

**The New Look-Through Rule:
W(h)ither Subpart F?¹**

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This report discusses new section 954(c)(6) from an historical, practical, and policy perspective. It begins with the history of antideferral regimes in general and subpart F in particular to establish the legislative context for the provision, and also reviews check-the-box planning under subpart F, which is a critical part of the backdrop of section 954(c)(6). It then examines section 954(c)(6) itself, compares it to the check-the-box planning that preceded it and discusses recent IRS guidance in the area. The report then offers some suggestions for future IRS guidance and some ideas about what Congress might think about doing next.

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Table of Contents

Introduction 349

I. The History and Context of Subpart F 350

 A. The Theory of Antideferral Legislation 350

 B. Background of Subpart F 351

 C. The Enactment of Subpart F 352

 D. Statutory Evolution of Subpart F Through 2005 355

 E. The State of Antideferral Regimes in 2005 357

 F. PFIC Rules 357

 G. Other Countries 358

II. Check the Box: Subpart F Planning 359

 A. Pre Check the Box: The *Kintner* Regulations 359

 B. Check the Box 360

 C. Notice 98-11 and Its Aftermath 361

 D. Limitations of Check-the-Box Planning 362

III. Enactment of Section 954(c)(6) 364

 A. Statute and Legislative History 364

 B. Section 954(c)(6) and Check the Box Compared 366

IV. IRS Guidance Under Section 954(c)(6) 368

 A. Notice 2007-9 368

 B. Issues for Future Regulations 373

V. Possible Next Steps for Congress 375

 A. Taking Section 954(c)(6) One Step Further 375

 B. What About the Rest of Subpart F? 376

 C. Other Possibilities 377

Introduction

On the surface, section 954(c)(6)² looks like a narrow technical rule. In fact, it is much more than that. At least until the end of next year, it has, without fanfare, effectively repealed antideferral rules for much of what subpart F of the Internal Revenue Code was originally intended to prevent — payments between controlled foreign corporations that reduce foreign tax. Of course, the check-the-box rules (in particular, their byproduct, the disregarded entity (DRE)), already did much of that work, but not directly, and certainly not without controversy. Section 954(c)(6) turns the phenomenon into an express congressional policy choice³ and, as a result of addressing the issue directly, implements that policy choice more completely and efficiently.

Section 954(c)(6) came into the law somewhat quietly, through an oddly named piece of legislation (the Tax Increase Prevention and Reconciliation Act of 2005,⁴ or TIPRA, which was enacted in May 2006).⁵ Section 954(c)(6) had earlier passed the Senate and the House as part of the American Jobs Creation Act of 2004, but was

²Internal Revenue Code of 1986, as amended (the code). Unless otherwise specified, all section references herein are to the code or the Treasury regulations promulgated thereunder.

³Proposed H.R. 6288 would make section 954(c)(6) permanent.

⁴P.L. 109-222, section 103(b), 120 Stat. 345 (2006).

⁵To be fair, it was first proposed (and passed the House) in 2005. The House bill had contained proposed section 954(c)(6), but the Senate bill did not.

¹Apologies to Prof. Curtis J. Berger, author of “W(h)ither Partnership Taxation?” 47 *Tax L. Rev.* 105, 1991-1992.

then dropped without explanation in conference.⁶ When it reemerged one-and-a-half years later in TIPRA it did not attract huge preenactment attention, and when finally enacted, its retroactive effective date surprised some taxpayers.⁷ At the other end of its time horizon, it is currently scheduled to sunset in less than two years, and some taxpayers wonder whether it makes sense to restructure all of their foreign operations now and possibly have to restructure again at the end of next year if section 954(c)(6) is not extended or made permanent.

The appearance of section 954(c)(6) highlights the continually evolving and frequently contradictory nature of subpart F policy. The legislature's original intent in enacting subpart F was to impose some constraints on the offshore movement of American capital, both to limit undue advantages enjoyed by investing abroad and to prevent tax avoidance through the use of offshore havens and shelters.⁸ As originally enacted, subpart F reflected a compromise between the two conflicting goals of capital export neutrality (defined as a state in which a U.S. investor is tax-indifferent to making an investment at home or abroad) and "competitiveness" or capital import neutrality (defined as a state in which a U.S. investor in a foreign country is not at a comparative disadvantage regarding investors from that country or from third countries, as that investor would be, proponents assert, if it alone faced current at-home taxation on its unrepatriated gains there).⁹ The last 45 years have not resolved the conflict, and that long-running tug-of-war is one of the reasons why subpart F has always been unpredictable and confusing.

It was frequently said before section 954(c)(6) was enacted that subpart F did not have a generalized look-through rule,¹⁰ but, as practitioners know, since 1997 there has been de facto look-through treatment in many cases through the use of the check-the-box rules.¹¹ The use of the check-the-box rules to achieve look-through treatment in the international context was initially controversial and, while Treasury backed down from its initial attack on the technique, it has never quite given up.¹² Section 954(c)(6) resolves the controversy, at least

for a while, by providing an explicit, and broader, look-through rule, which is a logical next step.

In taking that step, section 954(c)(6) raises both technical and policy issues. Thus, this report. Many of the technical questions relate less to the parsing of new statutory language than to figuring out how the new law fits into the enormously complicated system onto which it has been grafted. In January the IRS and Treasury released Notice 2007-9,¹³ which makes an excellent start at resolving many of those issues (although some of its decisions are questionable) and it leaves several questions unanswered. The broader policy questions include: (1) Why is this a three-year statute?¹⁴ (2) What is the statute trying to achieve as a policy matter? (3) In light of (2), does section 954(c)(6) stop in the right place? (4) Are its policy objectives even the right ones? In this report I attempt to understand that change to subpart F on the backdrop of its prior evolution, and in the greater context of international tax planning as it is practiced now and has been practiced over the last several decades. I'll look first at the historical background of subpart F and check-the-box planning, then at the changes brought about by the new look-through rule, and then move on to the broader implications of section 954(c)(6) and some thoughts on what next steps Congress and Treasury might take to rationalize the taxation of offshore activities.

I. The History and Context of Subpart F

A. The Theory of Antideferral Legislation

In general, under the code's classical system, a U.S. corporation, like a U.S. individual, is subject to tax on its income, and the individuals (or other corporations) who own shares in the corporation are not subject to tax on the

18-18 (2005 JCT Study), which recommended both a look-through rule for dividends received from CFCs and treatment of all single-member foreign DREs as corporations for U.S. tax purposes. See also related comments by former Treasury International Tax Counsel Hal Hicks, quoted in Lee A. Sheppard, "News Analysis: Check-the-Box Rules Not Sacred, Says Hicks," *Doc 2006-10706*, 2006 TNT 107-8, explicitly refusing to rule out regulatory cutback of the check-the-box rules.

¹³2007-5 IRB 401, *Doc 2006-25337*, 2006 TNT 245-6.

¹⁴There are few hints in the legislative history and it is difficult to figure out why Congress would choose a three-year period for such a structural change. There is, of course, a recent history of limited-duration code provisions ranging from section 965 (which was quite deliberately and, if you accept its premise, sensibly a provision of limited duration) to the sunset rate and similar reductions and the estate tax phaseout and repeal that are in the code (for which it is hard to figure out a rationale that isn't purely revenue-estimate driven and, frankly, cynical). Closer to the subject at hand are sections 953(e) and 954(h), subpart F exceptions for some active banking, financing, and similar business, first enacted as a one-year provision and serially extended since for increasing periods, with some changes. That may have been driven by a combination of revenue considerations and by a notion that enacting the provision temporarily is sort of a laboratory experiment to see how the provision works. Maybe that's what is going on with section 954(c)(6). We shall see. The change of control in Congress may well affect the outcome.

⁶The provision was included in H.R. 4520, 108th Cong., 2d Sess., section 311 (June 4, 2004), and in S. 1637, 108th Cong., 2d Sess., section 222 (May 19, 2004).

⁷See, e.g., New York State Bar Association Report No. 1123, submitted on Dec. 4, 2006, *Doc 2006-24305*, 2006 TNT 234-21 (NYSBA Report), and American Institute of Certified Public Accountants, "Comments on CFC Look-Through Rule Guidance," submitted on Dec. 11, 2006, *Doc 2006-25123*, 2006 TNT 242-43 (AICPA Report).

⁸S. Rep. No. 1881, 87th Cong., 2d Sess. (1962) (1962 Senate Report).

⁹For a succinct overview of that position, see David P. Hariton, "Notice 98-11 Notwithstanding, What Should Be Done With Subpart F?" *Tax Notes*, Apr. 20, 1998, p. 388.

¹⁰See, e.g., William L. Burke, "Subpart F and the 21st Century," *Tax Club report*, Apr. 30, 2001.

¹¹Reg. section 301.7701-2, -3, and -3T.

¹²See, e.g., "Options to Improve Tax Compliance and Reform Tax Expenditures," prepared by the staff of the Joint Committee on Taxation, JCS-02-05 (Jan. 27, 2005), *Doc 2005-1714*, 2005 TNT

(Footnote continued in next column.)

corporation's earnings and profits until the corporation's income is distributed to them in the form of a dividend or redemption or they sell their shares. Throughout much of the history of the code, an individual's gains on sale were taxed at capital gains rates that were significantly lower than tax rates applicable to dividends.¹⁵ Moreover, because the code defines corporate residence by reference to jurisdiction of incorporation, corporations that are incorporated under the laws of a foreign jurisdiction are not subject to U.S. tax at all, unless they undertake some activity that connects them with the United States. Thus, in the code's early days, when corporate tax rates were low, it was possible for a U.S. taxpayer to put passive assets into a U.S. corporation, keep them there, and pay low tax on the earnings. Even better, if the corporation was a foreign corporation investing in foreign assets, no one would pay any U.S. tax at all on income produced by the assets until those proceeds were actually brought home to the United States.

Those planning opportunities (sometimes called the incorporated pocketbook) did not escape the notice of our predecessors. Early statutory rules¹⁶ to combat inappropriate use of corporations (which required a showing of tax avoidance purpose) generally had proved ineffective to stop those techniques. In 1934 Congress finally caught on, and enacted the personal holding company (PHC) rules. Those rules taxed the undistributed income of a closely held corporation with substantial passive income at a rate that was much higher than the ordinary corporate rate.¹⁷ Wily taxpayers and their advisers responded to the PHC rules by creating their passive-asset-containing corporations offshore. In 1937¹⁸ Congress responded with the foreign personal holding company (FPHC) rules, which took a new and different approach.¹⁹ The rules applied to closely held corporations (more than 50 percent owned by five or fewer U.S. individuals, taking into account constructive ownership) that earned 60 percent²⁰ or more FPHC income (FPHCI), which was defined as dividends, interest, royalties, annuities, gains from the sale of stock and securities, and some kinds of

rents. If those tests were met, the FPHC rules taxed the corporation's U.S. owners currently on the corporation's undistributed income.

Those rules did not end tax planning opportunities involving foreign corporations; many opportunities for deferral remained. The corporation could be more widely held, or it could conduct an active business but be "stuffed" with passive assets as long as the income produced by those assets did not rise to the level of 60 percent of the corporation's income.²¹ Also, the PHC and FPHC rules had no impact at all on even wholly owned foreign subsidiaries of widely held U.S. corporations. Those fact patterns, however, largely escaped congressional attention until the 1960s.

B. Background of Subpart F

In the early 1960s, the Kennedy administration decided to revisit the area. One area of concern was the development of tax avoidance techniques for income, both passive and active, that large American companies had earned abroad. Multinationals were earning more and more passive income overseas and had also developed some more sophisticated uses of low- or no-tax jurisdictions to artificially reduce tax liability on their overseas active businesses. The paradigmatic example of such a transaction is classic earnings stripping: A subsidiary in a tax-haven jurisdiction enters into a transaction, say a loan, with an affiliate in a high-tax jurisdiction that requires the high-taxed affiliate to make very high tax-deductible payments. Those payments reduce tax in the high-tax jurisdiction and move the corresponding income to a tax haven that does not tax it (or at least does not tax it much). The income, having been shifted into a low-tax jurisdiction, is then kept offshore and any U.S. tax imposed on the income is deferred until the income is brought home (assuming it is brought home at all).

Example 1. U.S. parent (USP) has a foreign subsidiary (FS1) incorporated in Country A, a jurisdiction that taxes corporate income at 40 percent, and another foreign subsidiary (FS2) incorporated in Country B, a tax-haven jurisdiction that does not tax corporate income. FS1 has annual taxable income of \$100, on which it would have \$40 of income tax. FS2 is the owner of patents that FS1 needs to conduct its business. FS1 and FS2 enter into a licensing agreement such that FS1 owes FS2 \$50 of licensing fees per year. FS1 deducts the licensing fees paid to FS2 and thereby reduces its taxable income to only \$50 per year, and reduces its annual tax bill to \$20, thus saving \$20 of tax each year. Meanwhile, FS2 pays no tax on the \$50 (or, for that matter, on any amounts it is able to earn by investing the \$50).

Note that the same result can be achieved if, instead of entering into a licensing agreement, FS2 leases tangible property, performs services, sells goods, or makes a loan

¹⁵Not today, of course. Section 1(h)(11).

¹⁶The ur-antideferral regime, included in the Revenue Act of 1913, created an exception to the classical system in the cases of corporations "created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of" the high personal tax rates. Revenue Act of 1913, Part II.A, subdivision 2. U.S. shareholders of those corporations were required to include their share of the corporation's E&P whether or not those had been distributed. The Revenue Act of 1921 replaced that rule with a corporate-level tax for corporations formed or availed of to avoid the surtax. Revenue Act of 1921, ch. 136, section 220, 42 stat. 227.

¹⁷The PHC rules are still with us in somewhat similar form, and can be found in sections 541 through 547.

¹⁸A predecessor to section 367 had been enacted in 1932, but, as is the case with section 367 today, did nothing when the foreign corporation was initially capitalized with cash.

¹⁹The FPHC rules remained on the books for 67 years until repealed by the Jobs Act in 2004 (on the theory that subsequent legislation made them largely redundant), and were most recently located in sections 551 through 558.

²⁰Fifty percent after the first year (former section 552(a)(1)).

²¹The accumulated earnings tax could apply to some of the cases described in this report, primarily involving domestic corporations; however, as a practical matter, it generally was not applied to widely held corporations.

to FS1. Any transaction that results in FS1 making deductible payments to FS2 will suffice.

C. The Enactment of Subpart F

Like much tax law, subpart F was born out of a combination of popular outrage and adroit lobbying. In the early 1960s, concern grew over two intertwined problems: the relative unattractiveness of American, as opposed to European, manufacturing, and the American balance of payments crisis.²² Also, there was an increasing awareness of the use of sophisticated tax planning, such as the earnings-stripping transactions mentioned above.²³ The Kennedy administration, buoyed by optimistic nationalism and a can-do spirit, rolled up its sleeves and went to work. The administration identified two kinds of problematic deferral: tax deferral and tax haven deferral.²⁴ Tax deferral referred to the plain-vanilla practice of earning income abroad without paying current U.S. tax on it (generally, under then-applicable law, by declining to repatriate), while tax haven deferral refers to stashing income in jurisdictions that impose little or no tax (especially income that is not earned by an active business there), as discussed in Example 1 above. Tax haven deferral was particularly of concern when it “artificially” reduced foreign taxes.

After reflection, the Kennedy administration recommended the full repeal of most tax deferral.²⁵ It particularly emphasized the harm caused by tax haven deferral. As President Kennedy said in his April 1961 tax message:²⁶

The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more enterprises organized abroad by American firms have

arranged their corporate structures — aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven — so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.

Kennedy was also explicit about his understanding of the relationship between the availability of deferral and the decision to invest in a given jurisdiction. He noted that developed countries no longer needed the investment boost that U.S. tax deferral afforded, but that developing countries should continue to benefit from what amounts to an investment subsidy:

To the extent that these tax havens and other tax deferral privileges result in U.S. firms investing or locating abroad largely for tax reasons, the efficient allocation of international resources is upset, the initial drain on our already adverse balance of payments is never fully compensated, and profits are retained and reinvested abroad which would otherwise be invested in the United States. Certainly since the post-war reconstruction of Europe and Japan has been complete, there are no longer foreign policy reasons for providing tax incentives for foreign investment in the economically advanced countries.

At the same time, I recommend that tax deferral be continued for income from investment in the developing economies. The free world has a strong obligation to assist in the development of these economies, and private investment has an important contribution to make. Continued income tax deferral for these areas will be helpful in this respect. In addition, the proposed elimination of income tax deferral on U.S. earnings in industrialized countries should enhance the relative attraction of investment in the less developed countries.²⁷

The final bill that passed Congress accepted the president’s recommendation to end tax haven deferral, but balked at stopping general tax deferral completely.²⁸ The reasoning was perhaps that not all offshore economic activity was as odious as the tax-motivated financings taking place in the Caribbean or Switzerland (or, more precisely, the financings using companies incorporated in

²²See the statement by Treasury Secretary Douglas Dillon (Dillon Statement) in Message from the President of the United States Relative to our Federal Tax System, H.R. Doc. No. 140, 87th Cong., 1st Sess. 7 (1961) (President’s Tax Message). See also discussion in David R. Tillinghast, “The Passage of the Revenue Act of 1962: Subpart F at Its Birth,” Jan. 12, 2005. For an excellent overview of the thinking that lay behind the drive to end deferral, see Paul W. Oosterhuis, “The Evolution of U.S. International Tax Policy: What Would Larry Say?” *Tax Notes*, July 3, 2006, p. 87, Doc 2006-11895, 2006 TNT 128-19.

²³In fact, there are some indications that the use of those techniques was undergoing an explosion in the early 1960s; the Kennedy administration claimed that more than one-third of the approximately 500 U.S.-owned firms in Switzerland were formed in 1960. President’s 1961 Tax Recommendations, Hearings before the Committee on Ways and Means on the Tax Recommendations of the President Contained in his Message Transmitted to the Congress, Apr. 20, 1961, 87th Cong., 1st Sess. (Vol. I) 303, 343 (1961) (1961 Hearings Before the House), cited in “The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study,” prepared by the Office of Tax Policy (OTP), Treasury Department (Dec. 2000) (OTP Study).

²⁴1962 Senate Report, *supra* note 8.

²⁵The Kennedy proposal would have preserved deferral for investment in developing countries to aid their development.

²⁶President’s Tax Message, *supra* note 22.

²⁷*Id.*

²⁸H.R. 10650, 87th Cong., 2d Sess. (1962). The reasoning for curtailing the reach of the bill is found in H. Rep. No. 1447, 87th Cong., 2d Sess. (1962) (1962 House Report): “Your committee’s bill does not go as far as the President’s recommendations. It does not eliminate tax deferral in the case of operating businesses owned by Americans which are located in the economically developed countries of the world.” Even faced with a watered-down bill, business interests raised competitiveness concerns about the rules that were enacted. See discussion of the Senate floor debates at pages 20-21 of the OTP Study, *supra* note 23.

those jurisdictions).²⁹ Certainly, there was nothing wrong with a foreign subsidiary of an American company manufacturing widgets in Lille and selling them in Paris, and why should that American company be at a disadvantage compared with French widget makers? The House report in particular recognized that active businesses conducted by subsidiaries of American companies in foreign countries tended to stimulate American exports to those countries and that current taxation to U.S. shareholders on the active earnings of those businesses might disadvantage U.S. firms, noting that “it appeared that to impose the U.S. tax currently on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax.”³⁰ Congress reasoned that that distinction could be captured by making a rule that applied to a wider range of companies and types of income than those covered by the FPHC rules.

The drafters generally denied deferral to “subpart F income,” which was defined as income from the insurance of U.S. risks and foreign base company income. Foreign base company income was in turn defined as FPHCI plus foreign base company sales income and foreign base company services income. FPHC was defined by reference to section 553, a part of the FPHC regime (with modifications), which in turn referred to section 543, which defined PHC income for the even more venerable PHC rules. Foreign base company sales income includes income from property sold to, or purchased from, a related party, if the property was manufactured and sold for use outside the CFC’s country of incorporation. Foreign base company services income is income derived from the performance of specified services for a related party outside the CFC’s country of incorporation.³¹ That last category clearly has its origin in Kennedy’s mention of the use of “shifting management fees” as part of the arsenal of tactics used to create tax haven income.

By extending the reach of FPHCI to a wider range of foreign corporations, the new law killed two birds with one drafting stone. Some of the most commonly seen earnings-stripping techniques — namely related-party lending, leasing, and licensing — were automatically covered, as interest, rent, and royalties were among the

original categories of FPHCI.³² Current taxation of those categories of income captured not only income-producing assets that generated passive income and could be easily moved from one jurisdiction to another (the original focus of the FPHC rules), such as debt instruments, passively held stock, or intellectual property, but also now covered intercompany transactions that generated the same classes of income (interest, dividends, and royalties). None of the inter-CFC payments are truly “passive” income (indeed, as generally accepted accounting principles accounting recognizes, from the perspective of the parent they are not truly income at all). But with the exception of dividends, they can move taxable income from a high-tax jurisdiction to a low-tax jurisdiction, which appears to have been a target of the legislation.

The original version of subpart F also contained some notable exceptions. Subpart F income could be reduced by export trade sales, and some subpart F income invested in less-developed countries was excluded.³³ Those exceptions were all put in place as direct subsidies of specific activities to promote economic, nontax foreign policy objectives. There were exceptions for active income earned from unrelated parties that would otherwise have fallen within some of the FPHCI categories (for example, some interest, rents, and royalties).³⁴ There were related exceptions for the banking and finance industries, too; dividends, interest, and gains from the sale or exchange of stock or securities received from an unrelated party in the conduct of an active banking or finance business, as well as similar income earned in the investment of unearned premiums or reserves by insurance companies, were excluded, presumably on the theory that they were an integral part of their active income.³⁵ Likewise, interest received from a related party in the context of an active banking or finance business was exempted provided payer and recipient were both predominantly engaged in business with unrelated persons.³⁶ The Senate report explained that the last provision meant that “foreign personal holding company income will not arise merely because of normal business transactions between two or more related financial institutions.”³⁷

There was also an exception for shipping income that would otherwise have been subpart F income, motivated by concerns over national defense.³⁸ Foreign base company income was also excluded from current taxation if

²⁹The OTP Study cites a *Wall Street Journal* article stating that of 1,200 subsidiaries of U.S. corporations in Nassau, Bahamas, less than 50 were actually operated by employees of the offshore company, the remainder being administered by trust companies. See OTP Study, *supra* note 23, at 8.

³⁰1962 House Report, *supra* note 28. Note that the drafters of the House report did not mention whether the hypothetically disadvantaged U.S. firms would be so vis-à-vis local firms incorporated in the target country, or vis-à-vis other firms from third countries that were also active in the target country.

³¹H.R. 10650, 87th Cong., 2d Sess. (1962). Note that the categories are remarkably similar to current law, 45 years later. Also, note that both categories apply equally to payments from domestic companies to foreign affiliates, and thus also help to prevent earnings stripping from the United States to tax haven countries.

³²Some rents excluded from PHC and FPHC income were included under subpart F. Former section 954(b)(2). The reason for that distinction, which persists today between subpart F and the PHC rules, is obscure.

³³Former section 954(b)(1).

³⁴Oddly, those exceptions never made their way into the FPHC rules themselves.

³⁵Former section 954(c)(3)(B).

³⁶Former section 954(c)(4)(B).

³⁷1962 Senate Report, *supra* note 8, at 83.

³⁸This exception was provided by your committee primarily in the interests of national defense. In this regard it was

(Footnote continued on next page.)

the taxpayer could establish that the creation of the CFC did not have the effect of substantially reducing taxes on its income. There was an exception for U.S.-source income of a corporation in a U.S. trade or business already subject to U.S. corporate tax at the CFC level, which made sense because, by definition, no deferral occurred.³⁹ Another rule provided that subpart F income could be deferred if the CFC distributed at least a minimum amount of its earnings to its U.S. shareholders.⁴⁰ The point of the provision was to turn off subpart F when the combined U.S. and foreign effective tax rate was not significantly lower than the U.S. corporate tax rate. There was also a *de minimis* rule⁴¹ and an exception for amounts received from a related party organized in the same country.⁴²

The background of the same-country exception is somewhat mysterious. The stated justification at the time of enactment, according to the Senate report, was the somewhat Delphic statement that a U.S. shareholder of the two foreign corporations would not have been taxed if he had held the stock of the payer directly.⁴³ But, the same-country exception makes perfect sense when viewed through the lens of tax haven deferral as the Kennedy administration and Congress saw it. First, because the payments were coming from related parties, they were unlikely to be in the nature of truly passive income. Second, they could not meet the core concept of tax haven deferral, which is moving income that was actually earned in one country to a second country (that might be a tax haven). By definition, same-country payments don't do that. The drafters may also have believed that there was no need for subpart F to interfere with same-country intercompany transactions because there was limited risk of earnings stripping when both

subsidiaries were incorporated in the same country, and thus the payee would generally be subject to the same tax regime as the payer.⁴⁴

Like the FPHC rules, the subpart F rules applied only to foreign corporations with significant and concentrated U.S. ownership,⁴⁵ but applied that concept far more broadly than the FPHC rules had done. For the subpart F rules to apply, the foreign corporation has to be a CFC, then defined as a foreign corporation more than 50 percent of whose voting power was owned (directly, indirectly, or constructively) by U.S. shareholders; U.S. shareholders were in turn defined as United States persons each owning (directly, indirectly, or constructively) 10 percent or more of the voting power. That was similar to the FPHC rules in that five or fewer U.S. taxpayers had to own more than 50 percent of the company, but, unlike the FPHC rules, corporations could be among (or all of) the five or fewer U.S. taxpayers.⁴⁶ Completely different constructive ownership rules were used, based on existing rules in subchapter C,⁴⁷ and the 50 percent requirement looked only to the vote, as opposed to the value.⁴⁸ Also, unlike the FPHC rules, the CFC rules had no impact on small U.S. owners of a CFC who did not have enough stock to meet the threshold for U.S. shareholder.⁴⁹

Subpart F also added section 956, which treated CFC investments in U.S. property as repatriations that made their U.S. shareholders subject to current tax. That rule was intended to prevent *de facto* repatriation without current taxation by, for instance, causing a CFC to loan

believed desirable to encourage a U.S.-owned maritime fleet and U.S.-owned airlines operating abroad." 1962 Senate Report, *supra* note 8, at 85.

³⁹Originally, of course, that was not phrased in terms of "effectively connected" income because that concept did not exist yet.

⁴⁰Former section 963. The minimum distribution amount was defined by the effective foreign tax rate paid on the income. That rule was repealed by P.L. 94-12 (1975).

⁴¹*De minimis* then meant 30 percent. There was a mirror image "full inclusion rule" at 70 percent. As we all know, the latter is still 70 percent, but the former is now truly *de minimis*.

⁴²Former section 954(c)(4).

⁴³"Your committee saw no reason for taxing the U.S. shareholders on dividends received by a controlled foreign corporation from a related party where the U.S. shareholder would not have been taxed if he had owned the stock of the related party directly." 1962 Senate Report, *supra* note 8, at 83. What Congress had in mind is not clear. It seems that absent subpart F, the U.S. shareholder would be taxed on any payment either CFC made to him, but on no payments they made to each other (unless other regimes picked those up) regardless of whether they were in the same country or different countries.

⁴⁴Of course, that rationale would not have applied in jurisdictions such as the U.K., which until much later determined tax residence solely by the location of management and control of similar activities test.

⁴⁵Another antideferral regime that entered the code at the same time, the foreign investment company rules of section 1247, did not require that the requisite 50 percent U.S. ownership be concentrated, but that regime applied only to companies whose primary activity was investing.

⁴⁶That made perfect sense, as the drafters were expressly focused on foreign subsidiaries of U.S. multinationals.

⁴⁷Different rules were necessary given the introduction of corporations as perhaps the primary target of the legislation, although it has never been clear why the differences in some of the details of the attribution rules (for example, partner/partner in FPHC, but not in CFC) actually made any policy sense. But then the author and many other commentators find that particular rule hard to fathom anyway. *See, e.g.*, Patrick Gallagher, "Partnership Aggregate/Entity Problems Outside of Subchapter K," Tax Club, Dec. 13, 2006.

⁴⁸I never understood why the two regimes were different on that count, but 24 years later Congress figured out that it didn't either and conformed them. The law was changed by the Tax Reform Act of 1986, P.L. 99-514 (1986).

⁴⁹The CFC rules seem sensible in that regard. It's not clear why the FPHC rules never conformed to the notion, but perhaps that was because their mechanics were different and there was no simple way to implement it without adding new concepts to the FPHC rules. That also highlights a more general problem with tax legislation — small oddities like this tend never to get fixed.

money to its U.S. parent or an affiliate in a transaction that would not be otherwise taxable to the U.S. recipient of the money.⁵⁰

The 1962 legislation also added section 1248, a CFC rule not technically part of subpart F. Section 1248 dealt with a second issue involved in all offshore deferral — to the extent the income is not subject to current U.S. taxation, an individual can achieve not only deferral but conversion (to capital gains) by selling her shares (which are taxed at capital gains rates) instead of withdrawing cash in the form of dividends. Section 1248 denies that benefit in some situations by treating the gain attributable to the deferred earnings as a dividend. It is noteworthy that section 1248 does that in a relatively sophisticated and evenhanded way. First, for individuals, it reduces the tax on the dividend by as much as the dividend/capital gain rate differential if the CFC pays enough corporate tax. Second, it allows the same dividend characterization to corporations, which can be quite beneficial from a foreign tax credit perspective.

It is difficult to draw an overarching lesson from the legislation. Subpart F was, and remains, an amalgam. However, one major theme that ties many of the rules together is that subpart F is Congress's value judgment to the effect that results from doing "real" things (like manufacturing) in their natural location deserves deferral, but passive income, and income that is split off (to tax havens) from the activity that produced the value in the goods and services provided to customers, does not deserve deferral and should be subject to current U.S. taxation (or at least equivalent taxation somewhere else).⁵¹

Some see that as a compromise between capital export neutrality and competitiveness (capital import neutrality) concerns, but there is also a widely held perception that the enactment of subpart F was motivated as much by moral indignation at the very idea of foreign tax reduction planning as by a desire to protect the American fisc, as some of the punished activities, such as earnings stripping, did no direct damage to U.S. tax revenue. It could be argued that American lawmakers chose to legislate against those activities out of a consciousness of the country's leadership role: The United States was, at the time, far and away the world's most important economy, and very much a trailblazer in the development of tax and other legislation. There was likely some awareness of the possibility that if the United States permitted earnings stripping, then its trading partners might too, to American disadvantage.⁵² More explicitly, the legislative history indicates that the legislators recognized that permitting earnings stripping makes foreign

investment unduly attractive relative to domestic investment and that that would have a negative effect on American exports.⁵³ That point is also made quite strongly by Treasury Secretary Douglas Dillon in Kennedy's 1961 tax message.⁵⁴ But however one interprets the history, it seems clearly to contradict the assertions of some latter-day commentators that regulating transactions that reduce only foreign tax was not part of the original policy of subpart F.⁵⁵

D. Statutory Evolution of Subpart F Through 2005

Tinkering with the rules of subpart F began not long after enactment. Over the next 43 years, subpart F expanded and contracted in many ways. The treatment of specific industries changed (some several times), provisions appeared and disappeared to reflect changing nontax foreign policy objectives, and some of the technical mechanics changed once or several times. The general statutory framework, however, remained remarkably intact.

In 1969 Congress replaced the exception for CFCs whose organization did not have the effect of substantially reducing tax with an exception for any items of income of which it could be demonstrated that neither the organization of the CFC in the first place nor the effecting of the transaction that gave rise to the item of income had the substantial reduction of tax as a significant purpose.⁵⁶

In 1975 the minimum distribution provisions and the less-developed country exception were repealed, leaving subpart F with almost no nontax foreign policy content. Shipping income, which had previously been excluded from subpart F income by old section 954(b)(2), now became subpart F income and got its own category within subpart F, as foreign base company shipping income, which also covered aircraft, accompanied by an exception reducing such subpart F income to the extent it was reinvested in the same business.⁵⁷

Legislation enacted in 1976⁵⁸ expanded the exemption for income from otherwise passive portfolio investments earned by insurance companies to enable them to meet solvency requirements. Taxation of shipping income, introduced the year before, was revised to provide a same-country-type exception. Foreign policy returned, as subpart F income was also now conscripted into duty against enemies of America (and those who pay bribes), with new subpart F categories for income earned from violation of an international boycott and bribe income.

⁵⁰That perhaps common-sense notion operates in Byzantine and often counterintuitive ways, particularly when the CFC has multiple large shareholders that are unrelated to each other. Those curiosities are beyond the scope of this report.

⁵¹For a good discussion of the theme, see Martin A. Sullivan, "Economic Analysis: A Challenge to Conventional International Tax Wisdom," *Tax Notes*, Dec. 11, 2006, p. 951, *Doc 2006-24455*, 2006 *TNT* 238-6. Those points will be discussed further in the final section.

⁵²Dillon Statement, *supra* note 22.

⁵³1962 House Report, *supra* note 28.

⁵⁴Dillon Statement, *supra* note 22.

⁵⁵See, e.g., Mike Cooper, Gary Melcher, and Clint Stretch, "Suddenly Saving Foreign Taxes Is Abusive? An Untenable Proposal," *Tax Notes*, May 18, 1998, p. 885.

⁵⁶P.L. 91-172 (1969).

⁵⁷P.L. 94-12 (1975). That was not a complete about-face, as many shipping companies plowed all of their earnings back into new ships and were able to get the exclusion except for income that they actually repatriated (which would be taxable anyway) or redeployed in a different business.

⁵⁸P.L. 94-455 (1976).

Also in 1976, section 956 was relaxed to permit investment in the stock and securities of unrelated U.S. corporations and offshore oil rigs, on the theory that the former really was not indirect repatriation and would benefit U.S. markets, and the latter a straightforward move to encourage oil exploration during the oil crisis.

The next rounds of amendments, in 1982 and 1984, saw some industries that had been favored in the 1976 changes (namely insurance and oil and gas) lose ground. The 1982 bill added a new category of subpart F income for foreign-oil-related income from processing, distribution, sales, and services earned in countries other than those in which the oil or gas was extracted or sold.⁵⁹ In 1984 foreign base company services income was expanded to include services in connection with insurance of related-party risks in which the related party was located in a different country.⁶⁰ The 1984 legislation also included what is in effect a subpart F change in a completely different part of the code. In 1984 new section 864(d) ended deferral on related-party factoring income, and added those transactions to section 956.⁶¹

The Tax Reform Act of 1986⁶² made many far-reaching changes to subpart F, almost all of which expanded the tax base. FPHCI was expanded considerably beyond the core⁶³ of old sections 543 and 553 to include all income from commodities (unless derived in the conduct of an active commodities business), all income from the sale of property held for investment purposes, and gains from the sale of foreign currency (again, unless derived in the conduct of a currency trading business).⁶⁴ Income equivalent to interest, such as commitment fees for loans, was also added to the definition of FPHCI to prevent taxpay-

ers from reducing interest income by recharacterizing a portion of it as a fee, which would not be subpart F income.

The banking and insurance industries also took a hit in 1986. The exceptions for investment income received from the conduct of a banking or financial business were repealed, as was the exception for investment income earned by an insurance company. The 1986 legislation also broadened the definition of insurance income covered by subpart F from U.S. risks to risks outside the CFC's country of incorporation, and added special rules for captive insurers and related-party insurers (including a new definition of CFC).

Other 1986 changes were more technical. The rule excluding foreign base company income from current taxation if the taxpayer was able to establish that a principal purpose was not avoidance of tax was repealed and replaced with a more mechanical high-tax exception, under which income is not subject to subpart F if it is taxed in the source country at a rate greater than 90 percent of the U.S. corporate tax rate.⁶⁵ The 1986 act also made several changes to otherwise applicable rules to measure E&P, restricted the reduction of subpart F income by accumulated deficits to some categories of subpart F income,⁶⁶ and repealed the chain deficit rule.⁶⁷ It also changed the control test to apply if a CFC was owned by U.S. shareholders with more than 50 percent by vote *or* value, whereas before the test had simply been voting power (although the definition of a U.S. shareholder, an essential building block of CFC status, still turned solely on vote). That was done to stem manipulation of the rules accomplished by use of pliant foreign parties who would hold shares but vote in accordance with the wishes of the U.S. owners.⁶⁸ Also, the 1986 act decoupled the subpart F definition of FPHCI from the FPHC rules,⁶⁹ placing the new definition wholly within section 954(c).

In 1988 Congress modified many of the law changes that took place in 1986. Rules governing foreign insurance companies were tightened. The definition of a related person in section 954(d)(3) was simplified; in the case of a corporation, a related person is one that is owned by the same parties, directly or indirectly, more

⁵⁹P.L. 97-248 (1982).

⁶⁰P.L. 98-369 (1984).

⁶¹The receivable-selling transactions that 864(d) sought to discourage moved receivables (which had an unearned timing/financing component) offshore to a related CFC, when that timing/financing component did not constitute subpart F income (under then applicable law). That result obtained because, when the receivable came to be paid, it was sales income from the original customer, who was an unrelated third party, rather than being interest income or foreign base company sales or services income. The amount paid by the CFC was likewise not a section 956 event because it was an investment in the obligation, again not of a related U.S. party, but of the unrelated customer. Section 864(d) took a two-prong approach. It stated that any income arising from a trade or service receivable acquired by a foreign corporation from a related person would be treated as interest on a loan to the obligor under the receivable, and it expanded the definition of U.S. property in section 956(c)(3) to include any trade or service receivable that is the obligation of a U.S. person and that is generated by a related U.S. person's disposition of inventory or performance of services.

⁶²P.L. 99-514 (1986).

⁶³Dividends, interest, rents, royalties, and annuities.

⁶⁴Those were seen as modernizations — in 1962 there was less currency trading for investment purposes (the Bretton Woods system was still in effect) and commodities markets were less developed.

⁶⁵Section 954(b)(4). Under regulations, the treatment is elective. Reg. section 1.954-1(d)(1)(i).

⁶⁶After 1986, deficits were available only to reduce foreign base company shipping income and foreign base company oil-related income.

⁶⁷The chain deficit rule provided that a CFC's current deficit in E&P could be used to reduce or eliminate E&P in another CFC that was in the same chain of ownership. As noted below, it was partly reinstated in 1988.

⁶⁸Regulations and case law had struggled with the issue in the interim. See reg. section 1.957-1; *Estate of Edwin C. Weiskopf*, 64 T.C. 78 (Apr. 17, 1975); *Koehring Co. v. United States*, 42 AFTR2d 78-5540 (Aug. 4, 1978).

⁶⁹But kept the name. Congress was still addicted to cross-referencing, and used the new section 954(c) as the starting point for the definition of passive income under the passive foreign investment company rules.

than 50 percent by vote or value. In the case of partnerships, the person must own more than 50 percent by value alone. The chain deficit rule returned in a more modest form. The same-country rule was modified to include as subpart F income same-country related-person payments that create a deficit that could be used to reduce subpart F income in the payer or a related CFC. Section 954(c)(1), which provides that gain on the sale or exchange of property that gives rise to passive income or that does not produce income is subpart F income, was expanded to include gain from the sale or exchange of trusts, partnerships, or real estate mortgage investment conduits.⁷⁰

In 1993 Congress added new section 956A, a brand-new branch of subpart F that taxed U.S. shareholders on their share of “excess passive assets,” defined as the excess of the amount of passive assets over 25 percent of the CFC’s total assets. (That branch didn’t last long; it was cut off completely in 1996.)⁷¹ Meanwhile, the same-country exception shrank again, this time to eliminate from its scope dividends out of E&P that were accumulated when the payer and recipient were not related. Changes were also made to how previously taxed income and foreign tax credits are calculated.

Further changes were seen in 1997 to the definition of FPHCI to reflect the practices of modern finance; it was expanded to include income from notional principal contracts and payments in lieu of dividends, and an exception for dealers in financial instruments and some other property was added.⁷² Congress also added temporary section 954(h), which was a one-year exception for some income derived in the active conduct of a banking, financing, insurance, or similar business predominantly conducted with unrelated parties if some conditions were met. That resurrected subpart F relief for those industries for which it had been repealed 11 years earlier. After an interesting procedural turn, the exceptions were rewritten (as sections 953(a), 954(h), and 954(e)) extended for another year in 1998.⁷³ Sections 953(e) and 954(h) were then extended until 2002 in 2000,⁷⁴ and through 2007 in 2002,⁷⁵ and through 2009 in 2006.⁷⁶

In 2004 the Jobs Act made some important changes to subpart F, or more accurately to neighboring, and in many cases overlapping, regimes. The Jobs Act repealed outright both the FPHC and the foreign investment

company rules.⁷⁷ It also repealed the foreign base company shipping income rules, leaving international shipping income once again tax-free.⁷⁸

E. The State of Antideferral Regimes in 2005

In 2005, after 43 years of repeated changes, the statutory CFC rules were still remarkably similar to the rules enacted in 1962. They still applied in largely the same setting (to U.S. shareholders, still as defined in 1962) of CFCs (also defined pretty much in the same way as in 1962), and to pretty much the same things. Passive income was still covered, with its definition broadened largely to pick up evolution of financial markets and things that did not exist in 1962 (for example, swaps). Intercompany flows of income in those categories were still picked up (at least by statute), and the foreign base company sales and services income rules were still largely intact. Thus foreign tax reduction was still regulated (at least by statute), and the CFC rules still pulled back in at least some cases in which tax reduction was not happening (now determined by reference to the effective tax foreign tax rate rather than less mechanical earlier rules).⁷⁹ The CFC rules still implemented foreign policy objectives having little to do with U.S. tax policy (although those objectives had changed — in 1962 it was encouraging the development of less-developed countries, and in 2005 it was regulating bribes, kickbacks, boycotts, and terrorism). There were still special insurance and banking rules, which, although significantly stricter in 2005 than in 1962, were far more generous than they had been from the mid-1980s to the mid-1990s. There were a few more special industry rules than before (for example, foreign base company oil-related income), but others had come and gone (for example, shipping). There were still *de minimis* and full-inclusion rules, although the former had gotten stingier and rules relating to the use of deficits to reduce subpart F income had been cut back. Section 956 had been overhauled substantially, but it still covered pretty much the same territory. Section 956A came and went quickly. And section 1248 was largely unchanged, although less of a concern to individual taxpayers in the then-current environment (that is, section 1(h)(11)). But all in all, the creators of subpart F would recognize their handiwork 43 years later. The broad outlines of the 1962 compromise that created subpart F remained largely intact until 2005 (or, in practice, at least 1997, as discussed below).

F. PFIC Rules

While subpart F is generally considered to be the most elaborate antideferral regime of its type, Americans are lucky enough to also have a second regime, the passive foreign investment company regime that is (or at least

⁷⁰P.L. 100-647 (1988).

⁷¹P.L. 104-188 (1996).

⁷²P.L. 105-34 (1997).

⁷³*Id.* As an interesting side note, at the time of enactment President Clinton used his line-item veto power to kill it, but it was reinstated when the line-item veto was held unconstitutional in *Clinton v. New York*, 118 S. Ct. 2091 (1998).

⁷⁴P.L. 106-170 (2000).

⁷⁵P.L. 107-147 (2002).

⁷⁶P.L. 109-222 (2006).

⁷⁷Ancillary to the repeal of the FPHC rules, it added a new category of foreign base company income for some personal services income formerly covered by the FPHC rules, but not the CFC rules. It does not appear that a lot of thought went into that — indeed, the subsection is not even numbered correctly (section 954(c)(1)(I) should have been section 954(c)(1)(H)).

⁷⁸Unless it is rental income and passive. P.L. 108-357 (2004).

⁷⁹The evolution in some sense mirrors the evolution of other international provisions such as section 367(a), which also went from a no-tax-avoidance standard to specific mechanical requirements.

should be) focused entirely on passive income.⁸⁰ The PFIC rules in effect deny any deferral at all to U.S. shareholders regardless of their percentage holding of foreign companies that meet either of two definitional tests. The first test measures how much of a foreign company's income is passive income⁸¹ and the second measures the percentage of the company's assets that are passive assets.⁸² Passive income is defined by cross-reference to the subpart F rules, specifically the definition of FPHCI, and passive assets are those that produce, or are held for the production of, passive income.

If a company is a PFIC, U.S. holders of its stock must pay tax on either their share of its income (if they so elect and can get the information),⁸³ pay tax on an annual mark-to-market basis (if they so elect and the stock is publicly traded),⁸⁴ or pay tax only on realization events (distribution or disposition), but under a harsh regime that includes an interest charge, denies any capital gain treatment, and makes uneconomic assumptions.⁸⁵ The rules pick up things that they perhaps should not — financial services, leasing, some commodities activity, long-term startups — and sometimes have unduly punitive effects,⁸⁶ but those problems are beyond the reach of this report.

The PFIC rules were enacted in 1986, more than 20 years after subpart F. One purpose was to prevent circumvention of then-existing rules (FPHC and foreign investment company) that, similar to the CFC rules, applied only if U.S. ownership was 50 percent or more.⁸⁷ Unlike the CFC rules, which pick up any passive income beyond de minimis, the PFIC rules apply only to companies that are passive overall. Also, the PFIC rules target passive investment income (although perhaps not quite as surgically as they might) rather than tax haven deferral or earnings stripping. In light of those differences, the PFIC rules took a different approach to look-through rules than subpart F. The PFIC statute has since its enactment contained several look-through rules — not only does it generally look through 25 percent stock ownership (by value) of corporate subsidiaries of a possible PFIC,⁸⁸ but it also includes a broad general look-through rule for interest, dividends, rents, and roy-

alties from related parties that are not attributable to passive income.⁸⁹ Between those two rules the PFIC rules have always largely avoided picking up the earnings-stripping and income-shifting provisions that are the subject of section 954(c)(6).

Section 1297(e) coordinates overlap between the CFC and PFIC rules. It provides that a company that is both a CFC and a PFIC will be treated as a CFC regarding its U.S. shareholders (as defined in subpart F) but will continue to operate as a PFIC regarding U.S. taxpayers who own less than 10 percent of the CFC.

G. Other Countries

Subpart F was apparently the first of the antideferral regimes to make use of the concept of a CFC.⁹⁰ Since its enactment, other countries have grappled with the same problem (or rather, problems: erosion of the tax base and earnings stripping) in several different ways. Those systems are often broadly classed into "territorial" systems, in which the country taxes only income that is earned within its borders, and "worldwide" systems, which feature current taxation of all worldwide income earned by companies that are resident in or otherwise connected to the country. Of course, the vast majority of countries fall somewhere in between. Even in the most "territorial" systems, there is still generally a desire on the part of the authorities to protect the base somewhat by discouraging movement of income offshore, and thus many other countries have developed some kind of subpart-F-like compromise themselves.

Many countries have tax systems that are to some extent territorial. In France individuals are taxed on worldwide income, while corporations are taxed only on French-source income. A CFC regime operates to tax some nonbusiness income categories when the CFC is more than 50 percent owned by the French taxpayer and when the CFC is subject to taxation that is at least 50 percent lower than what it would be in France.⁹¹ Germany likewise has a CFC system that taxes specific kinds of passive income. If the CFC is not subject to a tax rate of at least 30 percent, any income that is not on an exempted-income list is subject to current taxation.⁹² Further down the spectrum toward a true territorial system, the Netherlands has a participation exemption that exempts all dividend income that is received from foreign subsidiaries, but provides exceptions for income from some kinds of passive investments. The passive status of an investment is determined at least partially by the percentage of ownership that the Dutch company

⁸⁰Sections 1291 through 1298. Actually, two is nothing. At one point there were five.

⁸¹Section 1297(a)(1).

⁸²Section 1297(b).

⁸³Sections 1293-1295. This bears a passing resemblance to the approach of the FPHC rules in that the tax is imposed on all income, not just passive income. Payment can be deferred with an interest charge, until the income is actually distributed or other triggering events occur. Unlike the CFC rules, the PFIC rules do not simply assume that shareholders will be able to get the information to report income or the cash to fund current taxes.

⁸⁴Section 1296.

⁸⁵Section 1291.

⁸⁶See, e.g., NYSBA Report 994, submitted on May 22, 2001, Doc 2001-14938, 2001 TNT 108-34.

⁸⁷Eighteen years after enactment of the PFIC rules, both the FPHC rules and foreign investment company rules were repealed, as they were considered superfluous.

⁸⁸Section 1297(c).

⁸⁹Section 1297(b)(2)(C). The rule in some ways is an unrecognized ancestor of section 954(c)(6).

⁹⁰OTP Study, *supra* note 23, at 58.

⁹¹See "The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses," prepared by the staff of the Joint Committee on Taxation, JCX-22-06 (June 21, 2006), Doc 2006-12053, 2006 TNT 120-17 (2006 JCT Study); see also "France: Instructions Published for Updated Controlled Foreign Corporation Regime," *Daily Tax Report*, Jan. 24, 2007.

⁹²2006 JCT Study, *supra* note 91.

holds.⁹³ Japan does not in general seek to tax the subsidiaries of domestic corporations, but does deny deferral to the “taxable undistributed profits” of “designated tax haven subsidiaries.” That amounts to current taxation on the 5 percent or greater shareholders of companies that are subject to tax rates of 25 percent or less, if the company is controlled by Japanese shareholders. Taxation is not restricted to passive income.⁹⁴ The United Kingdom also has CFC rules. A company is a CFC if it is resident outside the United Kingdom, controlled by persons within the United Kingdom, and subject to a lower level of taxation than it would be in the United Kingdom. Shareholders are generally taxed on income that does not result from active business activities.⁹⁵ Canadian taxpayers are subject to tax on worldwide income and are further taxed on passive income of nonresident affiliates. The concept of “affiliate” is quite broad and includes entities in which the Canadian taxpayer owns, directly or indirectly, as little as 10 percent of the entity’s equity.⁹⁶ However, other countries (such as China and Switzerland) do not have CFC rules.⁹⁷

II. Check the Box: Subpart F Planning

One of the most important structural changes to subpart F took place, at least initially, without congressional action at all. Instead, it resulted from regulations under a completely different part of the code — section 7701. Those are, of course, the so-called check-the-box rules.

A. Pre Check the Box: The *Kintner* Regulations

The code makes several important distinctions between partnerships and corporations, chief among them being that U.S. corporations pay tax on their income and partnerships do not, and the owners of corporations (under the classical system) do not pay tax on undistributed income and owners of partnerships do. Before 1997 the classification of an entity as a partnership or a corporation for U.S. income tax purposes was based on a test intended to gauge how similar the entity was to a state law corporation. State law corporations (and some other entities) were automatically classified as corporations for tax purposes. An entity that was not automatically so considered was classified according to a four-

factor test.⁹⁸ The four factors were continuity of life, centralization of management, limited liability, and transferability of interests. If an entity had more than two of the listed features, it was classified as a corporation; otherwise it was a partnership (if it had at least two owners).⁹⁹ The factors identified had no normative tax policy content in and of themselves, but instead simply represented an attempt to identify, as a matter of observation, the line between the two classic types of business entities.

Over time, of course, practitioners became increasingly adept at manipulating the four factors to change the tax result, even for entities that were clearly corporations in the eyes of nontax lawyers and businesspeople. Getting there, of course, took some amount of costly, pointless activity on the part of U.S. tax lawyers and foreign counsel, and sometimes created business inconveniences, but the U.S. tax savings frequently justified the cost. Entity classification thus was often effectively elective, but making the “election” required hard work and expense that was otherwise unproductive. The same thing was happening in the United States, with a proliferation of domestic entities that combined characteristics of both corporations and partnerships, chief among them the limited liability company, which was in some respects partnership-like, but had limited liability for all of its members, not just its limited partners.

Changing entity classification became an important subpart F planning technique, but by no means as important as the check-the-box rules are today. Even if an otherwise corporate entity were transformed into a partnership for U.S. tax purposes, most payments from that entity (other than dividends) still had the potential to give rise to subpart F income if the owners or payees were CFCs (although exactly which ones were not entirely clear).¹⁰⁰

Example 2:¹⁰¹ Assume USP owns 100 percent of the stock of CFC1, which is incorporated under the laws of Country A, and 100 percent of the stock of CFC2, which is incorporated under the laws of country B. CFC2 owns 55 percent of FJV, formed under the laws of Country B, with an unrelated party owning the remaining interest in FJV. CFC1

⁹³*Id.*

⁹⁴Shimon Takagi, “Foreign Income: Business Operations in Japan,” *BNA Tax Management Portfolio* 969-2d (2006).

⁹⁵Slaughter and May, “Foreign Income: Business Operations in the United Kingdom,” *BNA Tax Management Portfolio* 989-3d (2006).

⁹⁶Robert Couzin and Mark Novak, “Foreign Income: Business Operations in Canada,” *BNA Tax Management Portfolio* 955-3d (2003).

⁹⁷In addition to the countries discussed, the OTP Study lists the following countries as having CFC regimes as of Nov. 2000: Argentina, Australia, Denmark, Estonia, Finland, Hungary, Indonesia, Italy, Korea, Mexico, New Zealand, Norway, Portugal, South Africa, Spain, and Sweden. OTP Study, *supra* note 28, at 58. Israel and Venezuela have since introduced CFC regimes.

⁹⁸Actually, it was a six-factor test that also applied for trusts, but two of the six factors are shared by partnerships and corporations.

⁹⁹The factors were set forth in reg. section 301.7701-2, promulgated in 1960, and were in turn based on a Supreme Court case, *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

¹⁰⁰See the *Brown Group* line of cases, and regulatory response. *Brown Group, Inc.*, 102 T.C. 616, *Doc 94-3878*, 94 *TNT* 71-9 (1994); *Brown Group, Inc.*, 104 T.C. 105, *Doc 95-1277*, 95 *TNT* 17-8 (1995); *Brown Group, Inc. v. Commissioner*, 77 F3d 217, *Doc 96-2911*, 96 *TNT* 19-6 (8th Cir. 1996); reg. section 1.701-2, issued in 1994.

¹⁰¹This example, and all that follow, assume that subpart F exceptions not specifically discussed — such as high-tax, de minimis, section 954(c)(2) (active rents and royalties, export interest, dealer income), and, unless the context indicates otherwise, same-country — do not apply. Finally, of course, all examples in Part II assume that section 954(c)(6) is not yet part of the code.

makes a loan to FJV. CFC1's interest income on the loan would have been subpart F income irrespective of the classification of FJV.

The ability to turn what otherwise would have been a corporation into a partnership for U.S. tax purposes was quite helpful in other settings. First, it eliminated the non-same-country dividend problem. Rather than being dividends at all, distributions from a partnership were generally nontaxable (to the extent of the recipient's basis in the case of cash distributions under section 731).¹⁰² Second, it changed the result in many cases in which FJV was the payee.

Example 3: Assume that the facts are the same as in Example 2, except that CFC2 is incorporated in Country A, FJV makes the loan, and CFC1 pays the interest. If FJV is a corporation, the interest is subpart F income of FJV. If FJV is a partnership, however, CFC2's share of the interest may be exempt under the same-country exception, if CFC1 has a substantial amount of assets used in a trade or business in Country A.¹⁰³

B. Check the Box

Finally, in 1997, Treasury responded, sensibly, to de facto entity classification electivity by making electivity explicitly permissible. Excepting some entities that are ineligible to elect noncorporate classification (so-called per se corporations), all entities were given a default classification (which, in the case of non-U.S. entities, was based on a single factor, limited liability) but could change that classification by "checking the box," that is, filing a Form 8832 and electing to be treated as a corporation or a partnership.

The check-the-box rules were not intended to be subpart F rules, but had a tremendous impact on the area. That occurred in part because changing classification became so much easier and cheaper. But far more significant was a decision the rules were forced to make in the domestic context — how to treat an otherwise flow-through entity with a single owner. Before the emergence of the LLC and the check-the-box rules, that question had been debated somewhat but had remained of mainly academic interest, because for practical purposes it was virtually impossible to form a "classical" partnership with only one partner. In the odd event that the issue came up in the international context (when an entity with only one shareholder or partner had a preponderance of noncorporate factors), there was great uncertainty as to how the resulting entity should be treated.¹⁰⁴ But domestic LLCs, which became more and more common in the

early 1990s, generally did not require more than one member and the question of how a single-member LLC would be treated demanded an answer. The answer, in reg. section 301.7701-3, was that a single-member passthrough LLC was a DRE or "tax nothing" — as far as the code was concerned it did not exist. Practically, that meant that any wholly owned subsidiary that was not a per se corporation could check the box to be taxed as a passthrough and become a DRE; the code would not recognize its separate existence, and any activities that it undertook and any income that it earned would be ascribed directly to its parent.¹⁰⁵

That aspect of the check-the-box rules opened up enormous possibilities for international tax planning. Multinationals could now consolidate all their overseas holdings under a single offshore entity, classified (by election or default) as a corporation, and elect for all the lower-tier wholly owned entities to be taxed as passthroughs. As a result of those elections, payments made among the various subsidiaries (or between the subsidiaries and the first-tier CFC parent) that might previously have resulted in subpart F income in the absence of a specific exemption, now did not. That was not because the check-the-box rules directly addressed those kinds of intercompany payments — indeed, they did not. But what the disregarded entity rules did is lead mechanically to the conclusion that the payments did not exist. Thus, payments of locally deductible interest, rents, and royalties, or indeed any movement of capital within the family of disregarded subsidiaries and their parent, disappeared completely from the U.S. tax radar screen and would no more trigger U.S. taxation than a cash transfer between two bank accounts of a single domestic corporation. Thus, in circumstances in which an entity classification election was available, it became possible for U.S. taxpayers to avoid completely subpart F inclusions arising from some intercompany payments within groups of its foreign subsidiaries.

Example 4: Assume that USP establishes CFC1 in Country A, and CFC1 establishes wholly owned FS1 in Country A and wholly owned FS2 in Country B (each treated as a corporation). Under "classic" subpart F, any payments of interest, dividends, rents, or royalties between FS1 and FS2, or between FS2 and CFC, in either direction, will be classified as FPHCI and will result in current taxation for any U.S. shareholders. Similar capital flows between FS1 and CFC1 were potentially eligible for the section 954(c)(3) same-country exception if FS1 or CFC1, as applicable, has a substantial part of its assets used in a trade or business in country A.

If, however, FS1 and FS2 elect under the check-the-box rules to be treated as DREs, then, for U.S. tax purposes, they cease to exist as separate entities and their activities will be entirely attributed to CFC1, their parent. At that point, any transaction between FS1 and FS2 or between either of them and

¹⁰²Distributions in excess of basis were subpart F income from 1988 (when partnership interests were added to section 954(c)(1)(B)(ii)) until 2004, in the case of 25 percent or greater partnership interests.

¹⁰³Reg. section 1.952-1(g).

¹⁰⁴See LTR 7743060 (July 28, 1977); LTR 7743077 (July 29, 1977); LTR 7747083 (Aug. 26, 1977); LTR 7748038 (Aug. 31, 1977); LTR 7802012 (Oct. 11, 1977). All concluded that the foreign entity in question was "an integral part" of the owner for tax purposes, and all were subsequently revoked.

¹⁰⁵Reg. section 301.7701-3(b)(1)(ii) (for domestic entities) and -3(b)(2)(i)(C) (for foreign entities).

CFC1 will be treated as between CFC1 and itself, and will be totally disregarded by the code. They can make loans, pay interest, pay dividends, dissolve, or be sold¹⁰⁶ with no possibility of subpart F income to CFC1's U.S. shareholders.

C. Notice 98-11 and Its Aftermath

If there was any doubt as to whether the subpart F consequences of the DRE rules were intentional,¹⁰⁷ it was quickly erased by the swift fury of Treasury's response. Shortly after the initial appearance of the check-the-box rules, Treasury promulgated Notice 98-11,¹⁰⁸ which took aim at what it saw as the most offensive of the newly possible transactions, namely the use of DREs to strip earnings out of a high-tax jurisdiction into a low-tax jurisdiction. There were two transactions that the notice singled out as abusive, both involving hybrid branches, or entities that are treated as corporations in their country of incorporation but as passthroughs for U.S. income tax purposes.

Notice 98-11, Example 1. CFC1 owns all the stock of CFC2. CFC1 and CFC2 are both incorporated in Country A. CFC1 also has a branch (BR1) in Country B. The tax laws of Country A and Country B classify CFC1, CFC2, and BR1 as separate, non-fiscally-transparent entities. CFC2 earns only non-subpart F income and uses a substantial part of its assets in a trade or business in Country A. BR1 makes a transfer to CFC2 that the tax laws of both Country A and Country B recognize as a loan from BR1 to CFC2. CFC2 pays interest to BR1. Country A allows CFC2 to deduct the interest from taxable income. Little or no tax is paid by BR1 to Country B on receipt of the interest.

Notice 98-11, Example 2. CFC3 is incorporated in Country A. CFC3 has a branch (BR2) in Country B. The tax laws of Country A and Country B classify CFC3 and BR2 as separate, non-fiscally-transparent entities. BR2 makes a transfer to CFC3 that the tax laws of both Country A and Country B recognize as a loan from BR2 to CFC3. CFC3, which earns only non-subpart F income, pays interest to BR2 that Country A allows as a deduction against taxable income. Little or no tax is paid by BR2 on receipt of the interest.

Both of the above examples feature the use of a "hybrid branch" to reduce a CFC's foreign tax bill, but do not result in an offsetting subpart F inclusion (as would have resulted if the recipient were a CFC rather than a branch). If the branch had been a corporation, of course, the interest paid would be FPHCI under then applicable

law, and Notice 98-11 took the view that the check-the-box regulations generally should not change the result. Treasury reinforced that position shortly thereafter in proposed regulations that defined the term "hybrid branch" and operated to recharacterize payments to hybrid branches as subpart F income. A hybrid branch was defined as an entity that had a single member that was a CFC (or a partnership with CFC partners), that was a passthrough for U.S. tax purposes and that was not a passthrough for purposes of local tax law. A "hybrid branch payment" was defined as a payment that was regarded as a payment between the two entities under local law but was not income to the recipient under U.S. tax law, because it was considered a payment between two parts of a single entity. If a hybrid branch payment was made between a CFC and its hybrid branch or hybrid branches of the same CFC (or between hybrid branches and partnerships with CFC partners), and if that payment successfully reduced foreign tax, the non-subpart F income of the CFC would be recharacterized as subpart F income to the amount necessary to bring subpart F income to the amount that it would have been had the hybrid branch been a CFC.¹⁰⁹ Interestingly, the hybrid branch rules did nothing to nondeductible payments, like non-same-country dividends, perhaps implicitly reinforcing the view that maybe they never should have been covered in the first place.

Notice 98-11 and the hybrid branch regulations were attacked by businesspeople and tax practitioners in three main ways. First, they denied that Treasury had the authority to issue the regulations. That argument was typically based on the idea that Treasury had overstepped the grant of authority in section 7701.

Second, they attempted to dismantle the category of arguments that Notice 98-11 and the regulations represented a return to the original policy goals of subpart F. Some commentators argued that Congress in 1962 could not possibly have foreseen one or more of the elements that constituted the world of international tax planning in 1998, whether it was low tax rates applied to active businesses or the hybrids themselves.

Finally, they argued that Notice 98-11 and the regulations would have a negative impact on the American economy. That line of argument includes the assertion that the strategy would shift the income tax base to foreign governments and that the competitive ability of American companies would be diminished. The bulk of lobbying of Congress that took place was in that vein.

The uproar in the business community, and in Congress,¹¹⁰ over Notice 98-11 and the hybrid branch regulations was immediate and furious, and Treasury was forced to hastily withdraw the notice.¹¹¹ While the proposed regulations remain on the books in proposed form, they are widely considered to be a dead letter.

Another set of proposed regulations, in 1999, attacked the use of DREs in so-called extraordinary transactions,

¹⁰⁶Although gain on the sale of assets that produce passive income will be subpart F income. Section 954(c)(1)(B).

¹⁰⁷Virtually everyone seems to agree that the subpart F consequences were unintended, and few seem to have seen them coming, although at least one writer correctly predicted almost all of the foreign tax consequences of the new regulations. David S. Miller, "The Tax Nothing," *Tax Notes*, Feb. 3, 1997, p. 619, *Doc 97-3208*, 97 *TNT* 22-69.

¹⁰⁸1998-1 C.B. 433 (Mar. 28, 1998), *Doc 98-2983*, 98 *TNT* 12-8.

¹⁰⁹Prop. reg. section 1.954-9.

¹¹⁰S. Rep. 105-174, 105th Cong. 2d Sess. (1998).

¹¹¹Notice 98-35, 1988-2 C.B. 34, *Doc 98-20115*, 98 *TNT* 119-6.

in particular check-and-sell transactions.¹¹² In those transactions, when the sale of a wholly owned CFC is planned, the owner checks the box so that the CFC comes to be treated as a passthrough. The sale is then treated as a sale of assets for U.S. tax purposes, and subpart F is largely or completely avoided. The proposed regulations would essentially have disregarded the entity classification election. They were also strongly criticized, and were withdrawn in 2003.

The result was that earnings stripping, which had been targeted by subpart F when first enacted, became not only permissible but widely practiced. However, the debate over DREs — and the international tax consequences of their use — is by no means dead. In January 2005 the JCT released a study that advocated treating as corporations all single-member organizations that were separate business entities organized under foreign law.¹¹³ The study recommended disallowing DREs because they could be used to avoid subpart F, both on earnings stripping transactions and also in extraordinary “check and sell” transactions. Earnings stripping was attacked for “distort[ing] investment decisions, arguably making it more attractive in some cases to locate investments abroad than in the United States.” It stopped short of taking a pure capital-export-neutrality-based approach, and gave some credence to concerns about competitiveness and capital import neutrality. It did not mention taxation of intercompany dividends. More recently, Hal Hicks, before his recent departure as Treasury international tax counsel, said publicly that changes to foreign entity classification election are being considered.¹¹⁴

D. Limitations of Check-the-Box Planning

Check-the-box planning to avoid subpart F quickly became almost universal. The new flexibility meant that taxpayers had a lot less to worry about when structuring their international investments, and it undoubtedly took a lot of the urgency out of lobbying efforts to expand offshore deferral. However, because the check-the-box rules were not designed for the purpose of subpart F planning, they unsurprisingly did not fit like a glove. Several snags remained in the planning landscape.

1. Per se corporations. The check-the box regulations created the concept of per se corporations, which cannot check the box. In the international context, the definition of a per se corporation is one that Treasury puts on a list. Many non-U.S. jurisdictions have more than one corporate form, often one intended for public companies and the other (or others) for private companies, and Treasury typically puts the former on the list.¹¹⁵

¹¹²Former reg. section 301.7701-3(h).

¹¹³2005 JCT Study, *supra* note 12.

¹¹⁴See note 12, *supra*.

¹¹⁵That generalization holds true for much of Western Europe. To the extent that public versus private is the rationale for the list, it is not entirely clear why the list is necessary. Section 7704 already limits the ability of publicly traded entities to sustain a U.S. tax classification as a partnership. Perhaps what animates the list is a notion of parity — in the United States, state law corporations are per se, and maybe the notion is that

(Footnote continued in next column.)

However, some countries — for example, Canada and Japan — have no widely used corporate form that provides limited liability and is not on the reg. section 301.7701 per se corporation list.¹¹⁶ In those countries, while check-the-box planning does occur (generally using unlimited liability corporations in Canada and *yugen kaishas* (LLCs) and other entities in Japan, frequently over the objections of local counsel) it is more difficult. Also some types of companies, such as insurance companies, can never check the box in any jurisdiction.¹¹⁷

Example 5: USP owns CFC1 organized in Country A, which owns 100 percent of the stock of each of CFC2, a German *Gesellschaft mit beschränkter Haftung* (LLC), CFC3, a U.K. limited company, CFC4, a Canadian limited company, and CFC5, a Japanese *kabushiki kaisha* (joint stock company). CFC1 makes loans to each. If USP uses the check-the-box elections wherever possible, CFC2 and CFC3 will become DREs and the interest they pay will not give rise to subpart F income, but the interest from CFC4 and CFC5 will remain subpart F income.

Those examples clearly illustrate the limitations of the check-the-box approach. Because it was not designed with the intention of serving as a subpart F look-through rule, but only had that consequence because it made payments between some entities disappear, it had no such effect when it did not make payments disappear. Similarly, while interest from a 100 percent subsidiary that checked the box was no longer subpart F income (because it was not income at all), interest from a 99 percent subsidiary, whether corporate or passthrough, still might be. Perhaps an argument could be made under an aggregate theory of partnerships that the payment should be deemed to disappear if made by a partnership (FJV) to its owner to the extent of the owner’s interest in the former, but that argument might face an uphill battle.¹¹⁸

foreign corporations should not do better and at least one form of local entity should be on the per se list. But if that’s the case, the notion is not applied uniformly. As discussed in the text, there are some developed countries where all of the commonly used forms of limited companies are per se corporations, and others where none are (even if public). For example, Lazard is a Bermuda LLC that is a publicly traded partnership (for U.S. tax purposes) listed on the New York Stock Exchange.

¹¹⁶In Japan there are limited company forms other than the KK, which is the per se entity form, but in the author’s experience many Japanese counsel are frequently reluctant to use them because of concerns that customers and suppliers will not want to do business with those entities. In Canada it appears that all forms of LLCs are on the per se list, leaving only unlimited liability companies, whose legal risks are obvious.

¹¹⁷Reg. section 301.7701-2(b)(4) (insurance companies) and -2(b)(5) (banks). That means that the treatment of insurance companies and banks is inequitable in a way that is parallel to, for example, Japanese companies, as discussed in the example.

¹¹⁸Reg. section 1.469-7 (a narrow exception for “self-charged” items).

2. Joint ventures. The check-the-box rules only partly addressed the subpart F issues associated with payments to and from third-party joint ventures classified as entities for U.S. tax purposes.

Example 6: Assume the facts are the same as Example 2 above. USP owns 100 percent of CFC1, incorporated under the laws of Country A, and CFC2, incorporated under the laws of country B. CFC2 owns 55 percent of FJV formed under the laws of Country B, with an unrelated party owning the remaining interest in FJV. CFC1 makes a loan to FJV. Under the check-the-box rules, USP will, in many jurisdictions, be able to change the classification of FJV through an election rather than having to artificially change one or more of its legal characteristics. But interest on the loan would still have been subpart F income irrespective of the classification of FJV.

Other than making it easier to achieve the more modest goal of look-through treatment for purposes of the same-country and some other exceptions, the check-the-box rules had less impact on joint ventures than they had on the wholly owned checkable subsidiary. Significant subpart F income could still arise from interentity payments.

3. Multiple chains. Check-the-box planning also cannot work if, for whatever reason, a corporation's foreign subsidiaries are in multiple chains, rather than being consolidated under a single foreign holding company. If there are two first-tier foreign subsidiaries, the check-the-box technique is generally unavailing to eliminate subpart F inclusions on payments between those two corporations (including their subsidiaries), even though both may be 100 percent owned by the U.S. parent.

Example 7: USP establishes CFC1 in Country A and CFC2 in Country B. CFC1 has two wholly owned subsidiaries: FS1, which is incorporated in Country C, and FS2, which is incorporated in Country D. CFC2 also has two wholly owned subsidiaries: FS3, which is incorporated in Country E, and FS4, which is incorporated in Country F. Each of the CFC subsidiaries F1 through F4, elects to be treated as a passthrough entity under the check-the-box rules. As described previously, any payments among CFC1 and its subsidiaries, or among CFC2 and its subsidiaries, will disappear and will not result in subpart F inclusions. So, a payment between FS3 and FS4, for instance, will not give rise to current taxation.

However, payments of interest, rent, and royalties between the two groups will be treated as payments between CFC1 and CFC2 and, because the same-country exception does not apply, will give rise to subpart F income and will be currently taxable to the recipient CFC's U.S. shareholders. For instance, if FS1 makes a loan to FS4, interest paid from FS4 to FS1 will be treated as interest paid from CFC2 to CFC1 and will result in current taxation to the U.S. shareholders of CFC1.

Note that with a slight change in facts, the check-the-box election can create subpart F income.¹¹⁹ If FS4 were a Country A corporation, a check-the-box election would take the payment out of the same-country exception because, even though FS4 and CFC1 are both incorporated in Country A, FS4's disregarded entity status means that although in fact a Country A corporation, it is treated as a division of a Country B corporation (CFC2) and the same-country exception cannot apply to a payment to CFC1, another Country A corporation. Conversely, of course, check-the-box could create "same-country income" if CFC2 is incorporated in Country A and FS4 is incorporated in Country B.¹²⁰

4. Foreign base company sales and service income. Subpart F planning through the use of the check-the-box rules can also create subpart F income that would not otherwise have existed in other settings. Consider, for example, the fact pattern below involving foreign base company services income, which consists of income derived in connection with the performance of services for a related party when the services are performed outside of a CFC's country of incorporation. Under the facts below, check-the-box planning may inadvertently cause the rules to apply when they did not apply before.

Example 8: Assume USP is the sole owner of CFC1, incorporated in Country A. CFC1 has a wholly owned subsidiary, FS1, incorporated under the laws of Country B. FS1 performs architectural services for USP in Country B. Absent a check-the-box election, there is no subpart F income because, although FS1 is performing services for a related party, it is doing so in its country of incorporation. But if FS1 had filed a check-the-box election to be treated as a passthrough for U.S. tax law purposes, FS1 would be treated as a branch of CFC1, a Country A corporation. The income of FS1 would then appear to be subpart F income if one takes the view that CFC1, a Country A corporation, is performing services in Country B for USP, a related party. While that should not be a problem (because FS1, the service company, is operating in the jurisdiction where it is in fact incorporated), a technical reading of the statute and the check-the-box rules may lead to the opposite conclusion.

It is possible that a similar problem may also arise under the foreign base company sales income rules if FS1's activities include purchasing or selling property in Country B, although the branch rules of the foreign base company sales income provisions make the analysis more complex.¹²¹

5. Foreign tax credit issues. The use of classic check-the-box planning also gives rise to foreign tax credit issues. When a U.S. corporate shareholder that owns at least 10

¹¹⁹It can also reduce subpart F income if CFC1 and CFC2 are incorporated in the same country but FS1 and FS2 are not.

¹²⁰See Notice 98-11, Example 1, *supra*.

¹²¹The branch rule in the foreign base company sales rules might appear to solve the problem, but it is not clear under the regulations that the taxpayer can use the branch rule affirmatively in all cases. Reg. section 1.954-3.

percent of the voting stock of a foreign company receives a dividend from that company, it is treated, if it so elects, as receiving the amount of the dividend plus indirect foreign tax credits — the amount of taxes paid on the E&P that underlie the dividend. International check-the-box planning using DREs can blend foreign tax credit pools in a way that can be disadvantageous if the income is repatriated.

Example 9 (base case): Assume USP establishes holding company CFC1 in Country A, which has a 5 percent tax rate. CFC1 has \$100 of pretax income and pays \$5 in tax. CFC1 establishes wholly owned FS1 in Country B, which has a 35 percent tax rate, and FS1 has \$100 of pretax income and pays \$35 of tax in Country B. If USP wants to repatriate only \$65, it would prefer to do so with the highest amount of foreign tax credits available. USP will cause FS1 to pay as a dividend its \$100 to CFC1, and CFC1 will in turn pay as a dividend the same amount to USP. The dividend from FS1 to CFC1 is subpart F income, carrying with it a deemed paid credit of \$35 of tax paid under section 960, for a total dividend of \$100, and USP is treated as having paid the \$35 itself. The distribution from CFC1 to USP is excludable under section 959. As a result, USP has \$100 of income, \$35 of foreign taxes paid, and no residual U.S. tax liability.¹²²

If, however, USP causes FS1 to file an election to be treated as a DRE, the result is very different.

Example 10 (check the box): Now, because FS1 does not exist for purposes of the code, CFC1 is treated as having earned \$200 and paid \$40 of tax, for an effective tax of 20 percent. The dividend from FS1 will now be a subpart F nonevent, and \$65 repatriated from CFC1 will carry with it only \$16.25 of tax; that is, USP will be treated as having received \$81.25 and as having paid \$16.25, and will still owe \$12 of federal income tax on its dividend. In other words, there is no way to get the high-taxed \$65 of FS1's earnings back to the United States without diluting the robust tax credit that should accompany it.

III. Enactment of Section 954(c)(6)

A. Statute and Legislative History

New section 954(c)(6) was originally introduced in 2004, as part of the Jobs Act. It was passed by both the House and the Senate but removed from the Jobs Act during the conference on that legislation. It passed two years later as part of TIPRA.

The legislative history of the provision is not entirely internally consistent. The first time around, the Senate

¹²²Of course, in the real world life is not that simple with interest expense allocation and other factors, but that is just an illustration. Of course, check the box also created foreign tax credit planning opportunities. For example, if FS1 had \$90 of losses, a dividend from CFC1 would result in less income (\$10) accompanied by ample credits.

Finance Committee report for section 954(c)(6) stated that the committee recognized that multinational corporations were, as a practical matter, able to move active earnings around, but that they suffered from additional transaction costs when doing so, and the committee believed that such restrictions were undue.¹²³ When section 954(c)(6) was reintroduced as part of TIPRA, Sen. Jon Kyl, R-Ariz., said the law was intended to remove the competitive disadvantage that American firms faced vis-à-vis multinationals that are incorporated in other jurisdictions.¹²⁴ There was no allusion this time around to the fact that U.S. companies were already able to circumvent subpart F in many cases and should be allowed to do so explicitly and with improved efficiency; instead, the need for a look-through rule was presented as though the check-the-box rules did not exist. The tone was also somewhat different the second time around — rather than simply acknowledging an existing reality, the legislative history evidences a view that allowing intercompany flows was a good idea as a matter of policy. Also notable was that Kyl presented the provision as a natural extension of the same-country exception.

The original version of the statute read as follows:

(6) Look-thru rule for related controlled foreign corporations.

(A) In general. For purposes of this subsection, dividends, interest, rents, and royalties received or accrued from a controlled foreign corporation which is a related person shall not be treated as foreign personal holding company income to the extent attributable or properly allocable (determined under rules similar to the rules of subparagraphs (C) and (D) of section 904(d)(3)) to income of the related person which is not subpart F income. For purposes of this subparagraph, interest shall include factoring income which is treated as income equivalent to interest for purposes of paragraph (1)(E). The Secretary shall prescribe such regulations as may be appropriate to prevent the abuse of the purposes of this paragraph.

(B) Application. Subparagraph (A) shall apply to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

Section 954(c)(6) quickly became the subject of technical corrections, which have a complex history of their own and also provide significant insights as to how

¹²³"The Committee believes that present law unduly restricts the ability of U.S.-based multinational corporations to move their active foreign earnings from one controlled corporation to another. In many cases, taxpayers are able to circumvent these restrictions as a practical matter, although at additional transaction cost." S. Rep. No. 108-192, 108th Cong., 1st Sess. (2004).

¹²⁴"The proposal I am introducing today would extend this 'same-country' treatment to payments between related foreign subsidiaries that are located in different countries." 151 *Cong. Rec.* S3424, S. 750 (Apr. 11, 2005) (statement of Sen. Kyl) (Kyl Speech).

Congress might intend the rules to operate. Those insights come in a relatively extensive JCT report¹²⁵ prepared in connection with the Tax Technical Corrections Act of 2006.¹²⁶ That bill would have made three changes: It would have excluded from the scope of section 954(c)(6) payments attributable to income that was subpart F income or effectively connected income (rather than just subpart F income); it would have replaced the grant of antiabuse regulatory authority with a differently worded, but not meaningfully distinguishable, version; and it would have addressed payments that create specified deficits. Had it passed in full, it would have read as follows (new language in italics):

(6) Look-thru rule for related controlled foreign corporations.

(A) In general. For purposes of this subsection, dividends, interest, rents, and royalties received or accrued from a controlled foreign corporation which is a related person shall not be treated as foreign personal holding company income to the extent attributable or properly allocable (determined under rules similar to the rules of subparagraphs (C) and (D) of section 904(d)(3)) to income of the related person which is *neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States*. For purposes of this subparagraph, interest shall include factoring income which is treated as income equivalent to interest for purposes of paragraph (1)(E). The Secretary shall prescribe such regulations as may be *necessary or appropriate to carry out this paragraph, including such regulations as may be necessary or appropriate* to prevent the abuse of the purposes of this paragraph.

(B) *Exception. Subparagraph (A) shall not apply in the case of any interest, rent, or royalty to the extent such interest, rent, or royalty creates (or increases) a deficit which under section 952(c) may reduce the subpart F income of the payor or another controlled foreign corporation.*

(C) Application. Subparagraph (A) shall apply to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

Somehow, in the rush of year-end legislation, only the first two technical corrections passed, as part of the Tax Relief and Health Care Act of 2006.¹²⁷ Thus, section 954(c)(6) now states:

(6) Look-thru rule for related controlled foreign corporations.

(A) In general. For purposes of this subsection, dividends, interest, rents, and royalties received or accrued from a controlled foreign corporation which is a related person shall not be treated as foreign personal holding company income to the extent attributable or properly allocable (determined under rules similar to the rules of subparagraphs (C) and (D) of section 904(d)(3)) to income of the related person which is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States. For purposes of this subparagraph, interest shall include factoring income which is treated as income equivalent to interest for purposes of paragraph (1)(E). The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this paragraph, including such regulations as may be necessary or appropriate to prevent the abuse of the purposes of this paragraph.

(B) Application. Subparagraph (A) shall apply to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

As noted above, one rationale for section 954(c)(6), as presented to Congress in 2005, was that it is a natural extension of the same-country exception that brings U.S. international taxation in line with the reality of global commerce and similar laws in other countries by permitting the redeployment abroad of nonsubpart F earnings in a way that is unhindered by U.S. tax considerations.¹²⁸ The latter part of that statement makes it clear that, at least for a while, Congress is blessing the types of intercompany transactions covered by section 954(c)(6) and, unless Congress was blind to the fact that virtually all income tax systems allow deductions for most of those payments (other than dividends), likewise is blessing the foreign tax reduction of active income that they facilitate.

As to the first part of the statement, it is questionable on a policy level whether section 954(c)(6) is a logical extension of the same-country rule. In enacting the same-country exception, the drafters were undoubtedly aware that they were simultaneously not creating a parallel exception for non-same-country subsidiaries. As discussed above, the same-country rule appears to have been put in place largely because same-country transactions almost *ipso facto* could not give rise to the tax haven deferral that was a main target of the 1962 legislation.¹²⁹ Congress's thinking may have evolved over time (that is, it is hard to square the 1993 change relating to preaffiliation E&P with this view)¹³⁰ but it is clear that the statute

¹²⁵JCT, "Description of the Tax Technical Corrections Act of 2006" (JCX-48-06), Oct. 2, 2006, Doc 2006-20443, 2006 TNT 191-13 (JCT TCB Description).

¹²⁶H.R. 6264, 109th Cong., 2d Sess. (2006), and S. 4026, 109th Cong., 2d Sess. (2006).

¹²⁷P.L. 109-432.

¹²⁸Kyl Speech, *supra* note 124.

¹²⁹See text at *supra* notes 43-44.

¹³⁰Frankly, it is hard to find any rationale for that change other than base broadening. It is thus perhaps unsurprising that this exception does not appear in section 954(c)(6). Indeed, there are several statutory differences between section 954(c)(6) and (c)(3), some of which will be discussed in detail below.

was never designed to permit, let alone facilitate, foreign tax reduction. Section 954(c)(6) is clearly different — at least for a three-year period, it says that most tax haven deferral relating to intercompany payments is just fine.

It's unclear whether section 954(c)(6) will achieve its stated ends, but it will undoubtedly remedy many of the international tax planning pitfalls mentioned in the previous section. For that reason, from the taxpayer's perspective, section 954(c)(6) appears to be, at least if it is made permanent, a real technical improvement over check-the-box planning. By addressing the issue of intercompany payments explicitly, it reaches more uniform results than check the box, which had addressed the problem indirectly, and perhaps by accident.

First, section 954(c)(6) appears to provide pretty much everything that a check-the-box election would have allowed for payments between CFCs and their disregarded entities, for subpart F income at least.¹³¹ Under section 954(c)(6), those payments are excluded, to the extent they are attributable to earnings that are not subpart F income or ECI. Before, they were excluded because they did not exist, and as a practical matter, they could never have reduced subpart F income or ECI or created a deficit that might reduce subpart F income for the same reason (because in calculating the recipient CFC's subpart F income or ECI, they did not exist).¹³²

Second, section 954(c)(6) is a handy simplification over check-the-box planning, just as check the box was a handy simplification over planning under the *Kintner* regulations. It is no longer necessary to rearrange foreign subsidiaries so that they are in the right configuration, nor is it necessary to change the form of business entities that may exist in the wrong form (that is, a type of entity on the per se corporation list) to another form for which entity election is available.¹³³

Third, section 954(c)(6) accomplishes all that without many of the complications described in the previous section, although some do remain. I'll deal with each of the check-the-box snags discussed in the previous section in turn.

¹³¹Because section 954(c)(6) uses a different mechanism, it of course has different collateral implications. Under the check-the-box regime, profits and losses can be used to offset one another for purposes of computing subpart F income, either through allocation of deductions under section 954(b)(5) or simply by reducing E&P. That permits taxpayers to change the effective rate of foreign tax on E&P, as discussed below. Section 954(c)(6) also permits that, but only if the CFC with losses is a direct or indirect parent to the profitable CFC in the ownership chain and the profitable CFC pays dividends up.

¹³²Check the box works a bit better for dividends paid by lower-tier CFCs that are out of ECI. Under check the box, those would disappear; under section 954(c)(6), they are still dividends and after the technical corrections bill, subpart F income of the upper-tier recipient.

¹³³Not to mention that there is less risk of clerical error (forgetting to file Form 8832) or unearthing ancient documentation (proving that the taxpayer actually did file the form). That may be a minor setback for the section 9100 relief industry.

B. Section 954(c)(6) and Check the Box Compared

1. Per se corporations. Section 954(c)(6) is significantly more equitable than check-the-box planning as is between foreign jurisdictions in which U.S. taxpayers may invest. Unlike the check-the-box rules, section 954(c)(6) operates identically in different jurisdictions regardless of whether those jurisdictions offer a variety of corporate forms, and it may serve a capital export neutrality-like goal in that it reduces the role of the U.S. tax system in deciding which foreign jurisdiction deserves investment.¹³⁴ Taxpayers with sizable investments in per se corporations in Canada and Japan are no doubt happy about that. Whereas, in the past, taxpayers frequently could not redeploy earnings from such a country to other countries without incurring a subpart F inclusion, that's no longer the case.

Example 10: USP owns 100 percent of CFC1, which owns 100 percent of each of FS1, which is incorporated in Country A, and FS2, which is incorporated in Country J. Country J only has two kinds of entities that qualify for passthrough treatment, one of which is used only for fishermen's cooperatives and the other of which features unlimited liability. FS2 has excess E&P that USP would like to use to finance the construction of a children's hospital by FS1.

Before section 954(c)(6), if FS2 were located in a friendlier jurisdiction, USP would cause both FS1 and FS2 to elect to be disregarded. Any capital flows between the two entities would then be considered (for U.S. tax purposes) to be internal to CFC1 and thus not taxable income. Of course, because FS2 is located in a jurisdiction that does not recognize a corporate form that is both eligible for U.S. entity election and otherwise acceptable to USP, the check-the-box/holding company strategy is not available and USP would have been forced to forego deferral on any payments between FS2 (which is doomed to be a separate CFC) and FS1.

Under section 954(c)(6), however, USP can look through a payment from FS2 to FS1 and include currently in taxable income only amounts that are traceable to FS2's subpart F income.

On a related note, section 954(c)(6) is more equitable across industries. Insurance companies are per se corporations by statute and thus cannot enjoy the benefits of check-the-box planning. Under current law (also temporary, to be sure) much of their income is not subpart F income. Section 954(c)(6) allows that income to be redeployed just as in other industries.

2. Joint ventures. As discussed above, because the check-the-box technique relies on the fact that the relevant payment disappears, it is ineffective to eliminate subpart F income when the payment is made from a partnership. Until Notice 2007-9, it was not entirely clear how section

¹³⁴I will admit that I have never heard that articulated as a significant factor in any client's decision-making, but it could happen and surely that was not a policy goal of the per se corporation list.

954(c)(6) would apply to partnerships, although the IRS's track record in the area suggested that the result would be taxpayer-favorable,¹³⁵ and most commentators agreed that it should be. Section 954(c)(6), as interpreted by Notice 2007-9, applies to payments to and from partnerships to the extent that, viewing the partnership as an aggregate, the payment is between related CFCs and otherwise meets the requirements of section 954(c)(6).

Example 11: Assume USP1 has two wholly owned subsidiaries, CFC1 and CFC2, and unrelated USP2 has two wholly owned subsidiaries, CFC3 and CFC4. CFC1 and CFC3 enter into a 70/30 joint venture, FJV. CFC2 pays interest to FJV that is attributable to earnings of CFC2 that are not subpart F income or ECI. Under section 954(c)(6), CFC1's distributive share of the interest income is not subpart F income or ECI. Note that CFC3's share is subpart F income (and may result in current taxation to USP2).

Now assume instead that FJV pays interest to CFC2. It appears that 70 percent of the interest income may escape subpart F classification, unless allocable or attributable to earnings of CFC1 that would otherwise be subpart F income or ECI. The other 30 percent, attributable on an "aggregate" basis to CFC3, is likely subpart F income.

Note that there is interplay between section 954(c)(6) and the check-the-box rules, in that the choice under the check-the-box rules of whether FJV is a corporation or a partnership still matters for subpart F purposes. Section 954(c)(6) works even better on those facts if FJV is a corporation. In that case, 100 percent of the interest payments in either direction would be excluded from subpart F income for both USP1 and USP2. But, if one changes the facts so that the interest payment is to or from CFC4, USP1 is out of luck either way, but USP2 gets to exclude 30 percent either way if FJV is a partnership (but not if FJV is a corporation), assuming that the interest is not attributable to subpart F income (or ECI).

3. Complex corporate structures — multiple chains. Another important feature of section 954(c)(6) is that it applies to payments between entities that are merely related CFCs, as opposed to wholly owned by the same foreign holding company. That gives rise to an additional advantage over check-the-box planning. Taxpayers that have two or more separate offshore chains do not have to consolidate their holdings under one top-tier subsidiary and work to ensure that there is an unbroken chain of DREs from the holding company down, but can move capital around freely between the two chains without the risk of inadvertently creating subpart F income.

Example 12: USP establishes CFC1 in Country A and CFC2 in Country B. CFC1 owns 100 percent of CFC3 and CFC4, both formed under the laws of Country C, and CFC2 owns 100 percent of CFC5 and CFC6, both formed under the laws of Country D. In the case of any payments among CFC1 and its subsidiaries, or among CFC2 and its subsidiaries,

section 954(c)(6) will look through to the nature of the payer's E&P. Whether the lower-tier subsidiaries elect to be treated as passthrough entities under the check-the-box rules is not relevant. Subpart F income will result only if the payer has subpart F income or ECI that is reduced by reason of the payment. That effect is, in general, achievable under the check-the-box rules, as discussed above in Example 5. However, unlike as with the check-the-box regime, any payments between CFC1 or any of its subsidiaries, on the one hand, and CFC2 or any of its subsidiaries on the other, will no longer result in subpart F inclusions for the recipient-CFC's U.S. shareholders, except if the payer has subpart F income or ECI that is reduced by reason of the payment.

That change is particularly useful for planning that involves tax havens in conjunction with foreign holding companies in jurisdictions that have their own CFC rules. If all foreign subsidiaries are consolidated into a single chain, the jurisdiction of holding company at the top will often have been chosen for treaty purposes. If the holding company jurisdiction itself has CFC rules, that can interfere with the use of the tax haven-based finance subsidiaries. The alternative, the use of sister companies, is unlikely to have the same effect.

4. Foreign base company services income. Section 954(c)(6) also makes it possible to avoid some of the externalities of check-the-box planning. For example, it may relegate the foreign base company sales and services issue, as discussed in Part II.B.4 above, to the dustbin of history. That issue arose only as a result of the need for FS1 to file a check-the-box election. Under the new rules, there are fewer reasons to file that election and, if not filed, the problem goes away.¹³⁶

5. Foreign tax credit. Section 954(c)(6) also means that the foreign tax credit pools of brother-sister or parent-sub subsidiaries of a single CFC need not be automatically blended, as in Example 9 (check the box) in the previous section. Section 954(c)(6) does, however, cause some foreign tax credit blending of a different kind.

Example 13: Assume the same facts as Example 9. USP establishes CFC1 in Country A, which has a 5 percent tax rate. CFC1 has \$100 of pretax income on which it pays \$5 of tax. CFC1 has a wholly owned subsidiary FS1 in Country B, which has a 35 percent tax rate. FS1 has \$100 of pretax income and pays \$35 of tax. USP wants to repatriate \$65 from FS1 and to preserve its robust foreign tax credits so that it will not pay additional income tax in the United States. Before section 954(c)(6), as described in Example 8 (assuming no check-the-box elections), that could be accomplished by causing FS1 to pay a dividend to CFC1, and then causing CFC1 to pay a repatriating dividend to USP.

¹³⁵See *supra* note 100.

¹³⁶If an election has already been filed for FS1 within the past 60 months, things are a little more complicated, as elections generally cannot be changed until the end of that period. As discussed below, Treasury should consider providing relief in that setting from the 60-month rule. See *infra* Part III.D.4.

Thanks to section 954(c)(6), that strategy will now dilute the available foreign tax credits. If FS1 pays dividends of \$65 to CFC1, that \$65 will carry with it \$35 of foreign tax credits. Under section 954(c)(6), that dividend will not be subpart F income. On receipt of the dividend, CFC1 will have \$200 of E&P, having paid about \$40 of tax, for an effective rate of about 20 percent. If CFC1 now pays the \$65 dividend to USP, USP will be treated as having received about \$81.25 in dividend income but only as having paid \$16.25 of tax on that income. It will still owe about \$12.19.

It is the author's understanding that some taxpayers may have done transactions similar to that in early 2006, expecting the treatment in Example 9 (base case), and now find themselves with the treatment in Example 13. That, among other things, led some commentators to suggest that section 954(c)(6) should be elective for the portion of 2006 before enactment.¹³⁷ In Notice 2007-9 the IRS concluded, probably correctly (as a matter of statutory construction, if not fairness), that the statute was not elective.

It may still be possible to achieve results similar to Example 9 (base case) through the use of section 956.

Example 14: The facts are the same as Example 13. Instead of paying a dividend, FS1 lends \$65 directly to USP. Under sections 956, 951(a)(1)(B), and 960, USP has \$100 of income and \$35 of deemed paid foreign taxes, the same result as in Example 9 under prior law. If USP later repays the loan, and FS1 distributes the proceeds, the distribution from FS1 to CFC1 will be excluded from income under section 959(b) and any redistribution from CFC1 to USP will be excluded under section 959(a).

Of course, that is a different transaction in several respects, as the assets are still subject to the claims of FS1's creditors. Also, to work, the intercompany loan has to be respected as debt for U.S. tax purposes, which includes answering the simple question whether there is really an intent to repay (which might be doubted if immediately on repayment the funds are distributed right back to USP). Finally, could the IRS possibly take the view that this is somehow an abuse of section 954(c)(6)?

IV. IRS Guidance Under Section 954(c)(6)

A. Notice 2007-9

In light, perhaps, of the fact that section 954(c)(6) is scheduled to be around for only three years, the IRS and Treasury said they would move quickly to issue guidance, initially through a series of notices. Treasury kept its word, and on January 11, 2007, the first of those

¹³⁷The AICPA Report, *supra* note 7, argues explicitly that section 954(c)(6) should be elective year-by-year, CFC-by-CFC, by analogy to the high-tax kickout regulations. The author of the NYSBA Report, *supra* note 7, is more equivocal, stating that "it would be fair" to permit taxpayers to elect out.

notices, Notice 2007-9, appeared and succinctly addressed some of the open issues that commentators had raised.

1. Earnings from prior periods. Several commentators asked that guidance confirm that E&P accumulated by a foreign corporation before the time it was related to another CFC to which it makes a payment should be eligible for exclusion under section 954(c)(6). Part of the reason for the concern is that the same-country rule does not apply to dividends out of preacquisition E&P,¹³⁸ and some members of Congress,¹³⁹ as well as commentators,¹⁴⁰ viewed section 954(c)(6) as an extension of section 954(c)(3). Part III.A of this report explains how their policy rationales are in fact quite different, and senior Treasury Department officials have indicated (sensibly) that while there is a connection between the two regimes, they would not be slaves to avoiding items being in one and not the other.¹⁴¹ The same-country rule carveout for preaffiliation E&P is statutory (added in 1993) and has no parallel in the statutory language of section 954(c)(6). Notice 2007-9 reaches the appropriate result that (1) under section 954(c)(6), related-party status is tested only at the time that the relevant dividend, interest, rent, or royalty is paid or accrued¹⁴² and (2) in the case of dividends, the E&P of the distributing CFC need not have been accumulated while it was a CFC and/or a related person. Although not stated anywhere, the same is presumably true of interest attributable or allocable to pre-related-party or pre-CFC E&P of the payer (should that question ever arise).

A perhaps more interesting remaining question is whether it matters what type of income the payer earned before it was a CFC. Suppose, for example, that the payer-CFC was previously owned by an unrelated non-U.S. corporation and while so owned earned almost entirely passive portfolio income consisting of interest and dividends from investments, so that all of those E&P would have been subpart F income if it had been a CFC. CFC1 now acquires 60 percent of the stock of FC and thereafter receives a large dividend in excess of current E&P. What result?

Although that may not be an appealing fact pattern, I think section 954(c)(6) should apply. In the absence of the payment at issue, the underlying earnings were not anybody's subpart F income. From a policy perspective, while section 954(c)(6) should not reduce subpart F income below where it would have been if there had been no intercompany payment, it also should not increase it.¹⁴³ As discussed below, Treasury seems to agree with

¹³⁸Section 954(c)(3)(C).

¹³⁹Kyl Speech, *supra* note 124.

¹⁴⁰NYSBA Report, *supra* note 7.

¹⁴¹"Subpart F: Initial Notice on New Lookthrough Rule to Address Some Basic Issues, Hicks Says," *Daily Tax Report*, Dec. 18, 2006. In addition to the policy differences discussed throughout this report, there are many technical differences in statutory language.

¹⁴²Notice 2007-9, section 2.

¹⁴³That does not mean that intercompany payments will never increase U.S. taxable income of a U.S. taxpayer under the subpart F rules. Consider the following. USP owns 60 percent of

(Footnote continued on next page.)

that general principle (as evidenced by some of the decisions it announced in the notice). Note that it may be more difficult as a matter of statutory construction to reach the analogous answer if all of the preacquisition income of FC was ECI.

2. Other dividend issues.

a. What's a 'dividend'? Several commentators wondered whether section 954(c)(6) would apply to payments under the code that are not actually dividends in the corporate sense, but are treated as dividends under the code. The notice reaches the correct result for amounts treated as dividends under the language of the code, such as sections 302, 304, 356, and 964(e). The last result is different than under the same-country rules, but, once again, the difference makes at least technical sense because the same-country result is dictated by express statutory language¹⁴⁴ and there is no comparable language for section 954(c)(6). The notice limits that favorable treatment to amounts classified as dividends under the code¹⁴⁵ — under the notice, section 954(c)(6) will not apply to situations in which the CFC is an exchanging shareholder and has a deemed dividend under reg. section 1.367(b)-3(b)(3)(i).

b. Ordering rules. The notice does not provide a rule to determine the order in which E&P are treated as distributed for purposes of applying section 954(c)(6) to dividends. The notice correctly points out that this won't come up that often (if attributable to subpart F income, the distribution will generally be excluded under section 959, and if in excess of E&P it will not be a dividend), but the question will eventually have to be answered for distributions from corporations with both nonsubpart F income and ECI, and (unless *all* dividends from preacquisition earnings are excluded) for corporations with preacquisition earnings of a type that would have been subpart F income had it been a CFC.

3. Partnerships. As noted above, some commentators speculated how payments to and from partnerships would be treated under section 954(c)(6). Based on the relatively recent regulations promulgated in response to *Brown Group*,¹⁴⁶ it seemed likely that the IRS would take an "aggregate" view, and in fact it did, as discussed above.¹⁴⁷ That result is clearly appropriate.

4. Interest. The notice addresses several points relating to interest.

a. Allocation and attribution rules. Section 954(c)(6), on its face, states that to be eligible for exclusion, interest must be "attributable or properly allocable (determined under rules similar to the rules of subparagraphs (C) and

(D) of section 904(d)(3)) to income of a related person which is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States." That statutory language raised at least two significant questions to which the notice reached eminently sensible answers from a policy perspective, even if not obvious on the face of the statute.

First, several practitioners and commentators struggled with what the rules similar to the rules of subparagraphs (C) and (D) of section 904(d)(3) would look like in that context. Those rules, designed for a different purpose, do not ultimately fit that well in several respects — they draw lines that are important in the foreign tax credit basket setting in which they appear, but are not relevant under section 954(c)(6) and fail to draw distinctions that are important for section 954(c)(6). They also may miss the mark when trying to achieve the objective, set forth in the legislative history of the technical corrections bill, that section 954(c)(6) payments should not reduce the amount of income otherwise subject to current U.S. tax (under subpart F or the ECI rules).

Fortunately, there are rules that fit better, and the notice announced that the government would use them. In the case of subpart F income, section 954(b)(5) is directly on point for deductible payments. Similarly, for ECI, there are elaborate rules for allocating deductions in sections 882 and 861 and, when a treaty modifies the ECI rules, there are principles and rules to determine the net amount of income that is taxable as attributable to a PE. The notice appropriately concludes that those should be the guiding principles for allocation of interest expense (and, as noted below, other deductible payments). One might ask whether the statutory language of section 954(c)(6)(A) really permits that, but if it does not, the authority to issue antiabuse rules (and its legislative history) provide ample support. Perhaps when Treasury ultimately gets around to writing allocation rules for dividends, it will throw a bone to Congress and follow section 904(d)(3).

b. Amounts in excess of payer's earnings. The statute could be read to suggest that payments in excess of E&P of the payer would automatically be outside the scope of section 954(c)(6). Indeed, that is the most straightforward reading of the statutory language. Section 954(c)(6) states that, for the look-through rule to apply, the item must be traceable to income of the payer: "Dividends, interest, rents, and royalties received or accrued from a controlled foreign corporation which is a related person shall not be treated as foreign personal holding company income *to the extent attributable or properly allocable . . . to income of the related person which is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States*" (emphasis added). If the payer has no income at all, it is hard to see how that condition, taken literally, is met.

However, the literal reading leads to the wrong policy answer. Section 954(c)(6) should prevent payments between related CFCs from creating subpart F income when

CFC1 and 100 percent of CFC2. CFC1 earns \$100 of subpart F income and pays \$100 of interest to CFC2. If the interest payment did not exist, USP would have \$60 of income inclusion under section 951 (60 percent x \$100). With the interest payment, it has \$100.

¹⁴⁴Section 964(e)(2).

¹⁴⁵The notice does not expressly address other items raised by commentators, such as deemed dividends resulting from a section 482 adjustment, but it is hard to see how that could be treated differently from other dividends.

¹⁴⁶See *supra* note 100.

¹⁴⁷See discussion in Part III.B.2, *supra*.

none existed in the absence of that payment.¹⁴⁸ Indeed, the analogous statutory language in the same-country area is better crafted in that regard, in that it addresses the issue as an exception, not a condition; that is, it states that the same-country exception will not apply to interest, rents, and royalties from a related same-country corporation that reduce the payer's subpart F income.¹⁴⁹ Under the same-country language, if the payer has no income, there is no problem.

Because the statutory language is different, some believed that the statute might have to be amended to accomplish under section 954(c)(6) the sensible result for which section 954(c)(3) provided. In Notice 2007-9, Treasury generally respected statutory differences, but in that case it showed greater flexibility to reach the appropriate policy result. Under the notice, interest is, subject to the limitations discussed below, eligible for the section 954(c)(6) exclusions even if interest deductions exceed the gross income of the related CFC payer. The notice limits the treatment when (and to the extent) the interest deduction creates a deficit (a "prohibited deficit") that (1) under section 952(c) may reduce the subpart F income of the related CFC payer or another CFC; (2) reduces ECI; or (3) in the treaty context, reduces income attributable to a PE. That sensible limitation is based, of course, on unenacted technical corrections legislation (other than clause (3), which is a logical extension of the proposed statutory language).

Perhaps a statutory amendment conforming that aspect of section 954(c)(6) to section 954(c)(3) would still be a good idea. However, perhaps the statutory language issue already is (or at least may become) less than totally clear. The as-yet-unenacted changes proposed in the technical corrections bill introduce some textual ambiguity by stating that payments that create or increase some types of deficits are ineligible for the exclusion.¹⁵⁰ That language would be superfluous if a payment that created any deficit at all was per se outside of the scope of section 954(c)(6).

c. Other interest issues. The notice also provides that if the payer CFC incurs interest expense that, but for section 5(b) of the notice (which stipulates that a payment

is not eligible for section 954(c)(6) treatment to the extent it reduces ECI of the CFC-payer), is eligible for section 954(c)(6) treatment and incurs other interest expense, the portion of a payment that is eligible for section 954(c)(6) will be determined by prorating the payment.

5. Rents and royalties. In the rents and royalties area, the notice makes the same two sensible policy decisions it made in the interest area. First, deficits, other than prohibited deficits, are not disqualifying. Second, allocations will be made under the relevant rules for deductions (section 954(b)(4) for subpart F and sections 861 and 861 for ECI).

6. Effective date and transition rules. Several commentators noted that section 954(c)(6) was enacted with a retroactive effective date that appears to have surprised some taxpayers for one reason or another (perhaps because they may not have realized that even taxpayer-favorable rules can have consequences that upset planning that worked under prior law), and suggested that there be some type of transition relief, perhaps in the form of an election.¹⁵¹ The notice states tersely (but correctly) that the statute has a statutory effective date and is not elective. As discussed above, other more limited transition relief is clearly within the scope of Treasury's authority and should be considered.¹⁵²

7. Antiabuse rules. Section 954(c)(6) contains the following grant of authority to make antiabuse regulations:

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this paragraph, including such regulations as may be necessary or appropriate to prevent the abuse of the purposes of this paragraph.¹⁵³

The JCT report accompanying the technical corrections bill¹⁵⁴ provides some explanation of what Congress had in mind:

It is intended that the Secretary issue regulations under the TIRPA look-through rule, as amended by this provision. It is intended that the Secretary will prescribe regulations that are necessary or appropriate to carry out the amended TIRPA look-through rule, including, but not limited to, regulations that prevent the inappropriate use of the amended TIRPA look-through rule to strip income from the U.S. income tax base. Regulations issued pursuant to this authority may, for example, include regulations that prevent the application of the amended TIRPA look-through rule to interest deemed to arise under certain related party factoring arrangements pursuant to section 864(d), or

¹⁴⁸Admittedly, nothing in the statute or legislative history actually says that. The legislative history of the technical corrections bill does say that section 954(c)(6) should not reduce subpart F income or ECI below what it would have been if there had been no payment, but that statement is at best the inverse of the proposition in the text and thus does not logically lead to it. JCT TCB Description, *supra* note 125. See quote and discussion following note 154, *infra*.

¹⁴⁹"Subparagraph (A) shall not apply in the case of any interest, rent, or royalty to the extent such interest, rent, or royalty reduces the payor's subpart F income or creates (or increases) a deficit which under section 952(c) may reduce the subpart F income of the payor or another controlled foreign corporation." Section 954(c)(3).

¹⁵⁰"Subparagraph (A) shall not apply in the case of any interest, rent, or royalty to the extent such interest, rent, or royalty creates (or increases) a deficit which under section 952(c) may reduce the subpart F income of the payor or another controlled foreign corporation." H.R. 6264, 109th Cong., 2d Sess. (2006); and S. 4026, 109th Cong., 2d Sess. (2006).

¹⁵¹See, e.g., NYSBA Report, *supra* note 7, at 5 and AICPA Report, *supra* note 7.

¹⁵²Part IV.B.A, *infra*.

¹⁵³The first round of technical corrections added the words "necessary or" to the antiabuse language of the statute. That change leaves some people scratching their heads — how can a regulation that is "necessary" not also be appropriate? However, the accompanying committee reports provide some useful hints about what Congress had in mind (whether or not it had much to do with the changes to the statutory rule).

¹⁵⁴JCT TCB Description, *supra* note 125.

under other transactions the net effect of which is the deduction of a payment, accrual, or loss for U.S. tax purposes without a corresponding inclusion in the subpart F income of the CFC income recipient, where such inclusion would have resulted in the absence of the amended TIRPA look-through rule.

At least before the JCT explanation, some practitioners had wondered exactly what type of transaction could be an abuse of the purpose of a statute whose only stated purpose was to permit deferral and efficient redeployment of active income earned offshore. There are at least three possible answers. The first, which finds support in the JCT technical corrections bill description, is that section 954(c)(6) payments should not be used to reduce subpart F income, or other U.S. taxable income, without a corresponding increase in the subpart F income of the recipient. That is a coherent objective, and it informs the first two examples in Notice 2007-9. A second possible theme is that section 954(c)(6) should not be pushed beyond its intended scope to achieve deferral beyond what Congress intended. That concept seems to inform at least two of the examples under the notice as well. It is a bit circular, given that Congress did not provide many clues as to what the intended scope was. A third possible theme might be that section 954(c)(6) should not be used to facilitate the creation of a structure that might be seen as an abuse of other provisions of the code, such as the foreign tax credit rules. That category has been touched on by commentators, but is not addressed in the notice.

A second issue for antiabuse rules is the form they should take — narrow or broad, specific examples or general principles. The notice does not answer that question, but starts at least for now with specific examples that bear a resemblance to the approach of the partnership antiabuse regulations.¹⁵⁵ If Treasury sticks with that approach, I would urge that it follow the practice in that precedent of setting forth examples of fact patterns that are not abusive.

a. Payments that reduce income. The notice begins with a statement of principle, drawn directly from the JCT report, that transactions abuse section 954(c)(6) if they reduce the U.S. tax base by having the net effect of creating a deduction that reduces the taxable income of a person subject to U.S. tax without a corresponding inclusion in the subpart F income of the CFC recipient. It then illustrates that principle with the following example, involving factoring:

Example 15: (i) *Facts.* USP, a domestic corporation, owns 100 percent of the stock of CFC1 and CFC2. USP sells inventory to CFC1 in exchange for receivables. USP sells the CFC1 receivables to CFC2 at a discount, and CFC2 generates income on the collection of the CFC1 receivables.

(ii) *Analysis.* The income earned by CFC2 on collection of receivables is related-person factoring income as defined in section 864(d) and therefore is treated as interest income received on a loan from CFC2 to CFC1. However, because CFC2 acquired

the CFC1 receivables from USP at a discount, resulting in a current loss for USP, that interest income is not eligible for the section 954(c)(6) exception.¹⁵⁶

The example is based heavily on the legislative history of the technical corrections bill and seems to make sense.¹⁵⁷ It also appears to accept the suggestion made by many commentators that section 864(d) factoring income is eligible for exclusion under section 954(c)(6) and for that purpose is treated as interest income received from the obligor. Both points seemed obvious as a matter of statutory construction; both because section 864(d)(1) and (2) explicitly treat the income as interest from the obligor for purposes of subpart F and because section 864(d)(5) was not amended to add section 954(c)(6) to the list of relief provisions for which section 864(d)(1) interest is ineligible. That list does include section 954(c)(3), the same-country exception, and that may imply that the failure to add section 954(c)(6) is an oversight, but the oversight, if there is one, is for Congress to fix if it chooses.

b. Dividends and section 956. The next example was a bit more surprising. It involves section 956.

Example 16: (i) *Facts.* USP, a domestic corporation, owns 100 percent of the stock of CFC1 which in turn owns 100 percent of the stock of CFC2. At the beginning of year 1, when the stock of CFC2 has a value of \$300 and CFC2 has zero applicable earnings (within the meaning of section 956(b)(1)), CFC2 loans \$100 to USP in exchange for a note. During year 1, CFC2 generates \$100 of profits that are not subpart F income. Shortly before the end of year 1, CFC2 distributes \$100 to CFC1 that results in a \$100 dividend to CFC1 that is excluded from subpart F income under section 954(c)(6). CFC2 takes the position that its applicable earnings under section 956(b)(1) are reduced from \$100 to \$0.

(ii) *Analysis.* The USP note held by CFC2 is U.S. property (within the meaning of section 956(c)(1)(C)), and CFC2 generated \$100 of E&P during year 1. As a result, USP would have an income inclusion of \$100 under section 951(a)(1)(B), but for the applicable earnings limitation under section 956(b)(1). However, as a result of the year 1 dividend CFC2 paid to CFC1, CFC2 does not have any applicable earnings and USP therefore would not have a section 951(a)(1)(B) inclusion.

The notice concludes on those facts that the dividend income of CFC1 is not eligible for section 954(c)(6). The fact pattern is somewhat unusual — a second-tier CFC2 has invested in U.S. property when it has no E&P, then

¹⁵⁵Reg. section 1.701-2.

¹⁵⁶The example is verbatim from Notice 2007-9.

¹⁵⁷I will admit that I am not entirely sure. Much ink has been spilled on the issue of factoring and section 954(c)(6), and I must admit that I am not an expert on factoring and I do not fully understand all of the nuances. For example, I do not understand how a related-party factoring transaction involving a sale to a related-party results in a currently deductible loss notwithstanding section 267.

has E&P that are not subpart F income. If it held onto those earnings, its indirect parent would have a section 956 income inclusion, so the CFC instead distributes the earnings to its immediate parent, CFC1, to avoid having “applicable earnings.”¹⁵⁸ The notice’s conclusion that the distribution should not get the benefit of section 954(c)(6) makes sense in that section 954(c)(6) has allowed for a reduction of subpart F income, although I would note that if CFC1 were incorporated in the same country as CFC2 (and CFC2 has substantial trade or business assets in that country), the same planning would still work (and has for many years). Perhaps the better fix would be to amend section 956, to provide that current E&P are unreduced by distributions — just like in the rest of the code.

c. Expanding section 954(c)(6) beyond its intended scope. The notice then provides two illustrations of transactions that Treasury believes push section 954(c)(6) too far. Those examples draw on a familiar theme of antiabuse regulations — that some transactions having a “principal purpose” of achieving section 954(c)(6) benefits are inappropriate.

i. Options. The notice discusses the use of options to structure into CFC status for a payer, thus bringing payments within the scope of section 954(c)(6). Here the notice says the technique will not work if a principal purpose of the option (or similar instrument, including a convertible security, a put, unvested stock, or a contract)¹⁵⁹ is to qualify for section 954(c)(6). The notice stops short of attacking the more straightforward case of the acquisition of a small quantity of actual stock for the same purpose.¹⁶⁰

That approach is more troubling and is also contrary to approaches that the government has taken in other areas. The famous Seagrams/DuPont transaction used options to achieve a desired tax result and the government’s response was, appropriately in my view, to amend the statute, rather than try to use the vague and difficult-to-administer “principal purpose” approach that the notice proposes here. If the option makes the payer a CFC, with all the other consequences that entails (many of which are unfavorable), it is not clear why this consequence (section 954(c)(6)) should be denied. The example in the notice also runs somewhat contrary to one of the examples in the partnership antiabuse regulations in which the use of a U.S. partnership to create CFC status to obtain a benefit under the foreign tax credit

¹⁵⁸Like section 316, applicable earnings take into account current E&P, but unlike section 316 they are reduced by distributions. It is not entirely clear why section 956 is drafted that way, and whether the difference would ever lead to a correct result.

¹⁵⁹It is not entirely clear what the government is getting at here — it is not clear that some of those instruments (other than the convertible stock or debt) are section 318(a)(4) options and if they are not it is not clear that they would create CFC status in the first place.

¹⁶⁰See NYSBA Report, *supra* note 7, at 46 (Example 18), suggesting that the acquisition-of-stock fact pattern should not be covered.

basket rules was respected.¹⁶¹ The use of such a partnership there seems no less artificial than the use of an option here. (Note that Treasury seems to agree because in the notice it announces that it’s considering extending the antiabuse rules of section 954(c)(6) to “principal purpose” domestic partnerships.)¹⁶²

One could also question whether the test makes sense in that context at all. Section 954(c)(6) intentionally grants a benefit — deferral on a look-through basis — and that is the only benefit the example achieves. The scope of that benefit is mechanically defined by reference to the CFC rules, and those rules mechanically use option attribution. It seems to me that statutory language should be followed here.

ii. Conduits. Some commentators raised “conduit” entity scenarios as possible candidates for antiabuse regulations and unsurprisingly the government went for it, once again using a principal purpose test. I am not sure that I agree with the notice here — if a transaction has substance and takes advantage of two separate rules enacted by Congress to do what each was intended to do, I am not sure that is inappropriate.

Example 17: (i) *Facts.* USP, a domestic corporation, owns 100 percent of the stock of CFC1, a country Y corporation, and CFC2, a country Z corporation. FC, a country Z corporation, is not a CFC, but is a related person under section 954(d)(3). In year 1, FC leases property from CFC1 for \$100. USP causes the rental payment to be made through CFC2. Thus, CFC2 receives a payment from FC that is excluded from FPHCI under section 954(c)(3)(A)(i). CFC2 then makes a payment to CFC1 in satisfaction of the rent owed by FC, which is intended to qualify for the section 954(c)(6) exception. A principal purpose for the involvement of CFC2 in the transaction is to qualify the rental payment from FC to CFC1 as eligible for the section 954(c)(6) exception.

(ii) *Analysis.* If the rental payment had been made directly from FC to CFC1, it would have been included as FPHCI under section 954(c)(1)(A). By causing the payment to be made through CFC2, USP sought to convert the character of the income from FPHCI to income excluded from FPHCI. However, because a principal purpose of including CFC2 in the transaction as a conduit entity was to avoid inclusion of the rental payment from FC to CFC1 as FPHCI, the payment from CFC2 to CFC1 will be treated as being made from FC to CFC1. Therefore, the payment is not eligible for the section 954(c)(6) exception.

On what appear to be the facts of the example, the notice reaches what seems to be the right result, albeit for the wrong reason. The facts make it sound almost as if USP told FC to pay rent to someone who was not its landlord to avoid subpart F.¹⁶³ Of course, that doesn’t

¹⁶¹Reg. section 1.701-2(f), Example 3.

¹⁶²Notice 2007-9, section 7(a).

¹⁶³Treasury may have borrowed the wording from commentators.

work — the rent would be income of CFC1 (and thus subpart F income) under general assignment-of-income principles. Similarly, if USP were a bit more sophisticated and had CFC1 enter into a lease with CFC2 and CFC2 then entered into a back-to-back lease with FC, the lessee/sublessor position might be attacked either as a sham under recent case law¹⁶⁴ or as a conduit under *Aiken*.¹⁶⁵ But let's say the intercompany lease has more substance, such as meaningfully different terms or even that CFC2 manages the property and will release it at the end of the FC lease. Should there still be a section 954(c)(6) antiabuse problem? What if, knowing that section 954(c)(6) is available, USP causes CFC1 to sell the property to CFC2 for a note, and now CFC2 collects rent and pays interest on the note. Is that an abuse?

I think that the "a principal purpose" approach is the wrong way to go here.¹⁶⁶ The purpose of section 954(c)(6) is to permit deferral. While the same-country rule originally had a different impetus (it permits deferral under circumstances not expected to be problematic under the statutory scheme at the time), it too clearly and intentionally permits deferral. It is not obvious to me that a transaction that has substance, takes advantage of two rules sequentially, and accomplishes what each of them is intended to accomplish is in fact abusing anything that regulations should attack.

B. Issues for Future Regulations

The notice does a pretty good job of addressing most of the issues highlighted by professional organizations, such as the New York State Bar Association (NYSBA) and the American Institute of Certified Public Accountants, that commented on the statute. There are, however, a few left.

1. Dividends. As noted above, there are unanswered issues relating to dividends that should be addressed, including allocation rules for dividends out of ECI (the approach taken for deductible payments such as interest, rents, and royalties obviously can't work here). Future notices or regulations should also address the issues discussed above relating to the characterization of pre-affiliation E&P.¹⁶⁷

2. High-tax kickout, de minimis, and full inclusion. One issue, of which the government is well aware,¹⁶⁸ is how the high-tax kickout of section 954(b)(4) should affect the application of section 954(c)(6). Consider the following case:

Example 18: Assume USP owns CFC1 and CFC2. CFC2 earns nothing but passive income on which it pays tax at a rate of 34 percent. That is more than 90 percent of the U.S. rate and thus, assuming no other computational oddities, CFC2's income will not be

treated as foreign base company income for purposes of section 954(a), and thus is not subpart F income for purposes of section 952(a)(2). Assume that CFC1, which is located in a tax haven and pays no tax at all, lends \$100 to CFC2, which invests the cash in passive assets and pays interest to CFC1. What is the result?

The right answer is not completely obvious, and there seems to be some confusion to the answer to the analogous question under the same-country exception.¹⁶⁹ Some have suggested that the answer may mechanically turn on whether the income would have been "high taxed" even if the payment were not deductible.¹⁷⁰ One could also conclude, I guess, that the test is whether the payer is in fact high taxed because then its income is not foreign base company income¹⁷¹ (and thus is not subpart F income), so section 954(c)(6) should not apply because the payment is not attributable to subpart F income.

It seems to me that using the high-tax exemption for income resulting from classic passive assets when the income being exempted (CFC1's intercompany interest income) is not being taxed at all (because it ends up with CFC1) makes no policy sense, as that exemption has been completely divorced from its *raison d'être* of actual high foreign tax. I would provide that whether income is subpart F income should be determined without regard to the application of the high-tax exemption to the payer. I also believe that the existing regulations for the same-country rule can be read to get to the result that whether or not the payer is (or might, with adjustments, be) eligible for the high-tax exception is irrelevant.

My analysis is as follows. The regulations interpret the same-country rule as it applies to interest to restrict its application to situations when it is allocable to adjusted *gross* foreign base company income.¹⁷² Adjusted gross foreign base company income is gross foreign base company income adjusted to reflect only the application of the *de minimis* and full inclusion rules.¹⁷³ The application of the high-tax kickout has not yet taken place — that takes place two steps later in the regulatory mechanism as part of the calculation of adjusted *net* foreign base company income.¹⁷⁴ So I think the existing regulatory approach for the same-country rules reaches the right policy result (that the high-tax status of the payer is irrelevant) and I would extend that rule to section 954(c)(6). As an alternative, the overall tax burden on the income of the payer (including for this purpose income shifted to and taxes paid by the payee CFC) could be determined, but that seems far more complex.

Similar questions arise for the *de minimis* and full inclusion rules of section 954(b)(3). On those two, I come

¹⁶⁴*BB&T Corp. v. United States*, 99 AFTR2d 2007-376, Doc 2007-446, 2007 TNT 4-19 (M.D. N.C. Jan. 4, 2007).

¹⁶⁵*Aiken Indus., Inc. v. Commissioner*, 56 T.C. 925 (1971).

¹⁶⁶Note that the high-tax exception in particular, and indeed subpart F in general, have evolved over the last 40 years from "principal purpose" standards to bright-line rules. See discussion in Part I *supra*.

¹⁶⁷See Part IV.A.1.

¹⁶⁸See *supra* note 141.

¹⁶⁹Although the same-country issue may have theoretically been around for more than 20 years, it may not have come up much in the real world if payer and payee frequently had more or less the same tax rate.

¹⁷⁰NYSBA Report, *supra* note 7, at 25-26.

¹⁷¹Section 954(b)(4).

¹⁷²Reg. section 1.954-2(b)(4)(ii)(B)(1).

¹⁷³Reg. section 1.954-1(b)(1).

¹⁷⁴Reg. section 1.954-1(d).

out the other way both as a policy matter and also under the existing same-country regulations discussed above (because the rules are applied at the adjusted gross foreign holding company stage).

3. Additional antiabuse issues. As noted above, the notice does not address the third category of possible antiabuse regulations — those that take advantage of section 954(c)(6) to create structures that achieve what some might view as unduly favorable results in other areas. One area in which that might arise is foreign tax credit planning.

The question of what types of foreign tax credit planning are appropriate is a fascinating and complex subject that is well beyond the scope of this report. I would also argue that it is a subject beyond the scope of any affirmative policy of section 954(c)(6). Foreign tax credit planning is simply not what section 954(c)(6) is about. The sole purpose of section 954(c)(6) is to permit offshore earnings to be deferred in appropriate circumstances until they are repatriated (or deemed repatriated under section 956). The role of the foreign tax credit rules is to determine how much U.S. tax is due when the foreign earnings are repatriated — that is, no longer deferred. Their policies do not really relate to each other, at least on the surface.¹⁷⁵ Thus, while section 954(c)(6) may lead taxpayers to adopt structures that are different than those used under prior (check-the-box) law, and those structures will have different foreign tax credit-related consequences,¹⁷⁶ those consequences have nothing to do with any purpose under section 954(c)(6) and they should be judged on their own merits without section 954(c)(6) playing any significant role in the discussion.

That being said, let's look at two examples of using section 954(c)(6) to maximize foreign tax credits that the NYSBA report sets out for consideration under the antiabuse rules.¹⁷⁷

Example 19: USP owns CFC1, a Cayman Islands company, which conducts business in France through a disregarded entity. USP also owns CFC2. CFC1 transfers the French disregarded entity to CFC2 in exchange for a loan. The effect of the transaction is to create two separate pools of earnings, one with low-taxed income and the other with high-taxed income.

Example 20: USP owns CFC1, which owns CFC2. Both CFC1 and CFC2 have an effective tax rate of 10 percent. USP also owns CFC3, which historically has suffered losses. USP transfers CFC1 to CFC3 in a tax-free transaction and files appropriate gain

recognition agreements. Subsequently, CFC2 pays dividends to CFC1, which in turn pays dividends to CFC3. Because of CFC3's ongoing losses, the effective tax rate of dividends paid to CFC1 increases from 10 percent to 40 percent. Subsequently CFC3 makes a dividend distribution to USP.

Example 19 raises several issues and indeed might possibly be attackable under section 269 if there is no nontax reason for CFC2. But it does not strike me as an abuse of section 954(c)(6). As discussed above, I believe that section 954(c)(6) is agnostic regarding foreign tax credits. If there is a problem, it does not seem that the right remedy is to deny section 954(c)(6) treatment and create subpart F income. Whether foreign tax credit antiabuse rules should pick up the case is beyond the scope of this report.¹⁷⁸

Even if one takes the view that taking advantage of section 954(c)(6) to ameliorate one's foreign tax credit position is, potentially, an abuse of section 954(c)(6), my initial reaction to Example 20 is that it is not such an abuse. Part of my reasoning is that it is possible to achieve something similar to Example 20 by checking the box on CFC1 and CFC2 after the transfer and not using section 954(c)(6) at all. Also, at least as to the dividends from CFC2 to CFC3, denying 954(c)(6) treatment would not change the foreign tax credit result — the subpart F income would be at CFC3 and because of CFC3's losses the effective rate of tax under section 960 would still be concentrated. So again I think that section 954(c)(6) is not the issue, and the problem, if there is one, should be handled by foreign tax credit regulations.

4. Effective date and transition rules. Section 954(c)(6) creates a new look-through rule that does not require a check-the-box strategy to get there. Over the past decade, many taxpayers have made check-the-box elections to achieve a similar result. It seems to me that Treasury should allow those taxpayers to switch over to the new system and thus to change their elections, even if that change would otherwise have been subject to a 60-month waiting period. It might also be helpful if those regulations also stated that the revocation of a prior check-the-box election under that relief will not be deemed to have a "principal purpose of tax evasion or avoidance" under section 269.

¹⁷⁵For an interesting contrary view, see Edward D. Kleinbard, "The Theory and Practice of Subpart F as Applied to Financial Services Firms," (unpublished draft), The Tax Club, Oct. 25, 2001, arguing that the deferral permitted by subpart F is almost the only thing that makes many of the otherwise inequitable parts of the foreign tax credit rules bearable. Note, however, that this point may be less significant given subsequent statutory changes to the foreign tax credit rules.

¹⁷⁶See, e.g., examples 9 and 13, *supra*.

¹⁷⁷NYSBA Report, *supra* note 7, at 45 (examples 16 and 17).

¹⁷⁸I tend to think not, at least in a situation in which section 269 would not be a winning argument for the IRS. It does not strike me as terribly offensive to segregate in a single pool the foreign taxes imposed by a country on a business operating in that country, even if the owner of that business may have succumbed to the temptation to check the box of the entity operating that business in the pre-section 954(c)(6) era. The IRS may agree that section 954(c)(6) is not the way to attack perceived foreign tax credit abuses. While recent proposed regulations under section 901 refer to section 954(c)(6), they do so only to define the definitional scope of new proposed section 901 rules rather than to interfere with the scope of section 954(c)(6). See prop. reg. section 1.902-2(e)(5)(iv)(C)(4). For a thoughtful and thorough discussion of the foreign tax credit antiabuse (albeit one with which it seems that the IRS does not completely agree), see Yaron Z. Reich, "International Tax Arbitrage Transactions Involving Creditable Taxes," *Taxes*, Mar. 2007.

The NYSBA report suggests mirror-image relief in the event that section 954(c)(6) in fact sunsets and asks that such relief be announced now.¹⁷⁹ I agree with the NYSBA recommendation.

V. Possible Next Steps for Congress

Now, let's step back from what Congress has done with section 954(c)(6) (and what Treasury has done with it, or should do with it) to think about what Congress might logically do next.

A. Taking Section 954(c)(6) One Step Further

1. Consider making section 954(c)(6) permanent. First, Congress should decide whether it is serious about section 954(c)(6) and whether it should be permanent. As noted above, section 954(c)(6) is a rather odd candidate for a three-year-only statute.¹⁸⁰ If it makes sense to encourage free flows of the types of payments described in section 954(c)(6), Congress should recognize that this will often happen most efficiently under long-term arrangements and structures that taxpayers may be reluctant to implement if there is a real possibility that they will have to undo them in less than two years.¹⁸¹

2. Repeal foreign base company sales income rules, except when the related party is in the United States or earning ECI. Let's assume, just for now, that section 954(c)(6), as currently drafted, earns a permanent place in the code and represents a judgment by Congress that payments that move money around among CFCs and do not reduce subpart F income or ECI should get continued deferral, even if the impact is to reduce foreign taxes. Should more be done to the statute to implement that policy?

I think the answer is yes. For example, there are other parts of subpart F that have their roots in the same goal of preventing foreign tax reduction planning that section 954(c)(6) does not repeal. Those include the foreign base company sales and service income rules, both of which are designed to prevent the shifting of income that is part of a business from its natural jurisdiction to one where taxes are lower. If section 954(c)(6) now permits that to occur with a simple intercompany loan, why are related-party sales and service arrangements deserving of worse treatment?¹⁸² I would think that the foreign base company sales and services rules should be changed to apply

only when the related party is a U.S. entity or is engaged in an activity that generates ECI.¹⁸³

3. Codify look-through for sales of subsidiary stock. It is also not entirely clear why gain from the sale of stock of a CFC engaged in an active business should be subpart F income. Section 954(c)(6) already exempts the portion of the gain that is treated as a dividend under section 964(e). Why should the rest of the gain be treated differently? Note that it will not be if the seller uses "check and sell"¹⁸⁴ (itself a look-through technique that has much in common with section 954(c)(6), at least at a 30,000-foot level). Moreover, although not widely recognized, the use of a section 338 election, in combination with section 954(c)(6), may get to the same place, even when check and sell might be unavailable.

Example 21: USP owns 100 percent of CFC1, which in turn owns 70 percent of CFC2, and the balance is owned by unrelated parties. Assume that CFC1's tax basis in the stock of CFC2 is \$350, CFC2's E&P while USP has owned the stock are \$500 (of which CFC1/USP's share under section 1248 principles is \$350) and CFC2's tax basis in its assets is \$1,000. An unrelated purchaser wishes to purchase all of the stock of CFC2 for \$2,000.

If the transaction goes forward with no further planning, CFC1 will recognize gain of \$1,050 (sales price of \$1,400 minus basis of \$350).¹⁸⁵ Of that amount, \$350 would have been a dividend under section 1248 if USP rather than CFC1 had been the seller, and thus is treated as a dividend under section 964(e) that is excluded under section 954(c)(6). The remaining gain will be subpart F income by reason of section 954(c)(1)(B).

Now assume that FP makes an election under section 338(g) regarding its acquisition of the stock of CFC2. Under reg. section 1.338-9, CFC2's E&P will be increased to reflect the deemed asset sale for purposes of determining the seller's consequences under section 1248 and thus, presumably section 964(e). If so, all of the gain will not be a section 964(e) dividend that is excluded under section 954(c)(6), and no amount will be subpart F income under section 954(c)(1)(B). The same analysis may apply under check and sell, if available.

That technique bears some resemblance to a popular technique in the 1980s of using section 338 to improve the foreign tax credit consequences of a CFC sale. Congress ended that with section 338(h)(16), which states that

foreign base company sales and service income rules (other than for some transactions involving the United States).

¹⁸³There is a counterargument that goes something like this: Classic earnings-stripping payments (interests, rents, and royalties) remain important, are frequently taxed by the source country on a withholding basis, and thus are not that effective as an earnings-stripping device because sales and services income is not generally taxed on a source basis and thus evades the reach of the international regimes of many other countries. My personal experience is that there is frequently a treaty solution to the withholding problem.

¹⁸⁴*Dover v. Commissioner*, 122 T.C. 324, Doc 2004-9660, 2004 TNT 88-15 (2004).

¹⁸⁵For ease of illustration, foreign tax credits and related gross-ups are ignored.

¹⁷⁹NYSBA Report, *supra* note 7, at 48.

¹⁸⁰See *supra* note 14.

¹⁸¹Indeed, tax advisers are already setting up structures that involve greater complexity than otherwise would be necessary to deal with the eventuality that section 954(c)(6) will sunset. The regulatory change proposed by the NYSBA Report, *supra* note 7, is a small step in that direction — it would at least tell taxpayers that they can undo them if it comes to that. If making section 954(c)(6) permanent seems, for the reasons outlined in this report, to be too radical a step, a happy medium might be to restrict its application to dividends only. While there are strong arguments to be made against permitting earnings stripping, treating intercompany dividends as subpart F income has never made sense to me.

¹⁸²One recent bill, H.R. 6288, not only proposes to make section 954(c)(6) permanent, but would also largely repeal the

(Footnote continued in next column.)

section 338 does not apply for foreign tax credit purposes. No parallel provision states that section 338 does not apply for subpart F purposes because, until section 954(c)(6), none was needed.

In a moment of optimism, I wondered if section 954(c)(6) could be read to have done even more here — because the CFC subsidiary stock is not an asset that generates FPHCI to its owner. Now, perhaps, the sale of that stock should not give rise to FPHCI. Unfortunately, that is not how section 954(c)(1)(B) is drafted, so we will have to leave that idea for Congress. I think that a statutory look-through here makes sense (and, for that matter, in the PFIC rules, concerning which no one is quite sure what the law is).

4. Conform section 954(c)(6) and the same-country exception (or just repeal the same-country exception as superfluous). A smaller question is whether the same-country rules have any useful role to play if section 954(c)(6) becomes permanent. There are, of course, many technical differences between the two, to be sure, but I'm not sure that any of the differences reflects a thoughtful policy decision that one rule is appropriate in one place and the contrary rule is appropriate in the other. For example, under section 954(c)(3) the payer has to be related to the payee, but need not itself be a CFC. That certainly makes a difference in a wide range of fact patterns, but if one steps back and thinks about it, it is difficult to see why, as a policy matter, such a difference should exist. It seems to me that Congress should choose one approach and then apply it consistently to both.¹⁸⁶ There are other details that are different by statute (for example, sections 864(d) and 964(e), preaffiliation E&P), but for those there is no articulated rationale and it's hard to figure out exactly why the results should be different as a policy matter. Another drafting difference — the seemingly different statutory language regarding whether payments must be affirmatively attributable to nonsubpart F income — seems less likely to have been an accident, given that it's right in section 954(c)(3) (rather than in a cross-reference list elsewhere in the code) and the drafters of section 954(c)(6) were clearly looking at section 954(c)(3) itself. I had expected that this might have made a difference (for example, in the treatment of payments in excess of E&P) in the absence of a technical correction, but fortunately the notice avoided that problem and provided section 954(c)(6) with the more favorable and sensible rule of section 954(c)(3). If Congress agrees with me so far, and makes all the conforming changes, I'm not sure there's much point in having both rules, as opposed to having just section 954(c)(6) (with any modifications deemed appropriate) cover the waterfront.

B. What About the Rest of Subpart F?

Let's now assume that all of the changes described above are made, largely completing the interment of the foreign tax reduction branch of subpart F. If that occurs, should the rest of the CFC rules be examined and

possibly repealed? I think that the answer to examine is yes, but to repeal is no. Unless we change our entire system, there is enough left for the CFC rules to do that it may make sense to keep them.

Let's talk about what the rest of the CFC rules encompass. First, the code would continue to need some rule for payments that reduce ECI and non-subpart F U.S. taxable income. Second, subpart F denies deferral to true passive income. That seems reasonable, and indeed many of our trading partners do that one way or the other, even if they have otherwise territorial systems. We do, of course, have a second regime — the PFIC regime — that is targeted at passive income, and one might ask whether it is sufficient to deal with the whole offshore passive income issue. On balance, I think that the answer is no. The PFIC regime is a blunt instrument designed to deal with entire corporate groups, which may or may not have a significant number of U.S. shareholders, that have been set up to earn passive income. While those rules have their own problems, their basic approach makes some sense if a determination has been made that all U.S. taxpayers should be taxed if they invest in such a company. The subpart F approach is more surgical and far more appropriate to and effective in cases in which U.S. investors both control what is going on (so they have the ability to stuff passive income into a subsidiary doing something else) and have a sufficient stake in and control of the foreign company to obtain the information to comply with a more demanding and precisely defined regime like subpart F, which deals with the passive income separately.

Next, we have the other categories of subpart F income, which today boil down to insurance, banking and finance, some oil-related income, and some personal services income. As an overgeneralization, one can stretch to find themes here (businesses conducted in a country that might not be the most natural place for doing so), but much of the driving force behind the limits of those rules seems to be politics. The other categories of foreign base company income (boycotts, bribes, kickbacks, and terrorists) are even further beyond U.S. tax policy goals. It is hard for a tax practitioner to evaluate the importance of those industry-specific and nontax policies, but if they are important, and have to be addressed in the code, they need a statutory scheme to fit into, and while subpart F may not be ideal, it works well enough.

The other parts of the CFC regime (sections 956 and 1248), which are not antideferral rules, may have their place as well. Section 956 does rough justice in the CFC world by defining when repatriation has occurred sufficiently to justify a shareholder-level tax (that is, tax on the U.S. parent) under our system. If a wholly owned CFC earns money from operations and then lends money to its parent, the result is really not that different from a dividend of the same earnings, and, at least in the simple paradigm case, maybe section 956 reaches the right balance in the CFC setting. Other categories of U.S. property are more complex, but there is a theme that not only have earnings been brought back to the United States but they also have been put at the disposal of the U.S. parent. Query, however, whether the same policy considerations might suggest that a loan from a closely held domestic corporation to its shareholders might get

¹⁸⁶Transition relief may be appropriate if the tighter section 954(c)(6) standard is adopted.

the same treatment. The answer might be that we know that the domestic corporation is itself subject to tax, and that the personal holding company and accumulated earnings tax rules will regulate that activity sufficiently.

Section 1248 addresses something different, namely character of gain on exit. The rule makes sense (or at least used to) if one accepts the view that the tax rules should not make foreign investment permanently more or less attractive than domestic. Based on the assumption that dividends would be more heavily taxed than capital gains, section 1248 is intended to ensure that one full tax (from a U.S. perspective) is paid at least at some point on the earnings of a CFC when repatriated and realized to its controlling U.S. owners. Of course, while individual tax rates on dividends are low, section 1248 is not really accomplishing that for CFCs in some jurisdictions, but that's another story.

C. Other Possibilities

The final issue to be addressed is whether section 954(c)(6) is the right law at the right time. That is, of course, a question of economic and political policy, not something at which a tax practitioner is particularly expert. But as subpart F gets significantly reshaped (yet again), it may make sense to consider whether the whole system should be revisited in light of how much the world has changed since the circumstances of 1962 that first gave birth to that system.

First, a recap of the economics of subpart F. As the law was originally conceived by the Kennedy administration, the policy was to make investments in the United States equally attractive (at least from a tax standpoint) to investments in other countries.¹⁸⁷ Today, we refer to that goal as capital export neutrality; when it is achieved, a given chunk of capital is neutrally buoyant and will settle in the United States or overseas based solely on nontax factors. At that time, and since then, the countervailing position has been capital import neutrality, also a level playing field but one of a different kind. If capital import neutrality is achieved regarding Country X, then investors in Country X will all face the same tax rate and will thrive or fail based solely on their individual merits rather than because of some kind of tax disadvantage. That is what commentators, lawmakers, practitioners, and businesspeople are talking about when they use the word competitiveness. If the United States imposes an additional tax on an investment in a Country X widget factory,¹⁸⁸ U.S.-based General Widgets will be at a competitive disadvantage regarding Widgetmacher AG that is not subject to that tax.

¹⁸⁷Of course, even when subpart F was no more than a glimmer in some Harvard man's eye, there was an exception: developing countries. However, the presence of a carveout intended to assist poorer countries by having subpart F *not* apply to them only strengthens the general conclusion that it was intended to lead to a level playing field between the United States and other advanced economies, at least regarding taxation.

¹⁸⁸And that is what "denial of deferral" means — an extra tax that otherwise would not come due unless the U.S. taxpayer took some other action, such as repatriation.

In discussing capital import neutrality, it is a point of some importance, as I have mentioned above, whether we are talking about American companies competing against Country X investors or other third-country multinational investors. If we are talking about achieving parity with other Country X investors, it's enough to simply permit the U.S. taxpayer to operate with no additional levy. If, however, we are talking about competition with other multinationals, then the question becomes: Do they have any tricks that the U.S. taxpayer doesn't have? Are they able, for instance, to set things up to actually pay *less* tax than a Country X investor?

As I've discussed at length above, two facts are indisputably true. One, at the time of its enactment, and in subsequent revisions (before section 954(c)(6)), the drafters of subpart F did everything in their power to ensure that it could not be used to strip earnings. Two, section 954(c)(6) permits earnings stripping.

If you look behind the assertion that it will make American companies more "competitive," the argument for section 954(c)(6) seems to be: Our competitors can strip earnings, so we should be able to, too. There was, however, a reason that the Kennedy administration did not want earnings stripping going on because it made, all else being equal, a foreign investment more attractive than a domestic investment. So we have several questions of fact — Do other countries, the ones with whom we are competing, let their multinationals strip earnings? Does it make a real competitive difference? Is that difference so substantial that it might even affect the ability of American companies to attract capital? Or is it just a way to show greater profitability through a lower effective tax rate?¹⁸⁹ — and one of policy — Is it more important for American companies to best Dutch companies in China or to encourage American companies to invest in America?

Many observers who take a step back and look at the big picture tend to argue that the whole compromise of 1962, retaining deferral for bona fide business activities offshore, should be revisited.¹⁹⁰ Some politicians agree. In early 2007 Finance Committee member John F. Kerry, D-Mass., proposed the Export Jobs Not Products Act,¹⁹¹ which would amend subpart F largely to eliminate deferral. Under that bill, deferral would be preserved only for qualified home country income, which in general terms is income earned by a CFC for manufacturing and selling products in its country of incorporation or providing services in its country of incorporation to recipients substantively located there. While that is not the complete triumph of capital export neutrality (indeed, it may preserve the original victory of capital import neutrality on the fact pattern people were actually thinking about in 1962 — the widget manufacturer in Lille who

¹⁸⁹There is nothing wrong with U.S. companies seeking to reduce their tax rate, but if tax reduction is the goal, it is not clear why, as a matter of macroeconomic policy, it should be focused on offshore earnings reinvested offshore.

¹⁹⁰Notably, Martin Sullivan and the authors of the OTP Study, *supra* note 23. See *supra* note 51.

¹⁹¹S. 96, 110th Cong., 1st Sess. (Jan. 4, 2007).

COMMENTARY / SPECIAL REPORT

sells to a customer in Paris), it is clearly dramatically different from what we have today.

My personal feeling is that section 954(c)(6) is a questionable policy choice. Yes, it never made sense for intercompany dividends to give rise to subpart F income. But, it may not make sense to permit earnings stripping. Allowing earnings stripping is an incentive (a subsidy, almost) to making investments offshore rather than here. Such an incentive does not seem particularly timely. As Sen. Charles E. Schumer, D-N.Y., once asked, when all the American jobs have moved to China, what's going to be left here, restaurants?¹⁹²

¹⁹²Quoted in Niall Ferguson, "Curious . . . the Chinese Take Over but the Dogs Don't Bark," *Daily Telegraph*, Apr. 23, 2006, available at <http://www.telegraph.co.uk/opinion/main.jhtml?xml=/opinion/2006/04/23/do2302.xml&sSheet=/opinion/2006/04/23/ixopinion.html>.