹³

Proposals that dramatically shift the United States international tax system closer to a territorial system or to a full inclusion system are fraught with technical difficulties and uncertainties. In addition, such proposals strain an already polarized political system that must draft and consider such complex legislation. As is frequently stated with respect to such reform efforts, “the devil is in the details.” Certainly, the rancorous and divisive debate concerning health insurance reform over the past sixteen months indicates that major reform efforts in an area with explosive political potential must be undertaken under carefully controlled circumstances. To the extent that economic and policy justifications can

⁹ See Reuven S. Avi-Yonah, *The Logic of Subpart F: A Comparative Perspective*, 79 TAX NOTES 1775 (1998); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18 (1993); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999); Edward D. Kleinbard, *Throw Territorial Taxation from the Train*, 114 TAX NOTES 547 (2007). For a discussion of the principal features and structural issues presented by a full inclusion system, see JOINT COMMITTEE, ECONOMIC EFFICIENCY AND STRUCTURAL ANALYSIS, *supra* note 7, at 50–64.

¹⁰ J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Some Perspectives from the United States on the Worldwide Taxation vs. Territorial Taxation Debate*, 3 J. AUSTRALASIAN TAX TEACHERS ASS'N 35, 42–50 (2008). Because of existing flaws in the current United States international tax regime, Fleming, Peroni, and Shay admit that the current regime should be replaced with a well-designed territorial system. However, they stress that the appropriate debate is not between the current regime and a well-designed territorial system but between a well-designed full inclusion system and a well-designed territorial system. *Id.* at 38–40. In their view, a well-designed full inclusion system is preferable to a well-designed territorial system.

¹¹ *Id.* at 42–46.

¹² *Id.* at 46–49.

¹³ *Id.* at 59–67.

support an international tax regime that ranges from a full inclusion system to a territorial system, presumably political agreement across the ideological spectrum can be found to ensure that the current tax system does not burden foreign income more heavily than a full inclusion system or provide taxpayers with benefits that would not be available under a territorial system. Yet, a number of commentators have observed that elements of the current system result in exactly the latter situation: “the current U.S. international rules allow U.S. multinationals to achieve outcomes that are superior to exemption.”¹⁴

Perhaps a more appropriate, and realistic, approach in such a situation is simply to “muddle through” by proposing incremental, rather than fundamental, changes to the status quo that move in the direction of generally agreed upon policy objectives before tackling the more politically difficult issues associated with fundamental reform.¹⁵ In his first two budget proposals for the 2010 and 2011 fiscal years, President Obama appears to have adopted such an approach and has recommended several modest (although some might say timid¹⁶) reforms to the United States international tax regime.¹⁷ Three of those reform proposals are described

¹⁴ American Bar Association Section on Taxation, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 689 (2006) [hereinafter *ABA Task Force Report*]. See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L.J. 79 (2009); Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike)*, 59 SMU L. REV. 751 (2006). See also President’s Advisory Panel, *supra* note 6, at 104; STAFF OF THE JOINT COMM. ON TAXATION, 108TH CONG., *OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES* 189 (Comm. Print 2005) [hereinafter *JOINT COMM., OPTIONS TO IMPROVE*].

¹⁵ See Charles E. Lindblom, *The Science of “Muddling Through”*, 19 PUB. ADMIN. REV. 79 (1959); Charles E. Lindblom, *Still Muddling, Not Yet Through*, 39 PUB. ADMIN. REV. 517 (1979) (advocating evolutionary or gradual policy change).

¹⁶ Samuel C. Thompson, Jr., *Obama’s International Tax Proposal Is Too Timid*, 123 TAX NOTES 738 (2009).

¹⁷ DEP’T OF THE TREASURY, *GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2010 REVENUE PROPOSALS* 28–40 (2009) [hereinafter *FISCAL YEAR 2010 REVENUE PROPOSALS*]; DEP’T OF THE TREASURY, *GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2011 REVENUE PROPOSALS* 39–50 (2010) [hereinafter *FISCAL YEAR 2011 REVENUE PROPOSALS*]. See also STAFF OF THE JOINT COMM. ON TAXATION, 111TH CONG., *DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2010 BUDGET PROPOSAL—PART THREE: PROVISIONS RELATED TO THE TAXATION OF CROSS-BORDER INCOME AND INVESTMENT* (Comm. Print 2009) [hereinafter *JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS*]. The 2010 Revenue Proposals included the following: (1) reform the business entity classification rules; (2) defer the deduction of expenses, except R&E expenses, related to deferred income; (3) reform the foreign tax credit by determining the credit on a pooling basis and (4) preventing the splitting of foreign income and foreign taxes; (5) limit the shifting of income through intangible property transfers; (6) limit earnings stripping by expatriated entities; (7) prevent the repatriation of earnings in certain cross-border reorganizations; (8) repeal 80/20 company rules; (9) prevent the avoidance of dividend withholding taxes; and (10) modify the tax rules for dual capacity

below—the check-the-box rules, the foreign tax credit, and the rules regarding domestic and foreign source income and deductions. These proposals were selected, not because the proposals are uncontroversial and should be immediately enacted, but because they may serve as illustrations of incremental changes in the current United States international tax regime that are worthy of serious consideration by all sides in the on-going debate concerning international tax reform and, more importantly, as potential stepping stones in the discussion of international tax reform proposals and the development of a consensus regarding more comprehensive reform proposals.

taxpayers. See FISCAL YEAR 2010 REVENUE PROPOSAL at 28–40. The 2011 Revenue Proposals were the same as the 2010 Revenue Proposals except that items (1) and (6) were excluded, (2) was modified, and two additional items—the current taxation of excess returns associated with transfers of intangibles offshore and the disallowance of deductions for excess non-taxed reinsurance premiums paid to affiliates—were included. See FISCAL YEAR 2011 REVENUE PROPOSALS at 39–50.

The Obama Administration proposals generated considerable commentary. See, e.g., Reuven S. Avi-Yonah, *Obama's International Tax Plan a Major Step Forward*, 123 TAX NOTES 735 (2009); Robert H. Dilworth, *Proposed Multilateral FTC Pooling and U.S. Bilateral Tax Treaties*, 124 TAX NOTES 1227 (2009); Michael C. Durst, *The President's International Tax Proposals in Historic Perspective*, 123 TAX NOTES 1269 (2009); James P. Fuller, *U.S. Tax Review: Obama Administration's Tax Proposals*, 54 TAX NOTES INT'L 773 (2009); Erika Nijenhuis, *New York State Bar Association Submits Report on Various Obama Administration International Tax Proposals*, 2009 N.Y. ST. B.A. TAX SEC., available at LEXIS, 2009 TNT 232–75 [hereinafter Nijenhuis, *New York State Bar Association*]; James Reardon & Jon Ohrn, *The Practical Effects of the Obama International Tax Proposals*, 124 TAX NOTES 999 (2009); John M. Samuels, *American Tax Isolationism*, 123 TAX NOTES 1593 (2009); Lee A. Sheppard, *Defending the Obama International Proposals*, 123 TAX NOTES 1391 (2009); Lee A. Sheppard, *A Look at Obama's International Proposals*, 123 TAX NOTES 651 (2009); Robert B. Stack, Danielle E. Rolfes, Joshua T. Brady & John D. Bates, *Recent International Tax Proposals Raise Technical Issues*, 124 TAX NOTES 451 (2009); Martin A. Sullivan, *A Simple Overview of the Obama International Tax Proposals*, 123 TAX NOTES 1301 (2009); Martin A. Sullivan, *Obama Chooses a Clumsy Way to Limit Deferral*, 123 TAX NOTES 1163 (2009); Martin A. Sullivan, *Will Obama's International Proposals Kill U.S. Jobs?*, 123 TAX NOTES 1063 (2009); Martin A. Sullivan, *Obama Launches International Reform: The Battle Begins*, 123 TAX NOTES 646 (2009); Thompson, *supra* note 16; Mark A. Weinberger, *Six Observations on Obama's International Proposals*, 123 TAX NOTES 1599 (2009); Joann M. Weiner, *How Obama May Reform International Taxation*, 122 TAX NOTES 1552 (2009). See also Amy S. Elliott, *Obama's International Reforms Won't Create Jobs, Analysts Say*, 123 TAX NOTES 655 (2009); Chuck O'Toole, *Obama Scales Back Tax Agenda in Fiscal 2011 Budget*, 126 TAX NOTES 691 (2010); Chuck O'Toole, *Obama Presents International Tax Reform Proposals*, 123 TAX NOTES 643 (2009); Kristen A. Parillo & David D. Stewart, *Obama's Budget Drops Check-the-Box Repeal*, 126 TAX NOTES 708 (2010); Kristen A. Parillo, *Panelists Find Faults in Obama's International Tax Proposals*, 123 TAX NOTES 1387 (2009); Kristen A. Parillo, *Obama Plan Would Harm U.S. Multinationals, Olson Says*, 123 TAX NOTES 1088 (2009); Kristen Parillo, Randall Jackson, Charles Gnaedinger & Robert Goulder, *Treasury Details Obama's International Reform Proposals*, 123 TAX NOTES 792 (2009).

II. THE CHECK-THE-BOX RULES

The check-the-box Regulations were introduced in 1997 and constituted a radical departure from the prior classification criteria utilized to distinguish corporations from partnerships for United States income tax purposes. Since their introduction, the Regulations have become a part of the everyday fabric of international tax planning. In fact, some commentators have characterized the Regulations as “an unparalleled planning tool to minimize both foreign and U.S. tax on non-U.S. earnings.”¹⁸ As a consequence, it is unsurprising that the check-the-box Regulations, and entity classification more generally, have been a target of reform efforts in the international tax area.

Significant distinctions exist under the Internal Revenue Code between the tax treatment of a corporation and a partnership.¹⁹ With respect to the former, income is taxed at the entity level as earned and at the shareholder level when distributed. Additionally, losses incurred by the entity cannot be taken into account by its shareholders in order to offset other income. By way of contrast, the income of a partnership is taxed directly to its partners, and losses incurred by the entity are available to offset the partners’ other income.²⁰

A. Pre-Check-the-Box Classification Criteria for Enterprises

For tax purposes, whether an entity is classified as a partnership or as a corporation for tax purposes has been a difficult issue because of the vagueness of the sections of the Internal Revenue Code that define various entities.²¹ The Supreme Court in *Morrissey v. Commissioner*²² held that unincorporated organizations that “resemble” corporations could be associations taxable as corporations. The Court identified seven major corporate characteristics and stated that an organization resembled a corporation if it had more corporate than non-corporate characteristics. Six of the characteristics noted in *Morrissey* were embraced by the Regulations as the elements of the entity classification determination: associates; an objective to carry on business for profit; continuity of life; centralized management; limited liability; and free transferability of beneficial interest.²³

The Regulations (also known as the “Kintner Regulations,” based on a tax classification opinion in *Kintner v. United States*),²⁴ in effect from 1960

¹⁸ ABA Task Force Report, *supra* note 14, at 668.

¹⁹ See I.R.C. §§ 7701(a)(2), (3) (2006). See also I.R.C. §§ 1, 11 (2006).

²⁰ See generally ARTHUR B. WILLIS & PHILIP F. POSTLEWAITE, PARTNERSHIP TAXATION chs. 1, 3, 21 (7th ed. 2008).

²¹ See I.R.C. §§ 761(a), 7701(a) (2006).

²² 296 U.S. 344 (1935).

²³ Treas. Reg. § 301.7701-2(a)(1) (1960). See T.D. 6503, 25 Fed. Reg. 10,928 (1960).

²⁴ 216 F.2d 418 (9th Cir. 1954).

to 1996, employed these six characteristics for determining whether an organization more nearly resembled a corporation than a partnership (or trust) for classification purposes. The first two characteristics, associates and an objective to carry on business for profit, were ignored when determining whether an organization was classified as a partnership or as an association taxable as a corporation because they were common to both types of entities. The four remaining characteristics—continuity of life, centralized management, limited liability, and free transferability of interests—were used to determine an entity's tax classification.

According to those Regulations, an entity was classified as an association taxable as a corporation only if it possessed more corporate than non-corporate characteristics. Furthermore, although not specifically stated in the Regulations, each corporate characteristic was weighted equally. Thus, provided two of the four corporate characteristics were lacking, partnership status was assured. A general partnership formed under a statute conforming to the uniform partnership acts typically was classified as a partnership. At a minimum, it lacked limited liability and continuity of life. Although it might have centralized management and free transferability of interests, two of the characteristics were not enough for association status.

The limited liability company is an unincorporated business entity that basically is a cross between a closely-held corporation and a limited partnership. Limited liability company acts began to emerge in the United States during the late 1970s. The Internal Revenue Service wrestled for some time with whether a limited liability company should be classified for tax purposes by applying the characteristics of the Regulations or whether the fact of limited liability alone should require its classification as a corporation. Finally, it applied the Regulations and ruled that a multi-member limited liability company was to be taxed as a partnership.²⁵

B. Adoption of Elective Classification Regime—Check-the-Box Regulations

Given the partnership bias of the Regulations, it became virtually impossible for an unincorporated entity that wished to be taxed as a partnership not to be able to do so through proper drafting of the organizing and operating agreements. Furthermore, the proliferation of state laws providing for limited liability companies eliminated one of the reasons, limited liability, for an entity to incorporate. As a result, the Treasury Department and the Internal Revenue Service concluded that the rules of the Regulations had become formalistic and, in effect, permitted well-advised taxpayers to choose their taxable status by proper draftsmanship of the entity's governing agreements. A simpler, more flexible approach to the classification issue was sought.

²⁵ See generally WILLIS & POSTLEWAITE, *supra* note 20, at ch. 1.

In 1995, the Internal Revenue Service announced that it was considering allowing taxpayers to treat unincorporated entities as partnerships or corporations on an elective basis. Proposed Regulations were issued in 1996 to replace the corporate resemblance test of the prior Regulations. They were enthusiastically received as simplifying and liberalizing the entity classification rules and promptly were colloquially dubbed the check-the-box Regulations. The Treasury Department finalized the Regulations effective January 1, 1997.

C. Overview

The check-the-box Regulations completely replaced their prior counterparts.²⁶ They radically altered the classification criteria for tax treatment of an entity as a partnership or a corporation and introduced the concept of a disregarded entity.

The overall effect of the check-the-box Regulations is that an unincorporated entity recognized for federal tax purposes as an entity separate from its owners, engaged in business, and not a trust or a corporation is an eligible entity. An eligible entity with two or more members may elect to be classified and taxed either as a partnership or as an association taxable as a corporation. An eligible entity with only one member may elect to be classified as an association taxable as a corporation or to be a disregarded entity with its income taxed to its sole member, i.e., owner.²⁷

If the entity does not make an affirmative election as to its tax classification, it is determined under default provisions. The default provisions basically favor non-corporate classification for domestic entities. The default rules are different in the foreign context as they turn upon the concept of limited liability. If no member of the entity is liable under local law for the debts of the enterprise, an eligible entity which has not made an election defaults to corporate status. If liability for the debts of the enterprise exists for any member, the default classification status is a partnership if there are two or more members or a disregarded entity if there is only one.

D. Qualification

The Regulations provide a brief summary of the classification procedure and focus primarily on the method of determining whether an enterprise qualifies as an entity for classification purposes.²⁸ Thereafter, they provide the method of determining whether an entity is a business

²⁶ Treas. Reg. §§ 301.7701-1 to -3 (as amended in 1996).

²⁷ Treas. Reg. § 301.7701-3(a) (as amended in 1996).

²⁸ Treas. Reg. § 301.7701-1 (as amended in 2009).

entity.²⁹ They then identify a business entity that is an eligible entity and detail the choice of tax classification available to that entity.³⁰ Thus, three basic considerations are necessary to determine if an *unincorporated* enterprise is entitled to make the classification election: (1) whether the enterprise is considered to be an entity for federal income tax purposes; (2) if the enterprise is considered to be an entity, whether it is a business entity; and (3) if the enterprise is a business entity, whether it is an eligible entity.³¹

E. Entity

In order for an enterprise to be entitled to elect its classification for tax purposes, the check-the-box Regulations require that it must be considered an entity separate from its owners.³² The Code defines a “partnership” as including “a syndicate, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not . . . a corporation or a trust or estate.”³³ Whether an enterprise qualifies as an entity for purposes of the check-the-box Regulations is a matter of Federal income tax law.

The Regulations do not provide specific criteria for what constitutes an entity. They provide in general terms that “[a] joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.”³⁴ The operation of a trade or business or a financial operation or venture and a sharing of profits govern the existence of a separate entity.

The Regulations also provide that a joint undertaking merely to share expenses, such as two people jointly constructing a ditch to drain surface water from their property, does not create a separate entity.³⁵ Similarly, joint ownership of property that is kept in repair and rented does not constitute a separate entity. However, if the joint owners of property, e.g., an apartment building, in addition to renting space in the building also provide services to the tenants, a separate entity exists, because the providing of services constitutes the conduct of a business.

F. Business Entity

To be able to elect its classification for federal income tax purposes, an enterprise that qualifies as an entity also must qualify as a business entity,

²⁹ Treas. Reg. § 301.7701-2 (as amended in 2009).

³⁰ Treas. Reg. § 301.7701-3 (as amended in 2006).

³¹ Treas. Reg. §§ 301.7701-1(a), -2(a), -3(a) (as amended in 2006).

³² Treas. Reg. § 301.7701-1 (as amended in 2009).

³³ I.R.C. § 761(a) (2006). *See also* I.R.C. § 7701(a)(2) (2006).

³⁴ Treas. Reg. § 301.7701-1(a)(2) (as amended in 2009).

³⁵ *Id.*

which the Regulations define as “any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner . . .) that is not properly classified as a trust . . . or otherwise subject to special treatment under the Internal Revenue Code.”³⁶ The Regulations thus categorize all entities as either business entities or trusts. Whether an entity is classified as a trust, thereby preventing it from being a business entity, depends on the type of trust.³⁷ The Regulations refer to various types of trusts, only some of which are treated as trusts instead of business entities.

G. Eligible Entity

A business entity that qualifies as an eligible entity and has two or more members may elect to be classified for income tax purposes either as a partnership or as an association taxable as a corporation.³⁸ An eligible entity that has only one member may elect to be classified as an association taxable as a corporation or to be a disregarded entity with its income taxed to its owner.³⁹

An eligible entity is any business entity which is not identified in eight categories of the Regulations. An entity referenced therein is denied the ability to elect its classification for federal income tax purposes. Instead, it is classified as a *per se* corporation and taxed as such.

As the election is intended to be available to *unincorporated* entities, the Regulations enumerate those entities which possess, or are deemed to possess, characteristics identical to, or functionally equivalent to, those of incorporated entities. The most common types of *per se* corporations designated by the Regulations are business entities organized under a federal or state statute that are referred to as incorporated or as a corporation and certain designated business entities formed in one of approximately eighty listed foreign countries.⁴⁰ *Per se* corporations are classified as corporations for Federal income tax purposes and are thus ineligible to elect their tax classification.

In the international context, one of the more puzzling aspects of the check-the-box regime is the uncertain motivation and rationale for the *per se* status of various entities in different foreign countries. At a minimum, one would have thought that there would be a *per se* entity for each country in the world. However, with the world currently containing more than 150 countries, a list identifying only 80 countries is incomplete. As a

³⁶ Treas. Reg. § 301.7701-2(a) (as amended in 2009). An eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Treas. Reg. § 301.7701-3(a) (as amended in 2006).

³⁷ Treas. Reg. § 301.7701-4 (as amended in 1996).

³⁸ Treas. Reg. § 301.7701-3(a).

³⁹ *Id.*

⁴⁰ Treas. Reg. § 301.7701-2(b)(1), (8).

consequence, in those non-listed countries, any enterprise regardless of size, characteristic, similarity with the domestic concept of corporate existence, etc. may elect to check the box. This “entitlement by all” stands in stark contrast to domestic entities of the United States. Every incorporated enterprise in the United States, regardless of size or shape, is a *per se* corporation. As a consequence, if incorporated in the United States, the entity is precluded from eligible entity status and electing its tax classification under the check-the-box regime.

Even the listed *per se* business types for the eighty foreign countries fail to possess equivalent characteristics. For example, for most of South America, the *per se* entity that is precluded from the elective process is the “Sociedad Anónima.” This business form closely approximates that utilized by the United States since virtually any incorporated enterprise (public or private) is precluded from checking the box with regard to its classification for tax purposes. However, in the United Kingdom and other countries, e.g., Canada, the Netherlands, and Australia, the *per se* designation applies exclusively to publicly traded enterprises. Accordingly, a greater number of enterprises in those jurisdictions may check the box than would comparable enterprises in other parts of the world. Such inconsistent line drawing is difficult to defend.

H. Elective Classification

An eligible entity may elect its classification for Federal income tax purposes. If it has two or more members, it may elect to be classified either as an association, and thus taxed as a corporation, or as a partnership.⁴¹ If the eligible entity has only a single owner, it may elect to be classified either as an association, taxed as a corporation, or to be disregarded as an entity and have its income taxed to its owner.⁴² It is not necessary for the entity to affirmatively make a classification election. The classification process is greatly simplified by default classification provisions.⁴³

A domestic eligible entity that does not make an election automatically is classified as a partnership if it has two or more members. Such an entity that has a single owner is disregarded as an entity separate from its owner if it does not make an election.⁴⁴ In the foreign context, as discussed above, the default rules turn on whether all of the members of the entity possess limited liability for the debts of the enterprise.⁴⁵ If so, the default classification is corporate status. If any member possesses personal liability, the default classification is partnership or disregarded entity status depending upon the number of owners.

⁴¹ Treas. Reg. § 301.7701-3(a).

⁴² *Id.*

⁴³ Treas. Reg. § 301.7701-3(b).

⁴⁴ Treas. Reg. § 301.7701-3(b)(1).

⁴⁵ Treas. Reg. § 301.7701-3(b)(2).

I. Tax Consequences of an Election

A multi-member domestic entity entitled to elect under the check-the-box Regulations (C-T-B Regulations) will be treated by the United States for Federal income tax purposes as either a corporation or a partnership. If it elects corporate status, its income will be taxed to the entity as earned and at the shareholder level when distributed, while its losses will not flow through to its shareholders. If instead partnership status is elected (or if the entity fails to elect), the members will be subject to tax directly on the income generated and losses will flow through to the partners.⁴⁶

A single-member domestic entity entitled to elect under the check-the-box Regulations will be classified by the United States for income tax purposes as either a corporation or a disregarded entity. If it elects corporate status, its income will be taxed to the entity as earned and at the shareholder level when distributed, while its losses will not flow through to its shareholders. Alternatively, if disregarded entity status is elected (or if the entity fails to elect), "its activities are treated in the same manner as a sole proprietorship, branch or division of the owner."⁴⁷ The eligible entity, recognized as such under state law, disappears and becomes a "tax nothing." Accordingly, the income that it earns is taxed to its sole member.

Under the check-the-box Regulations, a single-member limited liability company constitutes an eligible entity. An eligible entity may elect its classification for Federal income tax purposes. Where the eligible entity has only a single owner, it may elect to be classified either as an association, taxed as a corporation, or to be disregarded as an entity. A disregarded entity is viewed as a division or a branch of its owner, and the income that it earns is taxed to its sole member.⁴⁸

If an eligible entity is classified as a disregarded entity, "its activities are treated in the same manner as a sole proprietorship, branch or division of the owner."⁴⁹ The eligible entity, while recognized as such under state law, disappears for Federal income tax purposes. The disregarded entity is not taxed on the income which it earned. Instead, the single-member owner is deemed to have earned the income, which is included with its other worldwide income.

If a single-owner limited liability company for United States federal income tax purposes elects to be treated as a disregarded entity, i.e., as a branch or a division of its owner, or fails to elect a classification, it will not be classified as a corporation. Accordingly, under United States federal income tax law, the income earned by the disregarded entity in a particular foreign country as well as that derived from the United States or other

⁴⁶ See, WILLIS & POSTLEWAITE, *supra* note 20, ch. 1.

⁴⁷ Treas. Reg. § 301.7701-2(a).

⁴⁸ Treas. Reg. § 301.7701-3(a).

⁴⁹ Treas. Reg. § 301.7701-2(a).

foreign countries would be reported by, and taxable to, its sole member/owner.

J. Hybrid Entities

Under the check-the-box regime, hybrid status, i.e., a classification as a transparent enterprise in one jurisdiction and a separate taxable entity in another at the same time, is easily accomplished. Under the prior classification regime, such simultaneous dual status was difficult, if not impossible, to achieve.

Hybrid entities give rise to numerous tax planning opportunities. By way of example, if an enterprise is treated as a foreign corporation for United States tax purposes but as a partnership by a foreign jurisdiction, the income derived by that entity will possibly not be taxed by the foreign jurisdiction, which considers the income to flow through to its members, while the income may not be taxed by the United States because it is derived by a foreign corporation.⁵⁰

There are four logical structures from the perspective of the United States which can arise—(1) a domestic regular hybrid entity (formed in the United States, treated as a transparent partnership by the United States and as an opaque separate entity by the foreign jurisdiction); (2) a foreign regular hybrid entity (formed outside the United States, treated as transparent by the United States and as an opaque separate entity by the foreign jurisdiction); (3) a domestic reverse hybrid entity (formed in the United States, treated as a separate entity by the United States but as transparent by the foreign jurisdiction); and (4) a foreign reverse hybrid entity (formed outside the United States, treated as a separate entity by the United States and as transparent by the foreign jurisdiction).

As discussed below, these structures have become the everyday work tools of international practitioners. The ability to take a single enterprise and yet treat it as transparent for the tax purposes of one jurisdiction and as a separate entity in another opens possible tax savings structures previously unimagined.

K. Tax Treaties

While hybrid entities permeate international tax structures, many of those structures emanate from countries with which the United States has tax treaties.⁵¹ The emergence of hybrid entities has also generated difficulties in the context of tax treaties. Of particular concern is the issue of residence. Since many treaties were entered before the check-the-box regime was adopted, an issue arises as to whether the entity, its members,

⁵⁰ See discussion *infra* accompanying notes 60–64 regarding other planning techniques available under the check-the-box regime.

⁵¹ See POSTLEWAITE & HOFFER, *supra* note 3, at chs. 12–14.

both the entity and the members, or neither the entity nor its members constitute a resident thereunder, a pre-condition to the utilization of the treaty and the receipt of the beneficial treatment provided therein.

Given the dates of entry of many treaties and the recent emergence of the concept, the Treasury, in order to address some of these issues, unilaterally promulgated the § 894 Regulations to address such settings.⁵² The general rule advanced by the Regulations is that an entity organized in a foreign country can only claim treaty benefits on the receipt of United States-source passive income if the entity is considered a “resident” of that country for tax purposes (i.e., the entity is *not* transparent).⁵³ If the entity is treated as transparent by that country, its members may claim treaty benefits if they are taxable on that income as “residents” of the foreign treaty partner.⁵⁴ The tax laws of the state in which the entities or members claiming treaty benefits reside are controlling, *not* the tax laws of the United States in which the income is sourced.⁵⁵

While the adoption of the Regulation eases the tension for inbound transactions (investment in the United States by foreign persons) involving passive income, interpretive difficulties continue for outbound activities (investment in foreign countries by United States persons). Few treaties address hybrid entities directly.

The partnership provisions of most older bilateral tax treaties, i.e., those predating the check-the-box regulations, are uncertain in their application. Given the dearth of hybrid structures when these treaties were entered, it is difficult, if not impossible, to intuit how the treaty drafters would have applied the partnership and corporate provisions of the treaty to the current, more advanced business structures. More modern treaties depart slightly from the older treaties with new textual language that appears to expand the scope of the provision beyond traditional partnerships, i.e., limited liability companies and the like. This expanded scope is more susceptible, albeit not explicit, in its possible application to hybrid structures. Some of the accompanying technical explanations to these treaties contain text and examples dealing explicitly with hybrid entities. Finally, given the omnipresence of hybrid structures, treaties in recent years are beginning to possess actual text that clearly addresses the tax issues arising in the hybrid context.

United States tax treaties can be grouped into three main categories with regard to their application to hybrid entities. All embrace the traditional rule that the tax laws of the country of residence are controlling in the determination of qualification for treaty benefits. These three categories are illustrated by the United States tax treaties with India

⁵² Treas. Reg. § 1.894-1(d) (as amended in 2002).

⁵³ Treas. Reg. § 1.894-1(d)(1) (as amended in 2002).

⁵⁴ *Id.*

⁵⁵ Treas. Reg. § 1.894-1(d)(3)(ii) and (iii) (as amended in 2002).

("partnerships"), the United Kingdom ("person that is fiscally transparent"), and Japan ("without regard to whether the income is treated as the income of such . . . members . . . under the tax laws of the first mentioned Contracting State"), respectively.⁵⁶

The United States-India treaty illustrates the traditional partnership language, found mainly in older treaties.⁵⁷ The more modern approach, typified by the United States-United Kingdom treaty, adheres to the principles of the traditional approach, but the wording of the text is more broadly focused through the use of the term "transparent entities," which should include limited liability companies, etc.⁵⁸ The recent United States-Japan tax treaty contains a detailed provision addressing specifically hybrid entities.⁵⁹ Therein, precise rules are prescribed for the determination of when and to whom an income item is eligible for treaty benefits when the transaction involves hybrid structures.

Despite the different wording of these three different treaty approaches to the issue, they share the same underlying premise that either the entity or its members must be taxable residents of a treaty country in order to claim treaty benefits. While the differing versions should likely be interpreted consistently when applied to varying hybrid entity scenarios, the lack of specificity in older treaties produces less than perfect certainty. As a consequence, if the check-the-box regime continues, treaties will need to be renegotiated with the addition of specific provisions addressing the difficulties of hybrid entities.

L. Examples of Tax Planning Through the Check-the-Box Regime

Hybrid entity structures give rise to significant tax planning flexibility, particularly with regard to the deferral of income and the utilization of foreign tax credits, which appears to produce unintended results.⁶⁰ Regular hybrid enterprises (transparent for purposes of the tax law of the United States, but treated as a separate entity for foreign tax purposes) and reverse hybrids (separate entity for United States purposes but transparent for foreign) now populate the terrain. The check-the-box regulations have expanded the number of settings where this issue comes into play, because "the regime has tended to multiply the situations in which there is a

⁵⁶ Philip F. Postlewaite, Stephanie R. Hoffer & Matthew Kemp, *The Adaptation of U.S. Tax Treaties to Changing Business Forms—A Case Study of Hybrid Entities*, INT'L TAX J., Sept. 2009, at 33.

⁵⁷ Tax Convention, U.S.-India, art. 4, Sept. 12, 1989, S. TREATY DOC. NO. 101-5 (1991).

⁵⁸ Tax Convention, U.S.-U.K., art. 4, Jul. 24, 2001, S. TREATY DOC. NO. 107-19 (2003).

⁵⁹ Tax Convention, U.S.-Japan Tax Treaty, art. 4, Nov. 6, 2003, S. TREATY DOC. NO. 108-14 (2004).

⁶⁰ See generally Mary C. Bennett, *Whose Tax Is It Anyway? Foreign Tax Credits in a Check-the Box World*, TAXES: THE TAX MAGAZINE, Mar. 2005, at 35; Philip F. Postlewaite, *The Check the Box Regulations Turn Ten—Will We Survive Their Teenage Years?*, 6 J. OF TAX'N. OF GLOBAL TRAN. 35 (2006).

mismatch between United States and foreign concepts of whose income is being subjected to the foreign tax.”⁶¹

M. Check-The-Box Election for Maximizing Available Credits

Taxpayers typically have either excess credits or an excess limitation. Rare is the case where a taxpayer’s maximum foreign tax credit is identical to the amount of the foreign income taxes imposed. Thus, in both settings, planning opportunities are presented. Those taxpayers with an excess limitation might consider releasing foreign tax credits for use on their United States tax return. Taxpayers in an excess credit position might consider releasing low-taxed foreign source income.

Such timing efforts can be facilitated through the use of separate subsidiaries and the availability of the check-the-box election.⁶² If a domestic parent has a number of subsidiaries, it can release the high-taxed or low-taxed results as needed through the use of such an election. The release of income from a high-taxed jurisdiction will not generate residual tax to the United States since the inclusion of that income, while taxable, will be at a rate lower than the rate at which the foreign tax was imposed. Similarly, release of income from a low-taxed jurisdiction may generate additional domestic tax but, if excess credits are already available, the effect of the inclusion will be minimized.

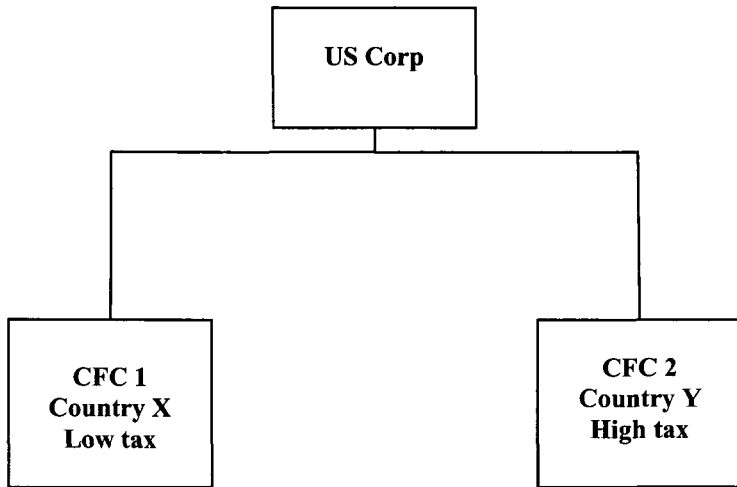
If a subsidiary is available with the desired profile based on the domestic parent’s overall tax situation, an election under the check-the-box regulations to make it a disregarded entity could result in the flooding of the pre-election credit position with the desired tax attributes of the converted subsidiary. As illustrated in Diagram 1, various structures might permit such opportunities.

⁶¹ See Bennett, *supra* note 60, at 35.

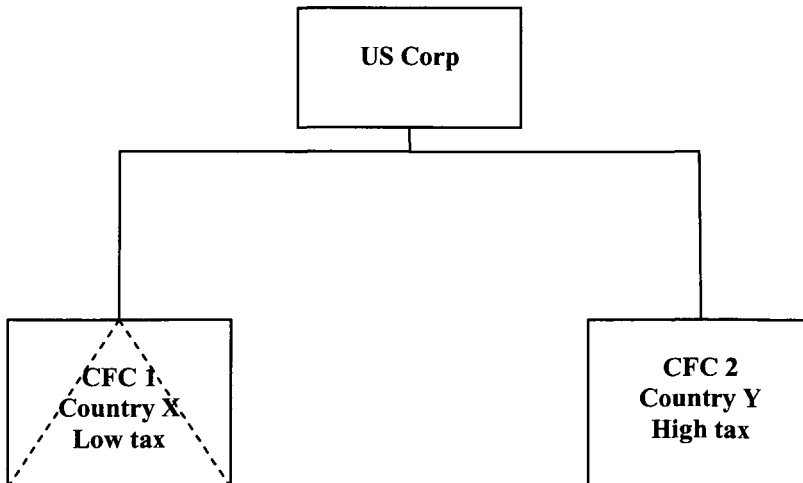
⁶² Because both subsidiaries are wholly-owned by a United States person, each will be classified as a Controlled Foreign Corporation (“CFC”). Under §§ 951–964, some or all of the earnings of the foreign subsidiaries may be imputed to its United States shareholders if derived from specified types of income deemed by Congress to be abusive. As with all international structuring, designs to maximize the availability of the foreign tax credit may collide with particular features of the CFC safeguard provisions. See POSTLEWAITE & HOFFER, *supra* note 3, at chs. 6, 7.

Diagram 1

Before



After



Such time-release blending of results creates tax planning opportunities. For example, assuming a business structure involving

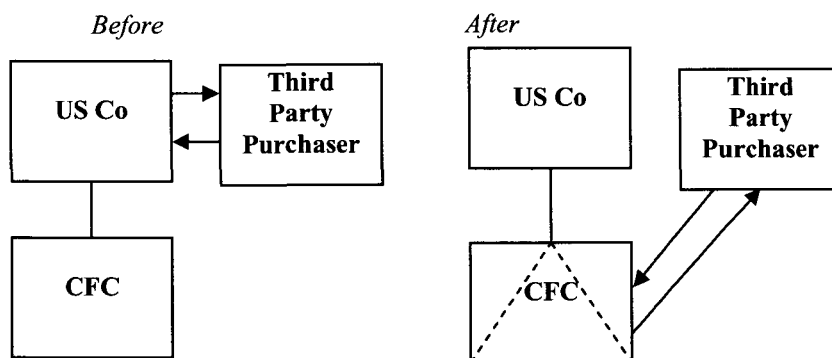
affiliated companies, all of which are CFCs, one based in a high-tax country and the other based in a low-tax jurisdiction, tinkering may prove advantageous for maximizing the availability of foreign tax credits. By having separate enterprises with different taxing climates and earnings profiles, the United States parent corporation, through the judicious use of the check-the-box election, can instantly mix the results of either of its CFCs with its own. Thus, in the excess credit setting, it may elect to treat the low taxed affiliate as a disregarded entity. Should an excess limitation exist, the election might be employed for the high tax enterprise.

N. Check-and-Sell

The check-and-sell technique has produced significant benefits in the Subpart F area by permitting the avoidance of current imputation of the sales proceeds to the United States shareholders. As a general proposition in the international arena, deferral of the payment of tax to the United States is a most desirable goal. Similarly, such a technique may afford benefits for purposes of effective tax planning regarding the foreign tax credit.⁶³

As illustrated in Diagram 2, the technique involves a pre-sale election on behalf of the foreign subsidiary to convert its tax status from that of a corporation to that of a disregarded entity.

Diagram 2



The technique may produce benefits, because it may avoid the passive basket limitation. A sale of stock will often trigger passive income and a minimal amount of foreign tax due to treaty or statutory treatment of the income from the sale of capital assets. While a taxpayer is enthusiastic

⁶³ See POSTLEWAITE & HOFFER, *supra* note 3, at ch. 6; *Dover v. Commissioner*, 122 T.C. 234 (2004).

about blending low-taxed income with high-taxed income, the existence of the basket regime minimizes the taxpayer's ability to do so in many cases.

However, if the check-the-box election is employed pre-sale, the sale is conceptualized as a sale of business assets. An important requirement for characterizing the sale as an asset sale is that the assets are those of the *parent* company. In certain situations, the Regulations explicitly treat the business assets of a subsidiary as those of the parent corporation.⁶⁴

O. Proposals for Reform

A high level Treasury official once compared the check-the-box Regulations to the war in Iraq: "It was the right thing to do, the concept was correct, the timing was right, but the process was flawed and we didn't give enough thought as to the follow-up."⁶⁵ Even with this recognition, the Treasury official recommended that the excesses of the check-the-box Regulations be revisited but thought any cure to its defects should be piecemeal at best: "I see the resolution as limiting its application in 'inappropriate' cases, enabling the benefits of the current rules to flow as I and many of us intended . . ."⁶⁶

As illustrated above, the latitude afforded international tax transactions through the use of the check-the-box regime has been extraordinary. The commentary surrounding the beneficence bestowed by the Regulations on the international tax planner has been characterized in the extreme, ranging from the all-time Christmas gift to "an unparalleled planning tool to minimize both foreign and U.S. tax on non-U.S. earnings."⁶⁷ What previously could not be accomplished with a particular structure that lacked the flexibility of the current regime is now within the realm of the possible by simply revisiting the proposed structure and employing various aspects of the check-the-box regime.

As noted by the ABA Task Force: "[t]he ability to employ inconsistently classified entities in foreign structures to achieve planning objectives" combined with "the relatively 'frictionless' ability to change a foreign entity's form for U.S. tax purposes" has created near boundless opportunities.⁶⁸ These changes have put "pressure on the structural infirmities of other tax rules."⁶⁹ The innumerable planning opportunities

⁶⁴ Treas. Reg. § 1.954-2(e)(3).

⁶⁵ Lowell D. Yoder, *International Taxation: Re-Thinking Check-the-Box*, TAXES: THE MAGAZINE, Mar. 2005, at 27, 28 (quoting Joe Guttentag).

⁶⁶ *Id.*

⁶⁷ ABA Task Force Report, *supra* note 14, at 668.

⁶⁸ *Id.*

⁶⁹ *Id.*

facilitated by the regime produces benefits previously unimagined: “[d]eferral, cross-crediting of foreign tax credits, overly favorable source rules, and other second-best structural features of the U.S. international rules” have been pushed beyond their intended limits when combined with the elective classification regime.⁷⁰

As a consequence, because of the extraordinary impact ushered in by the new approach, an increasing number of commentators and critics have called for reform. Some have suggested that the Regulations were invalid when issued. While various circuit courts of appeal have upheld them, none has addressed directly the mutually exclusive nature of the statutory language. Others have proposed improvements, and some have called for outright withdrawal of the Regulations in the international context.

P. Invalidation of the Check-the-Box Regime

While uncertainty persists as to what the determinative criteria is and/or should be through which to differentiate partnerships from corporations, it has been suggested that one thing is certain: Two enterprises identical in every respect must be classified similarly.⁷¹ Congress clearly did not intend that identical enterprises could be classified differently. However, under the check-the-box regime, identical unincorporated enterprises can be treated differently for tax purposes. Invalidation of the Regulation would eliminate much of the current chaos found in the international arena.⁷²

Two circuit courts of appeal have upheld the Regulations, but in contexts in which the taxpayers were attempting to avoid liability for their acts.⁷³ The difficulty in challenging the regime is one of standing, since those reformers eager to challenge the legitimacy of the Regulations lack the jurisdictional prerequisite to do so.

Q. Limitation of the Check-the-Box Regime to Domestic Entities

Another proposal has been the elimination of the election for foreign enterprises and the elevation of the default rule for such enterprises

⁷⁰ *Id.*

⁷¹ Philip F. Postlewaite & John S. Pennell, *The Partnership Tax Proposals of the Joint Committee on Taxation—“Houston, We Have a Problem,”* 76 TAX NOTES 527 (1997).

⁷² See generally, WILLIS & POSTLEWAITE, *supra* note 20, at ch 1.

⁷³ See *Littriello v. United States*, 484 F.3d 372 (6th Cir. 2007) (concluding that § 7701 was ambiguous and that the Supreme Court’s decision in *Morrissey v. Commissioner*, 296 U.S. 344 (1935), did not preclude the promulgation of reasonable Regulations); *McNamee v. Dep’t of Treasury*, 488 F.3d 100 (2d Cir. 2007) (concluding that the Treasury’s regulatory efforts in promulgating the check-the-box Regulations were “a permissible construction of the statute”).

to govern their classification.⁷⁴ The historic hallmark of corporate status has been limited liability by owners for the debts of the enterprise. Substituting such an approach would give a consistent classification standard and a change in status would require a real world, substantive event (the acquisition or loss of personal liability) leading to potential tax consequences or the expansion of the owner(s)' personal liability for debts of the enterprise with potential real world consequences.

R. Joint Committee Proposal

Under the proposal of the Joint Committee on Taxation, disregarded entity status would no longer be available.⁷⁵ Any single-owner, foreign business enterprise would be classified as a foreign corporation.⁷⁶ While such a proposal would limit some of the planning techniques discussed above, it appears to leave untouched entities with multiple owners. Particularly in light of the rampant use of special allocations in the international arena, one would imagine that many of the planning structures which employ a single-owner enterprise would work themselves into a partnership context in which the other partner would have little more than a de minimis interest.

S. Task Force of the ABA Tax Section

The Task Force of the American Bar Association's Tax Section appears to both embrace the Joint Committee Proposal as well as offer an alternative. Under its alternative, the Task Force would require that foreign entities which are subject to a comprehensive entity level tax by a foreign jurisdiction be classified as a corporation for tax purposes.⁷⁷ For those foreign entities not subject to a comprehensive entity level tax, partnership or disregarded entity status would be mandated depending upon the number of owners. As noted by its report, "this alternative would align the U.S. entity classification more closely with the treatment of the entity for foreign tax purposes," which would reduce "the availability of deferral to circumstances where an entity-level tax is imposed."⁷⁸

T. The Obama Administration

The most recent entry into the sweepstakes for altering the current check-the-box regime is that of the Obama Administration. As part of the

⁷⁴ See WILLIS & POSTLEWAITE, *supra* note 20, at ch. 1; Postlewaite, *supra* note 60, at 51–52.

⁷⁵ JOINT COMM., *OPTIONS TO IMPROVE*, *supra* note 14, at 183.

⁷⁶ *Id.*

⁷⁷ *ABA Task Force Report*, *supra* note 14, at 669.

⁷⁸ *Id.* at 670.

revenue proposals for the 2010 fiscal year, it proposed modifying the check-the-box rules with regard to their use in international transactions.⁷⁹ Under the proposal, disregarded entity status would generally not be available. Instead, such an entity would be classified as a corporation for tax purposes, albeit with two exceptions. First, an entity may elect to be classified as disregarded if the entity is created or organized in the same foreign country as its owner.⁸⁰ Second, first-tier foreign eligible entities would also be able to elect disregarded entity status subject to a tax avoidance motivation.⁸¹

In reviewing the Obama Administration's proposal, the staff of the Joint Committee on Taxation expressed several concerns.⁸² The first concerned its effectiveness, particularly with respect to the two exceptions: "Without additional guidance, these exceptions may permit taxpayers to engage in tax planning that could significantly undermine the intent of the proposal."⁸³ Additionally, the staff observed that, because of the proposal's inapplicability to domestic enterprises and the differing standards for the determination of residency, such entities could be employed to produce the same results.⁸⁴ Finally, the staff expressed concern that the use of a "nominal second owner" could circumvent the application of the safeguard legislation.⁸⁵

Significantly, the staff strongly suggested that the Administration's proposal did not go far enough. It noted that "[w]hile the proposal would address a variety of planning techniques that facilitate the avoidance of subpart F, it would leave untouched a significant range of other tax minimization strategies that also make use of inconsistent U.S. and foreign classifications. The proposal thus presents an opportunity to consider more generally the circumstances in which any inconsistency between the U.S. and foreign classifications of a business entity should be tolerated."⁸⁶

⁷⁹ FISCAL YEAR 2010 REVENUE PROPOSALS, *supra* note 17, at 28. The Obama administration did not retain the proposal in its revenue proposals for the 2011 fiscal year.

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 110–15.

⁸³ *Id.* at 112.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.* at 114.

III. THE FOREIGN TAX CREDIT

A. Overview of the Foreign Tax Credit

United States individuals and corporations are taxable on their worldwide income.⁸⁷ As a result, such taxpayers are subject to potential taxation in two places: the jurisdiction from which they derive their income (the country of source) and the jurisdiction in which they are organized or resident (the country of residence). Thus, a United States individual or corporation earning \$500 in State X may be taxed by both State X (assuming a twenty-five percent rate yielding a \$125 tax) and the United States (assuming a thirty-five percent rate yielding a \$175 tax). Without relief in one or both of the jurisdictions, the tax bill on \$500 of income would be \$300, imposing upon the taxpayer an effective tax rate of sixty percent.

This duplication of tax could have a particularly deleterious effect on international trade and investment. To prevent double taxation of foreign source income, the United States has adopted a foreign tax credit by which it extends a dollar-for-dollar credit against the taxes that it would otherwise levy against foreign income for any foreign taxes that are paid.⁸⁸ Through the use of such a credit, the United States as the country of residence defers to the taxing jurisdiction of the country of source. Thus, in the above example, a foreign tax credit for the corporation's State X tax payments would eliminate the United States tax and yield an overall tax rate of forty percent on the income derived in State X. The credit is available to domestic individuals (residents and citizens) and corporations, as well as non-resident individuals and foreign corporations deriving income effectively connected with the conduct of a United States trade or business.⁸⁹

⁸⁷ POSTLEWAITE & HOFFER, *supra* note 3, at §§ 1.01 and 1.02.

⁸⁸ I.R.C. § 901(b)(1) (2006) (allowing a credit against United States taxes by a United States citizen and a domestic corporation for foreign and possession "income, war profits, and excess profits taxes"). Alternatively, a deduction for such taxes is available under § 164(a)(3). A taxpayer must select *either* the credit or the deduction. In most cases, the § 901 credit is more advantageous than the deduction because a credit reduces tax on a dollar-for-dollar basis, while a deduction merely reduces the amount of income upon which the tax will be levied. The credit may also be favored because § 265(a)(1) denies a deduction for expenses (including foreign taxes) allocable to income exempt from United States tax, while the § 901 credit may be taken even though the foreign tax in question is attributable to such income. For purposes of the foreign tax credit, a foreign levy is considered a creditable tax if it is a compulsory payment under the authority of that country to levy taxes and it is not compensation for a specific economic benefit provided by the foreign country. Treas. Reg. § 1.901-2(a)(2)(i) (2008). See generally POSTLEWAITE & HOFFER, *supra* note 3, at §§ 6.02 and 6.06.

⁸⁹ I.R.C. §§ 901(a), 906(a) (2006).

B. The Foreign Tax Credit Limitation

In order to preserve its ability to tax United States source income in full, the foreign tax credit is limited. In the absence of such a limitation, the taxes paid on foreign source income would be credited against the taxes imposed by the United States on income derived in the United States. For example, if a fifty percent tax rate were applicable to a United States individual or corporation earning \$500 in State Y, the foreign taxes paid would be \$250. If that same taxpayer derives an additional \$500 of income in the United States yielding a tax of \$350 (assuming a thirty-five percent tax rate) on its world-wide income, the taxpayer would pay tax of only \$100 in the United States if the credit is not limited. This results in an effective tax rate on United States source income of twenty percent rather than the thirty-five percent statutory rate.

To avoid this result, § 904 limits the amount of the foreign tax credit to an amount determined under the following formula:⁹⁰

$$\begin{array}{ccccc} \text{Maximum} & & \text{Foreign} & & \\ \text{foreign} & & \text{taxable income} & & \\ \text{tax credit} & = & \frac{\text{Worldwide}}{\text{taxable income}} & \times & \text{United States tax} \\ & & & & \text{on worldwide} \\ & & & & \text{income} \end{array}$$

This formula limits the foreign tax credit to the tax imposed on the foreign source income by the United States at a tax rate equal to that imposed by the United States on the taxpayer's worldwide income. In this manner, the United States is able to protect its claim to tax the domestic source income of its own taxpayers. Adopting the facts of the prior example, the maximum foreign tax credit is limited to \$175 (\$500/\$1,000 x \$350). The taxpayer would pay United States tax of \$175 (\$350 - \$175) resulting in an effective tax rate on United States source income of thirty-five percent (\$175/\$500), which is the statutory rate. The total tax imposed by both State Y and the United States would be \$425 (\$250 + \$175). The tax attributable to the higher foreign tax rate is effectively viewed as a non-creditable cost of investing or conducting business in that country.⁹¹ In

⁹⁰ I.R.C. § 904(a) (2006).

⁹¹ This effect may be ameliorated somewhat through the carryback and carryover provisions for the foreign tax credit under § 904(c). The amount of foreign taxes paid or accrued in a taxable year may exceed the foreign tax credit limitation determined under § 904(a). This scenario results in the taxpayer having excess unused foreign tax credits. Treas. Reg. § 1.904-2(b)(2)(ii) (2009). On the other hand, the § 904(a) limitation in a given year may exceed the amount of foreign taxes paid, thus resulting in an "excess limitation." Treas. Reg. § 1.904-2(c)(2)(ii). Section 904(c) provides for a carryback and carryover of taxes from taxable years in which the taxpayer incurs excess foreign taxes to years in which

essence, the statutory approach does not permit any portion of the domestic tax payment attributable to United States source income to be offset by foreign taxes. From a policy standpoint, this is sensible because United States source income does not fall within the category of income that is subject to double taxation.

In addition to an overall limitation on the foreign tax credit, limitations must be applied separately to certain types of income, often referred to as income “baskets.”⁹² Broadly speaking, the purpose of the separate basket-limitation system is to restrict a taxpayer’s ability to average low-tax foreign source income from one jurisdiction with high-tax business income from another in an effort to utilize “excess” foreign tax credits.

Assume, for example, that C, a domestic corporation, derives foreign business income in State X taxed at a forty percent rate. C’s total taxable income for the year is 100,000 of which \$25,000 is attributable to the foreign activity. The remaining \$75,000 is attributable to business activity in the United States. C pays \$10,000 in foreign tax. C’s United States tax computed without regard to the foreign tax credit is \$35,000. The overall foreign tax credit limitation would be:

$$\begin{array}{rcl} \text{Maximum} & & \$25,000 \text{ foreign} \\ \text{foreign} & & \text{taxable income} \\ \text{tax credit} & = & \frac{\text{ } }{\text{\$100,000 worldwide}} \times \text{\$35,000 United} \\ & & \text{taxable income} \qquad \text{States tax on} \\ & & \qquad \qquad \qquad \text{worldwide income} \end{array}$$

Thus, C may claim a foreign tax credit of only \$8,750, even though it paid \$10,000 in foreign taxes. However, if \$5,000 of C’s \$100,000 taxable income consists of interest income from State Y that is exempt from tax in that country, the overall foreign tax credit limitation would be increased to \$10,500 (\$35,000 times \$30,000/\$100,000), resulting in the full \$10,000 of the foreign taxes paid in State X being creditable through the generation of the low-taxed foreign source interest income in State Y.

The ability to credit the United States tax on low-taxed foreign income with excess foreign taxes paid on high-taxed foreign income is

the taxpayer has an excess limitation. The unused foreign tax can be carried back one taxable year and forward ten taxable years. I.R.C. § 904(c) (2006). The Code establishes the order of years to which the unused foreign tax is to be carried, i.e., the first preceding year, then the first, second, third, fourth, fifth, sixth, seventh, eighth, ninth, and tenth succeeding taxable years. *Id.*; Treas. Reg. § 1.904-2(b)(1). To the extent that the unused foreign tax is not absorbed by the final carryover years, it is irretrievably lost.

⁹² See I.R.C. § 904(d) (2006).

referred to as cross-crediting.⁹³ By permitting the cross-crediting of excess foreign taxes on high-taxed foreign income against the domestic tax on low-taxed foreign income, the United States effectively concedes domestic taxation of the low-taxed foreign income to the high-tax foreign jurisdiction. As stated by the ABA Task Force, “[i]t is difficult to see how this is in the interests of the United States.”⁹⁴

C. The Basket Limitation on Cross-Crediting

To limit this form of manipulation of the foreign tax credit limitation, separate foreign tax credit calculations must be applied to two baskets of income: one for passive income and another for general income.⁹⁵ Passive income is defined as income that is classified as foreign personal holding company income under § 954 and, thus, includes interest, dividends, rents, royalties, annuities, net gains from certain property or

⁹³ See generally POSTLEWAITE & HOFFER, *supra* note 3, at § 6.18.

⁹⁴ ABA Task Force Report, *supra* note 14, at 771. However, as one commentator has stated, the “abuse” of cross-crediting depends on the presence or absence of a relationship between the high-taxed and low-taxed foreign income.

For those who worry about “cross-crediting,” the example they worry about is foreign taxes on one basket of income offsetting U.S. income on completely unrelated “other” foreign source income. For those who think that the system properly permits “credit-averaging,” the example is components of income from integrated cross-border businesses being sliced into pieces that make sense to tax collectors but not to businessmen. Income from operations in a multi-country undertaking, involving purchasing, manufacturing, selling, licensing and financing activities, is a part of a whole. U.S. taxes are taxes on related income. Foreign taxes on the various pieces are taxes on related income.

Robert H. Dilworth, *Tax Reform: International Tax Issues and Some Proposals*, INT’L TAX J., Sept. 2009, at 5, 54. Prohibiting cross-crediting of foreign taxes on pieces of related income from a globally integrated business will result in unrelieved double taxation. Under this view, cross-crediting may be justified in many, if not most, cross-border business situations.

⁹⁵ I.R.C. § 904(d)(1) (2006). Separate foreign tax credit limitations also apply to certain categories of income described in other Code sections. See, e.g., §§ 901(j), 904(h)(10), 865(h) (2006).

Between 1986 and 2004, the Code imposed separate limitations with respect to nine different kinds of income. These separate types of income included passive income, high withholding tax interest, financial services income, shipping income, certain dividends received from non-Controlled Foreign Corporations, certain dividends from Domestic International Sales Corporations (DISCs), taxable income attributable to certain foreign trade income, distributions from Foreign Sales Corporations attributable to foreign trade income, and, finally, all other income. Citing the need to simplify reporting and record keeping requirements for taxpayers, Congress amended §904(d) in 2004 by reducing the number of baskets to the current two. Although this change created the opportunity for increased cross-crediting, it greatly simplified the statutory structure of §904.

commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts.⁹⁶ Nevertheless, a number of exceptions exist. For example, income that would otherwise constitute passive income is treated as general category income if it is earned by a qualifying financial services entity or if it is high-taxed.⁹⁷ Passive income is deemed high-taxed if the foreign tax rate exceeds the highest rate of tax specified in § 1 or § 11, whichever is applicable to the taxpayer involved.⁹⁸ General income is defined simply as “income other than passive category income.”⁹⁹ Although cross-crediting of typically low-taxed passive foreign income and high-taxed active foreign income is generally prohibited, taxpayers retain substantial flexibility to blend high-taxed and low-taxed income of different types from the same or different jurisdictions in the general basket.¹⁰⁰

The opportunities for cross-crediting are enhanced by the provisions of § 904(d)(3) under which dividends, interest, rents, and royalties paid or accrued by a Controlled Foreign Corporation (CFC) are treated as either passive or general income for purposes of the separate basket limitations only to the extent that the payments would be treated as such in the hands of the CFC.¹⁰¹ These look-through rules are intended to alleviate the hardship that would result from a strict requirement that taxpayers allocate all dividends received from foreign subsidiaries to the passive basket. For example, if a U.S. taxpayer operated an active manufacturing business in a foreign country through a branch, none of the income earned would be passive basket income. If, however, the taxpayer operated the same business through a foreign subsidiary, the income would become passive basket income upon repatriation to the United States by way of dividends, interest, or royalties. Thus, dividends (and Subpart F inclusions), interest, rents, and royalties received by a United States

⁹⁶ I.R.C. § 904(d)(2)(A), (d)(2)(B)(i) (2006). See also I.R.C. § 954(c) (2006). The passive income basket also encompasses three specialized types of income that were divided into separate baskets under prior law. These include United States source dividends from a DISC or former DISC, taxable income attributable to certain foreign trade income, and distributions from former foreign sales corporations attributable to foreign trade income. I.R.C. § 904(d)(2)(B)(v). As a result, some of the complexity of the old law remains since taxpayers must still analyze and separate these items. The benefit of the two basket system, then, is not necessarily the achievement of simplicity, but is perhaps its permissive attitude toward the cross-crediting of high-taxed and low-taxed income.

⁹⁷ I.R.C. §§ 904(d)(2)(B)(iii)(II), (C), (D).

⁹⁸ I.R.C. § 904(d)(2)(F).

⁹⁹ I.R.C. § 904(d)(2)(A)(ii).

¹⁰⁰ The ABA Task Force described the current situation as allowing “virtually unlimited cross-crediting, except [for] passive income.” *ABA Task Force Report*, *supra* note 14, at 775.

¹⁰¹ I.R.C. § 904(d)(3).

shareholder from a CFC are assigned to the passive or general limitation baskets by reference to the category of income out of which the dividend or other payment was made.¹⁰² Under the look-through rules, the applicable payment or inclusion usually remains general basket income to the extent the CFC is engaged in an active business.

Expressed as an equation, the limitation applicable to passive income is:

$$\begin{array}{rcccl} \text{Maximum} & & \text{Passive foreign} & & \\ \text{passive basket} & = & \text{taxable income} & \times & \text{United States tax} \\ \text{foreign tax credit} & & \text{Worldwide} & & \text{on worldwide} \\ & & \text{taxable income} & & \text{income} \end{array}$$

By way of example, assume that a U.S. taxpayer derives \$100,000 of foreign taxable income in State X subject to a foreign tax rate of forty percent, resulting in a foreign tax of \$40,000. In addition, the taxpayer derives \$20,000 of foreign dividend income from State Y subject to a tax rate of five percent, resulting in an additional foreign tax of \$1,000. Finally, the taxpayer derives \$100,000 of domestic taxable income, yielding a worldwide taxable income of \$220,000, which is subject to a domestic tax rate of thirty-five percent resulting in domestic taxes computed without regard to the foreign tax credit of \$77,000. In this situation, the separate basket limitations would be applicable. The maximum passive foreign tax credit would be \$7,000 (\$20,000/\$220,000 x \$77,000). Because the credit cannot exceed the actual taxes paid on such income, the foreign tax credit would be equal to the foreign tax paid of \$1,000. The foreign tax credit limitation applicable to the general income basket would then apply to the remainder of the foreign source income, giving rise to a maximum foreign tax credit of \$35,000 (\$100,000/\$220,000 x \$77,000). The foreign tax of \$40,000 would exceed the \$35,000 limit and result in a \$5,000 foreign tax credit carryback or carryover. In the absence of the basket limitations applicable to foreign passive income and general income, the taxpayer would have been entitled to a maximum foreign tax credit of \$42,000 (\$120,000/\$220,000 x \$77,000) allowing the taxpayer to cross-credit the full amount of foreign taxes paid in States X, \$40,000, against the United States tax liability on the foreign source income derived from State Y.

¹⁰² *Id.*

D. The Indirect Foreign Tax Credit

In addition to a foreign tax credit for taxes directly paid by a U.S. taxpayer, the § 902 “deemed paid” provisions permit a domestic corporation meeting prescribed requirements of stock ownership in a foreign corporation to claim a credit for foreign taxes paid by that foreign subsidiary attributable to earnings distributed to the domestic shareholder.¹⁰³ In essence, the distribution “piggybacks” to the distributee the amount of foreign taxes incurred in earning such amounts. The practical significance of the § 902 formula lies in the fact that a domestic corporation, by choosing to enter a foreign market through a subsidiary instead of a branch, will not have entirely forfeited its claim to a foreign tax credit. However, because the deemed paid credit is not available until a dividend distribution is actually made from a foreign subsidiary to its domestic parent, unequal treatment between the use of subsidiaries and branches remains in cases of retained earnings. Finally, the deemed paid credit might also be seen as an attempt to ensure that the transfer of income from a subsidiary to a parent will occur through the conventional mechanism of the dividend payment, rather than the more circuitous routes of providing loans, goods, or services at a less than arm’s-length price.

A dividend distribution from a foreign subsidiary to its parent corporation may produce *both* direct and indirect credits for the year of distribution. If a foreign jurisdiction taxes shareholders upon the receipt of a dividend from the foreign corporation, in addition to the § 902 determinations discussed below, a § 901 credit may be available to the distributee corporation as well.

Section 902 permits a domestic corporation that receives a dividend from a foreign subsidiary in any taxable year to take a credit for taxes paid by the subsidiary if the domestic corporation owns at least ten percent of the voting stock of the foreign subsidiary.¹⁰⁴ For purposes of §902, the payor foreign subsidiary is designated a “first-tier corporation.”¹⁰⁵ The deemed paid provisions extend down to sixth-tier subsidiaries.¹⁰⁶ A first-tier corporation to which dividends are paid by a foreign corporation in which the first-tier corporation owns at least ten percent of the voting stock (a “second-tier” corporation) is deemed to have paid a portion of the taxes actually paid or accrued by the second-tier corporation. A second-tier

¹⁰³ I.R.C. § 902 (2006). The deemed paid credit under § 902 is also available with respect to inclusions in the domestic corporation’s income under Subpart F and the Personal Foreign Investment Company rules. I.R.C. §§ 960, 1295(f) (2006).

¹⁰⁴ I.R.C. § 902(a). The ten percent stock ownership requirement must be met at the time the dividend is received by the corporation. Treas. Reg. §1.902-1(a)(1) (as amended in 2009).

¹⁰⁵ Treas. Reg. § 1.902-1(a)(2).

¹⁰⁶ I.R.C. § 902(b); Treas. Reg. §1.902-1(a).

corporation to which dividends are paid by a foreign corporation in which the second-tier corporation owns at least ten percent of the voting stock (a “third-tier” corporation) is deemed to have paid a portion of the third-tier corporation’s taxes. This treatment is similarly available through “sixth-tier” corporations.

An additional ownership limitation is imposed for lower-tier subsidiaries. In order to claim the credit for lower-tier corporations, the domestic corporate parent must have at least five percent indirect ownership in those foreign corporations.¹⁰⁷ In a two-tier arrangement, the percentage of stock owned by the domestic corporation in the first-tier corporation multiplied by the percentage of stock held by the first-tier corporation in the second-tier corporation must equal at least five percent.¹⁰⁸ With a three-tier arrangement, the percentage share held by the domestic corporation and each tier corporation when multiplied together must equal at least five percent.¹⁰⁹ Similar requirements apply in determining the indirect ownership standards for lower-tier subsidiaries.¹¹⁰ The following examples describe the application of these rules:

Example 1. Domestic corporation A owns thirty percent of foreign corporation B (first-tier corporation). Corporation B owns forty percent of foreign corporation C (second-tier corporation). Corporation C owns fifty percent of foreign corporation D (third-tier corporation). In this case, both the ten percent direct ownership and the five percent indirect ownership requirements are met.

Ten Percent Direct Ownership:

- A owns more than ten percent of B (thirty percent)
- B owns more than ten percent of C (forty percent)
- C owns more than ten percent of D (fifty percent)

Five Percent Indirect Ownership:

- A owns greater than five percent of C (second-tier) through B (first-tier) ($30\% \times 40\% = 12\%$).
- A also owns greater than five percent of D (third-tier) through C (second-tier) and B (first-tier) ($12\% \times 50\% = 6\%$).

Thus, domestic corporation A can claim the foreign tax credit for

¹⁰⁷ I.R.C. § 902(b)(2). The credit of the second-tier corporation’s taxes is permissible if the taxpayer owns ten percent of the first-tier corporation when that corporation distributes the dividend received from the second-tier corporation. Treas. Reg. §1.902-1(a)(3).

¹⁰⁸ Treas. Reg. § 1.902-1(a)(3).

¹⁰⁹ Treas. Reg. § 1.902-1(a)(4).

¹¹⁰ Treas. Regs. §1.902-1(a)(3), (4). In addition, the § 902 deemed paid credit is not available for foreign taxes paid by subsidiaries in the fourth, fifth or sixth tiers unless the shareholder claiming the credit is a United States shareholder (as defined in § 951(b)), and the subsidiary is a Controlled Foreign Corporation. Treas. Regs. §1.902-1(a)(4)(ii).

taxes paid and deemed paid by all three of the tier corporations.

Example 2. Domestic corporation W owns twenty-five percent of foreign corporation X (first-tier). Corporation X owns thirty percent of foreign corporation Y (second-tier). Corporation Y owns forty percent of foreign corporation Z (third-tier). In this case, although the ten percent direct ownership requirement is met, the five percent indirect ownership requirement is not.

Ten Percent Direct Ownership:

W owns greater than ten percent of X (twenty-five percent)
X owns greater than ten percent of Y (thirty percent)
Y owns greater than ten percent of Z (forty percent)

Five Percent Indirect Ownership:

W owns greater than five percent of Y (second-tier) through X (first-tier) ($25\% \times 30\% = 7.5\%$). W owns *less than* five percent of Z (third-tier) through Y (second-tier) and X (first-tier) ($7.5\% \times 40\% = 3\%$).

Therefore, domestic corporation W cannot claim credit for taxes deemed paid by Y (second-tier) for foreign taxes actually paid by Z (third-tier). It can, however, claim the credit for taxes deemed paid by X (first-tier) for foreign taxes actually paid by Y (second-tier).

In general, a domestic parent corporation cannot claim a credit for foreign taxes paid by its foreign subsidiary unless the subsidiary makes a dividend distribution to the parent. Because a dividend is viewed under the Code as a manifestation of accumulated profits, it is the payment of the dividend which triggers the deemed paid provisions. The amount of the credit allowable is directly proportional to the size of the dividend as a percentage of available post-1986 undistributed earnings.¹¹¹ The actual computation numerically expressed is:

$$\text{\S 902 Credit} = \text{FTP} \times \frac{\text{DP}}{\text{UE}}$$

In this formula, the § 902 credit refers to the amount of tax paid by the first-tier corporation which is deemed paid by a domestic corporation.¹¹² “FTP” refers to the post-1986 foreign taxes paid (or deemed paid by a lower-tier

¹¹¹ As regards pre-1987 earnings, prior law is to apply. See I.R.C. § 902(c)(6) (2006). Additionally, dividends are treated as made from the most recent pool of earnings. They are paid first out of post-1986 earnings. I.R.C. § 902(c)(6)(B).

¹¹² If dividends are received from more than one first-tier corporation, the taxes deemed paid must be computed separately for each corporation. Treas. Reg. § 1.902-1(c)(1)(i)

corporation) by the first-tier corporation, “DP” refers to the dividends paid by the first-tier corporation to the domestic corporation, “UE” refers to the post-1986 undistributed earnings of the first-tier corporation, reduced by the amount of foreign taxes paid or accrued by such first-tier corporation. The taxes which a first-tier corporation is deemed to have paid through a second-tier corporation (as well as a second through a third) are calculated by applying the same formula.¹¹³ Thus, by way of example, assume that Corp X, a domestic corporation, owns 100 percent of Corp Y, a foreign corporation, formed in Year 1. Corp Y distributes its first dividend of \$300 in Year 3 at a time in which total undistributed earnings (reduced by foreign tax paid or accrued) equaled \$1,000.¹¹⁴ If Corp Y incurred a foreign tax liability from Year 1 to Year 3 of \$500, the deemed paid credit would total \$150 ($\$300/\$1,000 \times \500).

When a domestic corporation elects the foreign tax credit for taxes paid by a foreign subsidiary, the amount of taxes deemed paid must be treated and reported as dividend income.¹¹⁵ That is, the amount of the actual dividends received are “grossed up” to include an additional amount equal to the tax deemed paid on those dividends.¹¹⁶ The § 78 gross-up prevents the “overcrediting” of foreign taxes and equates the tax benefits of utilizing a foreign subsidiary with those of a branch for foreign operations. When a foreign branch is utilized, the direct foreign tax credit is available, yet all income is subject to United States tax. The use of a wholly-owned subsidiary instead results in the availability of the tax credit with domestic taxation of the dividend income only. The foreign earnings in the amount of the taxes actually paid would not be subject to domestic taxation. The gross-up concept eliminates this disparity as to distributed earnings of the subsidiary.

For example, assume that D, a domestic corporation, establishes H, a foreign subsidiary, in State Z. H earns \$100 in each of Years 1 and 2, subject to a 20 percent tax rate. H distributes a dividend to D in the amount of \$80, one-half of its after-tax earnings ($(\$200 \text{ earnings} - \$40 \text{ tax})/2$). In the absence of the § 78 gross-up, D would be subject to United States tax on \$80 of dividend income, yet receive a § 902 credit of \$20, the tax on the full \$100 of H’s pre-tax earnings ($\$40 \text{ tax} \times \$80/\$160$). In contrast, if H were a branch of D, D would be entitled to a credit for the \$20 tax on H’s earnings, but D would also be subject to domestic tax on H’s full \$100 of earnings.

¹¹³ Lower-tier subsidiaries also utilize the same formula. Treas. Reg. § 1.902-1(f) ex. (3).

¹¹⁴ This example assumes taxable years after 1986.

¹¹⁵ I.R.C. § 78 (2006).

¹¹⁶ The grossed-up income is treated as a dividend for all United States tax purposes, except the dividends-received deduction for eligible dividends received from foreign corporations under § 245. I.R.C. §§ 78, 245 (2006). Through this last prohibition, a double benefit (the tax credit and the deduction to the recipient) is denied.

To achieve parity in these two situations, § 78 requires that D include as additional dividend income the \$20 of foreign tax paid by H to State Z. Thus, D is deemed to receive a dividend from H of \$100 (\$80 actual dividend + \$20 gross-up) and is entitled to a deemed paid credit under § 902 of \$20.

E. Proposals for Reform

The importance of the foreign tax credit to domestic taxpayers cannot be overstated. Corporate management and its advisors expend substantial effort and resources in an attempt to cross credit their foreign tax liability so as to minimize the impact of the foreign tax credit limitation.¹¹⁷ Similarly, Congress and reformers have devoted considerable thought and resources in an attempt to limit the potential for abuse which exists with respect to the concept. Not surprisingly, reform proposals range from permitting only a deduction, rather than a credit, for foreign taxes paid, to particularized safeguards in areas deemed ripe for abuse.

F. The Obama Administration Proposals

Despite the overall limitation on the foreign tax credit and the separate limitations applicable to passive income and general income, opportunities still exist for cross-crediting of foreign taxes paid in one jurisdiction (i.e., the high-tax jurisdiction) against the United States tax on similar income from another jurisdiction (i.e., the low-tax jurisdiction). In its “purest form,” the limitation on the foreign tax credit would be applied on an item-by-item basis so that the foreign tax paid on a particular item of income would only offset the United States tax on that item of income.¹¹⁸ Because item-by-item limitations would be administratively cumbersome, the limitation has historically been applied with respect to groupings of similar income or on a country-by-country basis.¹¹⁹

The ability of taxpayers to cross-credit foreign taxes on income within the general income basket has led to “selective repatriation” strategies involving the deemed paid credit under § 902. Under this strategy, a domestic corporation will time the repatriation of earnings in the form of dividends from subsidiaries in jurisdictions with high-tax rates to

¹¹⁷ See generally POSTLEWAITE & HOFFER, *supra* note 3, at §§ 6.17 and 6.18.

¹¹⁸ JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 76.

¹¹⁹ During various periods prior to 1976, the foreign tax credit limitation was applied on a country-by-country basis (the “per-country limitation”), an overall basis, or a combination of the two. See Dilworth, *supra* note 94, at 55–56. Although a per-country limitation permits cross-crediting of foreign taxes paid on different types of income from a single country, the staff of the Joint Committee has noted that “the effect [is] . . . more limited than permitted under present law due to general uniformity of tax bases and tax rates within a country.” JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 78.

correspond with dividends from subsidiaries in jurisdictions with low-tax rates. In addition, because of the look-thru rules of § 904(d)(3), the repatriation of earnings in the form of dividends from subsidiaries in jurisdictions with high tax rates can also be timed to correspond with the receipt of royalties for the use of intangible property received from a CFC in a low-tax jurisdiction.¹²⁰ In both situations, the foreign taxes deemed paid by the domestic corporation under § 902 in the high-tax jurisdiction can be used to offset the United States tax on the foreign source income received from the subsidiary in the low-tax jurisdiction.

As a result, the Obama Administration has proposed that the amount of foreign taxes deemed paid for purposes of § 902 be determined on an “aggregate or blended basis” across subsidiaries without regard to the timing or source of any particular distribution of foreign earnings. Under this proposal, the domestic corporation would aggregate the amount of foreign taxes as well as the earnings and profits of all foreign subsidiaries for which the domestic corporation is entitled to claim a deemed paid credit, including all lower-tier subsidiaries, in applying the separate basket limitations. Thus, the amount of foreign taxes paid for purposes of § 902 would be determined under the following formula:

$$\text{Foreign tax paid} = \frac{\text{Amount of currently taxed income from all foreign subsidiaries}}{\text{Total earnings and profits of all foreign subsidiaries}} \times \text{Total foreign taxes from all foreign subsidiaries}$$

The report by the Staff of the Joint Committee on Taxation contains the following illustration of the proposal.

[A] domestic corporation, Parent Co., . . . owns 100 percent of the shares of each of Alpha Co. and Bravo Co., CFCs organized in Alphaland and Bravonia, respectively. Alpha Co. has pre-tax earnings of \$1,000 in the general limitation category, pays foreign taxes of \$125 (at a 12.5 percent tax rate), and has net earnings after taxes of \$875. Bravo Co. also has pre-tax earnings of \$1,000 in the general category, but pays foreign taxes of \$410 (at a 41 percent tax rate) and has net earnings after taxes of \$590. The aggregate amount

¹²⁰ The report from the Staff of the Joint Committee on Taxation notes that one study found that “almost two-thirds of all foreign-source royalties were sheltered by excess foreign tax credits in 2000, meaning that no residual U.S. tax was due.” JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 81.

of net earnings and profits of Alpha Co. and Bravo Co. is \$1,465 (\$875 + \$590), and the aggregate amount of foreign taxes paid is \$535 (\$125 + \$410).

If Alpha Co. distributes \$500 to Parent Co. as a dividend, the amount of foreign taxes that Parent Co. would be deemed to have paid under the proposal with respect to the distributed earnings is \$183 (or $\$535 \times (\$500/\$1,465)$). Similarly, if Bravo Co. distributes \$500 to Parent Co. as a dividend, the amount of foreign taxes that Parent Co. would be deemed to have paid with respect to the distributed earnings is also \$183 ($\$535 \times (\$500/\$1,465)$). Absent other factors, Parent Co. would be indifferent as to whether the \$500 is remitted from Alpha Co. or Bravo Co., leaving Parent Co. to decide the source of the dividend based on business needs, rather than U.S. tax considerations.¹²¹

Because the earnings of any foreign subsidiary in any jurisdiction would carry with them foreign taxes deemed paid at the average effective tax rate of all foreign subsidiaries, the proposal would eliminate tax benefits in timing the repatriation of earnings from high-tax and low-tax jurisdictions within each separate limitation basket.

In reviewing this proposal, the Joint Committee on Taxation noted several problems. First, the proposal would not eliminate all tax planning opportunities with respect to the foreign tax credit. As noted previously,¹²² the deemed paid foreign tax credit under § 902 along with the gross-up of the dividend paid under § 78 is intended to equalize the tax implications with respect to the use of foreign subsidiaries as compared to the use of foreign branches. However, timing differences exist with respect to the use of a foreign subsidiary as compared to a foreign branch since the income and foreign taxes paid by a foreign branch are accounted for currently by the domestic parent while the income and foreign taxes paid by a foreign subsidiary are accounted for only when an actual dividend distribution is made. Because the Obama Administration proposal applies only to foreign taxes paid through a foreign subsidiary, domestic corporations may be encouraged to earn high-taxed foreign income through a branch rather than a subsidiary in order to avoid the new requirements.¹²³ In addition, domestic corporations could remove low-taxed foreign income from the

¹²¹ JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 80–81 (footnotes omitted). The report notes that “[t]he blended effective tax rate on Parent Co.’s share of the aggregate earnings of Alpha Co. and Bravo Co. is 26.8 percent ($535/(1,000+1,000)$). Parent Co.’s deemed paid foreign taxes of \$183 on distributed earnings of \$500 would reflect that blended rate, once the section 78 gross-up amount (\$183) was taken into account, i.e., $\$183/(\$500 + \$183) = 26.8$ percent.” *Id.*

¹²² See *supra* text accompanying notes 115–116.

¹²³ JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 82–83.

new requirements by placing subsidiaries earning such income below the sixth tier of foreign corporations such that the deemed credit regime of § 902 would no longer be applicable.¹²⁴

Second, a number of technical and administrative issues would have to be addressed in order to implement the proposal.¹²⁵ Most significantly, rules would have to be developed to allocate subsidiary earnings and foreign taxes among multiple shareholders in order to determine aggregate earnings and foreign taxes for each shareholder. These rules would have to include provisions dealing with changes in a shareholder's proportionate interest as a result of acquisitions, dispositions, dilutions, mergers, and other corporate events. In addition to numerous substantive issues, reporting requirements would need to be addressed under which information concerning the earnings and foreign taxes of every foreign subsidiary that would affect the determination of the § 902 credit for the United States parent would have to be maintained and disclosed regardless of whether the parent received any distributions from the subsidiary. Transition rules would also be necessary.¹²⁶ To the extent that the new requirements apply only to earnings and foreign taxes arising after the effective date of the legislation, separate pre-effective and post-effective date pools of earnings and foreign taxes would have to be maintained with ordering rules for determining the pools associated with any dividend actually paid.

Third, tax treaty partners may consider the proposal inconsistent with treaty obligations that require relief from double taxation.¹²⁷ Many tax treaties require that the United States provide a credit to a domestic corporation that owns at least ten percent of the voting stock of a

¹²⁴ By moving the subsidiary below the sixth tier, the foreign corporation's earning and profits would be removed from the pool, thus increasing the amount of foreign tax credits that could be claimed. This would be off-set by the fact that the parent would no longer be able to claim credits for the foreign taxes paid by these corporations. See Stack, et al., *supra* note 17, at 456. One commentator has suggested that the sixth-tier limitation of § 902 be eliminated to prevent this manipulation of the proposed provision. Nijenhuis, *New York State Bar Association*, *supra* note 17, at 19.

The report of the Staff of the Joint Committee noted an alternative approach under which the foreign earnings and foreign taxes of both branches and subsidiaries would be included under a blending regime applicable to the foreign tax credit under both §§ 901 and 902. This approach was adopted in The Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. (2007), introduced by Representative Charles Rangel, Chair of the House Ways and Means Committee. JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 83. For a comparison of the proposal in H.R. 3970 and that by the administration, see Nijenhuis, *New York State Bar Association*, *supra* note 17, at 17–31; Stack, et al., *supra* note 17, at 455–61.

¹²⁵ JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 84–85.

¹²⁶ *Id.* at 85–86.

¹²⁷ *Id.* at 86–88. See Dilworth, *supra* note 17.

corporation resident in the foreign jurisdiction for the foreign taxes on the earnings out of which a dividend is paid.¹²⁸ Under the administration's proposal, the amount of taxes that would be deemed paid in the case of a foreign subsidiary in a high-tax foreign jurisdiction might be less than the amount of taxes actually paid. Thus, a treaty partner could argue that the proposal, if enacted, is a violation of the treaty.

In considering the treaty violation question, the staff of the Joint Committee on Taxation referred to the text of the Technical Explanation of the United States Model Convention ("Technical Explanation") which states that the treaty provision is consistent with § 902 of the Code.¹²⁹ However, the Technical Explanation also states that the credit is "subject to the limitations of U.S. law, as that law may be amended over time, *so long as the general principle of the Article, that is, the allowance of a credit, is retained.*"¹³⁰ As a result, the proposal may be consistent with United States treaty obligations because the proposal does not deny a credit, but rather defers a full credit until the earnings of all the foreign subsidiaries of a United States corporation have been distributed. Nevertheless, the proposal is different from the existing foreign tax credit limitations under § 904 which restrict a taxpayer's ability to credit foreign taxes against the United States tax on other foreign income. The proposal restricts a taxpayer's ability to credit foreign taxes against the United States tax on the same foreign income.¹³¹

G. ABA Task Force Proposals

The Task Force of the ABA also suggested a number of reforms to the foreign tax credit and its limitations.¹³² The Task Force stated that the current rules permitting the cross-crediting of foreign taxes has produced a system that is more favorable to taxpayers investing in high-tax countries than an exemption system, several forms of which have recently been

¹²⁸ See United States Model Income Tax Convention of November 15, 2006, art. 23(2)(b), available at <http://ustreas.gov/press/releases/reports/hp16801.pdf>.

¹²⁹ United States Model Technical Explanation Accompanying the United States Income Tax Convention of November 15, 2006, 74, available at <http://www.ustreas.gov/press/releases/reports/hp16802.pdf>.

¹³⁰ *Id.* (emphasis added). The Technical Explanation specifically states that the credit under the convention is subject to the various limitations of United States law that are found under §§ 901–908 of the Code. *Id.*

¹³¹ One commentator who believes the proposal is consistent with existing treaty requirements nevertheless suggested that Congress expressly provide that the provision is intended to override any treaty obligations that a treaty partner or a court may determine conflicts with the provision in order to avoid any protracted litigation that would likely result in the absence of such a statement. Nijenhuis, *New York State Bar Association*, *supra* note 17, at 30.

¹³² *ABA Task Force Report*, *supra* note 14, at 772–76.

promoted.¹³³ As described above, under the current foreign tax credit rules, taxes imposed in high-tax foreign jurisdictions can be credited against the United States residual tax on foreign income in low-tax jurisdictions. Under an exemption system, excess taxes on income in high-tax foreign jurisdictions cannot be used against United States taxes on income from other foreign jurisdictions. Furthermore, the current rules create incentives for taxpayers with excess foreign taxes to invest in lower-taxed foreign jurisdictions rather than the United States.¹³⁴ Finally, the beneficiaries under the current rules are the foreign jurisdictions; “the high-tax jurisdiction does not suffer the detriment of its high foreign taxes and the low-tax foreign country receives the benefit of the investment. The U.S. taxpayer finances these benefits.”¹³⁵

To remedy the cross-crediting problem, the ABA Task Force made several recommendations.¹³⁶ Along with maintaining the separate limitation for passive income, the Task Force recommended that credit for foreign taxes on business income be limited on a country-by-country basis.¹³⁷ It defended the use of a per country limitation because the tax rate and tax base within a country are substantially the same, thus reducing the opportunities for cross-crediting. A per country limitation would also provide no greater benefit than would be available under an exemption system.

The Task Force also highlighted the fact that certain sourcing rules with respect to income and expenses can be manipulated to result in the understatement of domestic source taxable income and the overstatement of foreign source taxable income.¹³⁸ Consequently, excess foreign taxes under the current foreign tax credit rules are effectively offsetting residual taxes

¹³³ For a discussion of proposed exemption systems, see Barker and Lokken articles.

¹³⁴ The incentive created to invest in low-tax foreign jurisdictions rather than the United States was one of the reasons cited by Congress in 1986 for creating the limitations under § 904 of nine separate baskets. STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 860–62 (Comm. Print 1987) [hereinafter JOINT COMM., GENERAL EXPLANATION]. See Dilworth, *supra* note 94, at 56.

¹³⁵ ABA Task Force Report, *supra* note 14, at 775.

¹³⁶ In addition to the recommendations described below, the Task Force recommended that the so-called “technical taxpayer rule” be modified in order to avoid the separation of income and foreign taxes among related persons. Specifically, the Task Force suggested that the Service be authorized to make primary and correlative allocations of foreign taxes to the person who has the income to which the taxes relate in order to achieve an appropriate matching of income and taxes. ABA Task Force Report, *supra* note 14, at 775–76. The Service issued Proposed Regulations in 2006 that modified the technical taxpayer rule to address this situation. Prop. Treas. Reg. § 1.901-2(f), 71 Fed. Reg. 44,240 (2006). For a discussion of the technical taxpayer rule and the Proposed Regulations, see POSTLEWAITE & HOFFER, *supra* note 3, at § 6.05.

¹³⁷ ABA Task Force Report, *supra* note 14, at 775–76.

¹³⁸ *Id.* at 772–74.

by the United States on income that may not even be subject to tax in a foreign jurisdiction.¹³⁹ As an example of this situation, the Task Force cites the rule applicable to the sourcing of gain from the sale of inventory. Generally, gain from the sale of inventory is foreign source income if title passes to the buyer outside the United States.¹⁴⁰ However, most foreign countries only tax such gain if it is attributable to a permanent establishment in the foreign jurisdiction. Because the Task Force viewed a foreign tax credit as appropriate only when income is subject to foreign tax in order to avoid or mitigate double taxation, a credit when foreign countries fail to impose tax is unnecessary. Thus, the Task Force recommended that gain from the sale of inventory be sourced to the residence of the taxpayer under the general source rule applicable to personal property, which provides that gain for the sale of personal property attributable to a foreign office or fixed place of business of the taxpayer and subject to an effective tax rate of ten percent or more is foreign source income.¹⁴¹

The Task Force similarly recommended that the source rule for royalties from the licensing of intangible property be consistent with the source rule for income from sale of personal property.¹⁴² Under existing law, royalties from the licensing of intangible property are sourced to the place where the intangible property is used.¹⁴³ Thus, income from the license of intangible property used in the manufacture of inventory outside the United States will be foreign source income. However, if the same intangible property is used in the manufacturing of inventory in the United States that is then sold abroad, the income will be divided between the domestic and foreign source, based, in part, on the place where title passes.¹⁴⁴ Interestingly, these different source rules apply despite the fact that the income, in whole or in part, represents a return on the intangible asset. As a result, taxpayers in an excess foreign tax credit situation can increase their foreign tax credit by separately licensing intangible property if no foreign withholding tax applies. Again, the Task Force recommended that royalties from the licensing of intangible property be sourced to the residence of the taxpayer under the general source rule applicable to personal property. Thus, royalties from the licensing of intangible property

¹³⁹ The Task Force also recognized that the converse situation could arise, in which a foreign country taxes income that the United States views as domestic source income, resulting in unrelieved double taxation. However, it noted that the converse situation is “far less common in practice.” *Id.* at 772.

¹⁴⁰ I.R.C. §§ 861(a)(6), 862(a)(6), 865(b) (2006).

¹⁴¹ I.R.C. § 865(a), (e)(1).

¹⁴² *ABA Task Force Report*, *supra* note 14, at 773–74.

¹⁴³ I.R.C. §§ 861(a)(4), 862(a)(4).

¹⁴⁴ I.R.C. §§ 861(a)(6), 862(a)(6), 863(b).

would be sourced to the residence of the taxpayer unless the royalties are attributable to a foreign office or fixed place of business of the taxpayer and subject to an effective tax rate of ten percent or more. Thus, royalties not subject to foreign tax would not be treated as foreign source income and would not increase the foreign tax credit limitation. Alternatively, if the payment of the royalty was subject to a withholding tax, but was not attributable to a foreign office or fixed place of business of the taxpayer and subject to an effective tax rate of ten percent or more, the Task Force recommended that the royalty be treated as foreign source but only in an amount equal to the foreign tax divided by the highest rate of tax applicable to the taxpayer.¹⁴⁵

IV. FOREIGN-SOURCE DEDUCTIONS AND DEFERRED FOREIGN INCOME

A. Overview

Because United States taxpayers are taxable on their worldwide income, the sourcing of income and expenses as foreign or domestic is generally irrelevant except in connection with the determination of the foreign tax credit limitation.¹⁴⁶ Expenses incurred for the generation of foreign-source income are deductible in the same manner as expenses for the generation of domestic-source income. Importantly, expenses incurred for the generation of foreign-source income are deductible even if the expenses exceed the taxpayer's foreign-source income or the taxpayer earns no foreign source income.

For example, if a United States taxpayer incurs debt to acquire the stock of a foreign corporation, the taxpayer may deduct interest with respect to the indebtedness even if no taxable income is currently generated by the stock. Although current law may require the taxpayer to recapture as domestic source income the amount by which the interest expense exceeds foreign-source income when foreign-source income is earned in a subsequent taxable year,¹⁴⁷ the taxpayer will enjoy the benefit of a current deduction of the expense and the deferral of the corresponding income. A current deduction of an expense and the deferral of the corresponding income can result in a negative effective tax rate of the income involved.¹⁴⁸

¹⁴⁵ If this change in the source rules were not adopted, the Task Force recommended that the rules determining the allocation of research and development expenses between foreign and domestic source be modified to ensure that foreign source income bear its full share of the burden of supporting R&D. *ABA Task Force Report*, *supra* note 14, at 774.

¹⁴⁶ See generally POSTLEWAITE & HOFFER, *supra* note 3, at § 6.26.

¹⁴⁷ I.R.C. § 904(f). See POSTLEWAITE & HOFFER, *supra* note 3, at § 6.21.

¹⁴⁸ One commentator provided the following example of this situation:

In addition, and as previously noted, the foreign tax credit requires the determination of both domestic and foreign source income and deductions in order to calculate the overall credit limitation as well as the separate basket limitations.¹⁴⁹ To the extent that different types of income are sourced under different rules, incentives exist to characterize income for purposes of the sourcing rules so as to maximize the amount of foreign source income and, thereby, maximize the foreign tax credit limitation that might otherwise apply. Similar incentives exist with respect to the sourcing of deductions except that the incentive is to characterize deductions as domestic.¹⁵⁰ If deductions can be sourced as domestic, they will reduce domestic source income subject to taxation in the United States. At the same time, this approach will increase foreign source income, thereby maximizing the foreign tax credit limitation.¹⁵¹

Assume that DC, a U.S. multinational corporation, has a marginal effective tax rate of 35% on its U.S.-source income and a marginal effective tax rate of 10% on its income earned in Country A by F Sub, a wholly owned Country A subsidiary. In support of F Sub's Country A operations, DC incurs \$100 of interest on U.S. borrowing and \$100 of general and administrative expense at DC's U.S. headquarters. Country A does not allow F Sub to deduct a cost reimbursement paid to DC for these expenses. If the United States defers F Sub's income, but allows a current \$200 deduction for these expenses, the result is a benefit of \$50 (i.e., \$200 multiplied by the 25% difference in the U.S. and Country A marginal tax rates) until the income taxed at a 10% rate by Country A is repatriated. In other words, allowing the deduction creates a negative tax on (i.e., subsidizes) the exempt foreign-source income during the deferral period to the extent of the difference between the U.S. and foreign tax rates times the deduction amount for the period of the deferral. Allowing a current deduction for interest and other costs attributable to deferred foreign-source income cannot be justified on tax policy grounds.

Fleming, Peroni, & Shay, *supra* note 14, at 117–18 (footnotes omitted).

¹⁴⁹ See *supra* notes 90–102 and accompanying text.

¹⁵⁰ Taxpayers may be indifferent to the sourcing of expenses as either foreign or domestic source if the foreign tax credit is not limited because there is sufficient foreign-source income in the limitation category even when the deduction is considered foreign-source or the expense is deductible under foreign law and the foreign income is subject to tax at a rate at, or above, the effective domestic tax rate. Fleming, Peroni, & Shay, *supra* note 14, at 111, n.107.

¹⁵¹ The sourcing of deductions is independent of whether the deductions are permissible under the law of the foreign country imposing the tax. If, in determining foreign-source taxable income for purposes of the foreign tax credit limitation, only the expenses deductible under foreign law were considered, foreign-source taxable income would be increased, resulting in a larger credit limitation. This would permit foreign taxes to offset United States taxes what would otherwise be considered domestic source taxable income. See *id.* at 111 (noting that the most important expenses for a domestic shareholder that are typically not allowable as a deduction by a foreign subsidiary under foreign law are interest, R&D expenses, and general and administrative expenses).

In order to properly determine the foreign tax credit limitation, the Regulations set forth a rather complex and cumbersome procedure for the allocation of deductions. Basically, the Regulations create a distinct two-tiered method to accomplish this task: "allocation" and, if necessary, "apportionment."¹⁵² The allocation process is the threshold determination which essentially entails matching deductions to the category of gross income to which those deductions most factually relate. As a general rule, a deduction is allocated to the class of gross income to which that deduction is "definitely related."¹⁵³ A deduction is definitely related to a class of gross income if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived.¹⁵⁴ Classes of gross income to which deductions are allocated are *not* pre-determined. The class of gross income to which deductions are allocated is driven and defined by the nature of the deduction being allocated. However, the Regulations give some guidance by providing that a class of gross income may consist of one or more items (or subdivisions thereof) of the gross income categories enumerated in § 61.¹⁵⁵ For instance, deductions for real estate taxes on a rental property would directly relate to the rents class of gross income.

Once deductions are matched with a particular class of gross income, the composition of that particular class of gross income must be analyzed to determine whether it is comprised solely of United States source income (a "residual grouping"), solely foreign source income (a

The proper sourcing of deductions is also of significant concern in an exemption or territorial tax system under which foreign source income is not subject to tax by the jurisdiction in which the taxpayer is resident. See PRESIDENT'S ADVISORY PANEL, *supra* note 6, at 102-05, 132-35, 239-43; JOINT COMM., OPTIONS TO IMPROVE, *supra* note 14, at 191.

¹⁵² Treas. Reg. § 1.861-8(a)(2) (as amended in 2009).

¹⁵³ Treas. Reg. § 1.861-8(b)(1), (2).

¹⁵⁴ Treas. Reg. § 1.861-8(b)(2). It is entirely possible that a deduction may not bear a definite relationship to *any* particular class of gross income. Treas. Reg. § 1.861-8(b)(1), (5). For example, certain general and administrative salaries for top level management of a corporation might not be traced to a given class of income. In such a case, the deduction is treated as definitely related and allocable to *all* of a taxpayer's gross income. Treas. Reg. § 1.861-8(b)(5). Such unmatched expenses, by definition, bypass the allocation process, but are ratably apportioned between the statutory groupings (i.e., foreign and United States source gross income) comprising the taxpayer's gross income. Treas. Reg. § 1.861-8(c)(3). For example, if a corporation's gross income was \$1,000,000, consisting of \$600,000 foreign source gross income and \$400,000 United States gross income, 60 percent of the managerial salaries would be apportioned to foreign source income and 40 percent to United States source income.

¹⁵⁵ Treas. Reg. § 1.861-8(a)(3). The Regulations list 15 of the items of gross income enumerated in § 61: compensation for services; business income; property gains; interest; rents; royalties; dividends; alimony; annuities; insurance contract income; pensions; discharge of indebtedness income; partner's distributive share of gross income; income in respect of a decedent; and income from an estate or trust.

“statutory grouping”), or some combination thereof. As the term and procedure suggest, the apportionment of allocated deductions within a class of gross income is required only in the last scenario.¹⁵⁶ When apportionment is required, the deduction already allocated to that mixed-source class of gross income under the first-tier allocation procedure is, in effect, sub-allocated between the foreign source income and United States source income comprising that class of gross income. The Regulations direct that the apportionment process be accomplished in a fact-based manner that “reflects to a reasonably close extent the factual relationship” between the deduction and the gross income grouping.¹⁵⁷ Examples of bases and factors which may be considered in making this factual determination include comparisons of sales, gross receipts, cost of goods sold, profit contributions, expenses and intangible costs incurred in generating the activity, and gross income.¹⁵⁸ These possible apportionment bases are by no means exclusive.¹⁵⁹ This open-ended list of bases, coupled with the malleable “factual relationship” standard, renders the apportionment process ripe for tax planning.

Special rules apply for the allocation and apportionment of certain types of expenses, two of the most important of which are interest expenses and research and development expenses.¹⁶⁰ The allocation and apportionment provisions applicable to interest expense are premised on the oft-questioned assumption that money is fungible, and thus, interest expense is considered as attributable to all activities and property regardless of the specific purpose for incurring the obligation.¹⁶¹ Thus, as a general rule, interest expense is allocable to *all* of the gross income generated, or expected to be generated, from the taxpayer’s income-producing activities and property.¹⁶² Once interest has been properly allocated, the Regulations provide specific methods of apportioning that interest to the statutory and

¹⁵⁶ The deduction is allocated in its entirety to the income in the statutory or residual grouping, whichever is appropriate. Temp. Treas. Reg. § 1.861-8T(c)(1) (as amended in 2009).

¹⁵⁷ *Id.*

¹⁵⁸ Temp. Treas. Reg. § 1.861-8T(c)(1)(i)–(vi).

¹⁵⁹ Temp. Treas. Reg. § 1.861-8T(c)(1).

¹⁶⁰ Other categories of expenses for which special rules apply include income taxes, legal and accounting fees, stewardship expenses, supportive function expenses, losses on the sale or exchange of property, and net operating expenses. See POSTLEWAITE & HOFFER, *supra* note 3, at § 6.31.

¹⁶¹ Temp. Treas. Reg. § 1.861-8T(e)(2), 1.861-9T(a) (as amended in 2009).

¹⁶² Temp. Treas. Reg. § 1.861-9T(a). The interest allocation rules generally apply to any expense or deductible loss incurred in consideration of the time value of money. Temp. Treas. Reg. § 1.861-9T(b)(1)(i). The allocation of interest expense is generally described at Treas. Reg. § 1.861-8(e)(2); Temp. Treas. Reg. §§ 1.861-8T(e)(2), 1.861-9T to -13T (as amended in 2009).

residual groupings comprising the class of income. Domestic corporations are subject to complex apportionment rules depending on the nature of the corporation's operations.¹⁶³ Generally, a domestic corporation must apportion interest expense to the various statutory groupings within the designated class of income on the basis of average asset values.¹⁶⁴ For example, if one-third of a domestic corporation's assets are used in activities that generate foreign-source income, one-third of its interest expense is deductible in determining taxable income from foreign sources. A domestic corporation may elect to determine the value of its assets on the basis of either the tax book value (i.e., adjusted basis) or the fair market value of those assets.¹⁶⁵

With respect to the allocation of interest expense between domestic and foreign source, an affiliated group of corporations is treated as one corporation (the "one-taxpayer rule").¹⁶⁶ Thus, the interest expense of all members of the group is treated as definitely related and, therefore, allocable to all of the gross income of the members of the group, and all of the assets of all the members of the group are taken into account in apportioning the interest expense.¹⁶⁷ Thus, each member of the affiliated group allocates its interest expense between domestic and foreign source by reference to the total percentage of the affiliated group's assets that fall into each category. An affiliated group for this purpose is defined as a group of corporations that is eligible to file a consolidated return under § 1504, which includes one or more chains of corporations connected through eighty percent stock ownership with a common parent corporation.¹⁶⁸

Importantly, a foreign corporation is not includable as part of an affiliated group for the purposes of allocating interest expense between domestic and foreign sources.¹⁶⁹ The exclusion of foreign corporations

¹⁶³ Domestic individuals generally apportion interest expense based on rules applicable to the different classifications of that interest under § 163. Temp. Treas. Reg. § 1.861-9T(d).

¹⁶⁴ I.R.C. § 864(e)(2); Temp. Treas. Reg. § 1.861-9T(f)(1), (g)(1)(i).

¹⁶⁵ Temp. Treas. Reg. § 1.861-9T(g)(1)(ii), (h).

¹⁶⁶ I.R.C. § 864(e)(1), (e)(6); Temp. Treas. Reg. § 1.861-11T(c), -14T(e)(2).

¹⁶⁷ This rule was enacted as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1215(a), 100 Stat. 2085, 2544-45 (1986). See JOINT COMM., GENERAL EXPLANATION, *supra* note 134, at 941-52. Prior to this time, an affiliated group of corporations could maximize the foreign tax credit limitation by having only domestic corporations with only domestic source income borrow to finance group activities. In such a situation, the interest expense was entirely sourced as domestic, thereby increasing the amount of foreign source taxable income and the foreign tax credit limitation. Fleming, Peroni, & Shay, *supra* note 14, at 111-12.

¹⁶⁸ I.R.C. § 864(e)(5); Treas. Reg. § 1.861-11(d)(1). The allocation of interest expense on the basis of the affiliated group's total assets applies regardless of whether the affiliated group files a consolidated return.

¹⁶⁹ I.R.C. §§ 864(e)(5)(A), 1504(b)(3) (2006).

ignores the existence of foreign debt, frequently resulting in an over allocation of interest expense to foreign source income and a reduction in the applicable foreign tax credit limitation. As stated by the Staff of the Joint Committee on Taxation,

The result is that the allocation under present law does not take into account the extent to which foreign members of the group may have borrowed outside the United States to finance their own operations. Instead, the present rules assume that debt incurred by U.S. group members disproportionately funds the operations of foreign subsidiaries and over-allocate interest expense to foreign source income (an effect commonly referred to as “water’s edge fungibility”). The effect of these rules is to understate the taxpayer’s foreign tax credit limitation.¹⁷⁰

To remedy this situation, Congress enacted legislation § 864(f) in 2004 which allows the domestic members of an affiliated group to elect to determine their interest expense allocation and apportionment on the basis of a world-wide affiliated group, under which all corporations, domestic and foreign, that satisfy the eighty percent ownership requirement are included as members in the affiliated group.¹⁷¹ Through subsequent legislation, however, Congress has delayed the effective date of this provision to taxable years beginning after December 31, 2017.¹⁷² Once the legislation becomes effective (assuming it ever does) and an affiliated group makes the election, the taxable income of the domestic members of the affiliated group from foreign sources will be determined by allocating and apportioning the interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group’s worldwide interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group over (2) the interest expense

¹⁷⁰ JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 17.

¹⁷¹ I.R.C. § 864(f)(1). The common parent of the domestic affiliated group must make the election. I.R.C. § 864(f)(5)(D). The election was originally enacted as part of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 401, 118 Stat. 1418, 1488-91 (2004), and made available for taxable years beginning after December 31, 2008.

¹⁷² Congress subsequently extended the original effective date of § 864(f) to taxable years beginning after December 31, 2010, as part of the Housing Assistance and Recovery Act of 2008, Pub. L. No. 110-289, § 3093(a), 122 Stat. 2877, 2912 (2008), and then to taxable years beginning after December 31, 2017, by the Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, § 15, 123 Stat. 2984, 2996 (2009). More recently, proposals have been made to repeal § 864(f) or to extend its effective date. The Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. § 3203 (2007) (introduced by Representative Charles Rangel, Chair of the House Ways and Means Committee, and providing for the repeal of § 864(f)); The Affordable Health Care for America Act, H.R. 3962, 111th Cong. § 554 (2009) (passed by the House of Representatives and providing for the repeal of § 864(f)).

incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the provision's principles were applied separately to the foreign members of the group.¹⁷³ Although the interest expense of a foreign subsidiary is taken into account for purposes of allocating the interest expense of the domestic members of the electing worldwide affiliated group, the interest expense incurred by the foreign subsidiary is not deductible for U.S. tax purposes. A group's election to allocate interest expense on a worldwide basis is expected to reduce the amount of the domestic members' interest expense that is allocated to foreign source income, to the extent that the group borrows offshore as well as in the United States.

The application of interest allocation rules for interest expense can be illustrated through the following example:¹⁷⁴ P is a U.S. corporation holding the stock of DS, a wholly-owned domestic subsidiary, and FS, a wholly-owned foreign subsidiary. Each subsidiary has assets with a value of \$200 and indebtedness of \$100, bearing the same rate of interest. If the affiliated group includes only domestic corporations, the P group would have assets with a value of \$300 (DS's assets with a value of \$200 and the stock of FS with a value of \$100). Because one third of the group's assets generate foreign source income, one-third of DS's interest expense would be allocated to foreign source income and two-thirds of DS's interest expense would be allocated to domestic source income. Alternatively, if the affiliated group includes both domestic and foreign corporations, the P group would have assets with a value of \$400 (DS's assets with a value of \$200 and FS's assets with a value of \$200). The interest expense of the domestic members of the group that is treated as foreign source would be the excess of one-half (foreign assets with a value of \$200/total assets of the affiliated group with a value of \$400) of the worldwide interest expense over the interest expense incurred by foreign members of the group. Because the interest expense of DS and FS is equal, all of DS's interest expense is allocable to domestic source income.

The Regulations also provide special allocation and apportionment rules with respect to research and experimentation (R&E) expenditures that are deductible under § 174. Generally, the place where the research and development actually takes place is *not* determinative of how R&E expenses are allocated between domestic and foreign source income. Instead, a taxpayer's R&E expenses are considered definitely related to all

¹⁷³ I.R.C. § 864(f)(1)(B).

¹⁷⁴ This example is taken from N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON INTERNATIONAL PROVISIONS OF H.R. 3970 AND EFFECTS OF REDUCTION IN CORPORATE TAX RATES 17 (Dec. 24, 2008), available at <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1173Report.pdf>, reprinted in LEXIS, 2008 TNT 249-24.

income reasonably connected to the broad product category or categories to which the R&E expenses relate. Thus, R&E expenses are deemed allocable to all gross income items as a class (including income from sales, royalties, and dividends) related to a particular product category or categories, regardless of whether the income in that class is domestic or foreign source.¹⁷⁵ Once R&E expenses are allocated to specific product categories, a certain portion of the research and development expenses is apportioned between domestic-source and foreign-source income on the basis of the geographic situs of the research generating the bulk of the expense.¹⁷⁶ Thus, the most important effect of the applicable sourcing rules is to apportion a relatively large amount of the total research and development expenditures to the jurisdiction where the research and development was performed—a favorable outcome when the research and development is carried out domestically.

The rules governing the apportionment of R&E expenses between United States and foreign source income are more complicated than the allocation rules. Basically, they consist of (1) a specified exclusive apportionment of an arbitrary percentage of the total R&E expenses to the jurisdiction where most of the research and development activity took place and (2) an apportionment of the remaining amount based on the application of either the sales method or the gross income method, at the taxpayer's election.¹⁷⁷ Under the sales method, fifty percent of the R&E expenses are exclusively apportioned to either the statutory grouping of gross income or the residual grouping of gross income arising from the geographic source where the research and development activities accounting for more than fifty percent of the amount of the total R&E expenses were performed.¹⁷⁸

¹⁷⁵ Treas. Reg. § 1.861-8(e)(3), -17(a)(1) (as amended in 2009). Product categories are determined by use of Standard Industrial Classification (SIC) codes (i.e., classifications established by the SIC Manual). Treas. Reg. § 1.861-17(a)(2). Taxpayers may divide R&E expenses between relevant product categories or may choose to aggregate (but not subdivide) categories. Treas. Reg. § 1.861-17(a)(2)(i). If an expense is not attributable to any specific product category, it is deemed to relate to *all* of the taxpayer's product categories. Treas. Reg. § 1.861-17(a)(2)(i).

¹⁷⁶ Treas. Reg. § 1.861-17(b).

¹⁷⁷ In the absence of an election, the taxpayer must utilize the sales method. A taxpayer cannot use both the sales method and one of the optional gross income methods. The entire R&E expenses must be apportioned using one or the other and the election is binding for five years, after which a change is permissible without the necessity of obtaining the Service's consent. Treas. Reg. § 1.861-17(d)(1)(ii), (e)(1), (e)(2).

¹⁷⁸ Treas. Reg. § 1.861-17(b)(1)(i), (c). See Treas. Reg. § 1.871-17(h) ex. (1) (for foreign tax credit purposes, where research and development was carried out in the United States, fifty percent of total deduction could be apportioned to the residual grouping of gross income from sources within the United States). A taxpayer may apportion an even greater percentage of the total R&E expense deduction to a specific jurisdiction if it proves to the Service that such an exclusive apportionment is warranted. The grounds for such an

Thus, the primary situs of the research and development activity will be the source of fifty percent of the total R&E expenses. The remaining fifty percent of the R&E expenses is then apportioned between the statutory and residual groupings within each allocated class of gross income according to the proportion that the sales within each of the statutory and residual groupings bears to total sales from the product category or categories to which the R&E expenses relate.¹⁷⁹

Under the gross income method, twenty-five percent of the R&E expense is exclusively apportioned to either the statutory grouping of gross income or the residual grouping of gross income arising from the geographic source where the research and development activities accounting for more than fifty percent of the amount of the total R&E expenses were performed.¹⁸⁰ Thus, the primary situs of the research and development activity will be the source of twenty-five percent of the total R&E expenses. The remaining seventy-five percent of the R&E expenses is then apportioned between the statutory and residual groupings in the proportion that the gross income in the statutory and residual groupings bear, respectively, to the total amount of gross income.¹⁸¹

Importantly, neither the sales nor the gross income method applies to expenditures required for compliance with governmental legal requirements; rather, they are allocated to domestic source if incurred in complying with United States law and to foreign source if incurred to comply with the law of a foreign jurisdiction.¹⁸²

increased exclusive apportionment are that “the research and experimentation is reasonably expected to have very limited or long delayed application outside the geographic source where it was performed.” Treas. Reg. § 1.861-17(b)(2)(i).

¹⁷⁹ Treas. Reg. § 1.871-17(h) ex. (1).

¹⁸⁰ Treas. Reg. § 1.861-17(b)(1)(ii), (d). Again, however, if the fifty percent geographic source test is not met, no exclusive apportionment will be made.

¹⁸¹ Treas. Reg. § 1.861-17(d)(2), (d)(3). This option is only available if (1) the amount of R&E expenses apportioned to the statutory grouping is not less than fifty percent of the amount that would have been so apportioned if the taxpayer had used the sales method and (2) the amount of R&E expenses treated apportioned to the residual grouping is not less than fifty percent of the amount that would have been so apportioned if the taxpayer had used the sales method. Treas. Reg. § 1.861-17(d)(2)(i), (ii). If the first requirement is not satisfied, the taxpayer may apportion fifty percent of the amount of the R&E expenses that would have been apportioned to the statutory grouping under the sales method to the statutory grouping and then apportion the balance of the amount of R&E to the residual grouping. Treas. Reg. § 1.861-17(d)(3)(i). If the second requirement is not satisfied, the taxpayer may apportion fifty percent of the amount of the R&E expenses that would have been apportioned to the residual grouping under the sales method to the residual grouping and then apportion the balance of the amount of research and experimental expenses to the statutory grouping. Treas. Reg. § 1.861-17(d)(3)(ii).

¹⁸² I.R.C. § 864(f)(1)(A) (2006); Treas. Reg. § 1.861-17(a)(4) (geographic-based allocations permitted if research and development is undertaken to meet government legal requirements and costs will generate only de minimis income in other jurisdictions).

The choice of sourcing rules applicable to research and development expenses generally mitigate any negative impact on the foreign tax credit limitation that might otherwise result under sourcing rules based solely on sales or gross income of the associated product category or categories to which the R&E expenses relate. Instead, taxpayers are permitted an exclusive apportionment of R&E expenses to the primary situs of the R&D activity, typically the United States. In this manner, a domestic taxpayer avoids “deflating” the numerator of the foreign tax credit limitation fraction and, thus, its § 904 foreign tax credit limitation. In addition, as the United States generally requires far more testing and analysis of new and existing products than do foreign countries, the special exception tying research and development to governmental legal requirements also serves to beneficially apportion R&E expenses to United States source income.¹⁸³

B. The Obama Administration Proposals

Significantly, the sourcing rules described above do not distinguish between foreign-source deductions that are attributable to the generation of foreign-source income subject to current United States taxation and foreign-source income that is deferred under the current international tax regime until the income is repatriated, typically in the form of a dividend. As a result, current foreign source deductions are available to reduce current foreign source income even if the deductions are attributable to income of a foreign subsidiary that is not currently subject to United States taxation. This mismatch between the timing of income and deductions creates incentives for taxpayers to make tax-deferred foreign investments.¹⁸⁴

Significantly, the ability to deduct expenses attributable to foreign source income while deferring the foreign source income itself produces a result under the current tax system that is better than the result available under an exemption system.¹⁸⁵ Under an exemption system, expenses attributable to foreign source income exempt from tax cannot be deducted in the determination of the taxpayer’s taxable income.¹⁸⁶ The deduction of such expenses under the current tax system produces tax savings for the taxpayer until such time as the deferred foreign source income subsequently is taxable. The mismatch of the deduction and the income results in a

¹⁸³ See I.R.S. Tech. Adv. Mem. 82-11-004 (Nov. 27, 1981) (stating that further testing required by United States FDA was qualified research and development expense under §174 despite fact that the product was already being marketed outside of the United States).

¹⁸⁴ JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 13.

¹⁸⁵ Fleming, Peroni & Shay, *supra* note 14, at 116–18.

¹⁸⁶ See, e.g., PRESIDENT’S ADVISORY PANEL, *supra* note 6, at 102–05, 132–35, 239–43 (disallowing deductions, including interest expense and overhead expenses, attributable to foreign source income under an exemption system).

negative effective tax rate, thereby creating the financial incentive for taxpayers to make tax-deferred foreign investments.

In order to remedy this problem, the Obama Administration has proposed that the current deduction of expenses that are related to foreign-source income on which U.S. tax is deferred be deferred until the income to which they relate is subject to U.S. tax.¹⁸⁷ By matching more closely the timing of expense deductions with income inclusion, the proposal is intended to reduce the incentive under present law for a domestic corporation to derive income through foreign subsidiaries in low-tax jurisdictions.¹⁸⁸ Although the proposal does not directly address concerns involving distortions under the current tax system with respect to a domestic corporation's decision regarding when the earnings of a foreign subsidiary are actually repatriated to the United States, the proposal may encourage corporations to repatriate the earnings of a foreign subsidiary if, in doing so, deferred foreign source deductions would be made available.¹⁸⁹

The Administration's revenue proposals for the 2010 fiscal year included a deferral rule in connection with all foreign-source expenses other than R&E expenses, which were explicitly excluded.¹⁹⁰ The types of

¹⁸⁷ FISCAL YEAR 2011 REVENUE PROPOSALS, *supra* note 17, at 39–40 (proposing the deferral of only interest expenses related to deferred foreign-source income); FISCAL YEAR 2010 REVENUE PROPOSALS, *supra* note 17, at 29 (proposing the deferral of all expenses except R&E expenses related to deferred foreign-source income). The Administration's proposal is similar to one adopted in The Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. (2007), introduced by Representative Charles Rangel, Chair of the House Ways and Means Committee. For a comparison of the proposal in H.R. 3970 and that by the administration, see Nijenhuis, *New York State Bar Association*, *supra* note 17, at 9–17; Stack, et al., *supra* note 17, at 452–54.

¹⁸⁸ As stated by the Treasury Department, the “ability to deduct expenses from overseas investments while deferring U.S. tax on the income from the investment may cause U.S. businesses to shift their investments and jobs overseas, harming our domestic economy.” FISCAL YEAR 2011 REVENUE PROPOSALS, *supra* note 17, at 39; FISCAL YEAR 2010 REVENUE PROPOSALS, *supra* note 17, at 29. However, the Joint Committee questioned any conclusion that the proposal would increase investment in the United States:

If the proposal has the effect of reducing incentives to invest abroad rather than in the United States, it is possible in theory that investment in the United States by U.S. taxpayers may increase. Because, however, empirical research has not produced definitive conclusions about the effect of foreign direct investment on U.S. labor productivity, wages, and aggregate national income, the proposal's effects on these features of the U.S. economy are uncertain.

JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 15 (citation omitted).

¹⁸⁹ JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 15–16.

¹⁹⁰ FISCAL YEAR 2010 REVENUE PROPOSALS, *supra* note 17, at 29. The exception for R&E expenses was based on the “positive spillover impacts of those investments on the U.S. economy.” Press Release, White House Office of the Press Secretary, Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives For Shifting Jobs Overseas (May

expenses that would be most affected by such a proposal are interest expenses, stewardship and supportive expenses, and general and administrative expenses.¹⁹¹ The administration's revenue proposals for the 2011 fiscal year narrowed the proposal and included a deferral rule only in connection with foreign-source interest expenses.¹⁹² The exclusion of stewardship and supportive expenses, along with general and administrative expenses, from the administration's later proposal may be explained in part as a result of criticisms that enactment of the original proposal would have encouraged corporations to move functions in the headquarters to foreign countries.¹⁹³ In addition, the 2011 proposal is clear that, because foreign-source income earned through a branch is currently subject to United States taxation, the deferral rule does not apply to interest expense properly allocated and apportioned to such income.¹⁹⁴

One commentator has proposed a three-step process under which interest expense would be allocated in a manner consistent with the proposal.¹⁹⁵ First, foreign-source interest expense would be determined

4, 2009), available at http://www.whitehouse.gov/the_press_office/LEVELING-THE-PLAYING-FIELD-CURBING-TAX-HAVENS-AND-REMOVING-TAX-INCENTIVES-FOR-SHIFTING-JOBS-OVERSEAS. In reviewing the proposal, the staff of the Joint Committee on Taxation noted that the exclusion of R&E expenses could be viewed as consistent with the administration's proposal to make the research tax credit under § 41 permanent but nevertheless questioned the exclusion as potentially undermining the overall policy goal of the proposal to reduce the incentive for United States taxpayers to shift income overseas. JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 18.

¹⁹¹ JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 16. Stewardship expenses are incurred by one company for oversight functions performed for the company's own benefit as an investor in a related company. They include expenses to facilitate compliance by the corporation with reporting, legal or regulatory requirements, as well as other "duplicative activities" and "shareholder activities." Treas. Reg. § 1.861-8(e)(4)(ii) (as amended in 2009). Supportive functions are those expenses necessary to operate a corporation but which are not necessarily related to any one entity or group of entities; they include overhead, supervisory and general and administrative expenses. Treas. Reg. § 1.861-8(b)(3).

¹⁹² FISCAL YEAR 2011 REVENUE PROPOSALS, *supra* note 17, at 39. Unlike the Obama Administration's 2011 proposal, the similar provision contained in The Tax Reduction and Reform Act of 2007 would apply to defer the timing of most deductions, including interest, R&E expenses, stewardship and supportive expenses, and general and administrative expenses. In addition, the provision would apply to defer the deduction of foreign-source expenses allocable to foreign-source income earned by a United States taxpayer through a branch as well as a foreign subsidiary. Thus, the Administration's 2011 proposal is significantly narrower than other similar proposals that have been considered.

¹⁹³ Fuller, *supra* note 17, at 774 (stating that "[t]his provision seems counterproductive if one of the purported goals is U.S. job creation").

¹⁹⁴ FISCAL YEAR 2011 REVENUE PROPOSALS, *supra* note 17, at 39. Other foreign-source income that is earned directly, such as royalty income, would be similarly treated. The administration's original proposal did not distinguish between foreign source income earned by a branch or through a subsidiary.

¹⁹⁵ Nijenhuis, *New York State Bar Association*, *supra* note 17, at 13–15.

based on the relative value of the taxpayer's domestic and foreign assets. Second, foreign-source interest expense attributed to foreign subsidiaries would be determined based on the relative value of the foreign assets directly held by the taxpayer and the value of the stock of the foreign subsidiaries held by the taxpayer. Third, deferred foreign-source interest expense would be determined based on the relative amount of deferred and distributed earning and profits of the foreign subsidiaries.¹⁹⁶ For example, assume that corporation P holds assets producing domestic source income with a value of \$1,500, assets of a branch producing foreign source income with a value of \$500 and the stock of a wholly-owned foreign subsidiary, FS, with a value of \$1,000.¹⁹⁷ P incurs interest expense of \$120, and FS has earnings and profits in the current taxable year of \$100, of which only \$50 is distributed. Under the current allocation and apportionment rules, \$60 of interest expense would be apportioned to foreign source income (i.e., \$120 interest expense x \$1,500 assets producing foreign source income/\$3,000 total assets held by P). Two-thirds of the total foreign source interest expense, \$40, would then be allocated to P's investment in FS (\$60 foreign source interest expense x \$1,000 value of the stock in FS/\$1,500 assets producing foreign source income). Because only half of FS's earnings and profits are taxable to P by the United States, \$20 of the foreign-source interest allocable to P's investment in FS would be deductible in the current year and the remaining \$20 foreign-source interest would be deferred.

The allocation and apportionment rules would produce a slightly different result if the rules permitting the allocation of interest expense on a worldwide basis ever become effective.¹⁹⁸ Using the facts in the previous example and assuming that corporation FS has assets with a value of \$2,000, liabilities of \$1,000 and interest expense of \$60, P's worldwide group has assets with a value of \$4,000, \$1,500 of which produce domestic source income and \$2,500 of which produce foreign source income.¹⁹⁹ Under the allocation and apportionment rules as modified by § 864(f),

¹⁹⁶ The proposal provides only for the deferral of interest expense properly allocated and apportioned to "a taxpayer's foreign-source income that is not currently subject to U.S. tax." FISCAL YEAR 2011 REVENUE PROPOSALS, *supra* note 17, at 39. The proposal does not specify how this foreign-source income would be computed. See JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 23. One commentator has suggested that deferred foreign-source income for this purpose be treated as the taxpayer's share of undistributed non-Subpart F earnings and profits of the taxpayer's foreign subsidiaries with respect to which the taxpayer satisfies certain specified ownership requirements. Nijenhuis, *New York State Bar Association*, *supra* note 17, at 10.

¹⁹⁷ This example is contained in Nijenhuis, *New York State Bar Association*, *supra* note 17, at 13–14 and 60.

¹⁹⁸ See *supra* text accompanying notes 166–168.

¹⁹⁹ This example is contained in Nijenhuis, *New York State Bar Association*, *supra* note 17, at 14–15 and 61.

\$112.50 of the affiliated group's combined interest expense would be apportioned to foreign source income (i.e., \$180 interest expense x \$2,500 assets producing foreign source income/\$4,000 total assets held by P and FS). Ninety dollars of the total foreign source interest expense would then be allocated to the assets held by FS (\$112.50 foreign source interest expense x \$2,000 value of the assets held by FS/\$2,500 assets producing foreign source income). Because FS actually paid \$60 of interest expense, only \$30 of P's interest expense would be attributable to FS.²⁰⁰ Because only half of FS's earnings and profits are taxable to P by the United States, only \$15 of P's interest expense attributable to FS would be deductible in the current year and the remaining \$15 foreign-source interest would be deferred.

To the extent that the rules permitting the allocation of interest expense on a worldwide basis result in a more appropriate allocation of interest expense between domestic and foreign source income, the inability of U.S. taxpayers to elect these rules means that the interest expense attributable to foreign sources is overstated under the current allocation and apportionment rules. Thus, the effect of the current rules is to understate a taxpayer's foreign tax credit limitation. This distortion is further compounded by the Obama Administration's proposal to defer foreign source interest expense to the extent that the earnings of a foreign subsidiary are deferred. The Joint Committee recognized this problem when it stated that "the overallocation of interest expense to foreign source income under the present 'water's edge' allocation rules would result in overstatement of the amount of interest expense subject to deferral—an effect that could be more costly than understatement of the foreign tax credit limitation if the taxpayer's offshore investments are located in relatively low-tax countries."²⁰¹ As a result, a significant review of these two intertwined provisions needs to be undertaken in order to obtain the set of rules that most appropriately provides for the determination of the amount and timing of foreign source interest deductions.

The administration's proposal provides that "[d]eferred interest expense would be deductible in a subsequent tax year in proportion to the amount of the previously deferred foreign-source income that is subject to

²⁰⁰ The remaining \$90 of P's \$120 interest expense is attributable to P's domestic and foreign branch assets producing domestic and foreign source income, respectively. More specifically, \$67.50 of interest expense is attributable to domestic source income producing assets (i.e., \$180 interest expense x \$1,500 assets producing domestic source income/\$4,000 total assets held by P and FS), and \$22.50 of interest expense is attributable to foreign source income producing branch assets held by P (i.e., P's interest expense of \$120 - \$67.50 of interest expense attributable to domestic source income producing assets - \$30 of P's interest expense attributable to FS).

²⁰¹ JOINT COMM., DESCRIPTION OF REVENUE PROVISIONS, *supra* note 17, at 18.

U.S. tax during that subsequent tax year.”²⁰² This statement suggests that taxpayers must maintain records of deferred interest expense and the associated deferred income and that deferred interest expense will only be deductible when the directly-associated deferred income becomes subject to U.S. tax. This approach would require ordering rules to determine when deferred income that accrues across several years becomes subject to U.S. tax. Alternatively, a multi-year pooling method could be adopted under which the deferred interest expense accumulated over a number of years could be deductible in proportion to the reduction in the pool of deferred income resulting from the distribution of the deferred income.²⁰³

V. CONCLUSION

The Obama Administration’s international tax reform proposals contained in the budget proposals for the 2010 and 2011 fiscal years, including the modifications of the check-the-box rules and the foreign tax credit and the deferral of certain foreign source deductions as described above, do not represent the type of comprehensive tax reform advocated by the proponents of either a pure worldwide tax system or a territorial/exemption tax system. However, serious debate over incremental reform proposals such as these may begin to generate a deeper appreciation on the part of policy makers and shapers within government and the international business community of the trade-offs and choices that must be made in order to bring the current international tax regime up to date with the realities of global business arrangements in the 21st century. Such an appreciation may then make the task of continued incremental tax reform, and perhaps even more comprehensive tax reform efforts, easier to achieve in the future as political and economic conditions change.

Incremental tax reform may also be the only feasible approach at a time when the political system is immersed in other difficult and contentious policy battles. Fundamental reform of the health system, the financial system, and possibly the immigration system are currently all “front-burner” issues, and the political system cannot be expected to undertake comprehensive reform efforts on multiple fronts at once. In addition, the tax legislative process itself, at least as experienced over the last several decades, has become analogous to an assembly line with minor change on an annual basis and significant change almost as frequently. The

²⁰² FISCAL YEAR 2011 REVENUE PROPOSALS, *supra* note 17, at 39–40.

²⁰³ See Nijenhuis, *New York State Bar Association*, *supra* note 17 (commenting on the original administration proposal contained in the 2010 fiscal year revenue proposals). One commentator also recommended that deferred expenses should be deductible if reductions in the earning and profits of a foreign subsidiary subsequently occur in order to avoid a situation in which the deferred expenses are permanently disallowed. *Id.*

machinery for incremental tax reform is in place and operating in both the Treasury Department and Capitol Hill as demonstrated by the Obama Administration's proposals and their review by the Joint Committee on Taxation.²⁰⁴

One cautionary aspect of incremental, as opposed to comprehensive, tax reform is the risk that an incremental approach may advance only those proposals that are projected to raise government revenue, particularly given the current budgetary constraints that confront the federal government, and that such proposals will be viewed by the legislative process as largely a means to fund other budgetary priorities. Presumably, comprehensive tax reform would include changes to the current tax system that would both increase and decrease government revenues as policy choices regarding the type of tax system, a desire to stimulate employment and business growth in the United States, and the concern for additional governmental revenue are made. Thus, an incremental approach to tax reform given current budgetary constraints may be a one-sided battle in which the need for increased government revenue is favored. Moreover, the legislative process may well "cherry-pick" among reform proposals on the basis of revenue projections given the revenue demands of unrelated legislative priorities, all without adequate attention to the effects that such piecemeal change will have on the coherence of the tax system itself. These concerns can be allayed only through the vigilance of the policy makers in the Treasury Department and the tax-writing committees on Capitol Hill who are the parties primarily responsible for the integrity of the tax system.

²⁰⁴ See *supra* note 17.

