1-1-1996

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ARTICLES

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I. INTRODUCTION

Historically, U.S. corporations have encountered significant economic and legal obstacles to conducting business in Latin America. The economies of Latin America have long suffered from raging inflation, volatile currencies, massive external debt, and stifling government bureaucracies. Latin American countries have maintained substantial tariff barriers to foreign imports and have generally been hostile to foreign investment. In addition, the countries in this region frequently have used stringent exchange controls to restrict the repatriation of the earnings of local subsidiaries to their foreign parent corporations.

U.S. investment in Latin American countries has also been inhibited by the local tax environment. These countries' governments traditionally relied upon substantial withholding taxes on payments of dividends, interest, and royalties as a major source of revenue. Apart from the recent exception of Mexico, none of the major Latin American countries have income tax treaties with the United States. As a consequence, in addition to paying high withholding taxes without treaty reductions, U.S. companies risk double taxation. At the same time, generally ineffective enforcement of tax laws plague the Latin American countries.

Times are changing, however. Latin America is moving toward the free market, and many of the government-owned industries are being privatized. In an effort to attract more foreign investment, Latin American governments have reduced legal barriers to such investment, eliminated exchange controls, reduced taxes, and are gradually improving the enforcement of their tax laws. Nevertheless, Latin American governments struggle with the competing interests of attracting foreign investment while maintaining and expanding their sources of tax revenue.

Further, the United States has finally begun to build an income tax treaty network in Latin America. Mexico signed an income tax treaty with the United States in 1992, which went into force at the end of 1993. Pressure is growing for the United States to negotiate tax treaties with other major Latin American countries (e.g., Argentina, Brazil, Chile, and Venezuela). Thus, it appears that a substantially improved tax situation for U.S. corporations operating in Latin America is on the horizon.

When U.S.-based multinationals embark on doing business in Latin America, they not only face the diverse matrix of the economic and tax challenges described above, but they also become subject to some of the most complex and daunting of U.S. tax provisions in the U.S. Internal Revenue Code (the Code). The anti-deferral rules alone consist of six different tax regimes; U.S. foreign tax credits will not necessarily apply to all of the applicable foreign taxes; foreign currency translation issues often will be acutely important (given the frequent hyper-inflationary currencies involved); and the use of hybrid or reverse-hybrid entities, limited liability companies (LLC) and limited partnerships may be particularly relevant in light of these U.S. and other foreign tax considerations.

In order to better understand the specific tax challenges and the resulting planning opportunities which arise in this region, this Article provides an overview of the fundamental U.S. tax principles which overlay the outbound U.S. tax arena, including discussions of some of the principal tax planning considerations for the U.S.-based multinational doing business in Latin America.[1]

II. SUMMARY OF THE U.S. ANTI-DEFERRAL TAX REGIMES

A. *The Personal Holding Company and Accumulated Earnings Taxes*

The U.S. anti-deferral regimes are aimed at the use of a corporation to accumulate income at the corporate level and to indefinitely defer the income tax at the shareholder level by not distributing corporate earnings. To prevent the use of "incorporated pocketbooks," Congress enacted the Personal Holding

1. This Article contains material excerpted and condensed from two articles written by our partners: John M. Peterson, Jr. et al., *A Passive-Aggressive Approach To Anti-Deferral In The 1990s: Critical Analysis and Planning Techniques Under Section 956A*, 72 TAXES 1084 (1994) [hereinafter Peterson], and Barbara C. Spudis et al., *Using Partnerships in International Tax Planning*, 73 TAXES 834 (1995) [hereinafter Spudis]. These articles were presented at the University of Chicago Law School's 47th and 48th Annual Federal Tax Conferences. John M. Peterson, Jr. and Kent F. Wisner are partners in Baker & McKenzie's San Francisco/Palo Alto office; and Barbara C. Spudis and David A. Waimon are partners in Baker & McKenzie's Chicago office. The excerpts and condensed material are reprinted herein with the permission of the authors. CCH, Incorporated, the publisher of Taxes Magazine, has also provided its permission to use the excerpts and condensed material herein.

Company provisions[2] and the Accumulated Earnings Tax provisions.[3] These regimes imposed a penalty tax at the corporate level on undistributed corporate earnings. The rate of the penalty tax has generally been equal to the individual income tax rate that was avoided by not distributing the income of the corporation to individual shareholders.[4]

The Personal Holding Company tax applies if (a) more than fifty percent of the value of the stock of the corporation is concentrated in the hands of five or fewer individuals and (b) at least sixty percent of the adjusted ordinary gross income of the corporation consists of "personal holding company income."[5] For this purpose, personal holding company income includes most types of passive income, such as dividends, interest, most royalties, certain rents, income from certain personal service contracts, and income from trusts and estates.[6]

In contrast, the Accumulated Earnings Tax is triggered by the accumulation of earnings beyond the reasonable needs of the corporation's business and not by share ownership or the type of income earned by the corporation.[7]

B. *Foreign Personal Holding Companies*

In 1937, Congress enacted rules for Foreign Personal Holding Companies (FPHC) similar to the Personal Holding Company rules.[8] The FPHC rules prevent shareholders of foreign corporations from using the foreign corporations as "incorporated pocketbooks" to achieve the indefinite deferral of shareholder level tax if these shareholders have a high degree of control over the corporation and income of the corporation is primarily passive.

FPHCs must satisfy an *income test* and an *ownership test.* Under the *income test,* at least sixty percent of the foreign

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2. *See* I.R.C. §§ 541-547 (1995).
3. *See id.* §§ 531-537; *see also* the "Collapsible Corporation" rules of I.R.C. § 341 (1995).
4. The current penalty rate is 39.6% for both the Accumulated Earnings tax and the Personal Holding Company tax. *See id.* §§ 531, 541.
5. *Id.* § 542.
6. *Id.* § 543.
7. *Id.* §§ 532, 533, 537.
8. *See id.* §§ 551-558.

corporation's adjusted gross income for the taxable year must be "foreign personal holding company income."[9] FPHC income consists of dividends, interest, royalties (other than certain active business computer software royalties), annuities, gains from the sale or exchange of stock or securities (except for regular dealers in such stock or securities), gains from certain commodities futures transactions, certain income from estates and trusts, certain income from personal service contracts, amounts received as compensation to the shareholder for the use of property of the corporation by the shareholder, and rents (unless such rents constitute fifty percent or more of gross income).[10] The *ownership test* is satisfied if at any time during the taxable year more than fifty percent of either (a) the value or (b) the total combined voting power[11] of all classes of the foreign corporation's stock is owned, directly or indirectly,[12] by not more than five individuals who are citizens or residents of the United States (U.S. Group).[13]

If a foreign corporation is a FPHC, all of its U.S. shareholders, not just the U.S. Group, must include in their income their pro rata share of the FPHC's "undistributed foreign personal holding company income."[14] Undistributed FPHC income consists of all taxable income, adjusted for taxes, charitable contributions, net operating loss carryovers, and certain other deductions and reduced by certain dividends paid during the taxable year.[15]

The U.S. shareholder's pro rata share of FPHC income is the amount the shareholder would have received as a dividend if the foreign corporation had distributed its undistributed FPHC income on the last day of the taxable year in which or with which the taxable year of the foreign corporation ends.[16] Thus,

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9. *Id.* § 552(a)(1).

10. *Id.* § 553.

11. Value was the only measure until 1986. *See* Pub. L. No. 99-514, § 1222(b), 100 Stat. 2556 (1986).

12. Once a foreign corporation becomes a FPHC by satisfying the income and ownership tests for a taxable year, the *income test* threshold drops to fifty percent for future years. The FPHC rules have their own set of attribution rules. *See* I.R.C. § 554 (1995).

13. *Id.* § 552(a)(2).

14. *Id.* § 551(a).

15. *See id.* §§ 556, 561.

16. *Id.* § 551(b).

the application of the FPHC rules results in tax at the shareholder level instead of the corporate level as is the case for the Personal Holding Company and Accumulated Earnings Taxes.

In practice, the FPHC provisions have been relatively easy to avoid either by dispersing the ownership of a majority of the foreign corporation's stock among six or more persons or by careful planning to ensure that the foreign corporation earns sufficient active business income to stay under the sixty percent passive income threshold.

C. *Controlled Foreign Corporations and Subpart F*

In 1962, Congress again acted to limit deferral for foreign corporations.[17] President Kennedy initially proposed ending deferral completely except for foreign corporations organized in a few developing countries. Congress, however, determined that a complete end to deferral would have had a negative impact on the competitiveness of U.S.-based multinational businesses.

As a compromise, Congress focused on foreign corporations used as foreign base companies either as a holding company or a tax haven operating company through which income could be accumulated without a significant tax burden. In this manner, Congress extended the anti-deferral rules to include not only the passive income covered by the FPHC provisions (e.g., dividends, interest, rents and royalties) but also operating income from certain related-party transactions outside the country of incorporation of the base company. Moreover, unlike the FPHC provisions, the Subpart F rules apply to corporate shareholders as well as individuals.

Under Subpart F, certain U.S. persons owning stock (U.S. Shareholders) of controlled foreign corporations (CFC) must include in income their pro rata share of designated types of income earned by the CFC. A U.S. Shareholder is a U.S. citizen or resident individual, corporation, partnership, or trust owning (directly, indirectly, or constructively) ten percent or more of the total combined voting power of any foreign corporation.[18] A

17. Internal Revenue Act of 1962, President's Message, Hearings: House Committee on Ways and Means, 87th Cong., 1st Sess., on the President's Tax Recommendations contained in his Message of April 20, 1961, Vol. 1, at 8 (1962).

18. I.R.C. § 951(b) (1995).

CFC is any foreign corporation whose stock is owned more than fifty percent, by vote or by value, by such U.S. Shareholders.[19] Prior to the addition of Section 956A in 1993, the income includible by the U.S. Shareholders of the CFC consisted of the sum of the shareholder's pro rata share of (a) "Subpart F income" (as defined in Section 952) and (b) any increase in the CFC's "earnings invested in United States property" (determined under Section 956).

Section 956 requires U.S. taxation of the earnings of a CFC to its U.S. Shareholders if those earnings are effectively repatriated to the United States through an investment in U.S. property. For example, CFC loans to U.S. persons[20] and CFC purchases of assets located in the United States generally constitute investments in U.S. property.[21]

Subpart F income consists of three principal categories of income: (a) insurance income (as defined in Section 953), (b) "foreign base company income" (as defined in Section 954), and (c) pursuant to Section 952(a)(3)-(5), certain income taxable under the international boycott rules of Section 999, amounts relating to illegal bribes and kickbacks (or similar payments), and income of the CFC from certain blacklisted countries (as defined in Section 901(j)). "Foreign base company income" is further defined to include five subcategories of income: (i) FPHC income,[22] (ii) foreign base company sales income,[23] (iii) foreign base company services income,[24] (iv) foreign base company shipping income,[25] and (v) foreign base company oil-related income.[26] Income subject to a high rate of foreign tax, however, may be excluded from Subpart F income.[27]

The income inclusions under Subpart F, like those under the FPHC rules, are computed as if the CFC had distributed a

19. *Id.* § 957. Prior to 1986, this test was by vote only. *See* Pub. L. No. 99-514, § 1222(a)(1), 100 Stat. 2556 (1986).

20. *See, e.g.*, Temp. Treas. Reg. § 1.956-2T (1988).

21. *See generally* I.R.C. § 956(b) (1995).

22. *Id.* § 954(c).

23. *Id.* § 954(d).

24. *Id.* § 954(e).

25. *Id.* § 954(f).

26. *Id.* § 954(g).

27. *See id.* § 954(b)(4) (Subpart F income does not include income that has been subject to an effective foreign tax rate that is equal to at least ninety percent of the U.S. corporate rate).

dividend on the last day of the taxable year.[28] In contrast to the FPHC provisions, Subpart F inclusions are recognized only by the U.S. Shareholders of a CFC, not by all U.S. persons owning stock in the foreign company.[29]

Subpart F is aimed at ending deferral of U.S. tax on low-taxed foreign source income which (i) is inherently mobile and easily manipulated; (ii) does not bear a sufficient economic connection with the jurisdiction in which the CFC is organized; or (iii) has already been effectively repatriated. The U.S. tax on other active business income of a CFC, even if subject to low rates of foreign tax, can still be deferred. Moreover, where ownership of a foreign corporation is widely dispersed among U.S. persons so that U.S. Shareholders do not own more than fifty percent of the foreign corporation, even passive income remains free of U.S. tax until distributed to U.S. persons.[30]

Through careful Subpart F planning, many U.S.-based multinational corporations have been able to accumulate large amounts of earnings from active businesses in offshore subsidiaries.[31] Although the Accumulated Earnings Tax does apply to foreign corporations, it was rarely imposed because of its inherently subjective criteria of reasonable business needs and intention to avoid shareholder-level taxes.

D. *Passive Foreign Investment Companies*

Congress added another anti-deferral regime in 1986, imposing an extremely complex set of rules for Passive Foreign Investment Companies (PFIC). The PFIC regime was specifically aimed at foreign mutual funds that avoided the FPHC and Subpart F rules through dispersal of, and limitations on, stock

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28. *Id.* § 951(a).

29. *Compare* I.R.C. §§ 951(a)(b) (1995) *and* § 551(a) (1995).

30. An exception to this general rule is I.R.C. § 953(c), which applies the Subpart F regime to captive insurance companies without regard to the ten percent threshold on United States Shareholders of I.R.C. § 951(b) to the extent that U.S. persons own twenty-five percent or more of the foreign captive insurance company. *Id.* §§ 951(b), 953(c).

31. The investment income from the reinvestment of such accumulated earnings in interest-bearing or dividend-producing assets is generally subject to U.S. tax, either under Subpart F or the Passive Foreign Investment Companies (PFIC) rules, discussed *infra* part II.D. However, before I.R.C. § 956A, the principal amount of such earnings was not subject to U.S. taxation unless the principal exceeded the relatively high fifty passive asset limitation of the PFIC rules.

ownership by U.S. persons.[32]

A PFIC is a foreign corporation that has either (a) seventy-five percent or more of its income classified as "passive income" or (b) has at least fifty percent of its assets classified as passive assets.[33] If a foreign corporation is a PFIC (and does not elect alternative tax treatment) an interest charge[34] is imposed on distributions from the foreign corporation to a U.S. person or upon a disposition of the foreign corporation's stock by a U.S. person, regardless of the U.S. person's level of ownership of the foreign corporation's stock.[35] The interest charge is imposed on the distributed earnings that had the benefit of U.S. tax deferral.[36] If a PFIC and its U.S. person shareholders that otherwise would be subject to the PFIC interest charge prefer, the foreign corporation may elect to be a qualified electing fund (QEF)[37] in which case its income is subject to U.S. tax on a current basis (i.e., ending deferral without an interest charge).[38]

Passive income is defined by reference to the FPHC income definition of Section 954(c).[39] Passive assets are assets held by the foreign corporation which produce passive income.[40] These general rules were applied to specific assets in Notice 88-22.[41]

The PFIC provisions include complex *look-through rules* that can be used to trace income and assets to active businesses. Thus, interest, dividend, rent, and royalty income received from a related person[42] which is allocable to active business income

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32. *See* S. REP. NO. 313, 99th Cong., 2d Sess. 393 (1986) [hereinafter 1986 SENATE REPORT].

33. I.R.C. § 1296 (1995).

34. The interest rate used for this charge is the rate applicable to underpayments of tax under I.R.C. § 6621. *See id.* § 1291(c)(3).

35. *Id.* § 1291.

36. The amount of any distribution subject to the interest charge is an amount defined as an "excess distribution." *See id.* § 1291(a)(1). Gain from a disposition is treated as an excess distribution. *Id.* § 1291(a)(2). An excess distribution is generally any amount that exceeds 125% of the average actual distributions included in the shareholder's gross income for the prior three years. *Id.* § 1291(b).

37. *Id.* § 1293.

38. The interest charge regime was designed for investors not having sufficient access to a PFIC's records necessary to make QEF computations, control to compel regular, "nonexcess" distributions, or liquidity to pay tax on the current inclusions of a QEF that would occur without an actual cash distribution. *See* 1986 SENATE REPORT, *supra* note 32, at 394.

39. I.R.C. § 1296(b)(1) (1995).

40. *Id.* § 1296(a)(2).

41. 1988-1 C.B. 489.

42. For this purpose, a "related person" is as defined under the CFC rules in

of the related payor is *not* considered passive income (*income look-through rule*).[43] In addition, if a foreign corporation owns at least twenty-five percent (by value) of the stock in another corporation, the foreign corporation is treated as if it held its proportionate share of the assets of the other corporation and directly received its proportionate share of the income of the other corporation (*stock look-through rule*).[44]

The PFIC rules apply to CFCs[45] although Subpart F is given priority over the PFIC provisions where an income inclusion would occur under both rules.[46] Even though the PFIC provisions were originally targeted at foreign mutual funds, they are sufficiently broad to reach a wide cross-section of foreign corporations in which U.S. persons own stock. As a result, U.S. multinationals had to plan around the PFIC provisions. They reinvested funds abroad in active assets, did not repatriate income from potential PFICs, used the PFIC look-through rules to keep their passive income and passive assets below the PFIC thresholds, or restructured their foreign operations.

E. Excess Passive Assets Rules of Section 956A

1. Overview

In 1993, Congress added Section 956A to the Code to remedy a new perceived abuse of the deferral of U.S. tax on the income of CFCs: "The committee believes . . . that deferral of U.S. tax on accumulated active business profits is not necessary to maintain the competitiveness of business activities conducted by CFCs where such accumulated profits are held in the form of excessive accumulations of passive assets."[47] Congress concluded that any accumulation of passive assets in excess of twenty-five percent of total assets was "excessive" and, therefore, not deserving of the "privilege" of deferral. Although Congress want-

I.R.C. § 954(d)(3) (1995).

43. *Id.* § 1296(b)(2)(C).

44. *Id.* § 1296(c). Congress also protected certain industries that produce otherwise passive income and assets through active businesses such as banks and insurance companies. *See id.* § 1296(b)(2)(A), (B).

45. *See* Rev. Rul. 87-90, 1987-2 C.B. 216.

46. I.R.C. § 951(f) (1995).

47. H.R. REP. NO. 111, 103d Cong., 1st Sess. 691 (1993) [hereinafter 1993 HOUSE REPORT].

ed to encourage U.S. parent corporations of CFCs to repatriate accumulated CFC earnings and invest them in the United States, Section 956A provides a strong incentive to CFCs to invest in active business assets outside the United States.

2. Computation of Income Inclusion

As discussed *supra*,[48] a U.S. Shareholder of a CFC is subject to current U.S. taxation on its pro rata share of the earnings of a CFC constituting Subpart F income or invested in U.S. property. Under Section 956A, a U.S. Shareholder of a CFC also must include in income the lesser of (i) the U.S. Shareholder's pro rata share of the increase in the CFC's "excess passive assets"[49] or (ii) the shareholder's pro rata share of the CFC's "applicable earnings."[50]

The amount of a CFC's excess passive assets in a given tax year is equal to the excess of (a) the average of the amount of passive assets held by the CFC as of the close of each quarter of the taxable year over (b) twenty-five percent of the average of the amount of the CFC's total assets as of the close of each quarter of the taxable year.[51] For purposes of this computation, the amount taken into account with respect to any asset is its adjusted tax basis, rather than its fair market value.[52] The amount of the CFC's liabilities does not affect the computation of a CFC's excess passive assets.

A CFC's applicable earnings in a given tax year is the sum of (1) the CFC's earnings and profits accumulated in taxable years beginning after September 30, 1993 and (2) the CFC's current earnings and profits.[53] Thus, a U.S. Shareholder may recognize income under Section 956A if a CFC has current earnings and profits, even if it has an accumulated deficit. To prevent the double taxation of earnings, a CFC's applicable earnings are reduced by actual distributions and amounts previously

48. *See supra* notes 16-29 and accompanying text.

49. The increase in excess passive assets is the CFC's excess passive assets, less the earnings of the CFC which have previously been subject to tax under Section 956A. I.R.C. § 956A(a)(1) (1995).

50. *Id.* § 956A(a)(2).

51. *Id.* § 956A(c)(1).

52. *Id.* § 956A(c).

53. *Id.* § 956A(b)(1).

included in the U.S. Shareholder's income.[54]

An asset is a passive asset for purposes of Section 956A if it "produces passive income (as defined in Section 1296(b)) or is held for the production of such income."[55] As discussed *supra*, Section 1296(b) defines passive income as FPHC income defined in Section 954(c). Thus, a CFC generally will be treated as holding passive assets to the extent of its cash, regardless of whether the cash is held for working capital; marketable debt or equity securities; option, warrants, future or forward contracts (not arising from bona fide hedges); and property subject to a lease or a license where such property is not used in an active trade or business by the CFC.[56]

3. Application of CFC Grouping Rules

Certain groups of related CFCs (CFC Group) must be treated as a single corporation for purposes of determining whether the CFC Group has excess passive assets.[57] These rules prevent U.S. Shareholders from avoiding the application of Section 956A by isolating passive assets in CFCs that have no earnings. Under these aggregation rules, the excess passive assets are determined with respect to the CFC Group as a whole. A CFC Group is defined as one or more chains of CFCs connected through stock ownership with a top-tier CFC provided that (a) the top-tier CFC owns directly more than fifty percent (by vote or value) of the stock of at least one of the other CFCs and (b) more than fifty percent (by vote or value) of the stock of each of the CFCs (other than the top-tier CFC) is owned (directly or indirectly) by one or more other members of the group.[58]

The assets of each of the members of a CFC Group are aggregated when determining whether the CFC Group, as a whole, has excess passive assets. If a CFC Group has excess passive assets, the excess must be allocated among the members of the

54. *Id.*

55. *See id.* § 956A(c)(2).

56. *Id.* § 954(c)(2)(A). *See also* Notice 88-22, *supra* note 41.

57. I.R.C. § 956A(d)(1)(A) (1995).

58. *Id.* § 956A(d)(2). Only the indirect ownership rules of I.R.C. § 958(a), but not the constructive ownership rules of I.R.C. § 958(b), apply in determining whether a CFC is included in a CFC Group. I.R.C. § 956A(d)(2)(B) refers to direct and indirect ownership, but not constructive ownership.

group based on each member's applicable earnings.[59] This approach maximizes the U.S. Shareholders' income inclusion, as the excess passive assets of one member of the group may cause the deemed repatriation of the earnings of another member.

4. Application of the Look-through Rules

Under the stock look-through rule discussed in connection with the PFIC provisions above, if a foreign corporation owns (directly or indirectly) at least twenty-five percent of the stock of another corporation (measured only by value), the foreign corporation will be treated as if it owned a proportionate amount of the other corporation's assets for purposes of applying the PFIC passive income and passive asset tests.[60] Section 956A incorporates this stock look-through rule for purposes of determining whether a CFC or a CFC Group has excess passive assets.[61] The stock look-through rule does not apply, however, where the shareholder and issuing corporations are members of the same CFC Group.[62] If a CFC acquires more than fifty percent of the stock of another CFC (by vote or value), the assets of the CFCs will be combined, and the stock look-through rule will be disregarded.[63]

As discussed *supra*, certain income received from a related-party (as defined in Section 954(d)(3)) will *not* be treated as passive income to the extent that such income is properly allocable to the nonpassive income of the related-party payor (income look-through rule).[64]

The legislative history of the PFIC provisions indicates that rules similar to the foreign tax credit look-through rules in the regulations under Section 904(d) should be applied to allocate payments made by a related-party to the related-party's passive and nonpassive income.[65] Payments of interest are allocable

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59. *Id.* § 956A(d)(1)(B). A CFC with an accumulated deficit is not taken into account in determining the sum of applicable earnings. S. REP. NO. 36, 103d Cong., 1st Sess. 153 (1993) [hereinafter 1993 SENATE REPORT].

60. I.R.C. § 1296(c) (1995).

61. *Id.* § 956A(c)(3)(A).

62. *Id.* § 956A(d)(1).

63. *Id.* § 956A(d)(2).

64. *Id.* § 1296(b)(2)(C).

65. H.R. REP. NO. 795, 100th Cong., 2d Sess. 272 (1988); *See also* Notice 88-22, *supra* note 41.

first to the payor's passive income.[66] If the interest payment exceeds the payor's passive income, the payment is allocable to nonpassive income.[67] A dividend, however, is treated as having been paid pro rata from the payor's passive and nonpassive earnings and profits.[68]

5. Treatment of Specific Types of Assets

The trade accounts receivable of a CFC generally are not passive assets for purposes of Section 956A, even if the receivables incidentally produce "passive" interest income.[69] The rationale for this rule is that the receivables arose from the active conduct of the CFC's business and that any interest income with respect to the receivables is incidental to the CFC's business.[70]

Section 956A provides that the PFIC rules regarding leased property apply for purposes of determining whether a CFC or CFC Group has excess passive assets.[71] Under Section 1297(d), if a foreign corporation is the lessee of tangible personal property for a period of twelve months or more, the foreign corporation generally will be treated as the owner of such property. The adjusted basis of the leased property is deemed equal to the unamortized portion of the present value of the lease payments, using the applicable federal rate as a discount rate.[72] Accordingly, where leased property is used in the CFC's trade or business, the property is treated as an active asset.[73]

Section 956A also provides that the PFIC rules regarding research expenditures apply for purposes of determining whether a CFC or CFC Group has excess passive assets.[74] Under Section 1297(e)(1), the adjusted tax basis of a CFC's total assets for any given taxable year is increased by an amount equal to its

66. *See* Treas. Reg. § 1.904-5(c)(2)(ii)(C) (1995); I.R.C. § 954(b)(5) (1995).

67. I.R.C. § 954(b)(5) (1995).

68. *See* Treas. Reg. § 1.904-5(c)(4)(i) (1995).

69. *See* Notice 88-22, *supra* note 41 (which provides that trade receivables are not passive assets under the PFIC rules).

70. For the treatment of factored receivables, see H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 165 (1993) [hereinafter 1993 CONFERENCE REPORT].

71. I.R.C. § 956A(c)(3)(B) (1995).

72. *Id.* § 1297(d)(2).

73. These leasing rules, however, do *not* apply where the lessor is a related person (as defined in I.R.C. § 954(d)(3)) or where the principal purpose of the lease is to avoid the application of the PFIC rules or I.R.C. § 956A. *Id.* § 1297(d)(3).

74. *Id.* § 956A(c)(3)(C).

unreimbursed research and experimental expenditures (as determined under Section 174) incurred during the taxable year and the two preceding taxable years.[75] Similarly, under Section 1297(e)(2) if a CFC licenses "intangible property" for use in its trade or business, the adjusted tax basis of its total assets is increased by 300 percent of the royalty paid by the CFC.[76] However, a CFC is not entitled to increase the tax basis of its assets if it licenses the property from a related foreign corporation or enters into the license with the principal purpose of avoiding Section 956A.[77]

Congress directed the Department of the Treasury (Treasury) to study whether similar rules should apply with respect to marketing expenditures.[78] The Treasury report, released on November 22, 1994, concluded that marketing expenditures should not be capitalized and taken into account as part of the CFC's total assets for determining whether the CFC or the CFC Group has excess passive assets.[79]

Under the PFIC rules, income earned from the active conduct of a banking or insurance business are not treated as passive income.[80] Similarly, income earned in the active conduct of a securities business by a CFC, which is a registered securities broker or dealer, is not treated as passive income.[81] Accordingly, assets that generate such banking, insurance, or securities business income are not to be treated as passive assets for purposes of Section 956A.

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75. Payments made pursuant to a qualified cost sharing arrangement also will be treated as research expenditures for purposes of I.R.C. § 1297(e)(1). 1993 SENATE REPORT, *supra* note 59, at 157.

76. I.R.C. § 1297(e)(2)(A) (1995).

77. *Id.* § 1297(e)(2)(B).

78. 1993 CONFERENCE REPORT *supra* note 70, at 168.

79. *Report to The Congress on Adjusting the Excess Passive Assets Rules and the Passive Foreign Investment Company Rules to Account for Marketing Intangibles*, Daily Tax Rep. (BNA) (Dec. 30, 1994).

80. I.R.C. § 1296(b)(2)(A), (B) (1995); *see also* Prop. Treas. Reg. § 1.1296-4 (defining what constitutes an active banking business and a qualified bank affiliate for purposes of the PFIC rules).

81. I.R.C. § 1296(b)(3) (1995); *see also* Prop. Treas. Reg. § 1.1296-6 (defining what constitutes an active securities dealer or broker and a qualified securities affiliate for purposes of the PFIC rules).

F. Coordination of Anti-deferral Regimes

As previously discussed, there are myriad anti-deferral regimes which potentially may cause the U.S. Shareholders of a foreign corporation to be subject to current U.S. taxation with respect to the earnings of a foreign corporation. However, these regimes are not mutually exclusive. Absent prioritization rules, the overlap of these regimes creates the potential for multiple U.S. taxation of the same earnings. A foreign corporation may simultaneously constitute a FPHC,[82] a PFIC, and a CFC, subject to current taxation under the Subpart F provisions. Moreover, the earnings of a CFC are potentially subject to current U.S. taxation because they are Subpart F income,[83] invested in U.S. property,[84] or invested in excess passive assets.[85] The priority rules which coordinate the anti-deferral regimes and the ordering rules for determining the nature and amount of income inclusions under the Subpart F provisions are discussed below.

1. Prioritizing the Anti-deferral Regimes

The Treasury's three primary anti-deferral weapons (the FPHC regime, the PFIC rules, and the Subpart F provisions) are aimed at different perceived abuses by U.S. taxpayers and triggered under different conditions.[86] No single section of the Code establishes priority rules for the anti-deferral regimes. Instead, priority rules are scattered throughout the anti-deferral provisions. In general, these rules give priority to Subpart F provisions over the FPHC and PFIC regimes. In addition, the FPHC rules have priority over the PFIC rules. However, none of these regimes is inoperative by virtue of the application of another anti-deferral regime.

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82. Technically, a foreign corporation can also be a Personal Holding Company. However, where the foreign corporation is also a FPHC, the Personal Holding Company rules do not apply. I.R.C. § 542(c)(5) (1995). Moreover, the Personal Holding Company rules generally apply only to the U.S. source income of a foreign corporation. *Id.* § 882(b).

83. *Id.* §§ 951(a)(1)(A), 952.

84. *Id.* §§ 951(a)(1)(B), 956.

85. *Id.* §§ 951(a)(1)(C), 956A.

86. *See supra* part II.A-E.

Under the current Section 951(d), income which would be subject to tax under both the FPHC rules and the Subpart F provisions will be taxed only under the Subpart F provisions. Nonetheless, both regimes continue to apply. Thus, a FPHC's active business income is taxed by virtue of the FPHC rules, even though it would not be taxable under the Subpart F rules.[87] Similarly, investments in U.S. property, which would not be taxed under the FPHC rules, result in taxation under the Subpart F provisions.[88]

The FPHC provisions have priority over the PFIC rules.[89] As a result, where the income of a foreign entity has been taxed as FPHC income, such income will not again be subject to inclusion under the PFIC rules.[90] The PFIC rules, however, continue to apply to a FPHC and, thus, provide a backstop to the FPHC rules. Given that a foreign corporation's status as a FPHC is determined on a year-by-year basis,[91] this can be particularly important. Once a foreign corporation becomes a PFIC, however, it generally will continue to be treated as a PFIC.[92] Accordingly, a foreign corporation might easily lose the taint of being a FPHC but ordinarily will continue to be tainted by the PFIC rules.

The Subpart F provisions have priority over the PFIC rules.[93] As a result, where a CFC's earnings have been included in the income of a U.S. Shareholder under Subpart F, such earnings will not be includible again under the PFIC provisions. For example, where a CFC is a PFIC which has elected to be a QEF,[94] Subpart F income earned by the PFIC will be taxable under Section 951(a)(1)(A), rather than Section 1293, which generally requires the inclusion of the income of a QEF.[95]

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87. *Compare* I.R.C. § 551(a),(b) (1995) *and* I.R.C. § 951(a)(1) (1995).
88. *See id.* § 956.
89. *Id.* §§ 551(g), 1291(b)(3)(F).
90. *Id.*
91. *Id.* § 552(a).
92. *Id.* § 1297(b)(1).
93. *See id.* § 951(f).
94. *See supra* notes 37-8 and accompanying text.
95. For purposes of determining whether a PFIC has made an excess distribution, amounts included in income of U.S. persons as deemed dividends under I.R.C. § 951(a)(1)(A), the FPHC rules as a result of a QEF election are not treated as distributions, nor are distributions of "previously taxed income" (PTI) under any of these provisions. *See* I.R.C. § 1291(b)(3)(F) (1995); Prop. Treas. Reg. § 1.1291-2(b)(2).

2. Coordinating Subpart F Income Inclusions

The U.S. Shareholders of a CFC may be forced to include in their income a pro rata share of (a) actual dividend distributions made by the CFC, (b) Subpart F income earned by the CFC, (c) the CFC's investments in U.S. property, and (d) the CFC's excess passive assets.[96] A series of complex rules designed to coordinate these potential income inclusions and prevent the multiple U.S. taxation of a CFC's earnings are provided in Section 959.

Section 959 causes a CFC to account separately for its earnings which have been previously subjected to current U.S. taxation under the Subpart F provisions. Such earnings, referred to as "previously taxed income" (PTI), are not again subjected to U.S. taxation when actually distributed to the CFC's U.S. Shareholders.[97]

A CFC must maintain a separate PTI pool for each type of income subject to U.S. tax pursuant to the Subpart F provisions.[98] Accordingly, a separate PTI pool must be maintained with respect to income included under Section 951(a)(1)(A) (Subpart F PTI pool); income included under Sections 951(a)(1)(B) and 956 (Section 956 PTI pool); and income included under Sections 951(a)(1)(C) and 956A (Section 956A PTI pool).

Maintaining these separate PTI pools is critical since income inclusions under both Sections 956 and 956A are computed by measuring increases in earnings not previously taxed under these Sections. Thus, a U.S. Shareholder's income inclusion under either Section 956 or Section 956A normally is equal to the lesser of (i) the CFC's quarterly average of amounts invested in U.S. property (in the case of Section 956) or excess passive assets (in the case of Section 956A) reduced by the amount of earnings previously taxed under Sections 956 or 956A, or (ii)

96. I.R.C. § 951(a) (1995).

97. Pursuant to I.R.C. § 961, the tax basis in the stock of a CFC is increased to reflect the fact that earnings of the CFC have been subject to U.S. tax. This prevents a U.S. Shareholder from having to pay tax twice with respect to previously taxed amounts if he or she sells the stock of the CFC before any earnings are actually distributed.

98. I.R.C. § 959(c) (1995).

"applicable earnings."[99] For the purposes of both Sections 956 and 956A, applicable earnings is the current and accumulated earnings and profits reduced by actual distributions and amounts previously taxed under both Sections 956 and 956A.[100] Thus, maintaining separate Section 956 and Section 956A PTI pools is necessary to facilitate these computations.

Section 959 mandates the following sequence for determining a U.S. Shareholder's income inclusion with respect to a CFC.[101] First, the CFC's Subpart F income for the tax year is included in the income of the U.S. Shareholder and added to the CFC's Subpart F PTI pool. Second, actual distributions are treated as having been distributed first from the CFC's PTI pools (in a specific order provided in Section 959(c)) and then from untaxed earnings and profits.[102] Third, Section 956 is applied to determine the effect of investments in U.S. property.[103] Finally, Section 956A is applied to determine the effect of excess passive assets.[104]

Actual dividend distributions made by a CFC are treated as if distributed first from the Section 956 PTI pool and the Section 956A PTI pool, then from the Subpart F PTI pool, and finally, from untaxed earnings and profits.[105] If the CFC has both Section 956 PTI and Section 956A PTI pools, the distribution is treated as having been made from both PTI pools on a proportionate basis.[106] Income inclusions which result from investments in U.S. property or excess passive assets in the year of a distribution are not deemed to increase the Section 956 or Section 956A PTI pools for purposes of characterizing the distribution.[107] Under the ordering rules, distributions are taken into account before Section 956 and Section 956A income inclusions are computed.[108]

99. *See id.* §§ 956(b)(1), 956A(b).

100. For purposes of I.R.C. § 956A, applicable earnings only includes the earnings of the CFC for tax years beginning after September 30, 1993.

101. *See* I.R.C. § 959(f) (1995).

102. *Id.*

103. 1993 SENATE REPORT, *supra* note 59, at 149.

104. *Id.*

105. I.R.C. § 959(c) (1995).

106. *Id.* § 959(c)(1).

107. 1993 SENATE REPORT, *supra* note 59, at 149.

108. I.R.C. § 959(f)(2) (1995).

Amounts which would have been included in the income of a U.S. Shareholder under Section 956 as an investment in U.S. property are treated as first attributable to the Subpart F PTI pool and then to taxed earnings and profits.[109] Amounts which would be included in the income of a U.S. Shareholder under Section 956A as a result of the CFC having excess passive assets are also treated as first being attributable to the Subpart F PTI pool and then to untaxed earnings and profits.[110] However, with respect to income inclusions under Section 956A, the Subpart F PTI pool is taken into account only for Subpart F income earned in tax years beginning after September 30, 1993.[111]

If an amount would have been included in the income of a U.S. Shareholder as either an investment in U.S. property or excess passive assets, but for the fact that the income inclusion was attributable to the Subpart F PTI pool, that amount is converted from Subpart F PTI to either Section 956 PTI or Section 956A PTI.[112]

G. *Planning Techniques to Minimize the Impact of Section 956A*

Given the complexity of Section 956A (and the interplay between Section 956A, Section 956, the Section 959 PTI rules, and the PFIC rules), Section 956A likely will be one of the most fruitful areas for creative tax planning in the 1990s. Tax planning to minimize the adverse impact of Section 956A can be broken into four principal areas, involving a series of the following specific planning ideas:

1. Effective Management of the Asset Base to Minimize Excess Passive Assets:
   a. Investment of passive assets in traditional business assets;
   b. Investment of passive assets in intercompany debt or equity;

109. *Id.* § 959(f)(1)(A).
110. *Id.* § 959(f)(1)(B) (1995).
111. *Id.*
112. Treas. Reg. § 1.959-3(b) (1995).

c. Leading and lagging of receivables and payables;

d. Capitalization of research and experimentation expenses;

e. Purchase vs. lease decision for new assets;

f. Placement of U.S. real estate or tangible personal property in CFC Group; and

g. Investment in municipal or other tax exempt bonds.

2. Restructuring of the Stock Ownership of CFCs Under the Aggregation Rule:

a. Aggregation of CFCs into a CFC Group;

b. Disaggregation of CFCs into smaller CFC Groups; and

c. Placement of new operations.

3. Impact of Repatriation Strategies:

a. Advisability of distributing PTI;

b. Section 956 as a repatriation vehicle; and

c. Consideration of potential mismatches between PTI and applicable earnings.

4. Potential Decontrol of Foreign Subsidiaries.

Some of the planning techniques above might be considered fairly basic, common sense reactions to the Section 956A regime. Others involve more intricate or subtle applications of the Section 956A rules or more radical restructuring of assets or stock ownership.[113]

113. Given the specific focus of this Article, however, a discussion of these planning techniques is beyond the scope and space requirements which our editors will permit. Nevertheless, for the unbowed, there are some excellent existing articles on this topic. *See, e.g.*, Peterson, *supra* note 1.

H. Coordination of Section 956A Planning With PFIC Planning

From the perspective of a U.S.-based multinational, the principal effect of the PFIC provisions is to limit the ability to accumulate passive assets in foreign subsidiaries as a result of the fifty percent passive asset test.[114] Since the mechanics of the twenty-five percent excess passive asset determination under Section 956A closely parallel the mechanics of the fifty percent passive asset test for PFIC status, the Section 956A rules are essentially a stronger version of the PFIC rules. Nevertheless, the PFIC rules continue to apply to CFCs and taxpayers must deal with them alongside the Section 956A rules in their international tax planning.

There are a few key differences between the PFIC provisions and Section 956A. First, the PFIC provisions do not contain an aggregation rule along the lines of Section 956A(d). Under the stock look-through rule of Section 1296(c) for twenty-five percent-owned foreign corporations, the assets of lower-tier foreign subsidiaries are combined with the assets of upper-tier foreign subsidiaries in the same chain for PFIC purposes. However, this asset look-through is downstream only. Assets of upper-tier foreign subsidiaries or brother-sister foreign subsidiaries in the same CFC group are not taken into account. Consequently, one or more CFCs can fail the fifty percent passive asset test for PFIC status, even though they are included in a CFC Group that has no excess passive assets for Section 956A purposes. Taxpayers must, therefore, closely monitor the passive asset levels of each CFC and CFC chain within a CFC Group for PFIC purposes.

Second, since there is no aggregation or look-through backwards up a chain of CFCs for PFIC purposes, it is possible to separate an operating business that generates low-tax income from the passive assets it has accumulated. This can be done by

114. Under I.R.C. § 1296(a)(2), a foreign corporation will be a PFIC if fifty percent or more of its assets are passive assets. Under Notice 88-22, *supra* note 41, the passive asset calculations are done on a quarterly basis. A foreign corporation also will be a PFIC if seventy-five percent or more of its gross income for a taxable year is passive income. However, the passive income test rarely applies to CFCs that are not already subject to the seventy percent full inclusion rule of Section 956(b)(3)(A).

dropping down the operating assets of the business to a new lower-tier foreign subsidiary, leaving behind the passive assets. The drop down of assets typically would be a tax-free exchange under Section 351. The new lower-tier foreign subsidiary would commence operations with a clean slate for purposes of the PFIC passive asset test. The foreign subsidiary that initially conducted the business which generated the passive assets may itself become a PFIC. However, the impact of it becoming a PFIC effectively can be neutralized by making a QEF election.[115]

Finally, while Section 956A applies only to CFCs, the PFIC rules apply to any foreign corporation.[116] Consequently, taxpayers must monitor the passive asset levels of any non-CFC subsidiaries for PFIC planning purposes.

I. Summary of Anti-deferral Considerations

Section 956A apparently was designed to encourage CFCs to repatriate their income to the United States to the extent such earnings exceed their working capital needs. To the extent that there is any increase in the incentives to repatriate profits, it comes at the cost of mind-numbing complexity and costly administrative burdens for both the Internal Revenue Service (I.R.S.) and taxpayers.

Some of this complexity is clearly unnecessary. In particular, there is no reason for the PFIC rules to apply to CFCs. The Section 956A rules would reach the same accumulations of passive assets at a much lower threshold and the Subpart F rules already cause inclusion of all (or virtually all) passive income in excess of de minimis amounts. Nevertheless, taxpayers are subject to both sets of rules.[117] The only instance where the PFIC rules apply to CFCs, while the Subpart F rules do not, is the

115. Under I.R.C. § 1297(b)(1), a taxpayer will never be treated as holding stock in a PFIC if a QEF election is in place for all years during which the foreign corporation would be a PFIC. The effect of making a QEF election is that any U.S. person owning stock of the foreign corporation must include in its income its pro rata share of the corporation's earnings and profits on a current basis for each year during which the foreign corporation is a PFIC. To the extent that any earnings and profits of a CFC are already includible in the income of its U.S. Shareholders under Subpart F, the income will not be included again under the QEF rules. *Id.* § 951(f).

116. *Compare* I.R.C. § 956A(a) (1995) *and* I.R.C. § 1296(a) (1995).

117. *Compare* I.R.C. § 957(a) (1995) *and* I.R.C. § 129(a) (1995).

case where the Section 956A rules (computed on a CFC Group basis) would not cause an income inclusion, while the PFIC rules (computed on the basis of the stock look-through rules that only consolidate a single chain of ownership) would cause an income inclusion.[118] In those instances where both the PFIC rules and Section 956A apply, taxpayers face income inclusions under Section 956A and at the same time are saddled with the possibility of draconian interest charges on distributions, dispositions, or QEF inclusions of all earnings and profits without the Section 956A passive asset limitation. Surely the revenue at stake cannot be worth the cost to taxpayers and the I.R.S. of administering and auditing such a complicated statutory scheme.

Moreover, for U.S.-based multinational businesses that already have substantial low-taxed accumulated earnings in CFCs that have not yet been subject to U.S. taxation, Section 956A actually provides a stronger incentive to reinvest such profits outside the United States in active businesses than it does a repatriation incentive. In addition, the mechanics of Section 956A foster counter-intuitive (and otherwise economically inefficient) behavior in the management of a multinational group's financial affairs, such as accelerating payment of trade accounts payable and the deferring collection of trade accounts receivable. As such, Section 956A cannot be said to have implemented its stated policy goals well.

More fundamentally, Section 956A may not be based on sound goals that benefit the U.S. fiscally in the long run. The U.S. tax policy of deferral of U.S. tax on the foreign source earnings of foreign corporations may be oft stated, but it is increasingly observed only in the breach. The FPHC provisions required concentrated U.S. control and passive income to end deferral.[119] The Subpart F provisions required concentrated control (though measured slightly differently) and either passive income or "abusive" active income to trigger current U.S. taxation.[120] The PFIC provisions dropped the control aspect completely and, for the first time, ended deferral for accumulations of nonabusive active business income in the form of passive assets

118. *Compare* I.R.C. § 956A(d) (1995) *and* I.R.C. § 1296(c) (1995).
119. *See id.* § 552(a)(1)(2).
120. *See id.* § 957(a); *see also, e.g.,* § 954(a).

in a set of provisions that seemingly were supposed to be targeted only at foreign mutual funds but ended up being applicable to all U.S.-based multinational businesses. Section 956A also explicitly drops the requirement that the transactions which generate the income be in some way abusive, in favor of a cap on deferral based on accumulation of passive assets, but at least maintains a U.S. control requirement. Accordingly, while deferral remains a theoretical possibility which no doubt will continue to prove beneficial to U.S.-based multinational companies doing business in Latin America (and other parts of the globe), the anti-deferral regimes are providing an increasingly restricted and challenging playing field within which to work.

III. FOREIGN TAX CREDIT

A. *Introduction*

One of the more important U.S. tax considerations in foreign operations of U.S. corporations is to ensure the maximum use of the foreign tax credit. The United States taxes the worldwide income of U.S. corporations. In order to avoid international double taxation, U.S. corporations are allowed to credit their foreign income taxes against their U.S. income taxes. In order to prevent the use of the foreign tax credit to reduce the U.S. tax on U.S. source income, Section 904 generally limits the foreign tax credit to the amount of U.S. tax paid on foreign source income. Under this mechanism, foreign source income ordinarily is taxed at the greater of the U.S. tax rate or the foreign tax rate applicable to such income.

U.S. corporations have found it difficult to use all of their foreign tax credits after the enactment of the Tax Reform Act of 1986 (1986 Act). The 1986 Act added several separate limitation categories (discussed in detail *infra*) and revised provisions regarding the source of income and the allocation and apportionment of deductions.[121] As a result of these changes, most U.S.

121. *See* Joseph L. Andrus, *Allocating Interest Expense for the Foreign Tax Credit*, 41 TAX NOTES 1105, 1127 (1988); Gerald T. Ball et al., *New Tax Law Makes Major Changes to the Foreign Tax Credit Limitation*, 66 J. TAX'N 140 (1987); David M. Maloney & Terry C. Inscoe, *A Post-Reformation Analysis of the Foreign Tax Credit Limitations*, 13 INT'L TAX J. 111 (1987); James R. Mogle & Barbara M. Angus, *Foreign Tax Credits After Tax Reform: The Search for Shangri-La*, 65 TAXES 921

corporations have "excess foreign tax credits" and, therefore, wish to reduce their foreign taxes.

B. *Creditable Foreign Taxes*

1. Introduction

In order to qualify for the foreign tax credit, a levy imposed by a foreign government must constitute an income tax or a tax in lieu of an income tax.[122] A foreign tax is considered an income tax only if "the predominant character of that tax is that of an income tax in the U.S. sense."[123] As illustrated below, U.S. corporations operating in Latin America frequently encounter issues of whether foreign levies constitute creditable foreign income taxes.

2. Business Assets Taxes

In 1988, Mexico enacted a business assets tax which functions as an alternative minimum tax.[124] The assets tax was enacted in large part to prevent foreign corporations and their Mexican subsidiaries from underpaying their Mexican income tax through aggressive transfer pricing policies.[125] Since that time, similar business asset taxes have been enacted in Argentina, Venezuela, Peru, Ecuador, and Bolivia.[126] The assets tax in Mexico and other Latin American countries is not designed to be a wealth tax, but rather is a backstop to the income tax in an environment of weak and ineffective tax enforcement, rampant corruption, and tax evasion.[127]

(1987).

122. I.R.C. §§ 901(b)(1), 903 (1995).

123. Treas. Reg. § 1.901-2(a)(1)(ii) (1995).

124. *See* John A. McLees, *Fine Tuning the Mexico Assets Tax*, 3 TAX NOTES INT'L 117 (1991); John A. McLees, *The Mexico Assets Tax: Comfort Ruling for U.S. Taxpayers Doing Business in Mexico*, 3 TAX NOTES INT'L 1173 (1991).

125. *See* John A. McLees, *Doing Business in Mexico under the U.S.-Mexico Income Tax Treaty: Initial Thoughts*, 5 TAX NOTES INT'L 995, 999 (1992).

126. *See* Peter D. Byrne, *The Business Assets Tax in Latin, America — No Credit Where it is Due*, 9 TAX NOTES INT'L 533 (1994). For a discussion of the Venezuelan assets tax, see Malcolm Caplan, *Venezuela Enacts New Enterprise Assets Tax*, 8 TAX NOTES INT'L 771 (1994).

127. *See* Byrne, *supra* note 126, at 534.

In Revenue Ruling 91-45, the I.R.S. ruled that the Mexican business assets tax was not a creditable income tax.[128] At the time of the ruling, the assets tax was imposed at the rate of two percent of the average annual value of the assets of Mexican legal entities, individuals residing in Mexico and the Mexican permanent establishments of foreign residents.[129] A taxpayer could credit against its assets tax liability for any year the amount of its income tax liability for the year.[130] Thus, the taxpayer would pay the assets tax for any year only to the extent it exceeded its income tax liability. Moreover, the asset tax was refundable to the extent the taxpayer's income tax liability for the succeeding five years exceeded its asset tax liability for those years.[131]

The foreign tax credit regulations provide that a foreign tax has the predominant character of an income tax in the U.S. tax sense only if it is likely to reach net gain in the normal circumstances in which it applies.[132] A tax will satisfy this requirement if the base of the tax is computed by reducing gross receipts by the costs and expenses attributable to such gross receipts.[133] In Revenue Ruling 91-45, the I.R.S. ruled that it was not an income tax for foreign tax credit purposes as the Mexican business assets tax was based on the value of assets, rather than income.

The I.R.S. also ruled that the assets tax was not a tax in lieu of an income tax within the meaning of Section 903 because it can be imposed in addition to, and not merely in substitution for, the income tax.[134] As mentioned above, a taxpayer would be subject to both the assets tax and the income tax in any year the asset tax exceeds the income tax.

The foreign tax credit regulations provide that if, under foreign law, the taxpayer's tentative liability for one tax (e.g., the assets tax) can be reduced by the taxpayer's liability for a second tax (e.g., the income tax), then the amount considered payable with regard to the second tax is considered the entire

128. 1991-2 C.B. 336.
129. *Id.*
130. *Id.*
131. *Id.*
132. Treas. Reg. § 1.901-2(a)(3)(i) (1995).
133. *Id.* § 1.901-2(b)(1), (4)(i).
134. *Id.* § 1.903-1(a)(2), (b)(1).

liability for that tax, and only the remainder is considered paid with respect to the first tax.[135] Accordingly, the I.R.S. ruled that in a year for which the tentative assets tax liability exceeded the income tax liability, the total amount of income tax liability is considered paid as such, and only the excess of the tentative assets tax over the income tax is considered a payment of assets tax.[136] Furthermore, the I.R.S. ruled that any refund of assets tax triggered by an excess of income tax over tentative assets tax for a subsequent year would not reduce the creditable income tax for the subsequent year.[137]

Revenue Ruling 91-45 generally is favorable to U.S. companies. It is unclear, however, whether its rationale would be applicable to similar asset taxes in other Latin American countries. For example, the Venezuelan assets tax is one percent of net assets and can be carried forward to offset income tax in excess of assets tax for subsequent years.[138] The use of asset tax for one year as a credit against income tax for a subsequent year is, in substance, no different from receiving a refund of the asset tax in the later year to the extent the income tax exceeds the assets tax for the later year. Accordingly, the principles of Revenue Ruling 91-45 also should apply to the Venezuelan assets tax.[139]

3. Interest Subsidies

For years, U.S. banks have quarrelled with the I.R.S. about the appropriate U.S. tax consequences of the Brazilian withholding tax on interest payments by Brazilian borrowers.[140] From 1959 to 1974, Brazil imposed a twenty-five percent withholding

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135. *Id.* § 1.901-2(e)(4).

136. Rev. Rul. 91-45, 1991-2 C.B. 336.

137. *Id.*

138. *See* Caplan, *supra* note 126.

139. The U.S. foreign tax credit consequences of the asset taxes imposed by other Latin American countries are not entirely clear. See Byrne, *supra* note 126.

140. *See* Continental Ill. Corp. v. Comm'r, 55 T.C.M. (CCH) 1325, 1329 (1988), *aff'd*, 998 F.2d 513, 519-21 (7th Cir. 1993), *cert. denied*, 114 S. Ct. 685 (1994); Citizens S. Corp. v. Comm'r, 91 T.C. 463 (1988), *aff'd*, Citizens S. Corp. v. Comm'r, 919 F.2d 1492 (11th Cir. 1990) (per curiam). The rate of subsidy was reduced to fifty percent of the tax on July 26, 1979, increased to ninety percent of tax on December 7, 1979, reduced to forty percent of the tax on May 8, 1980, and reduced to zero on July 28, 1985. Norwest Corp. v. Comm'r, 63 T.C.M. (CCH) 3023, 3023-3 (1992), *aff'd*, 69 F.3d 1404 (8th Cir. 1995).

tax on interest payments to foreign lenders.[141] In 1974, Brazil reduced the tax rate to five percent in an effort to attract foreign investment.[142] In 1975, Brazil pushed the tax rate back up to twenty-five percent but rebated a fraction of the tax (eighty-five percent) to the borrower.[143]

U.S. banks made both gross and net loans to Brazilian borrowers. The interest rate specified in a gross loan is the rate before withholding tax. The interest rate specified in a net loan is the rate after taxes have been withheld. In the case of a net loan, the borrower must increase or "gross up" the interest payment for the withholding tax so that the lender will receive an after-tax interest payment corresponding to the interest rate in the loan agreement.[144]

For example, if the interest rate of a net loan is nine percent, the Brazilian borrower must determine the hypothetical pre-tax interest rate that would result in an after-tax interest payment of nine percent. The grossed-up interest rate would be twelve percent for a withholding tax of twenty-five percent. The grossed-up rate would generate an interest payment of twelve dollars for a $100 loan. Of this amount, three dollars would be paid to the Brazilian government as withholding tax, and the U.S. lender would receive the remaining nine dollars.

The interest earned on Brazilian loans is included in a U.S. lender's income.[145] The amount included for a gross loan is the agreed upon interest payment, which includes the withholding tax paid to the Brazilian government.[146] The amount included for a net loan is the interest payment actually received (nine dollars in the above example), plus the increase due to the gross-up (three dollars), provided that the withholding tax is actually being paid to the Brazilian government.[147]

The Brazilian withholding tax on interest is sufficiently similar to the U.S. income tax to be "creditable" under the for-

141. *Norwest Corp.*, 63 T.C.M. (CCH) at 3023-3.
142. *Id.*
143. *Id.*
144. *Id.*
145. I.R.C. § 61(a)(4) (1995).
146. *See Continental Ill.*, 998 F.2d at 517-18.
147. *Id.*

eign tax credit.[148] The Brazilian interest subsidy, however, complicates matters. As a practical matter, the subsidy means that part of the tax withheld is never paid to the Brazilian government. Nevertheless, U.S. banks traditionally have claimed a foreign tax credit for the full amount of the tax withheld.[149] The I.R.S. took the position, however, that the Brazilian withholding tax was not creditable to the extent that the tax was rebated to the borrower by the Brazilian tax authorities.[150]

In Revenue Ruling 78-258,[151] the I.R.S. ruled that the Brazilian withholding tax was not creditable to the extent of the subsidy.[152] In 1980, the I.R.S. issued temporary foreign tax credit regulations providing that taxes used to provide subsidies, such as the Brazilian subsidy, would not be considered "income tax paid or accrued to a foreign country."[153] In 1983, the I.R.S. issued final foreign tax credit regulations which also provide that taxes used to provide subsidies are not creditable.[154]

The I.R.S. position on subsidies was codified as Section 901(i) by the 1986 Act. Section 901(i) provides that a foreign tax is not creditable to the extent that the foreign country provides a subsidy, based on the amount of the tax, to the taxpayer or to parties with whom the taxpayer has engaged in a transaction. In 1991, the I.R.S. revised the foreign tax credit regulations to reflect Section 901(i).[155]

U.S. banks which have attempted to take a full foreign tax credit on the Brazilian interest withholding tax have consistently lost, with the courts holding that the subsidies paid by Brazil to the Brazilian borrowers reduced the foreign tax credits of the U.S. banks.[156]

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148. Nissho Iwai Am. Corp. v. Comm'r, 89 T.C. 765, 775 (1987).

149. *Continental Ill.*, 998 F.2d 513.

150. *Id.*

151. 1978-1 C.B. 239.

152. A grandfather clause in the ruling provided that it would not disallow a foreign tax credit for Brazilian withholding tax, on interest accrued or received before January 1, 1980, on loans made prior to March 16, 1978.

153. Temp. Treas. Reg. § 4.901-2T(f) (1995), T.D. 7739, 1981-1 C.B. 396, 404-407 (superseded 1983). The temporary regulation was applicable to tax years ending after June 15, 1979. Temp. Treas. Reg. § 4.901-2(g) (1995).

154. Treas. Reg. § 1.901-2(e)(3) (*rev'd* 1991). T.D. 7918, 1983-2 C.B. 113, 123-24. The final regulations were effective for taxable years beginning after Nov. 14, 1983.

155. T.D. 8372, 1991-2 C.B. 338.

156. Norwest Corp. v. Comm'r, 69 F.3d 1404, 1407-09 (8th Cir. 1995), *aff'g* 63

C. Documentation of Foreign Tax Credits

Net loans can be treated by the U.S. bank in one of two ways for U.S. tax purposes.[157] First, the bank can report only the net interest as income. In this example, only the nine dollar net interest payment would be reported as income. The three dollar gross-up amount would be ignored, both for income inclusion purposes and for foreign tax credit purposes. Thus, the lender would recognize nine dollars in income and would receive no foreign tax credit for the withholding tax.[158]

Second, the U.S. bank can report the gross interest payment (twelve dollars in the above example) as income and claim a foreign tax credit for the withholding tax (three dollars in the above example).[159] The second approach is preferable to the first approach because the tax benefit of the foreign tax credit is greater than the tax cost of the gross-up. Whether a U.S. bank can use the second approach depends on whether the taxpayer can provide sufficient documentation to prove that the withholding tax was actually paid to the foreign government.[160]

Section 905(b) provides that a taxpayer is entitled to a foreign tax credit only if it establishes to the satisfaction of the I.R.S. the amount of its foreign source income and the amount of foreign tax claimed as a credit. The Section 905(b) regulations provide that a corporate taxpayer must submit Form 1118 with its tax return to claim a foreign tax credit and that the form must be accompanied by receipts for taxes paid and foreign tax returns for taxes accrued.[161]

In Notice 88-65, the I.R.S. suspended the requirement that foreign tax receipts and tax returns be attached to the taxpayer's return effective as of January 1, 1988.[162] Neverthe-

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T.C.M. (CCH) 3023, 3023-5 to 3024 (1992); Continental Ill. Corp. v. Comm'r, 55 T.C.M. (CCH) 1325, 1329 (1988), *aff'd*, 998 F.2d 513, 519-21 (7th Cir. 1993), *cert. denied*, 114 S. Ct. 685 (1994); First Chicago Corp. v. Comm'r, 61 T.C.M. (CCH) 1774, 1778-79 (1991); Nissho Iwai Am. Corp. v. Comm'r, 89 T.C. 765, 774-78 (1987).

157. *See Continental Ill.*, 998 F.2d at 517-18.

158. *Id.*

159. *Id.*

160. Treas. Reg. § 1.905-2(a)(1), (2) (1995).

161. *Id.*

162. 1988-1 C.B. 552.

less, taxpayers must provide such documentation to the I.R.S. to substantiate their foreign tax credits on audit. The I.R.S. has the discretion to waive the requirement of a receipt or tax return and accept "secondary" evidence that the tax has been paid.[163] In the absence of a receipt, the I.R.S. may allow the taxpayer to submit a photocopy of a check or similar document, accompanied by a certification of identification and other evidence.[164] In the absence of a foreign tax return, the I.R.S. may allow the taxpayer to submit various statements in lieu of the tax return.[165] In the case of withholding taxes, if the taxpayer cannot secure evidence of payment from the withholding party, the I.R.S. has the discretion to accept secondary evidence that the tax was withheld.[166] The regulations provide that the I.R.S. should have "due regard for the taxpayer's books of account and to the rates of taxation prevailing in the particular foreign country during the period involved."[167]

In *Continental Illinois Corp. v. Commissioner*, the Tax Court reviewed the sufficiency of documentation collected by a U.S. bank to claim a foreign tax credit for withholding tax on interest payments made by borrowers in Mexico and other countries.[168] As proof of payment of the foreign taxes, the taxpayer offered letters from the borrowers stating that they had paid the withholding taxes.[169] The Tax Court held that such letters were sufficient secondary evidence to justify a foreign tax credit for the withheld taxes.[170] The court further held that the I.R.S. abused its discretion in rejecting the borrowers' letters and denying the credit. On appeal, however, the Seventh Circuit reversed the Tax Court on this point, holding that the borrowers' letters did not qualify as adequate proof because they did not constitute receipts or tax returns.[171]

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163. Treas. Reg. § 1.905-2(a)(2) (1995); *id.* § 1.905-2(b) (1995).
164. *Id.* § 1.905-2(b)(1).
165. *Id.* § 1.905-2(b)(2).
166. *Id.* § 1.905-2(b)(3).
167. *Id.*
168. 61 T.C.M. (CCH) 1916, 1939-46, *aff'd in part, rev'd in part*, 998 F.2d 513 (7th Cir. 1993).
169. *Id.* at 1943-44.
170. *Id.* at 1943.
171. Continental Ill. Corp. v. Comm'r, 55 T.C.M. (CCH) 1325, 1329 (1988), *aff'd*, 998 F.2d 513, 519-21 (7th Cir. 1993), *cert. denied*, 114 S. Ct. 685 (1994).

In *Norwest Corp. v. Commissioner*, the Tax Court held that the I.R.S. did not abuse its discretion in rejecting letters written by a Mexican borrower to substantiate a U.S. lender's claim for a foreign tax credit.[172] Unlike the letters in *Continental Illinois*, the letters failed to state that taxes had actually been paid to the Mexican tax authorities.[173] Therefore, the Tax Court held that the letters did not constitute acceptable secondary evidence that taxes had been withheld and paid.[174]

D. Separate Limitations

1. General

As mentioned above, the Section 904 foreign tax credit limitation is applied separately to certain categories of income (commonly called "baskets"). There are ten separate limitation categories:

1. Passive income;
2. High withholding tax interest;
3. Financial services income;
4. Shipping income;
5. Dividends from each noncontrolled Section 902 corporation (commonly called "10/50 basket" dividends);
6. DISC dividends;
7. Foreign trade income of a FSC;
8. FSC dividends;
9. Foreign oil and gas extraction income; and
10. All other income (commonly called "general basket" income).[175]

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172. 70 T.C.M. (CCH) 779, 783 (1995).

173. *Id.* at 783.

174. *Id.*

175. I.R.C. § 904(d)(1) (1995); Treas. Reg. § 904(g)(10) (1995). Separate limitations also are applicable to certain treaty-benefitted income. *See* I.R.C. § 904(g)(10) (1995).

The separate foreign tax credit limitations are designed to prevent a taxpayer from using excess foreign tax credits generated by one category of foreign source income (typically, general basket dividends from foreign subsidiaries operating in high tax countries) to offset the U.S. tax on another category of income (typically, passive basket interest income which normally is subject to little or no foreign tax).

Although most of the separate limitation categories can be applicable to Latin American operations, only a few of the categories deserve further discussion in this Article. These categories are passive income, high withholding tax interest, financial services income, and 10/50 basket dividends.

2. Passive Income

Passive income generally consists of any income which, if received by a Controlled Foreign Corporation (CFC), would be Foreign Personal Holding Company (FPHC) income.[176] Thus, passive income includes dividends, interest, passive rents, and royalties, certain net gains from the sale or exchange of property giving rise to passive income commodities transactions and foreign currency transactions, income equivalent to interest, and certain similar items.[177] Passive income does *not* include income in other separate limitation categories, export financing interest, high taxed income, or income that would otherwise be classified as passive income, but is characterized as other separate category income under the look-through rules described *infra* Part III.D.6.

The passive basket does *not* include highly taxed passive income.[178] Instead, highly taxed passive income falls in the general basket.[179] Passive income is highly taxed if the effective rate of foreign tax on the income exceeds the maximum U.S. tax rate (currently thirty-five percent for corporations).[180] The

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176. I.R.C. § 904(d)(2)(A)(i).
177. *Id.* § 954(c); Treas. Reg. § 1.904-4(b).
178. I.R.C. § 904(d)(2)(A)(iii)(III) (1995).
179. Treas. Reg. § 1.904-4(c)(1) (1995).
180. I.R.C. § 904(d)(2)(F) (1995); Treas. Reg. § 1.904-4(c) (1995).

purpose of this *high tax kickout rule* is to prevent the use of excess foreign tax credits on high tax passive income to pay the U.S. tax on low taxed passive income. With this rule, a taxpayer generally cannot have excess foreign tax credits in the passive basket. The regulations further refine the high tax kickout rule by requiring that it be applied separately to certain groupings of passive income.[181] These groupings are:

a. Subpart F passive income inclusions for each CFC;

b. Passive income from within the country of operation of each foreign qualified business unit (QBU) of the taxpayer (e.g., a foreign branch);

c. Other passive income subject to withholding tax of fifteen percent or more;

d. Other passive income subject to withholding tax of less than fifteen percent; and

e. Other passive income subject to no withholding tax.[182]

Passive foreign income is especially targeted by the foreign tax credit separate limitation rules because it is highly mobile income. Before the enactment of separate limitations for passive income, a U.S. taxpayer could invest excess funds abroad and shelter the resulting passive income with excess foreign tax credits generated by its active business operations abroad. The separate limitations, coupled with the Subpart F rules, generally result in low-taxed foreign source income of CFCs being subject to U.S. tax on a current basis and the U.S. tax on that income being reduced only by the foreign tax, if any, actually imposed on the passive income. These rules, therefore, reduce the tax incentives of keeping excess cash offshore.

U.S. companies operating in Latin America typically prefer not to retain excess cash in their Latin American subsidiaries because of the inflation and unstable currencies in Latin America. Nevertheless, high withholding taxes on the repatriation of

181. Treas. Reg. §§ 1.904-4(c)(2), (3), (4), (5) (1995). The regulations provide special grouping rules for (a) rent or royalty income to which an item of rent or royalty expense is directly allocable; (b) passive partnership income; (c) currency gains and losses; and (d) certain passive dividends. Treas. Reg. § 1.904-4(c)(5) (1995).

182. *Id.* § 1.904-4(c)(5) (1995).

earnings and exchange controls can lead to the accumulation of passive assets and the concomitant recognition of passive income in Latin American subsidiaries. If the passive income is subject to high local income taxes, it might be excluded from Subpart F income.[183] If the passive income is subject to low rates of foreign income tax, however, it will be subject to current U.S. tax and the passive income foreign tax credit limitation.[184]

Gains from foreign currency transactions also can lead to passive income in Latin American subsidiaries. Even if foreign currency exposures are hedged, adverse tax consequences can arise from the mismatching of the gains and losses from the hedged and the hedging transactions.

3. High Withholding Tax Interest

High withholding tax interest is any interest (other than export financing interest) subject to a foreign withholding tax of five percent or more.[185] This limitation was intended to combat a perceived foreign tax credit abuse by U.S. banks providing loans to foreign borrowers. As such loans often were made on a net basis, as discussed *supra*, the borrower bore the economic risk of the foreign withholding tax on the interest on the loan. Since the U.S. bank could obtain a foreign tax credit for the withholding tax, but arguably did not bear the economic burden of the tax, the U.S. bank generally would prefer a high withholding tax rate.[186]

High withholding tax interest includes interest received from most countries that do not have an income tax treaty with the United States and interest received from countries having treaties with the United States that impose at least a five percent withholding tax under the treaty. Interest from countries whose treaties with the United States exempt interest from withholding tax (e.g., France, Germany, the Netherlands and the

183. I.R.C. § 954(b)(4) (1995); Treas. Reg. § 1.954-1(d)(1) (1995).

184. I.R.C. §§ 954(c)(1)(A), 904(a).

185. *Id.* § 904(d)(2)(B)(i); Treas. Reg. § 1.904-4(d).

186. If the U.S. bank were engaged in an active financing business, its interest income would fall into the financial services basket, rather than the passive basket. Thus, the U.S. bank generally could use excess foreign tax credits from high-taxed interest income to offset the U.S. tax on low-taxed foreign source interest income.

United Kingdom) and countries that do not impose withholding tax on interest under local law (e.g., Caribbean tax havens) is not subject to this separate basket. Furthermore, interest received by a U.S. parent corporation from its wholly-owned foreign subsidiaries normally will fall into the general basket, regardless of the rate of withholding tax imposed, under the look-through rules discussed *infra* Part III.D.6.

The 1986 Act provided a transitional rule for the high withholding tax interest basket for loans made to certain foreign countries (including the major countries in Latin America).[187] The transitional rule phased in the application of the basket over several years. This rule, however, was repealed for taxable years beginning after 1989.[188]

The high withholding tax interest basket typically will apply to loans made by U.S. banks to unrelated borrowers in Latin America because of the high withholding tax rates imposed on interest by those countries. One notable exception is Mexico. Under the income tax treaty between Mexico and the United States, the rate of Mexican withholding tax on interest paid by Mexican borrowers to U.S. banks (after a five-year transition period) is 4.9 percent.[189] This rate was deliberately chosen to avoid the high withholding tax interest basket.[190] Other Latin American countries have now reduced their withholding tax rates on interest paid to foreign banks.[191]

187. Pub. L. No. 99-514, § 1201(e)(2), 100 Stat. 2520 (1986), *amended by* Pub. L. No. 100-647, § 1012(a)(5), 102 Stat. 3492 (1988).

188. Pub. L. No. 101-239, § 7404(a), 103 Stat. 2361 (1989).

189. Mexico unilaterally reduced the withholding tax rate on interest paid to foreign banks to 4.9% effective October 1, 1993. *See* Nicasio del Castillo et al., *U.S.-Mexico Income Tax Treaty: Practical Implications and Planning Opportunities for U.S. Investors*, 23 TAX MGMT. INT'L J. 128, 135 (1994).

190. Phillip D. Morrison, *U.S.-Mexico Income Tax Treaty Breaks New Ground — Implications for the New U.S. Model and for Latin America*, 5 TAX NOTES INT'L 825, 826-28 (1992).

191. In 1995, Argentina reduced its withholding tax rate on interest to 4.5%. The withholding tax rate on interest paid to foreign banks is 4.95% in Venezuela and 4% in Chile.

4. Financial Services Income

Financial services income consists of income of taxpayers predominantly engaged in the active conduct of a banking,[192] insurance, financing, or similar business.[193] It does not include export financing interest or high withholding tax interest. The passive income of such taxpayers falls into the financial services income basket, rather than the passive basket. Interest earned by U.S. banks on loans to unrelated foreign borrowers in Latin America (other than Mexican borrowers) generally will fall into the high withholding tax interest basket, rather than the financial services basket, because of the high withholding taxes in Latin America.

5. 10/50 Basket Dividends

Dividends from each separate noncontrolled Section 902 corporation are subject to a separate foreign tax credit limitation.[194] A noncontrolled Section 902 corporation is a foreign corporation which is not a CFC in which the U.S. corporation owns ten percent or more of the voting stock.[195] This separate limitation is known as the "10/50 basket."

Since the 10/50 basket applies separately to each noncontrolled Section 902 corporation, if a U.S. corporation has interests in many such foreign corporations, it cannot average the foreign tax rates imposed on the earnings of such corporations for foreign tax credit limitation purposes. In other words, any excess foreign tax credits generated by the dividends paid by a noncontrolled Section 902 corporation cannot be used to offset the U.S. tax on the taxpayer's other low-taxed foreign income. By the same token, any excess foreign tax credit limitation generated by the dividends cannot be used to absorb excess foreign tax credits generated by other income.

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192. For a discussion of the potential for deferral of U.S. income tax on interest income from export financing, see Ricardo Corona, Comment, *The Continuing Viability of the Banking and Financial DISC: A Tool for Sheltering Export Finance Income*, 27 U. MIAMI INTER-AM. L. REV. 361 (1996).

193. I.R.C. § 904(d)(2)(C) (1995); Treas. Reg. § 1.904-4(e) (1995).

194. I.R.C. § 904(d)(1)(E) (1995).

195. *Id.* § 904(d)(2)(E); Treas. Reg. § 1.904-4(g)(1).

The 10/50 basket problem typically arises in the context of joint ventures between U.S. and foreign corporations in which the U.S. corporation owns fifty percent or less of the stock of a foreign joint venture corporation. The 10/50 basket can be avoided by structuring the foreign joint venture entity to be treated as a partnership for U.S. tax purposes or by interposing a U.S. partnership between the shareholders (e.g., the U.S. and foreign joint venture partners) and the foreign entity to cause it to be a CFC.[196] In cases in which the use of a partnership is not feasible or desired, the U.S. company can use other means of achieving CFC status for the foreign entity (and thereby avoiding the 10/50 basket). If the U.S. and foreign joint venture partners each own exactly fifty percent of the stock of the foreign entity, CFC status can be achieved, for example, by the U.S. Shareholder (a) buying one share of the stock of the foreign joint venture partner, (b) acquiring an option to purchase additional stock in the foreign joint venture corporation, or (c) acquiring nonvoting preferred stock in the foreign joint venture corporation.[197] If the U.S. venturer's interest is significantly below fifty percent, however, structuring the venture as a partnership may be the only way to avoid the 10/50 basket.

The 10/50 basket also can apply to the pre-acquisition earnings of a foreign corporation acquired by a U.S. corporation. Dividends paid by a CFC out of earnings and profits accumulated before it became a CFC are treated as dividends from a noncontrolled Section 902 corporation.[198] Furthermore, dividends paid by a CFC out of earnings and profits accumulated while it was a CFC, but during which the current U.S. Shareholder owning more than 90 percent of the voting stock of the CFC was not a U.S. Shareholder of the CFC, will be treated as dividends from a noncontrolled Section 902 corporation.[199] A U.S. Shareholder that acquires stock resulting in ownership of ninety percent or less of the voting stock of an existing CFC is entitled to use the look-through rules for dividends paid by the

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196. *See* discussion on partnerships *infra* part V.C.1.

197. *See generally* Bruce N. Davis & Steven R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 TAX L. REV. 165, 213-225 (1991).

198. I.R.C. § 904(d)(2)(E) (1995); Treas. Reg. § 1.904(g)(3) (1995); Prop. Treas. Reg. § 1.902-1(d)(3)(i).

199. Treas. Reg. § 1.904-4(g)(3) (1995); Prop. Treas. Reg. § 1.902-1(d)(3).

CFC out of post-1986 pre-acquisition earnings and profits.[200] As a practical matter, the acquiring U.S. Shareholder can usually avoid the 10/50 basket by making a Section 338 election with respect to its acquisition of the CFC (which eliminates pre-acquisition earnings and profits). Moreover, the pre-acquisition earnings and profits of selling U.S. Shareholders will be converted to previously taxed income by the operation of Section 1248.[201]

6. Look-through Rules

The adverse effects of the separate foreign tax credit limitations are substantially ameliorated by the look-through rules applicable to dividends, interest, rents, and royalties paid by CFCs and to Subpart F income of CFCs.[202] Dividends from a CFC are treated as having the separate limitation character of the earnings and profits of the CFC. Thus, if twenty percent of the earnings and profits of the CFC from which a dividend is distributed constitutes passive income, twenty percent of the dividend constitutes passive income to the shareholder.[203]

Interest, rents and royalties received from a CFC are treated as having the character of the CFC to which the CFC's deductions for such items are properly allocable.[204] For example, if the deduction for a royalty paid by a CFC is allocable to the CFC's manufacturing income, the royalty income to the licensor falls into the general basket, rather than the passive basket. Interest paid by a CFC to a U.S. Shareholder, however, is first allocated to the passive income of the CFC.[205]

Amounts included in the income of a U.S. Shareholder of a CFC as Subpart F income are treated as having the same character as the income of the CFC giving rise to the inclusion.[206] For example, if Subpart F income is attributable to the passive income of a CFC, the inclusion of the Subpart F income in the income of the U.S. Shareholder falls into the passive basket.

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200. Prop. Treas. Reg. § 1.902-1(d)(3)(v) (Example 3).
201. *See* I.R.C. § 959(e) (1995).
202. *Id.* § 904(d)(3); Treas. Reg. § 1.904-5 (1995).
203. I.R.C. § 904(d)(3)(D) (1995); Treas. Reg. § 1.905-5(c)(4) (1995).
204. I.R.C. § 904(d)(3)(C) (1995); Treas. Reg. §§ 1.904-1(c)(2), (3) (1995).
205. I.R.C. § 954(b)(5) (1995); Treas. Reg. § 1.904-4(c)(2) (1995).
206. I.R.C. § 904(d)(3)(B) (1995); Treas. Reg. § 1.904-5(c)(1) (1995).

Under the look-through rules, dividends, interest, rents, royalties, and Subpart F income received by U.S. parent corporations from their wholly-owned subsidiaries operating in Latin America typically will fall into the general basket. Such income will be subject to a separate limitation only if the subsidiaries earn income in the separate income categories.

IV. FOREIGN CURRENCY

A. *General*

All U.S. corporations operating in Latin America engage in transactions involving foreign currency. The U.S. tax treatment of foreign currency transactions is especially important to these corporations because of the volatility of the currencies of Latin American countries.

Foreign currency transactions normally are bifurcated for U.S. tax purposes into two components: (1) a transactional component and (2) a foreign currency component.[207] The principal U.S. tax issues with respect to the foreign currency component are its amount, character, timing, and source. Prior to the Tax Reform Act of 1986 (1986 Act), these issues were resolved by applying general U.S. income tax concepts and treating the foreign currency as property.[208] Due to the inconsistent development of the U.S. tax law regarding foreign currency transactions, Congress enacted a comprehensive set of foreign currency provisions as part of the 1986 Act.[209] These provisions borrow substantially from the concepts of financial accounting regarding foreign currency translation.[210]

The foreign currency provisions employ two basic concepts.[211] The first is the concept of a Qualified Business Unit (QBU). A QBU is a separate and clearly identified unit of a

207. *See, e.g.*, National Standard Co. v. Comm'n, 80 T.C. 551 (1983), *aff'd*, 749 F.2d 369 (6th Cir. 1984).

208. *See* STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, H.R. DOC. NO. 3838, 100th Cong., 1st Sess. at 1086 (1987).

209. I.R.C. §§ 985-989 (1995).

210. FOREIGN CURRENCY TRANSLATION, Statement of Financial Accounting Standards No. 52 (Fin. Accounting Standards Bd. 1981).

211. I.R.C. § 989(a) (1995).

trade or business of a taxpayer that maintains separate books and records.[212] A corporation has at least one QBU and can have multiple QBUs.[213] Generally, a foreign branch of a U.S. corporation is considered a separate QBU from the home office if (a) its activities constitute a separate trade or business and (b) the branch maintains a separate set of financial books.[214]

The second concept is that of "functional currency."[215] The functional currency of the QBU is either (i) the U.S. dollar or (ii) the foreign currency of the economic environment in which a significant part of the QBU's activities are conducted and in which the QBU keeps its books and records.[216] A QBU must use the dollar as its functional currency if it (a) conducts its activities primarily in dollars; (b) resides in the United States or any possession or territory of the United States where the dollar is the standard currency; (c) does not keep books and records in the currency of any economic environment in which a significant part of its activities is conducted; (d) produces income or loss that is effectively connected with the conduct of a U.S. trade or business; or (e) for taxable years beginning after August 24, 1994, otherwise would be required to use a hyperinflationary currency as its functional currency.[217]

If a business activity qualifies as a QBU, the determination of the QBU's functional currency turns on the "economic environment" in which the QBU conducts its trade or business. This determination is based upon all of the facts and circumstances.[218] The relevant factors include (a) the currency of the country in which the QBU is a resident; (b) the currencies of the QBU's cash flows, revenues and expenses, borrowings and lendings, sales markets and pricing, and other decisions; (c) the duration of the QBU's operations; and (d) the significance and/or volume of the QBU's independent activities.[219]

A change in a QBU's functional currency constitutes a

212. *Id.*
213. Treas. Reg. § 1.989(a)-1(b), (c) (1995).
214. *Id.* § 1.989(a)-1(b)(2)(ii).
215. I.R.C. § 985(b)(1) (1995).
216. *Id.*
217. Treas. Reg. § 1.985-1(b)(1), (2) (1995).
218. *Id.* § 1.985-1(c)(2).
219. *Id.* § 1.985-1(c)(2)(i).

change of accounting method.[220] A taxpayer must use a particular functional currency consistently from year to year.[221] It can change its functional currency only with the consent of the I.R.S.[222] The I.R.S. will allow a change of functional currencies only in certain narrow circumstances.[223] If a QBU changes its functional currency, it is required to make certain adjustments to its accounts.[224]

B. *Foreign Currency Rules for Foreign Subsidiaries*

A foreign subsidiary of a U.S. corporation must ordinarily make all calculations for U.S. tax purposes in its functional currency.[225] Although a foreign corporation can have multiple QBUs with different functional currencies, the foreign corporation must use a single functional currency to consolidate the operations of its QBUs.[226] Thus, the foreign corporation must use a single functional currency for calculating earnings and profits, Subpart F income, and credible foreign taxes. After each QBU calculates its income or loss in its own functional currency, such amount is translated into the functional currency of the foreign corporation.[227]

The foreign corporation's earnings and profits are determined in its functional currency and then translated using the "appropriate" exchange rate for particular items.[228] The appropriate exchange rate for actual distributions of earnings and profits, or deemed distributions under Section 1248, is the exchange rate on the date the distribution is included in the U.S. Shareholder's income.[229] In the case of income recognized under Subpart F, the Foreign Personal Holding Company (FPHC) provisions and the Passive Foreign Investment Company provisions, the appropriate exchange rate is a weighted average ex-

220. I.R.C. § 985(b)(4) (1995).
221. Treas. Reg. § 1.985-4 (1995).
222. *Id.*
223. *Id.* § 1.985-4(b).
224. *Id.* § 1.985-5.
225. I.R.C. § 985(a) (1995).
226. Treas. Reg. § 1.985-1(d)(1) (1995).
227. *Id.* § 1.985-1(d)(2).
228. I.R.C. § 986(b) (1995).
229. *Id.* § 989(b)(1), (2).

change rate for the taxable year.[230]

For the purpose of calculating the Section 902 deemed-paid foreign tax credits allowed to its U.S. Shareholders, a foreign subsidiary must translate foreign tax payments into U.S. dollars.[231] Accrued and unpaid taxes are translated into U.S. dollars at the exchange rate in effect on the last day of the taxpayer's taxable year.[232] Foreign taxes actually paid (i.e., withholding, estimated, and return tax payments) are translated into U.S. dollars on the date of payment.[233] Credits and refunds of foreign taxes are translated into U.S. dollars at the exchange rate on the date of the original tax payment.[234] All other adjustments to taxes are translated into U.S. dollars at the exchange rate for the date when the adjustment is paid.[235]

If a U.S. Shareholder has claimed a credit for a foreign tax and that foreign tax is subsequently redetermined, the U.S. Shareholder is required, under certain circumstances, to redetermine the amount of its foreign tax credit for the earlier year.[236] If previously taxed income is distributed to a U.S. Shareholder, the U.S. Shareholder must recognize foreign currency gain or loss attributable to the movement in currency rates between the dates of income recognition and actual distribution.[237] The currency gain or loss is ordinary and has the same source as the related income inclusion. The foreign currency gain or loss is calculated by subtracting the U.S. dollar basis of the distributed previously taxed income from the U.S. dollar value of the previously taxed income distribution translated at the spot rate on the date of the distribution.[238]

230. *Id.* § 989(b)(3).
231. *Id.* § 986(a)(1).
232. Temp. Treas. Reg. § 1.905-3T(b)(1) (1995).
233. I.R.C. § 986(a)(1)(A) (1995); Temp. Treas. Reg. § 1.905-3T(b)(2) (1995).
234. I.R.C. § 986(a)(1)(B)(ii) (1995); Temp. Treas. Reg. § 1.905-3T(b)(3) (1995).
235. I.R.C. § 986(a)(1)(B)(i) (1995).
236. *See* Temp. Treas. Reg. § 1.905-3T(c), (d) (1995); Temp. Treas. Reg. § 1.905-4T (1995).
237. I.R.C. § 986(c) (1995).
238. *See* I.R.S. Notice 88-71, 1988-2 C.B. 374. *See also* I.R.S. Notice 88-70, 1988-2 C.B. 369.

C. *Foreign Currency Rules for Foreign Branches*

The foreign currency rules applicable to foreign branches are different from those applicable to foreign subsidiaries because the profits and losses of foreign branches of U.S. corporations must be currently translated into U.S. dollars and included in the U.S. taxpayer's taxable income.[239] Prior to the 1986 Act, foreign branches of U.S. corporations could translate their earnings using either the profit and loss method or the net worth method. The 1986 Act requires all branches to use the profit and loss method.[240]

Under the pre-1987 profit and loss method, the taxpayer translated the unremitted foreign currency profits of the foreign branch into U.S. dollars at the exchange rate in effect at the end of the year.[241] Remittances from the branch were translated into U.S. dollars at the exchange rate in effect on the date of remittance. Currency gain or loss was recognized at the time of remittance.[242]

Under the pre-1987 net worth method, the branch's annual profit or loss was the difference between the beginning and ending net worth of the branch, translated into U.S. dollars at the exchange rate in effect at the end of each year. The net worth method resulted in the current recognition of unrealized exchange gains and losses.[243]

Prior to 1987, taxpayers with foreign branches operating in weak currency environments generally used the net worth method in order to accelerate exchange losses. Conversely, taxpayers with foreign branches operating in strong currency environments typically employed the profit and loss method to defer exchange gains. The 1986 Act eliminated this flexibility. After 1986, a taxpayer with a foreign branch QBU using a functional currency other than the U.S. dollar must (1) compute the taxable income or loss of the branch separately in its functional currency, (2) translate the income or loss from the functional currency to U.S.

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239. *Compare* I.R.C. §§ 986 *and* 987 (1995).
240. H.R. REP. NO. 841, 99th Cong., 2d Sess. at II-673-75 (1986).
241. *Id.*
242. Rev. Rul. 75-106, 1975-1 C.B. 31.
243. Rev. Rul. 75-107, 1975-1 C.B. 32.

dollars using the appropriate exchange rate, and (3) make proper adjustments for transfers of property between QBUs having different functional currencies.[244]

The appropriate exchange rate for the translation of a foreign branch's functional currency profit and loss into U.S. dollars is the weighted average exchange rate for the taxable year.[245] The weighted average exchange rate is calculated by taking the simple average of the daily exchange rates, excluding weekends, holidays, and other nonbusiness days, for the taxable year.[246] If the taxpayer elects to credit the foreign taxes of the foreign branch, the foreign taxes paid by the branch must be translated into U.S. dollars at the exchange rate on the date of payment of the taxes.[247]

The U.S. taxpayer with a foreign branch using a foreign functional currency must recognize exchange gain or loss on the transfer of currency or property from the branch to the U.S. home office to reflect changes in the dollar value of the foreign currency earnings between the time the taxpayer reports the earnings and the time of remittance.[248] In order to calculate the exchange gain or loss on remittances from foreign branches, the taxpayer must calculate a "basis pool" and an "equity pool" for each branch.[249] The basis pool reflects the U.S. dollar adjusted book value of the home office's investment in the branch. In other words, it reflects the basis of the home office in the equity pool of the branch.[250] The equity pool reflects the adjusted undistributed foreign currency earnings and profits of the branch.[251] The exchange gain or loss is equal to the difference between the dollar value of the remittance and the portion of the basis pool attributable to the remittance.[252] The proposed regulations provide detailed guidance regarding the maintenance of an equity pool for a branch.[253]

244. I.R.C. § 987 (1995).
245. *Id.* § 989(b)(4).
246. Treas. Reg. § 1.989(b)-1 (1995).
247. Prop. Treas. Reg. § 1.987-1(b)(3).
248. I.R.C. § 987(3) (1995); Prop. Treas. Reg. § 1.987-2(a).
249. Prop. Treas. Reg. § 1.987(a)(1).
250. *See id.* § 1.987-2(c)(2).
251. *Id.* § 1.987-2(c)(1).
252. *Id.* § 1.987-2(a)(1).
253. *Id.* § 1.987-2(c).

The proposed regulations implementing Section 987(3) require taxpayers to determine the source and character of any Section 987 gain or loss by using the same method the taxpayer uses to allocate and apportion its interest expense under Section 861.[254]

D. *Transactions in Nonfunctional Currency*

Section 988 sets forth rules for calculating the income of a QBU when it enters into transactions denominated in a currency other than its functional currency, such as when a U.S. corporation enters into transactions denominated in foreign currency or when a foreign subsidiary with a foreign functional currency enters into transactions denominated in other foreign currencies or the dollar. Section 988 applies only with respect to "Section 988 transactions" specifically defined in that section. A transaction will constitute a Section 988 transaction only if the amount the taxpayer receives or pays is denominated in nonfunctional currency or by reference to the value of one or more nonfunctional currencies.[255] The specified Section 988 transactions are: 1) the acquisition of a debt instrument or becoming the obligor under a debt instrument; 2) accruing any item of expense or gross income or receipts to be paid or received after the date of accrual; 3) entering into or acquiring any forward contract, futures contract, option, or similar financial instrument; 4) disposing of nonfunctional currency.[256] Other transactions, such as foreign currency denominated equity investments, are not subject to Section 988.[257]

Gains and losses from Section 988 transactions are ordinary to the extent that the gains and losses are attributable to changes in exchange rates.[258] All gains from foreign currency, forward options, futures, and notional principal contracts qualifying as Section 988 transactions are ordinary gains under Section 988.

254. *Id.* § 1.987-2(f).
255. I.R.C. § 988(c)(1)(A) (1995).
256. *Id.* § 988(c)(1)(B), (C)(i)(I).
257. *Id.* § 988(a)(1)(B); Treas. Reg. §1.988-3(b).
258. I.R.C. § 988(a)(1)(A); Treas. Reg. § 1.988-3(a).

Foreign currency gain or loss is generally recognized under Section 988 only when there is a realization and recognition event with respect to the settlement or termination of the Section 988 transaction.[259] Gains and losses from Section 988 transactions are governed by numerous measurement and timing rules. In general, the amount of exchange gain or loss recognized on a Section 988 transaction is the difference in the exchange rate of the nonfunctional currency between the booking date (e.g., the date of accrual of an expense) and the payment date (e.g., the date the expense is paid) and normally is recognized on the payment date.[260]

The source of foreign currency gains or losses on Section 988 transactions is determined by the residence of the QBU realizing the gain or loss.[261] Effectively connected gain or loss realized by foreign corporations, however, is treated as U.S. source income.[262]

E. *Hyperinflationary Currency/DASTM*

If a QBU conducts its business in an economic environment with a hyperinflationary currency, it can elect the Dollar Approximate Separate Transactions Method (DASTM).[263] DASTM is intended to approximate the results of calculating a hyperinflationary QBU's income using a U.S. dollar functional currency, but without maintaining its books completely in U.S. dollars.[264] A currency is hyperinflationary if the cumulative in-

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259. Treas. Reg. § 1.988-2(a)(1)(i), (b), (d)(2)(i) (1995).

260. I.R.C. § 988(b)(1), (2) (1995).

261. Treas. Reg. § 1.988-4(a) (1995).

262. *Id.* §§ 1.864-4(c), 1.988-4(c).

263. *See generally* Douglas L. Hassman et al., *A Practical Guide to Applying DASTM to the Current and Prior Taxable Years*, 10 TAX NOTES INT'L 662 (1995); Steven R. Lainoff & Todd Y. McArthur, *The Final Functional Currency Regime for U.S. Taxpayers Operating in Hyperinflationary Environments: Mandatory DASTM*, 23 TAX MGMT. INT'L J. 583 (1994); Charles W. Cope & Robert A. Katcher, *Final DASTM Regulations: An Aid to Business Operating in Hyperinflationary Countries*, 64 TAX NOTES 1357 (1994); David W. Dusendschon & Nick D. Hansen, *Mexico is No Longer Hyperinflationary, and Tax Cost Lessens For U.S. Investors*, 3 J. INT'L TAX. 92 (1992); Jeffrey M. Colón & Alan L. Fischl, *IRS Proposes Major Changes to Dollar Approximate Separate Transactions Method Regulations*, 21 TAX MGMT. INT'L J. 151 (1992).

264. The DASTM rules for QBUs with hyperinflationary functional currencies are an exception to the general rule that no currency gains or losses of foreign branches

flation rate for the currency's country is at least 100 percent in the three-year period immediately preceding the last day of the preceding taxable year.[265] The DASTM provisions are designed to approximate a transaction-by-transaction translation approach; that is, to begin with the local currency amount, then convert this amount into U.S. dollars on a transaction-by-transaction basis. For taxable years beginning after August 24, 1994, any QBU that otherwise would be required to use a hyperinflationary currency as its functional currency must use DASTM.[266]

Many of the countries in Latin America have hyperinflationary currencies within the meaning of the DASTM regulations.[267] The currencies of Argentina, Brazil, Ecuador, Nicaragua, and Uruguay were hyperinflationary for all of the 1987-1995 taxable years. Colombia, the Dominican Republic, El Salvador, Mexico, and Venezuela had hyperinflationary currencies for some of those taxable years.[268]

To calculate a QBU's income or loss and earnings and profits under DASTM, a taxpayer uses a four step process:

> (1) Preparing an income or loss statement from the QBU's books and records . . . as recorded in the QBU's hyperinflationary currency . . . ;
>
> (2) Making the adjustments necessary to conform such statement to United States generally accepted accounting principles and tax accounting principles . . . ;
>
> (3) Translating the amounts of hyperinflationary currency as shown on such adjusted statement into dollars in accordance with paragraph (c) of this section; and
>
> (4) Adjusting the resulting dollar income or loss or earnings and profits (or deficit in earnings and profits) and, where

are recognized until earnings are repatriated.

265. Treas. Reg. § 1.985-1(b)(2)(ii)(D) (1995).

266. *Id.* § 1.985-1(b)(2)(ii)(A). There are two exceptions to this rule. The foreign currency of a QBU that otherwise would be required to use hyperinflationary currency as its functional currency, but is a branch of a foreign corporation having a nondollar non-hyperinflationary functional currency, can use the functional currency of the foreign corporation. Second, a foreign corporation that is not a CFC is not required to use DASTM.

267. *See* Hassman, *supra* note 263, at 665.

268. *Id.*

necessary, particular items of gross income, deductible expense or other amounts, in accordance with paragraph (e) of this section to reflect the amount DASTM income or loss as determined under paragraph (d) of this section.[269]

V. USING PARTNERSHIPS WHEN DOING BUSINESS IN LATIN AMERICA

A. *Overview*

Tax structuring for the post-World War II expansion of U.S. businesses into Latin America has historically consisted of choosing between establishment of either a foreign branch or a foreign corporate subsidiary.[270] The U.S. investor and, as a result, the U.S. tax practitioner did not traditionally consider the potential advantages of a partnership structure. In recent years, however, international business opportunities increasingly have presented themselves in a manner, such as joint ventures or strategic alliances, which lend themselves to the partnership form. As a result of this increased attention to partnership forms as a business matter, tax practitioners have become more familiar with the advantages of partnerships.[271] Unfortunately, partnership forms remain an unfamiliar vehicle in most of Latin America, where a strong tradition exists for the use of locally incorporated companies.

This section of the Article surveys and describes the functions performed by partnership forms in international tax planning today,[272] with emphasis on the uses of partnerships in tax planning for U.S.-based multinationals establishing operations

269. Treas. Reg. § 1.985-3(b) (1995).

270. *See* Spudis, *supra* note 1 (providing the basis for this section).

271. *See generally* David R. Ryder et al., *Beneficial Uses of Foreign Entities and Structures in Tax Planning for the U.S. Multinational Company*, 70 TAXES 1021 (1992); George B. Javaras et al., *Partnership Joint Ventures of Operating Businesses*, 72 TAXES 779 (1994); Bruce N. Davis & Steve R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 TAX L. REV. 165 (1991); James M. Boyle et al., *Alliances Not in Partnership or Corporate Form — Will You be My Partner? No Thanks*, 72 TAXES 812 (1994).

272. Throughout this discussion, general partnerships, limited partnerships and limited liability companies are referred to generically as "partnerships," except where otherwise noted.

in Latin America, including the use of hybrid entities (i.e., an entity characterized for tax purposes as a partnership in one country, but as a corporation in another country) in order to minimize or defer tax.[273]

B. *U.S. Multinationals Starting Up Latin American Operations: Using Pass-through Entities to Obtain U.S. Tax Benefits For Foreign Losses*

The pass-through of foreign losses to a U.S. parent corporation is by far the most common use of a partnership in international tax planning. The U.S. corporation establishing manufacturing operations in Latin America usually will find the pass-through of losses beneficial from a U.S. tax standpoint. If a foreign corporate subsidiary incurs losses, the losses are locked in the subsidiary and are not usable currently against the U.S. parent's taxable income. In contrast, a foreign branch of a U.S. company or a foreign entity treated as a partnership for U.S. tax purposes will permit current use of the losses by the U.S. parent, subject to the limitations and recapture rules described below.

The taxpayer's foreign tax credit situation also has an impact on the decision to conduct foreign operations in the corporate or pass-through form. If a U.S. taxpayer is in an excess foreign tax credit position, it generally will obtain no current tax benefit from foreign losses. In this situation, the foreign loss usually will reduce the taxpayer's foreign tax credit by an amount equal to the tax benefit of the loss deduction.[274] The taxpayer should be able to carry forward the additional excess foreign tax credit and use it to offset the U.S. tax on the income of the foreign operation in later years after it becomes profitable. The net tax result, however, generally is no better than conduct-

273. It is beyond the scope and space limitations of this Article to discuss the current U.S. law with respect to the classification of an entity as a partnership or as a corporation for U.S. tax purposes, including such significant current issues of foreign entity classification as the "without further action" problem, the single economic interest issue and the single-member entity issue. Likewise, we will not be able to discuss the current I.R.S. proposal to implement an elective system of entity classification (the "check-a-box" proposal) and I.R.S. concerns about extending such an elective system to foreign entities. *See* Spudis, *supra* note 1.

274. *See* I.R.C. § 904(a)-(d) (1995).

ing the operations in a foreign subsidiary.

1. Branch v. Partnership

The choice between a branch and a partnership may turn on local law requirements. The operations may be of a nature or extent that call for formation of an entity under the local law in the applicable Latin American jurisdiction. If so, while such an entity could not be treated as a branch, it could be owned by two members of an affiliated group owned by a single U.S. parent and organized so as to be classified as a partnership.

Even if the tax consequences of a partnership or a branch are the same, nontax concerns may weigh in favor of a partnership. Many foreign jurisdictions have business entities which provide limited liability to their owners and which, under the current U.S. classification rules, can be characterized as partnerships for U.S. tax purposes. In contrast, operations in branch form are likely to expose the U.S. parent to full liability for the activities of the branch. Thus, if the partnership form offers limited liability under the local foreign law, it may be favored over a branch.

2. Limitations on Losses

The ability of U.S. taxpayers to use foreign losses against income otherwise subject to U.S. tax are subject to a number of rules designed to monitor and limit the use of such losses and to recapture them in certain situations.[275] The relevant anti-foreign loss provisions include: (i) for foreign tax credit purposes, overall foreign loss recapture[276] and separate limitation categories and basket ordering rules for losses;[277] (ii) loss recapture on incorporation;[278] and (iii) the dual consolidated loss rules.[279]

275. *See generally* D. Kevin Dolan & Carolyn M. DuPuy, *Foreign Losses*, 71 TAXES 935, 936-42 (1993); *see* Ryder, *supra* note 271, at 1041-50; *see* Davis, *supra* note 271, at 257-61.

276. I.R.C. § 904(f)(1) (1995); Treas. Reg. § 1.904(f)-2 (1995).

277. I.R.C. § 904(f)(5) (1995).

278. *See id.* §§ 367(a)(3)(C), 904(f)(3) (1995); Treas Reg. § 1.904(f)-2(d) (1995).

279. I.R.C. § 1503(d) (1995); Treas. Reg. §§ 1.1503-2, 1.1503-2A (1995).

a. Overall Foreign Loss and Separate Limitation Losses

Foreign losses impact the U.S. taxpayer's foreign tax credit. Prior to 1976, a U.S. taxpayer could use foreign losses to reduce U.S. source taxable income, thereby reducing its U.S. tax, and then, when the foreign operations turned profitable, obtain a foreign tax credit for foreign taxes paid on such profits. In 1976, however, Congress enacted Section 904(f), requiring the recapture of foreign losses used to reduce U.S. tax.[280]

Pursuant to Section 904(f)(1), if foreign losses have been used to reduce U.S. source income, the taxpayer must create an overall foreign loss account and, when it earns future foreign source income in the same limitation category, such income must be recharacterized as U.S. source income. The amount recharacterized as U.S. source is fifty percent of the foreign source income or such higher percentage as the taxpayer may elect.[281] As a result, the foreign tax credit limitation of the taxpayer is reduced because the recaptured income is converted from foreign source income to U.S. source income for purposes of the limitation.

In the Tax Reform Act of 1986 (1986 Act), Congress enacted the foreign tax credit separate limitation categories of Section 904(d), pursuant to which foreign income or loss for each separate category is isolated for foreign tax credit limitation purposes, thereby preventing the averaging of effective foreign tax rates on different categories of income.[282] The 1986 Act also revised Section 904(f) to provide ordering rules for the allocation of foreign losses among the separate foreign tax credit baskets. Under such rules, foreign source losses first offset other foreign source income in the same basket, then income of other baskets on a pro rata basis and finally, only after exhausting all foreign source income, U.S. source income.[283] Conversely, when foreign source income subsequently arises in the loss basket, it is first allocated to reverse the losses previously allocated from the loss

280. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1032(a) (1976).

281. I.R.C. § 904(f)(1)(B) (1995).

282. *See generally* Gregg D. Lemein & Debra Falduto Novack, *International Mergers and Acquisitions*, 67 TAXES 844, 845 (1989).

283. *See* I.R.C. § 904(f)(5) (1995).

basket to the other baskets until those losses are recaptured.[284]

The practical effect of these rules is that the taxpayer obtains a current tax benefit for the foreign loss by offsetting separate basket income subjected to a low rate of foreign tax, but that tax benefit is subsequently recaptured when general basket income is recharacterized as separate basket income and subjected to U.S. tax with no offsetting foreign tax credit. The pass-through of foreign losses typically will be useful when the losses exceed all foreign source income and, thus, offset U.S. source income.[285] In general, the recapture rules of Section 904(f) will cause an equal and offsetting tax detriment by denying the foreign tax credit on income in later years equal to the amount of the loss. Since this recapture is not subject to interest, however, the taxpayer may benefit from using the foreign source losses to offset U.S. source income currently, especially if recapture is not projected in the short term.

b. Loss Recapture on Branch Incorporation

Pursuant to Section 367(a)(3)(C), upon the transfer by a U.S. person of foreign branch assets to a foreign corporation, the transferor must recognize income equal to any losses previously deducted by the U.S. taxpayer, less the branch's taxable income and any gain recognized under Section 904(f)(3).[286] The amount of income recognized is limited to the gain realized on the transfer.[287]

While Section 367(a)(3)(C) refers to a branch, a transfer of a partnership interest is treated as a transfer of the partner's pro rata share of the partnership's assets.[288] Thus, incorporation of a partnership will have the same effect as incorporation of a

284. I.R.C. § 904(f)(5)(C) (1995).

285. If a taxpayer has excess foreign tax credits in the general basket and it incurs a general basket foreign loss which only offsets income in the general basket, the foreign loss will generate additional excess foreign tax credits equal to and completely offsetting the U.S. tax benefit from the deduction of the loss. If the taxpayer has excess foreign tax credit limitations in the general basket, or in a separate basket to which the foreign loss is allocated, the U.S. tax benefit of the loss deduction ordinarily will exceed the loss of foreign tax credit.

286. *See* Temp. Reg. § 1.367(a)-6T (1995) (detailing rules regarding branch loss recapture).

287. *Id.* § 1.367(a)-1T(b)(3), -6T(c)(2).

288. I.R.C. § 367(a)(4) (1995).

branch for purposes of these rules. As is true with the overall foreign loss recapture rules, however, there is no interest or time value of money component included in the Section 367 recapture rules. Accordingly, even if recapture is inevitable, current use of losses will maximize the tax benefit.

c. *Dual Consolidated Loss Rules*

The above rules concern recapture of losses when the loss operations subsequently generate income. A separate set of loss limitation rules is designed to prevent the use of the same foreign losses for both U.S. and foreign tax purposes. Section 1503(d), enacted by the 1986 Act, provides that the dual consolidated loss (DCL) of any domestic corporation may not reduce the taxable income of any other member of the affiliated group. Under the Section 1503(d) regulations, a DCL includes losses incurred by: (i) domestic corporations subject to income tax in a foreign country on their worldwide income or on a residency basis; (ii) foreign branches of domestic corporations; and (iii) interests held by domestic corporations in a partnership, including hybrid entities treated as corporations locally.[289] A loss of a branch or a partnership is referred to in the regulations as a loss of a "separate unit."[290]

The regulations generally disallow a foreign loss of a separate unit, unless the taxpayer files with its tax return for the year of the loss an "agreement" that certifies that the loss has not been, and will not be, used to offset the income of any other person for foreign tax purposes.[291] Moreover, the taxpayer must file, with its tax return for each of the fifteen taxable years following the taxable year of the loss, an annual certification that the loss has not been used to offset the income of another person for foreign tax purposes.[292] The regulations set forth a number of recapture triggering events, including the use of the loss by a foreign person, the transfer of the separate unit out of the group, or the failure of the separate unit otherwise to contin-

289. *See id.* § 1503(d); Treas. Reg. § 1.1503-2(c).
290. Treas. Reg. § 1.1503-2(c) (1995).
291. *Id.* § 1.1503-2(g)(2)(i).
292. *Id.* § 1.1503-2(g)(2)(vi).

ue to be included in the group.[293] If there is a triggering event, and no exception is applicable, the taxpayer must recapture and report as gross income the total amount of the loss to which the triggering event applied on its tax return for the year of the triggering event.[294] Interest is imposed on this type of loss recapture and is computed as if the additional tax owed due to recapture had been owed in the taxable year in which the loss originally gave rise to a tax benefit for U.S. tax purposes.[295]

The DCL rules are complex; the associated fifteen year filing requirement is an administrative burden and interest is imposed on recapture of the losses. As a result, these rules could deter a U.S. corporation from structuring foreign operations to permit the pass-through of foreign losses. Nevertheless, the losses will not be recaptured if the partnership does not experience a triggering event. The mere conversion of a hybrid entity by the amendment of its articles from a corporation to a partnership for U.S. tax purposes is not alone a triggering event under the DCL rules. Thus, while such an "incorporation" could cause recapture under Section 367(a) and Section 904(f), if Section 1503 does not apply, no interest will be imposed on the recapture of the losses, and the taxpayer will have enjoyed a net financial benefit from the loss pass-through. Even if Section 1503 recapture could occur with interest, current pass-through of losses is desirable as a hedge against the possibility that the foreign operations will never become profitable.

C. *Foreign Tax Credit Planning*

1. Avoiding the 10/50 Basket in Joint Ventures

The standard structure for international joint ventures between unrelated U.S. and foreign corporations is an entity treated as a partnership for U.S. tax purposes. The foreign corporate form is not selected primarily because Section 904(d)(1)(E) mandates a separate foreign tax credit limitation for dividends from each separate noncontrolled Section 902 corpora-

293. *Id.* § 1.1503-2(g)(2)(iii).
294. *Id.* § 1.1503-2(g)(2)(vii).
295. *Id.* § 1.1503-2(g)(2)(vii)(A).

tion.[296] A noncontrolled Section 902 corporation is a foreign corporation which is not a Controlled Foreign Corporation (CFC) in which the U.S. corporation owns ten percent or more of the voting stock. As previously noted, this separate limitation is commonly known as the "10/50 basket."[297]

Joint venture partners often will each own fifty percent of the joint venture, and neither will control it. Alternatively, the U.S. party may have a voting interest share that is larger than ten percent, but less than fifty percent. In either case, dividends from the joint venture corporation will be isolated in the separate limitation. Worse yet, the limitation applies separately to each corporation so that, even if a U.S. corporation had less than fifty percent interests in many foreign joint venture corporations, it could not average the dividends from those corporations for foreign tax credit limitation purposes. Any excess foreign tax credits generated by the dividends paid by the joint venture could not be used to offset the U.S. tax on the taxpayer's other low-taxed foreign income.[298] By the same token, any excess limitation generated by the dividends could not be used to absorb excess foreign tax credits on other income.[299]

If, however, the joint venture entity is treated as a partnership for U.S. tax purposes, distributions of joint venture profits to the U.S. joint venture partner will not be subject to the 10/50 basket. Instead, as a partner in an entity treated as a partnership for U.S. tax purposes, the U.S. joint venture partner would receive a direct foreign tax credit under Section 901 for its allocable share of the taxes paid by the foreign partnership.[300] The partner's share of income from the partnership normally would fall within the general limitation basket. Thus, even if the foreign partnership pays tax in excess of the partner's U.S. tax rate, the U.S. partner will have an opportunity to use the excess foreign tax credits from the partnership against the U.S. tax on lower-taxed foreign source income in the general basket.[301]

296. I.R.C. § 904(d)(2)(E) (1995).

297. *See* discussion *supra* part III.D.5.

298. I.R.C. § 904(d)(1) (1995).

299. *Id.*

300. *Id.* § 702(a)(6).

301. The partnership anti-abuse rules approved the use of a partnership to avoid the 10/50 basket. *See* Treas. Reg. § 1.701-2(d) (1995) (Example 3).

The interposition of a foreign partnership as owner of the shares of a joint venture corporation does not solve the problem. The Section 904(d) regulations permit the I.R.S. to look-through the partnership to determine the nature of the partners' income for purposes of the separate limitation baskets.[302] Thus, even if a foreign partnership owned 50/50 by the joint venture partners owns all of the stock of a foreign corporation which conducts the joint venture operations, dividends from the corporation included in the income of the U.S. joint venture partner will be dividends from a noncontrolled corporation subject to the 10/50 basket.[303]

An alternative solution to the 10/50 basket problem is to set up the joint venture operations in a corporation, but to cause the corporation to be a CFC. This can be achieved by having the two joint venturers take smaller interests in the corporation and having a jointly-owned U.S. partnership as a third shareholder to a sufficient extent to cause the corporation to be more than fifty percent owned by U.S. Shareholders. Section 951(b) defines a U.S. Shareholder as a U.S. person that owns ten percent or more of the voting stock of a corporation. A U.S. partnership is considered to be a U.S. person for this purpose, without any look-through to the fact that the interests in the partnership are held equally by U.S. and foreign persons.[304] The U.S. partnership's interest, when aggregated with the direct stock ownership of the U.S. joint venture partner, would cause the corporation to be a CFC. CFC status means that the look-through rules of Section 904(d)(3) would apply to determine the foreign tax credit basket of dividends, interest, royalties, and rents paid or deemed-paid by the CFC.[305] Because of the look-through rule, most income of a CFC engaged in an active business will be general basket income and not subject to the 10/50 basket.

The partnership anti-abuse regulations recently promulgated under Section 701 have approved this planning technique using a U.S. general partnership.[306] In order for this structure to give rise to CFC status, however, the partnership-shareholder

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302. *See id.* § 1.904-5(h).

303. *Id.* §§ 1.904-5(h), -4(g).

304. I.R.C. §§ 957(c), 7701(a)(30) (1995). This treatment is an example of the characterization of a partnership as an entity separate from its partners.

305. *Id.* § 904(d)(3)(A).

306. Treas. Reg. § 1.701-2(e) (1995) (Example 3).

must be a U.S. partnership.[307] As a result, the U.S. joint venture partner will have to ask the foreign joint venture partner to hold a portion of its interest in the foreign joint venture corporation through a U.S. partnership. Many foreign joint venture partners will be opposed to any structure that might involve exposure to U.S. tax. Technically, a foreign partner of a U.S. partnership is subject to U.S. taxation only on U.S. source partnership income or partnership income effectively connected with a U.S. trade or business.[308] Nevertheless, even if the U.S. partnership is not engaged in a U.S. trade or business because its activity is limited to holding shares in a foreign corporation, the foreign partner still may be apprehensive about the potential applicability of U.S. taxation.[309]

Many joint ventures are formed as partnerships for reasons other than the 10/50 basket issue, such as a need to pass-through foreign losses, as discussed above. Nevertheless, the enactment of the separate limitation baskets under Section 904(d) in 1986 has made partnerships the preferred form for foreign joint ventures.[310]

The deemed-paid foreign tax credit of Section 902 is available only to corporations that own at least ten percent of the voting stock of the foreign-taxed corporation.[311] Thus, a U.S. joint venture participant owning less than ten percent of the voting stock of the foreign joint venture corporation will not be

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307. *Id.*

308. *See* I.R.C. §§ 881-884 (1995).

309. In such a case, other means of achieving CFC status that do not involve a U.S. partnership might be considered, *e.g.*: (i) if the stock of the foreign joint venture partner is publicly traded, the U.S. joint venturer might consider buying shares of stock in the foreign partner; (ii) the U.S. venturer might acquire an option to purchase enough stock in the joint venture corporation to put its interest over fifty percent, *see* I.R.C. §§ 958, 318 (1995); or (iii) the U.S. venturer might acquire non-voting preferred stock in the joint venture corporation so as to own more than fifty percent by value. If the U.S. venturer's interest is significantly below fifty percent, however, structuring the venture as a partnership may be the only way to avoid the 10/50 basket.

310. Use of a branch is usually not a consideration for joint ventures, because the need of the investors to be able to isolate the operations in a separate entity (for business accounting, legal or regulatory reasons) will require the parties to form a separate legal entity. Inevitably, a form that offers limited liability, but that can be characterized as a partnership for U.S. tax purposes, will be preferred. Even domestically, limited liability companies increasingly are becoming the form of choice for joint ventures between two corporations.

311. I.R.C. § 902(a) (1995).

entitled to a deemed-paid foreign tax credit with respect to the joint venture. If the foreign operations were, instead, conducted in partnership form, a Section 901 direct credit would be available to the U.S. joint venture participant, regardless of the extent of its ownership interest.[312] As a practical matter, however, if the U.S. joint venture participant's interest is less than ten percent, it probably will not have the ability to influence structuring decisions regarding the joint venture.

2. Revenue Rule 71-141: Effect of Interposed Partnership on the Deemed-Paid Credit

In order for a domestic corporation to credit foreign taxes paid by a foreign subsidiary under Section 902, the corporation must own at least a ten percent interest in the voting stock of the foreign subsidiary.[313] As discussed above, a deemed-paid credit is allowed for taxes paid by second or third-tier foreign subsidiaries, but the first and second-tier subsidiaries must own at least ten percent of the voting stock of the second or third-tier subsidiaries, respectively, and the domestic corporation must maintain at least a five percent indirect interest.[314]

In applying the minimum ownership rules of Section 902, taxpayers generally have treated corporate shares held by partnerships as owned proportionately by the partners. This practice is based on Revenue Ruling 71-141, in which two U.S. corporations formed a domestic general partnership, each taking a fifty percent interest.[315] The general partnership owned forty percent of the voting stock of a foreign corporation. The ruling held that each U.S. partner should be treated as owning its share (twenty percent) of the foreign corporation's voting stock. Therefore, each partner was permitted to take a Section 902 credit since each satisfied the ten percent minimum ownership requirement. The logic of the ruling appears to flow from Section 702(a)(6), which provides that each partner must take into ac-

312. *See id.* § 901(a).

313. *Id.* § 902(a). The interest must be held through a direct chain of ownership; ownership by affiliates is not counted for purposes of the ten percent shareholder test. *See* First Chicago Corp. v. Comm'r, 96 T.C. 209 (1991); Rev. Rul. 85-3, 1985-1 C.B. 222.

314. I.R.C. §§ 901(a), 902(b)(3) (1995).

315. Rev. Rul. 74-141, 1971-1 C.B. 211.

count separately its share of foreign taxes.

On January 6, 1995, the I.R.S. issued proposed regulations under Section 902 and, in the preamble, indicated that consideration was being given to restricting the circumstances in which the principle of Revenue Ruling 71-141 would be applied.[316] In the preamble, the Service requested comments on whether the holding of Revenue Ruling 71-141 should be expanded to allow taxes paid by a foreign corporation to be considered deemed-paid by domestic corporations which are partners in domestic limited partnerships or foreign partnerships, members in limited liability companies, and beneficiaries of domestic or foreign trusts.[317] To the great consternation of tax practitioners,[318] the preamble implied that Revenue Ruling 71-141 should be read narrowly to mean that a deemed-paid credit would be available only if the interposed partnership were a domestic, general partnership. The rational for the reservation seems to have been that because creditability hinges upon a ten percent or greater interest in voting stock, a limited partner or LLC member may not be able to exercise the vote directly and, thus, the credit should not be allowed.

Under an aggregate view of a partnership, however, each partner should be considered to own its pro rata share of the shares owned by the partnership. As a result, the character of the shares owned by the partnership (voting or nonvoting) should pass-through to the partner. Under this analysis, the fact that the limited partner in a limited partnership or the member in an LLC does not directly vote the shares does not mean that they should not be considered to own voting shares. Section 702(a) lists a variety of tax items that are to be characterized at the partner level, but none of them are dependent upon the partner directly taking the action that gave rise to the tax item (e.g., paying the expense that gives rise to the deduction). Moreover, Section 702(b) provides that the character of any item included in a partner's distributive share is to be determined as if such item were incurred in the same manner as incurred by the partnership. Accordingly, as long as the partnership has voting

316. INTL-933-86 (Jan. 6 1995), *reprinted in* CCH INCOME TAX REGULATIONS, Vol. 6, ¶ 49,559.

317. *Id.*

318. *See IRS Regulations: Section 902-Foreign Firm Credit: API Objects to "Contraction" of Foreign Tax Credit Regs*, 67 TAX NOTES 472 (1995).

shares in the foreign corporation, the eligibility for the deemed-paid foreign tax credit should be determined as if the partner held voting shares.

D. *Subpart F Planning*

A U.S. Shareholder of a CFC must include in its income its pro rata share of a CFC's Subpart F income even if not distributed to the shareholder.[319] Subpart F income includes foreign base company sales income.[320] Foreign base company sales income, in turn, includes income derived from the purchase of property from any person and its sale to a related person or the purchase of property from a related person and its sale to any person if the property is sold for use outside the CFC's country of incorporation.[321] A corporation is a "related person" if it owns more than fifty percent of the total combined voting power of all classes of stock of the CFC.[322]

In cases in which a U.S. corporation conducts foreign operations indirectly through a CFC which owns a partnership interest, the application of the Subpart F rules raises many questions, the answers to which turn upon whether an entity or aggregate approach to partnership taxation is applied. While the most recent case law developments described below suggest that an entity approach to partnership taxation must be applied in analyzing the Subpart F income of a partner that is a CFC, the 1994 partnership anti-abuse rules infer that a contrary approach may be required.[323] Thus, while the most recent case law on this subject might be read to infer that consideration be given to using a partnership to avoid Subpart F "foreign base company income," the 1994 partnership anti-abuse regulations still appear to make this a questionable planning structure. A more detailed discussion of this issue follows.

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319. I.R.C. § 951(a)(1) (1995).

320. *Id.* § 954(a)(2).

321. *Id.* § 954(d)(1). Such income includes sales and purchases on behalf of a related party, i.e., commission sales. Treas. Reg. § 1.954-3(a)(1)(i) (1995).

322. I.R.C. § 954(d)(3) (1995).

323. Treas. Reg. § 1.701-2 (1995).

1. The Partnership as Base Company: *Brown Group, Inc. v. Commissioner*

In situations where a CFC is a partner in a foreign partnership that conducts activity which would have given rise to Subpart F income had the partnership been a corporation, will the corporate partner be considered to have Subpart F income? Authority for an aggregate analysis is found in Section 702(a)(8) which provides that each partner must separately take into account the partner's distributive share of items that, if separately taken into account by any partner, would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately.[324] The character of separately stated items is determined as if such items were realized in the same manner as incurred by the partnership.[325]

Revenue Ruling 89-72 represented the Service's initial position on this issue.[326] In that ruling, a domestic corporation, P, manufactured machines in the United States. It had a wholly-owned Country Y subsidiary, S, and a CFC, which owned a twenty-five percent interest in PRS, a partnership organized in Country X. PRS purchased machines from P for sale and use in Country X. If S had directly sold the machines purchased from P in Country X, such income would have been foreign base company sales income to S. The I.R.S. relied on Section 702(b) in characterizing the distribution to S as if it were realized directly by S from the source from which it was realized by the partnership. Thus, the I.R.S. held that S's distributive share of PRS's income earned from the sale of machines purchased from P was to be treated as foreign base company sales income.

324. I.R.C. § 702(a)(8) (1995); Treas. Reg. § 1.702-1(a)(8)(ii) (1995).
325. I.R.C. § 702(b) (1995); Treas. Reg. § 1.702-1(b) (1995).
326. Rev. Rul. 89-72, 1989-1 C.B. 257.

In *Brown Group Inc. v. Commissioner* (*Brown Group I*),[327] a publicly traded domestic corporation was the common parent of an affiliated group of corporations which filed consolidated returns for U.S. income tax purposes.[328] Brown Group International (International), a Delaware corporation, was one of its subsidiaries. International owned 100 percent of Brown Cayman, a CFC in the Cayman Islands.[329] Thus, International was a U.S. Shareholder within the meaning of Section 951(b).[330]

Brown Cayman had an eighty-eight percent interest in the net profits and losses of Brinco, a Cayman Islands partnership. Brinco acted as a purchasing agent for International and received a ten percent commission based on the purchase of footwear manufactured in Brazil.[331] The footwear was sold primarily in the U.S. and International included the commissions paid to Brinco in its cost of goods sold.[332] As a partnership, Brinco could not be a CFC and was not related to International under Section 954(d)(3).[333] If Brown Cayman had directly purchased the footwear on behalf of International, the commissions income would have been foreign base company sales income to Brown Cayman. The sole issue in dispute was whether Brown Cayman's distributive share of partnership income from Brinco was Subpart F income includible in the consolidated gross income of the Brown Group, Inc.[334]

In the first Tax Court decision under *Brown Group I*, Judge Jacobs held that Brown Cayman's distributive share of the Brinco partnership income was not Subpart F income with respect to Brown Cayman or International.[335] Judge Jacobs determined that Brinco was not a CFC and, thus, its income was Subpart F income to Brown Cayman only if the existence of

327. 102 T.C. 616 (1994), No. 104-92, 1994 U.S. Tax Ct. LEXIS 26, at *2, *withdrawn* Sept. 27, 1994. *Brown Group, Inc. v. Comm'r* has been deleted from the official Tax Court Reporter and, thus, must be obtained through an unofficial tax service.

328. *Brown Group*, 1994 U.S. Tax Ct. LEXIS at *2.

329. *Id.* at *3.

330. *Id.*

331. *Id.* at *5.

332. *Id.*

333. *Id.* at *10.

334. *Id.* at *2.

335. *Id.* at *11.

Brinco as an entity was ignored.[336] He asserted that Brinco was not a "sham"[337] and the character of Brown Cayman's distributive share of Brinco's income should be determined at the partnership level.[338]

Because the Subpart F provisions were silent, Judge Jacobs supported the entity approach by looking to other sections of the Code that characterize income at the partnership level.[339] The court noted that the character of income from the sale of property is determined at the partnership level.[340] Furthermore, the determination of whether an expense is deductible is dependent upon partnership motive and not by the motive of partners in joining the partnership.[341] The partnership level must first be examined in deciding whether a prepayment of interest results in a distortion of income.[342] The court also noted that the regulations interpreting Section 954(f), which explicitly adopt the aggregate approach, are the exception and "the entity theory of taxation is the general rule of Subpart F of the Code."[343]

Applying the entity approach, the court noted that Brinco could not earn Subpart F income because it is not a CFC.[344] Moreover, the commission income was not Subpart F foreign base company sales income because, under former Section 954(d)(3), Brinco was not a related person to either Brown Cayman or International.[345] Under Section 702(b) and the regulations thereunder, the character of the income earned by Brinco remains the same in the hands of Brown Cayman.[346] Because the income was not Subpart F income to Brinco, it could not be Subpart F income to Brown Cayman.[347] The court

336. *Id.* at *15-16.

337. Brinco was structured as a partnership to provide flexibility in the previously independent purchasing agents' salary, to provide entrepreneurial interests in Brinco's operations, and to permit the partners to avoid Brazilian currency controls and currency fluctuations. *Id.* at *4.

338. *Id.* at *16.

339. *Id.* at *19.

340. *Id.* at *20 (citing U.S. v. Basye, 410 U.S. 441 (1973)).

341. *Id.* at *21 n.2 (citing Simon v. Comm'r, 830 F.2d 499, 506-07 (3d Cir. 1987)).

342. *Id.* at *26 (citing Resnik v. Comm'r, 66 T.C. 74, 81 (1976)).

343. *Id.* at *29.

344. *Id.* at *30.

345. *Id.* at *11.

346. *Id.* at *30.

347. *Id.*

found that Revenue Ruling 89-72 was incorrect as a matter of law.[348]

In a move necessary "to avoid frustrating the purpose of Congress in enacting Subpart F," the Tax Court reviewed and reversed its earlier withdrawn decision in a second decision: *Brown Group, Inc. v. Commissioner*[349] (*Brown Group II*). In *Brown Group II*, Judge Halpern, writing for the majority, noted that the objective of Subpart F is to remove tax deferral benefits of "tax haven" devices.[350] In its result-oriented decision, the majority opinion stated that an entity approach "would lead to just the type of siphoning of profits that Congress was concerned with when it subjected foreign base company income to the conduit treatment of Subpart F."[351] Thus, the court held that International must take into account its pro rata share of Brown Cayman's Subpart F income to determine its federal income tax liability. The majority looked to the tax liability of International to determine whether Brinco had to state separately its commission income which could constitute Subpart F income to International. Without reading the Code literally, the majority held that the commission income must be separately stated "[t]o give effect to section 702(a)(7) and section 1.702-1(a)(8)(ii), Income Tax Regs., and to avoid frustrating the purpose of Congress in enacting Subpart F."[352]

In applying the aggregate approach, the majority opinion stated that the partnership is ignored and the individual partners take account of such income as if they had earned it directly.[353] Accordingly, it is reasoned that Brown Cayman should be put into the shoes of Brinco for determining whether Brown Cayman was earning commission income on sales by third parties to International.[354] The court held that Brown Cayman had commission income derived in connection with the purchase of personal property on behalf of International, that the commissions were Subpart F income, and that International must in-

348. *Id.*
349. 104 T.C. 105 (1995).
350. *Id.* at 114.
351. *Id.* at 116.
352. *Id.* at 114.
353. *Id.* at 117-18.
354. *Id.* at 119.

clude in its gross income this Subpart F income.[355]

The majority sought further support from the definition of the Subpart F income at issue, foreign base company sales income, defined in Section 954(d)(1) as "income (whether in the form of profits, commissions, fees, or otherwise) derived *in connection with* . . . the purchase of personal property from any person on behalf of a related person . . . ."[356] Using the broad dictionary definition of "in connection with" as "logically related," the majority held that Brown Cayman's distributive share of partnership profits was connected to and dependent on purchases made on behalf of a party related to Brown Cayman.[357] Thus, the Tax Court appears to have based its analysis and conclusions with respect to international partnership structures on general notions of Congressional intent, which may not always be clear or apparent to taxpayers.

In the dissent to *Brown Group II*, Judge Jacobs stuck to his earlier withdrawn decision, but acknowledged that acceptance of his position would result in a tax windfall to the taxpayer because International would be able to deduct the commissions paid to Brinco as cost of goods sold and Brown Cayman's distributive share of commissions would not be taxed.[358] The dissent noted, however, that the I.R.S. had probably already closed the loophole for partnership transactions that occur on and after December 30, 1994, by its promulgation of the partnership anti-abuse regulations.[359] If these anti-abuse rules had been in effect for the years in question in this case, the dissent alluded that such regulations would have been applied.[360]

However, on January 25, 1996, the first anniversary of the *Brown Group II* decision, a new chapter in the Brown Group, Inc. saga arrived with the filing of the Eighth Circuit's appellate decision that reversed and vacated the Tax Court's decision in *Brown Group II*. Based upon the court's reasoning, it appears that there will be further rulings on this issue. This third decision in *Brown Group, Inc. v. Commissioner*[361] (*Brown Group*

355. *Id.* at 121.
356. *Id.* at 119 (emphasis added by the court).
357. *Id.* at 120.
358. *Id.* at 139.
359. *Id.* at 140.
360. *Id.*
361. No. 95-2110, 1996 U.S. App. LEXIS 910, at *1 (8th Cir. 1996).

III) adopted the reasoning and holding of Judge Jacobs' January 25, 1995 dissenting opinion from the Tax Court's en banc ruling in *Brown Group II*.[362] The U.S. Court of Appeals for the Eighth Circuit[363] held:

> that a [CFC] partner's distributive share of foreign partnership income cannot be deemed to be 'Subpart F income' where the commissions [earned by the partnership as the foreign purchasing agent for a U.S. Shareholder of the CFC partner] did not constitute 'Subpart F income' under the pre-1987 [definition of 'related person' under Section] 954(d)(3) . . . .[364]

The Eighth Circuit reached this decision seemingly on the basis of two principal holdings. First, the court determined that a foreign partnership which was controlled by (but did not control) a CFC could not be considered a "related person" with respect to the U.S. Shareholder (on whose behalf the partnership was acting as the foreign purchasing agent) under the pre-1987 version of Section 954(d)(3)(A).[365] Second, the court explicitly held that "the Tax Court erred in ignoring the partnership entity."[366] In *Brown Group II*, the majority opinion had applied the "aggregate theory," rather than the "entity theory" of partnership taxation, in order to be able to treat the CFC partner as earning the commission income directly for purposes of applying the foreign base company sales income definition of Section 954(d)(1). Thus, the Eighth Circuit explicitly rejected the "aggregate theory" for purposes of determining the character of the partnership's income.[367]

As a result, the court reasoned that the commissions earned by the foreign partnership could not possibly be Subpart F income under Section 954(d)(1) because (i) the partnership was not a related-party and (ii) since the income characterization has to take place at the partnership level (under the "entity theory")

362. *Id.* at *10. Judge Jacobs originally had been the author of the majority decision in Brown Group I, reversed in Brown Group II.

363. Senior Circuit Judge Leonard I. Garth, sitting by designation from the Third Circuit, authored the opinion for a unanimous three judge panel.

364. *Id.* at *1.

365. *Id.* at *10-11.

366. *Id.* at *10.

367. *Id.* at *12-13. (citing U.S. v. Basye, 410 U.S. 441 (1973)).

and since the partnership (at least in this case) was not a corporation, the commission income cannot be considered received by a CFC.[368] In fact, this latter point is emphasized wherein the court observed that "even if we were to accept the I.R.S.'s broad interpretation of 'related person,' it is irrelevant to the present inquiry because [the partnership] is not a controlled foreign corporation, and therefore its income, whether earned on behalf of a 'related person' or not, cannot be characterized as Subpart F income."[369]

Thus having seemingly premised its ultimate holding on both of the foregoing findings, the court went on, somewhat incongruously, to observe:

> Although our holding may result in a tax windfall to the Brown Group due to the particularized definition of 'related person' under the pre-1987 version of section 954(d)(3) . . . , such a tax loophole is not ours to close but must rather be closed or cured by Congress. Indeed, Congress has done just that. It closed this loophole the following year, in 1987, when it amended section 954(d)(3) to broaden the definition of 'related person' to include not only partnerships that control CFCs but also those that are controlled by CFCs or their parents . . . . Because the 'loophole' in Subpart F taxable income has been closed, the issue that arises in the present case is unlikely to occur again.[370]

In other words, the court appears to state that the aforesaid 1987 change in the definition of "related party" under Section 954(d)(3) should serve to close the "tax loophole" and, thus, presumably preclude future "tax windfalls." However, in its earlier analysis and discussion — set forth most starkly in the above quote from footnote 6 — the court suggested that it would have to reach the same holding even if the partnership was a "related party" because the partnership, by definition, is not a CFC.[371] As a consequence, the apparent foundations for the case's ultimate holding are muddied by this latter discussion regarding the 1987 amendment of Section 954(d)(3) and its alleged loophole closing effects.

368. *Id.* at *10-12.
369. *Id.* at *11 n.6.
370. *Id.* at *15-17 (citations omitted).
371. *Id.* at *11.

The court also observed (as did Judge Jacobs) that the partnership anti-abuse regulations[372] will permit the I.R.S. to recast partnership transactions that make inappropriate use of Subchapter K rules and, in particular, can treat a partnership as an aggregation of its partners, in whole or in part, as appropriate to carry out the purpose of any provision of the Code or regulations, presumably including Subpart F, but only with respect to transactions occurring on or after December 29, 1994.[373]

As quoted above, the court suggested that the purported "tax loophole" can only be "closed or cured by Congress" and, after observing the Section 954(d)(3) "related person" definitional change in 1987 allegedly does so, inexplicably goes on to suggest that the partnership anti-abuse regulations were endorsed by Congress "for transactions occurring on and after December 30, 1994, Congress for the first time has apparently permitted, *in special circumstances not relevant here.*"[374] Presumably, this statement is supposed to infer that if the 1987 Section 954(d)(3) "related person" definitional change did not close the loophole, then arguably Congress has sanctioned the I.R.S. doing so for post-1994 years. However, given the factual finding, pursuant to the parties' stipulation, that the partnership was not a "sham," it is not entirely clear that this court would find the "special circumstances" present to permit the I.R.S. to pursue its aggregate approach for recasting the Subpart F type transaction in this case.

Accordingly, the technical legal signals which *Brown Group III* sends for future tax planning in this area are, at best, mixed, although the principal message seemingly should be interpreted to proceed with extreme caution. This apparent uncertainty is, of course, only exacerbated by the 1994 partnership anti-abuse regulations briefly mentioned above. Thus, the totality of the *Brown Group III* decision, the partnership anti-abuse provisions, and various related revenue rulings[375] suggest that, at a mini-

372. *See* Treas. Reg. § 1.701-2 (1995).

373. Brown Group, Inc., No. 95-2110, 1996 U.S. App. LEXIS 910, at *17 (8th Cir. 1996).

374. *Id.* (emphasis added). The original text of this decision was amended on Feb. 6, 1996, with the issuance of revised pages 12 and 13 of the opinion, wherein the explicit statement that *Congress had issued* the partnership anti-abuse regulations under Section 1.701-2 was deleted.

375. *See, e.g.*, Rev. Rul. 89-72, 1989-1 C.B. 257; Rev. Rul. 90-112, 1990-2 C.B.

mum, the use of a partnership in an international context will be subject to considerable scrutiny. Moreover, notwithstanding the specific taxpayer victory in *Brown Group III* for a pre-1987 tax year, it would seem most prudent to interpret *Brown Group III* as providing that when an intermediary CFC owns a foreign partnership interest, the structure must be planned so as to avoid Subpart F income by applying all the Subpart F rules and exceptions at the CFC partner level as though the income or activity had been carried on directly by the CFC.

2. Conversion of Subpart F Income to Non-Subpart F Income

For purposes of the anti-deferral provisions of Subpart F, Section 954(c) defines Foreign Personal Holding Company (FPHC) income to include dividends, interest, royalties, rents, and annuities.[376] If a CFC receives dividends from a foreign corporation engaged in an active business in a different country, the dividends ordinarily will constitute FPHC income.

If the payor foreign corporation, instead, were organized as a partnership, the CFC's distributive share of partnership income would not constitute FPHC income. The Subpart F character of the distributive share would be analyzed by looking through to the activities of the partnership.[377] If the partnership is not engaged in transactions giving rise to "foreign base company income," the CFC's distributive share of that income should not be Subpart F income.

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186 (U.S. real property owned by partnership which has a CFC as a partner constitutes U.S. property held by the CFC for purposes of I.R.C. § 956(b) (1995)); Rev. Rul. 91-32, 1991-1 C.B. 107 (aggregate approach used to determine source of foreign partner's gain or loss on disposition of partnership interest).

376. I.R.C. § 954(c)(3) (1995). Dividends and interest from a related corporation in the same country are excluded for this purpose.

377. *Id.* § 702(a)(8), (b); Treas. Reg. § 1.702-1(b) (1995); *but see supra* text accompanying notes 320-78.

E. *Collateral Issues in Using Partnerships in Outbound Planning*

1. Dispositions of Foreign Partnership Interests by U.S. Partners

The tax treatment of the disposition of a partnership interest generally is covered by Sections 741 and 751, pursuant to which the gain on disposition typically will be capital gain, except to the extent the partnership has unrealized receivables and substantially appreciated inventory.[378] The U.S. partner's tax issues on disposition are not exceedingly complex because the U.S. partner will be subject to tax on all its worldwide income.[379] The most interesting issue normally will be the source of any income or gain recognized on the disposition. The source will be relevant for purposes of determining the availability of a foreign tax credit for any foreign taxes paid on the disposition or, even if no foreign taxes are paid on the disposition, the impact of the income or gain on the U.S. seller's Section 904 foreign tax credit limitation for foreign taxes paid with respect to other operations.[380]

Moreover, Section 865 provides a general rule that income from the sale of personal property is sourced according to the seller's residence.[381] If a partnership is viewed as an entity, the disposition of a partnership interest by a U.S. partner, therefore, would result in only U.S. source income. On the other hand, if the partnership is viewed as an aggregate and one looks through the partnership to determine the nature of the assets, the exceptions to the general rule of Section 865 would apply to source

378. I.R.C. § 751(a) (1995).

379. *Id.* § 61(a).

380. *Id.* § 904(a).

381. *Id.* § 865(a). Section 865(j) gives the Commissioner authority to promulgate regulations regarding sourcing of losses. In the absence of such regulations, losses appear to be allocable under Treas. Reg. § 1.861-8(e)(7) (1995), which provides that loss on the sale of a capital asset is allocable to the class of gross income to which the asset ordinarily gives rise in the hands of the seller. As described below, sale of a partnership interest may give rise to Subpart F FPHC income and, thus, passive basket income for Section 904 purposes. If so, one could take the position that loss on the disposition of such a partnership interest is allocable against foreign source passive income.

the gain under the specific rules provided for inventory property, depreciable property, the sale of intangibles, and the sale of property by offices or fixed places of business.[382]

Section 865(i)(5) provides that, in the case of a partnership, "except as provided in regulations, this section shall be applied at the partner level."[383] Thus, for residency testing, one looks to the residence of the partner, not the residence of the partnership. This rule does not, however, answer the question of whether the sourcing rules are applied to the interest or by examining the separate assets comprising the interest.

On this point, a look-through approach seems most sensible. First, the residence-based rule would give rise to only U.S. source income when a U.S. partner disposes of an interest in a foreign partnership with entirely foreign operations; this result seems uncharacteristically obtuse even for the U.S. tax system. Second, the Service has applied a look-through approach in examining dispositions by foreign partners of interests in partnerships with U.S. assets.[384]

Section 865(e)(1)(A) and (B) override the general rule of residence-based sourcing of Section 865(a) for income derived from sales attributable to a foreign office. Section 865(e)(1) permits foreign sourcing of gain attributable to the foreign office or other fixed place of business of a U.S. resident, provided that the gain is subject to foreign tax of at least ten percent. In general, a partner is considered to have a foreign office or other fixed place of business if the partnership has one.[385] Section 865(e)(1) requires that the gain be attributable to the foreign office. In cases in which the foreign partnership has no U.S. assets or activity, disposition of an interest in the partnership apparently would give rise to gain attributable to such foreign office. Section 865(e)(1)(B) provides that, in order to qualify as foreign source income, the income must be taxed by the foreign country at the rate of at least ten percent. Assuming this test is met, therefore, foreign source gain from the disposition of a partnership interest would be possible to the extent attributable

382. *Id.* § 865(b)-(e).

383. *Id.* § 865(i)(5).

384. *See* Rev. Rul. 91-32, 91-1 C.B. 107.

385. Donroy, Ltd. v. U.S., 301 F.2d 200 (9th Cir. 1962); Unger v. Comm'r, 58 T.C.M. (CCH) 1157 (1990), *aff'd*, 936 F.2d 1316 (D.C. Cir. 1991).

to a foreign office. The Service has applied this exception to a partnership in a private letter ruling.[386] Nevertheless, a statutory look-through analysis has not been adopted for purposes of sourcing all varieties of gain from the sale of personal property by partnerships, despite legislative proposals to that effect in 1990 and 1991.[387]

Apart from the source of gain on disposition of a partnership interest, the Subpart F treatment of the gain on disposition of a partnership interest should also be examined. Section 954(c)(1)(B)(ii) provides that Subpart F FPHC income includes the excess of gains over losses from the sale or exchange of certain classes of property, including an interest in a partnership. This is a surprising rule given congressional intent that Subpart F FPHC income include net gains on the disposition of noninventory property that gives rise to passive income or is not income-producing.[388] An alternative view would be that Subpart F FPHC income would arise only to the extent the assets of the partnership were of a type that would give rise to such gain. Nevertheless, the plain language of the statutory provision is indisputable.

A question also arises as to the appropriate treatment for Section 904 foreign tax credit limitation basket purposes of gain on the sale of a partnership interest. As described above, gain from the sale of a partnership interest would be treated as Subpart F FPHC income. Section 904(d)(2)(A)(i) provides that income is treated as passive basket income for purposes of Section 904 if it is of a kind that would be FPHC income. Therefore, since the gain from the disposition of a partnership interest apparently would be characterized as Subpart F FPHC income, the passive basket becomes applicable for purposes of Section 904. Even though a look-through approach would seem appropriate, especially for partners with ten percent or greater interests in the partnership, the statutory provisions appear to preclude

386. *See* CCH IRS LETTER RULINGS REPORTS No. 764, Oct. 23, 1991, LTR 9142032 (July 23, 1991), in which the Service rules that foreign source treatment will be available for gain of a U.S. partner on its sale of a partnership interest to the extent the gain was found to be attributable to the foreign office.

387. H.R. 5442, 101st Cong., 2d Sess. § 6 (1990); H.R. 2948, 102d Cong., 1st Sess. § 10 (1991).

388. STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, H.R. DOC. NO. 3838, 100th Cong., 1st Sess. 965 (1987).

such an approach.[389]

2. Transfers of Appreciated Property to Foreign Partnerships

a. Section 1491 Excise Tax on Outbound Transfers

Section 721(a) provides that no gain or loss shall be recognized to a partnership or any of its partners in the case of contribution of property to the partnership in exchange for an interest in the partnership. Under Section 1491, however, an excise tax of thirty-five percent of any unrealized appreciation is imposed on the transfer of appreciated property to a foreign partnership by a U.S. person. Section 1491 states that it applies to any transfer of appreciated property to a foreign partnership.[390] In addition to contributions to capital, apparently it also was intended to apply to installment sales to foreign partnerships.[391] In addition, this excise tax will apply to constructive outbound transfers deemed to arise upon (i) conversion of a foreign corporation to a partnership by amendment of its articles;[392] and (ii) technical termination of a foreign partnership under Section 708 which gives rise to a deemed distribution and recontribution of assets.[393]

The consequences of imposition of tax under Section 1491 can be extremely harsh. Because the tax is an excise tax, its imposition does not give rise to gain recognition and, thus, the transferee partnership does not receive a basis step-up to fair market value and the transferor's basis in its partnership interest is not stepped-up.[394] Moreover, because the Section 1491 tax is an excise tax, income tax credits and net operating losses that might reduce income tax or taxable income are, by definition, inapplicable to reduce the excise tax.

389. Prop. Reg. § 1.904-7(i)(1) (1987) provided for a look-through approach, but current regulations require passive basket treatment. *See* Treas. Reg. § 1.904-5(h)(3) (1995).

390. I.R.C. § 1491 (1995).

391. S. REP. NO. 938, 94th Cong., 2d Sess. 223 (1976).

392. *See* Priv. Ltr. Rul. 92-52-033 (Dec. 31, 1992).

393. *See* Rev. Rul. 80-293, 1980-2 C.B. 128; Priv. Ltr. Rul. 84-01-052 (Oct. 5, 1983).

394. *See* I.R.C. §§ 723, 1012 (1995).

b. Exceptions to Application of Section 1491

Section 1492 contains an exception which provides that an excise tax will not be imposed if the transferor elects to treat the transfer as a sale under Section 1057 or elects to apply the "principles of Section 367."[395] An election to apply Section 1057 would cause the transfer to be treated as a sale and give rise to gain recognition, but it also would give the partnership a basis in the property equal to the value. Alternatively, Section 1491 could be avoided by an actual sale, but an actual sale would require documentation that is unnecessary if a Section 1057 election is made and such a sale would not give the transferor a heightened basis in its partnership interest. Alternatively, as discussed below, an election to apply the principles of Section 367 will avoid the application of Section 1491.

c. Method of Election

Section 1492(2)(B) provides that the election to apply the principles of Section 367 must be made on or prior to the date of the transfer, a requirement that takes many U.S. taxpayers by surprise. If the Section 1492 election is not made in a timely manner, however, Section 1494(b) permits the Service to issue regulations to abate, remit, or refund the excise tax if the taxpayer, after the transfer, elects to apply principles similar to the principles of Section 367. The regulations currently make no provision for recoupment of the tax, however.[396] Section 1057 provides that the election to treat a transfer as a sale or exchange shall be made at such time and in such manner as the Secretary may prescribe. Pursuant to regulations, this election need only be made with the taxpayer's return for the tax year in which the transfer occurred.[397]

395. *Id.* § 1492 (1995).
396. *See* Treas. Reg. § 1.1494-1 (1995).
397. *See id.* § 301.9100-12T.

d. Election to Apply Principles of Section 367

Section 1492 provides that Section 1491 shall not apply if the taxpayer elects to apply the principles of Section 367 to the transfer. Regulations have never been promulgated describing how to apply the principles of Section 367 to a transfer to a foreign partnership. Presumably, the election triggers the application of Section 367(a) regarding the tax-free transfer of assets used in a foreign active trade or business and the principles of Section 367(d) regarding recognition on transfers of intangibles.

Under Section 367(a), gain is not recognized on the transfer of certain specified property to a foreign corporation for use in the corporation's active conduct in a trade or business outside the United States. The active trade or business exception does not apply to certain tainted assets, such as inventory, accounts receivable, and foreign currency denominated instruments.[398] Transfers of stock in foreign subsidiaries are subject to separate rules, pursuant to which such transfers generally will be tax-free if gain recognition agreements are executed.[399]

If intangibles are contributed to a foreign venture, the U.S. contributor is treated under Section 367(d) as if the intangibles were sold for annual payments contingent on productivity of the intangible. The intangible property covered by Section 367(d) is defined as "knowledge, rights, documents and any other intangible within the meaning of Section 936(h)(3)(B) that constitutes property for purposes of Section 332, 351, 354, 355, 356 or 361."[400] Under Section 936(h)(3)(B), intangible property is, in turn, defined to mean any patent, invention, formula, process, design, pattern, or know-how; copyright, literary, musical, or artistic composition; trademark, tradename or brand name; franchise, license or contract; method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or any similar item which has substantial value independent of the services of any individual.

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398. I.R.C. § 367(a)(3)(B) (1995); Treas. Reg. § 1.367(a)-5T (1995).
399. *See* I.R.S. Notice 87-85, 1987-2 C.B. 395.
400. Treas. Reg. § 1.367(a)-1T, (d)(5)(i), (d)-1T, (b) (1995).

e. *Planning for Outbound Transfers of Intangible Property*

If Section 367(d) applies to an outbound transfer of intangible property, the amount recognized from the deemed-sale in exchange for contingent payments is U.S. source ordinary income which, as discussed above, is usually detrimental from a foreign tax credit planning perspective.[401] If, however, the intangible property is made available to the foreign partnership by a license, rather than by a sale, the royalty income will be foreign source income.[402] If an election is made to treat the transfer as a sale for payments that are contingent on the productivity, use or disposition of the intangible, the sales proceeds will be foreign source income under Section 865(d).[403] Accordingly, it normally will be preferable to either license intangibles or sell them for a contingent price, rather than accept a deemed-sale for contingent payments under Section 367(d). A license may be preferred over a sale if deductions for royalty payments are available to the foreign partnership.

Alternatively, consideration might be given to avoiding the outbound transfer issue by transferring the intangible assets to a U.S. partnership owned by the joint venturers, rather than a foreign partnership. If the U.S. partnership subsequently licenses the intangibles to a foreign partnership owned by the same joint venturers, there will have been no outbound transfer. Such a structure also would avoid the application of Section 1491 and Section 367(d) and would give rise to foreign source income from royalties. Implementation of this structure hinges, though, on the foreign partner's willingness to enter into a U.S. partnership with the accompanying potential exposure to U.S. tax.

f. *Redundancy of Section 1491*

The need for the Section 1491 tax in the context of transfers to foreign partnerships is highly questionable. Given that a partnership is a pass-through vehicle, such that earnings of a foreign partnership flow through and are immediately taxable to

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401. I.R.C. § 367(d)(2)(C) (1995).
402. *Id.* § 862(a)(4).
403. *Id.* § 865(d)(1)(B).

the U.S. partners without deferral, the potential abuse originally targeted by Section 1491 (removal of income-generating assets outside the U.S. tax net) would not appear to be present. Moreover, even if the foreign partnership presents an opportunity for abuse, perhaps by allocations to a foreign partner affiliate, the rules of Section 704(c) should force the allocation of the built-in gain back to the contributor, in which case Section 1491 again appears to be redundant.

Section 704(c) applies to contributions of appreciated or depreciated property to partnerships and provides that income, gain, loss, and deductions with respect to property contributed by a partner must be shared among all partners to take account of the variation between the partnership basis in the property and its fair market value at the time of contribution. Section 704(c) and the regulations promulgated thereunder require that, upon disposition of the property by the partnership, the resulting gain or loss must be allocated to the contributor partner to the extent it existed at the time of contribution.[404] Section 704(c) has a more complicated aspect, however, which is a requirement that amortization or depreciation deductions with respect to the contributed property are required to be allocated in a manner other than the basic sharing agreement of the partners in order to reduce the basis-fair market value discrepancy. Thus, Section 704(c) allocates tax items generally to the noncontributor partner.[405] The Section 704(c) regime has become increasingly refined with the promulgation of extremely thorough regulations, circumscribed by a reasonableness standard and containing an internal anti-abuse rule.[406] As a result, the Section 704(c) rules should prevent any arguable potential for the offshore shifting of taxable income and gain.

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404. *See* Priv. Ltr. Rul. 91-03-033 (Oct. 23, 1990) (outbound contribution of stock to a partnership held not to give rise to gain recognition at the time of the initial transfer, but requiring gain recognition upon subsequent disposition pursuant to Section 704(c)).

405. The regulations promulgated under Section 704(c) permit the partnership to select one of three methods for making such depreciation allocations. The selection of the method and its impact on the tax positions of the parties is beyond the scope of this article. *See* Javaras, *supra* note 271, at 810, for a discussion of the application of Section 704(c) allocations in an international context.

406. *See* Treas. Reg. § 1.704-3 (1995).

The Revenue Reconciliation Bill of 1995[407] would have repealed the Section 1491 excise tax on outbound transfers. In its place, the bill would have required the full recognition of gain on a transfer of property by a U.S. person to a foreign corporation or to a foreign partnership. Under the bill, however, regulations were to be issued under principles similar to the principles of Section 367 and would apply to any such transfer in lieu of recognition.

Regulations also could be prepared under which recognition of gain would not be triggered by Section 1491 in cases where "the Secretary is satisfied that application of other code rules (such as those relating to partnerships or trusts) would prevent the avoidance of tax consistent with the purposes of the bill."[408] This may be a reference to the fact that Section 704(c) may require recognition in certain circumstances. The Ways and Means Committee Report on the bill provides that it is anticipated that, prior to the promulgation of regulations, the Secretary will continue to permit taxpayers to elect to apply the principles of Section 367, rather than the Section 1491 excise tax, "provided that the election is made by the time for filing the income tax return for the taxable year of the transfer."[409] This leniency, if implemented by the I.R.S., would mean that elections would not be required on or before the time of the transfer. However, if Section 1491 is not repealed, at a minimum, the interaction of the principles of Sections 1491, 704(c) and 367 should be clarified in regulations.

F. Summary of Partnership Considerations

In summary, it is clear that partnership forms have an important role to play in the U.S.-based multinationals tax planning for Latin American operations, despite the practical problems sometimes encountered in achieving partnership treatment under U.S. classification rules. Although partnerships taxable as such in Latin American jurisdictions are only now gaining accep-

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407. As reported out of the Ways and Means Committee on September 25, 1995, § 14,423, *reprinted in* CCH STD. FED. TAX RPTS. EXTRA EDITION No. 44 (Oct. 3, 1995).

408. *Id.* at 285.

409. *Id.* at 284.

tance, the use of hybrid entities is becoming increasingly popular in achieving the appropriate blend of U.S. and local tax results for the U.S.-based multinational business and should be carefully weighed in light of the above U.S. tax considerations.

VI. OTHER U.S. TAX ISSUES

A. *Blocked Income*

Many Latin American countries have laws prohibiting the payment of certain types of income to foreigners, known as blocked income. Such laws sometimes prevent U.S. multinationals from receiving payments, such as royalties, from their Latin American subsidiaries. In addition to the financial problems that may result from blocked income, U.S. multinationals face the possibility that the I.R.S. may allocate the blocked income to the U.S. parent company despite the fact that local law precludes the parent from receiving the income.

Section 482 authorizes the I.R.S. to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more commonly controlled companies. The I.R.S. takes the position that it can allocate income among commonly controlled taxpayers under Section 482 despite the fact that such income may be blocked income.[410] In contrast, taxpayers have argued that allocations of blocked income are beyond the scope of Section 482, because local restrictions prevent a taxpayer from exercising the control necessary for the application of Section 482 to the allocated income.

In 1968, the Treasury Department promulgated regulations which provided that the I.R.S. could use Section 482 to allocate blocked income. Treasury Regulations Section 1.482-1A(d)(6) allowed a taxpayer to elect to defer reporting an allocation of blocked income, provided the taxpayer also deferred the deduction of costs associated with such income.[411]

Taxpayers have won a number of cases involving the allocation of blocked income. In *First Security Bank of Utah v. Com-*

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410. *See* Robert H. Aland, *Can IRS Use Section 482 to Allocate Income which Cannot be Earned under Applicable Law?*, 52 J. TAX'N 220 (1980).

411. *See* Treas. Reg. § 1.461-1(a)(4) (1995).

missioner,[412] the Supreme Court held that the I.R.S. could not allocate insurance-related income from a credit life insurance company to a related banking corporation, where the bank was prohibited under banking law from receiving insurance income.[413] The Court held that Section 482 did not apply to the allocation, because legal restrictions prevented the taxpayer from having the degree of control required for Section 482 purposes.[414]

In *Procter & Gamble Co. v. Commissioner*,[415] the Sixth Circuit held that Spanish government restrictions on the payment of technology royalties to related-parties precluded an allocation of income under Section 482 to a U.S. licensor.[416] Moreover, the court held that Treasury Regulations Section 1.482-1A(d)(6) did not apply with regard to the allocation, because Section 482 was inapplicable in the absence of an exercise of common control.[417] In this regard, the court stated that the regulation was intended to apply only to temporary restrictions, and that the prohibition at issue was viewed as permanent (or at least of indefinite duration).[418] The Sixth Circuit also held that whether a law is domestic or foreign is irrelevant if it prohibits a taxpayer's receipt of income.[419]

The blocked income issue was addressed most recently in *Exxon Corp. v. Commissioner*.[420] *Exxon* involved a Saudi Arabian crude oil resale pricing restriction put into effect by the Saudi government during a period in which Saudi crude oil was priced below other comparable crude oils (commonly referred to as the "Aramco Advantage").[421] The restriction prohibited the sale of Saudi crude for an amount in excess of the official Saudi selling price.[422] The Tax Court considered whether the restriction, and taxpayers' compliance with it, prevented the I.R.S.'s proposed allocation of profits between related buyers and sellers of Saudi

412. 405 U.S. 394 (1972).
413. *Id.*
414. *Id.*
415. 961 F.2d 1255 (6th Cir. 1992), *aff'g* 95 T.C. 323 (1990).
416. *Id.*
417. *Id.*
418. *Id.*
419. *Id.*
420. 66 T.C.M. (CCH) 1707 (1993).
421. *Id.*
422. *Id.*

crude oil.[423] The court held that the I.R.S. could not make an allocation under Section 482, based on the principles enumerated in *First Security Bank* and *Procter & Gamble*.[424]

In 1994, the Treasury Department promulgated new regulations under Section 482 (1994 Regulations).[425] Treasury Regulations Section 1.482-1(h)(2)(ii) defines a foreign legal restriction as a restriction that is publicly promulgated and generally applicable to all similarly situated taxpayers, regardless of whether they are controlled or uncontrolled. In addition, the restriction must not be imposed as part of a commercial transaction between the taxpayer and the foreign government imposing the restriction.[426] Further, a foreign legal restriction will only be taken into account if the taxpayer has exhausted all remedies, except those with a negligible chance of success, afforded under foreign law or practice for the restriction's waiver.[427] Finally, the restriction must expressly prevent the payment or receipt, in any form, of part or all of the arm's length amount within the meaning of Section 482, and it must not have been otherwise circumvented by the taxpayer.[428]

The 1994 Regulations provide also that a foreign legal restriction shall be taken into account only to the extent that it affects the results of arm's length transactions.[429] In the absence of evidence of an effect on transactions between uncontrolled taxpayers, the restriction will be disregarded in determining an arm's length result, except that the amount subject to the foreign legal restriction can be treated electively as deferred until payment or receipt of the blocked income.[430] Deductions and credits chargeable to the deferred amount continue to be subject to deferral, under Treasury Regulations Section 1.461-1(a)(4).

The blocked income provisions of the 1994 Regulations, which represent a straightforward attempt by the I.R.S. to re-

423. *Id.*
424. *Id.*
425. The final 1994 regulations generally adopt, with certain modifications, provisions in proposed regulations promulgated in 1993.
426. Treas. Reg. § 1.482-1(h)(2)(ii)(A) (1995).
427. *Id.* § 1.482-1(h)(2)(ii)(B).
428. *Id.* § 1.482-1(h)(2)(ii)(C).
429. *Id.* § 1.482-1(h)(2)(i).
430. *Id.*

verse the decisions in the *First Security Bank*, *Procter & Gamble*, and *Exxon* cases, are the cause of some confusion (and, at least in part, of questionable validity). Most foreign legal restrictions on royalty payments, for example, apply only to related-party transactions.[431] To constitute a foreign legal restriction under the 1994 Regulations, the restriction must be equally applicable to unrelated-party transactions.[432] As noted above, however, the Supreme Court in *First Security Bank* held that the requisite control for Section 482 purposes does not exist when a foreign legal restriction blocks income, and the court in *Procter & Gamble* agreed. Thus, it is difficult to see how this provision in the 1994 Regulations can be applicable where the control predicate to a Section 482 adjustment is not present.

B. *Debt-For-Equity Swaps*

In the 1980s, Latin American countries had difficulty meeting their debt obligations to banks in the U.S. and other countries. Because of the risk of default, banks found that their loans to Latin American countries were valued by the market at a fraction of the face value. Debts owed by Mexico, for example, could be sold at only fifty percent of their face value.

As a partial solution to this debt crisis, many debtor countries instituted so-called "debt-for-equity swaps." These deals involved the forgiveness of debt by U.S. banks in exchange for equity in existing or newly formed subsidiaries in the debtor country. Equity investment in these subsidiaries was made desirable by the debtor government by transferring to the subsidiary a bank account, denominated in the local currency, which could be used for long-term investment in the debtor country.

In Revenue Ruling 87-124,[433] the I.R.S. ruled on the tax treatment of a typical "debt-for-equity swap." In the ruling, a U.S. bank held a $100 dollar-denominated debt against a foreign government.[434] A U.S. company purchased the debt from the U.S. bank for sixty dollars, which was the prevailing market

431. *See, e.g.*, Procter & Gamble, 961 F.2d 1255 (6th Cir. 1992), *aff'g* 95 T.C. 323 (1990).

432. Treas. Reg. § 1.482-1(h)(2)(ii)(A) (1995).

433. Rev. Rul. 87-124, 1987-2 C.B. 205.

434. *Id.*

value of the debt.[435] The U.S. bank, on behalf of the U.S. company, delivered the debt to the central bank of the foreign government, thus cancelling the debt.[436] The foreign central bank credited the bank account of a foreign company by 900 local currency units.[437] These local currency units, worth ninety dollars at the then current exchange rate ($1 = 10 local currency units), could be spent by the foreign company only on local investment.[438] The foreign company then issued all of its capital stock to the U.S. company. This stock was restricted in that it could not be sold to an individual or company in the foreign country.[439]

The I.R.S. held that the "debt-for-equity swap" should be taxed as if the following transactions had taken place:

1. The U.S. company bought the debt from the U.S. bank for $60; thus, the U.S. bank recognized a tax loss equal to the difference between the amount realized from the sale of the debt ($60) and its adjusted basis in the debt ($100);

2. The U.S. company traded the debt to the foreign government for 900 local currency units; thus, the U.S. company recognized gain equal to the amount realized from the exchange (the fair market value of the local currency units) and the company's adjusted basis in the debt ($60); and

3. The U.S. company contributed the 900 local currency units to the Mexican company in exchange for all of its capital stock; this stage of the transaction would be entirely nontaxable as a contribution to capital.[440]

The only U.S. tax paid on the transaction was the tax paid by the U.S. company on its gain from the exchange of debt for local currency.[441] This gain was a function of the fair market

435. *Id.*
436. *Id.*
437. *Id.*
438. *Id.*
439. *Id.*
440. *Id.* at 206.
441. *Id.*

value of the local currency units.[442] The I.R.S. recognized that the fair market value might be lower than the exchange value of the currency units, due to the restrictions placed on the local currency bank account. For taxpayers, this part of the ruling came as a relief. If the U.S. company could prove that the fair market value of the local currency was only $60, then no tax would arise from the swap.

Revenue Ruling 87-124 dealt also with the situation in which the U.S. bank itself took an equity interest in the Mexican subsidiary in exchange for the debt. The I.R.S. concluded that the bank would recognize a tax loss equal to the difference between the fair market value of the 900 local currency units and its adjusted basis in the debt ($100).

In *G.M. Trading Corp. v. Commissioner*,[443] the Tax Court considered a real "debt-for-equity swap." The taxpayer, a U.S. company, organized a Mexican subsidiary.[444] The U.S. company then purchased a $1,200,000 Mexican government debt from an unrelated bank for $600,000.[445] The Mexican government deposited Mexican pesos in the restricted bank account of the Mexican subsidiary.[446] If the pesos were not restricted, they would have had a market value of about $1,000,000.[447] The subsidiary issued shares of its stock to the Mexican government, which then transferred the shares in the Mexican subsidiary to the U.S. company.[448]

The U.S. company surrendered the debt to the Mexican government, which then cancelled it.

The Tax Court treated the transaction as follows:

1. The U.S. company purchased the $1,200,000 debt from the unrelated bank for $600,000;
2. The U.S. company exchanged the $1,200,000 debt with the Mexican government for pesos worth $1,000,000;

442. *Id.*
443. 103 T.C. 59 (1994).
444. *Id.*
445. *Id.*
446. *Id.*
447. *Id.*
448. The subsidiary issued 173,670 shares of class B stock. The only class of stock previously issued was class A stock, all of which was owned by the U.S. company.

and

3. The U.S. company contributed pesos worth $1,000,000 to the capital of the subsidiary.[449]

The Tax Court adopted the treatment of the transaction outlined in Revenue Ruling 87-124, rejecting the taxpayer's view that the transaction was entirely a tax-free contribution to capital by the U.S. company to the Mexican subsidiary.[450] Like Revenue Ruling 87-124, *G.M. Trading* held that the U.S. company should recognize gain equal to the difference between the value of the restricted pesos and the U.S. company's cost of the debt.[451]

Unlike the I.R.S. in Revenue Ruling 87-124, the Tax Court in *G.M. Trading* refused to acknowledge that the restrictions on the peso bank account would reduce the value of the account below the market value of an equal number of unrestricted pesos.[452] The Tax Court held that the fair market value of the account was $1,000,000, the value of the pesos in the account converted into dollars at the current exchange rate.[453] Therefore, the U.S. company was required to recognize gain of $400,000, the excess of $1,000,000 (the value of the pesos) over $600,000 (its basis in the debt).

In the alternative,[454] the U.S. company argued that the "debt-for-equity swap" should be viewed as if:

1. The U.S. company contributed $600,000 to the capital of its Mexican subsidiary; such a contribution would be tax-free;
2. The Mexican subsidiary purchased the debt from the bank for $600,000; such a purchase would not result in tax to the subsidiary; and
3. The Mexican subsidiary exchanged the debt with the Mexican government for the restricted pesos.[455]

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449. *G.M. Trading Corp.*, 103 T.C. 59.
450. *Id.*
451. *Id.*
452. *Id.*
453. *Id.*
454. The U.S. company's main argument was that the value of the peso bank account was only $600,000, and, therefore, the U.S. company would have no gain.
455. *G.M. Trading Corp.*, 103 T.C. 59.

The U.S. company argued that any gain associated with the receipt of the restricted pesos should be treated as a contribution of capital by the Mexican government to the Mexican subsidiary.[456] Contributions to capital by a government are nontaxable under Section 118.[457]

The Tax Court rejected the U.S. company's Section 118 argument.[458] The Tax Court held that the transfer of the pesos to the restricted bank account was not a contribution to capital because the Mexican government received "a specific, direct, and quantifiable" benefit from the transfer, i.e., the surrender and cancellation of the original debt.[459]

G.M. Trading can be criticized on several grounds.[460] The most compelling criticism, however, is that the facts clearly establish that the restricted pesos had a value precisely equal to the market value of the U.S. dollar debt. Why would the Mexican government pay more in pesos for the debt than the market value of the debt? If the restricted pesos were really worth $1,000,000, why would not the Mexican government sell the restricted pesos for $1,000,000, buy back the debt for $600,000 and pocket the difference? The only answer is that the Mexican government could not have sold the restricted pesos for $1,000,000. The only reasonable conclusion from the facts of the case is that the restricted pesos were worth precisely $600,000 and that neither the U.S. company nor the Mexican subsidiary recognized any gain on the transaction.

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456. *Id.*
457. *Id.*
458. *Id.*
459. *Id.*
460. *See* Philip H. Spector, *Mexican Debt-Equity Swap Lands in the Tax Court*, 23 TAX MGMT. INT'L J. 496 (1994) (criticizing *G.M. Trading v. Comm'r*); Internal Revenue Service, *Background on Debt/Equity Swaps*, TAX NOTES TODAY, 95 TNT 124-11 (June 27, 1995) (defending *G.M. Trading*); M. L. Dionne, *Revenue Ruling on Debt/Equity Swaps Leaves Unanswered Questions—To the Delight of the Tax Bar*, 39 TAX NOTES 166 (Apr. 11, 1988) (citing criticisms of Rev. Rul. 87-124); New York State Bar Association, Tax Section, *Report on Developing Country Debt-Equity Swaps*, TAX NOTES TODAY, 88 TNT 244-19 (Dec. 6, 1988) (criticizing ruling).