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# USE OF HYBRIDS IN INTERNATIONAL TAX PLANNING: PAST, PRESENT AND FUTURE

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Professor Nina J. CRIMM: The concept of hybrids has been part of the evolution and development of agriculture and livestock for centuries. More recently, scientists and academics have manipulated genetic structures of crops and livestock to strengthen and capitalize on certain characteristics. Apparently, hybridization has not merely been left up to those scientists and

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academics. We have heard several examples today. As noted by Edward Kleinbard on this morning's Financial Products panel: "Contrary to claims of some academics, pigs do not always have wings." Parenthetically, however, I would like to point out that when they do, the hybrid pig can negotiate movement in ways that it never could without those wings. Moreover, as spoken on the Corporate Reorganizations panel this morning: "Some dogs have five legs" and some greedy taxpayers have "little pig eyes." I admit that I am not certain of the strengths of this last example and what those strengths capitalize on, but as we can see, the concept of hybrids has entered into tax law.

A hybrid entity is a transparent or pass through entity, such as a partnership, for U.S. tax purposes but it is not a transparent entity and instead is a corporation for foreign law tax purposes. A reverse hybrid is just the opposite. It is recognized for U.S. tax purposes as a corporation but as transparent or as a flow through entity for foreign tax purposes. With that, I will turn this discussion over to our panel.

Mr. Paul R. McDANIEL: As Professor Crimm indicated, the focus of our program is on the increased use of hybrid entities by U.S. companies in cross-border transactions. Today, we are going to focus our attention on the hybrid entity. That is, the U.S. company going abroad where it seeks to utilize the dual classification of a corporation in a foreign jurisdiction but transparent treatment either as a partnership or as a branch or division for U.S. tax purposes.

While this inconsistent treatment of entities was at least theoretically possible under prior law, it was a difficult structure to achieve in practice. However, with the issuance of the check-the-box regulations,[1] the use of hybrids by U.S. taxpayers has increased. We can expect the use of hybrids to continue to increase substantially.

As many of you know, the check-the-box regulations replaced the long-time four-part test for distinguishing partnerships from corporations: Continuity of life, limited liability, free transferability of interests, and centralized management.[2]

This test had become formalistic in its application. Properly

1 Treas. Reg. §§ 301.7701-1 to -3 (1998).
2 Treas. Reg. § 301.7701-2 (1998).

advised taxpayers could readily select and achieve the entity classification desired. This test has been replaced by the check-the-box regulations and I will discuss those very briefly to set the stage for the panel discussion.

All business entities under the check-the-box regulations are divided into two categories. The first category is per se corporations and the second is entities that are eligible to elect their tax classification. In the purely domestic context—in the U.S. context—a per se corporation is one that is organized under the corporate laws of a state; these entities are always classified as a corporation.

Limited liability companies are classified as partnerships if there are two or more owners or are simply disregarded if there is only one owner. That is to say, in the single owner case, it is treated as a branch or a division. Thus, to get away from this default classification as a partnership, the taxpayer must make a positive election to be treated as a corporation.

In the international context, the regulations also list certain per se corporations on a country-by-country basis. These corporations are always corporations, and will be so treated for tax purposes by the United States. No election is available with respect to those entities and that list is being added to from time to time.

The default classification of foreign entities depends on the degree of limited liability or unlimited liability that is enjoyed by the owners of the foreign entity. If all the members of an entity have limited liability, then it is classified as a corporation unless there is an election made to treat it as a partnership.

On the other hand, if all the members but one have limited liability, that is to say there is at least one member of the entity that has unlimited liability, it is classified as a partnership unless the election is made to be treated as a corporation.

As you can see, under the check-the-box regime, it is now much more likely than ever before that an entity will be treated as a separate taxpayer by a foreign country but as a branch or partnership for U.S. tax purposes.

Now, this disparity inevitably has invited tax planning to reduce overall taxes, both U.S. and foreign, by taxpayers engaged in cross-border transactions. There are several major areas in which a lot of the tax planning has taken place. I will focus spe-

cifically on four of these areas.

The first is to mitigate the effects of section 367. As you know, in many instances where a U.S. taxpayer transfers assets to a foreign entity, a tax is imposed on the appreciation in value that has taken place while the assets were located in the U.S. taxing jurisdiction. The check-the-box regulations have been utilized in this area to avoid some of those limitations because if the entity to which assets are being transferred is a division for U.S. tax purposes, then there has been no transfer beyond the U.S. taxing jurisdiction. Thus, gain recognition that would occur due to the transfer to a corporation does not take place.

The second major area is the avoidance of limitations that are imposed by Subpart F of the Internal Revenue Code. As I am sure many of you know, Subpart F is an anti-deferral regime under U.S. tax principles. Corporations are separate and distinct taxpayers from their shareholders. When this rule is applied in the international context, it means that there is no U.S. taxation of the earnings of a foreign subsidiary of a U.S. company until those earnings are actually repatriated back to the United States.

Subpart F is one of at least three anti-deferral regimes which limit the ability of taxpayers to defer taxes on foreign income earned by their foreign subsidiaries and, in very general terms, taxes currently to the U.S. owner passive investment income and what is called foreign base company income. Foreign base company income, in general terms, is income derived as a result of transactions with related parties and sales or the performance of services outside the country of the incorporation of the foreign subsidiary. Both of these are areas in which the hybrid check-the-box regulations can be useful.

A third area is the avoidance of transfer pricing problems under section 482. Section 482, as you recall, permits the Commissioner of Internal Revenue to reallocate income and deductions among related taxpayers in order to correctly reflect income. If one checks the box, then one is no longer dealing with a related party but is simply dealing with oneself. We will also discuss the impact of the check-the-box regulations on transfer price planning.

A fourth category is foreign tax credit planning. The check-the-box regulations can be used to avoid various limitations that

are imposed upon the allowance for foreign tax credits or increase the allowable foreign tax credit in some circumstances.

The last category is what we are going to deal with in our discussion today. At the time the check-the-box regulations were issued, the IRS and Treasury expressed concern or reservations about the effect of the check-the-box rules in the international context and alerted people in the preamble that they were going to continue to study this area to see what potential abuses could arise.

Those concerns have surfaced in a couple of instances. Two notices issued in January and temporary and proposed regulations issued recently deal with what the IRS considered to be abuses that have been generated as taxpayers have taken advantage of the check-the-box regulations in the international context.

Notice 98-5[3] deals with foreign tax credit abuses and we will discuss that further. Notice 98-11[4] deals with abuses of Subpart F. Many of the important provisions are effective as of last January the 16th.

Finally, Treasury has proposed legislation as a part of the budget package that would affirm its authority to issue these and other regulations in these areas.

In our panel discussion today, we are going to focus on the use of hybrids and outbound transactions in three contexts. Alan Granwell is going to discuss the use of hybrids to move intangible assets off shore without incurring the tax under section 367 and the impact of the recent IRS and Treasury pronouncements on the ability to do this. Bill Bricker will consider the use of hybrids in the context of manufacturing operations and in particular comment on the impact of the IRS positions on Subpart F planning. Karen Brown will discuss the use of hybrids in the sales context and will discuss the impact of recent IRS pronouncements on section 482 transfer pricing plans.

Mr. Alan W. GRANWELL: Good afternoon. It is a great pleasure to be here.

Let me address the topic at hand, the use of hybrids in international tax planning. Before the check-the-box provisions, if a

3 I.R.S. Notice 98-5, 1998-27 I.R.B. 35.

4 I.R.S. Notice 98-11, I.R.B. 1998-6, 9.

U.S. multinational wanted to transfer intangibles offshore, it had to deal with two provisions. One, as Paul mentioned, is section 367(d). Basically this provision provides that if a U.S. person transfers an intangible offshore, then that transaction will be treated as a sale of the intangible for contingent payments, which payments are computed subject to the commensurate with income rules. The notional royalties that are deemed received initially were treated as U.S. source income. That has been amended by the Taxpayer Relief Act of 1997 ("1997 Act") in which the notional payments are treated as foreign source income. This amendment is rather significant, particularly if such foreign source income is subject to the "look through" rule for foreign tax credit purposes. That is a topic for another day.

There is another provision that was done away with in large part by the 1997 Act which also was a concern: Section 1491 dealing with transfers of appreciated property to foreign partnerships and certain other foreign entities.

U.S. multinationals have different options in transferring intangibles offshore. One, they can make a capital contribution of the intangible to a foreign entity that is classified as an association taxable as a corporation, which implicates section 367(d). Two, they can license the intangible. The license of an intangible means that you have a transfer pricing issue because the licenser, the U.S. multinational, retains ownership of the intangible and grants the licensee the use of the intangible for a limited period of time. In this context, there are issues as to whether the transfer is viewed as a license or as a transfer of substantially all the rights, which equates the transfer to a sale. Third, there is another option, which is known as a cost-sharing agreement. In that arrangement, two parties—they do not have to be related—join together in a written agreement to share the costs of intangible development. By sharing those costs, they are entitled to exploit the intangibles developed under the cost-sharing agreement. The option used depends on the circumstances of the particular transaction. Each has benefits and detriments in the context of overall international tax planning for a U.S. multinational corporation.

The use of a hybrid entity has made some of this type of planning more interesting, particularly until the publication of the

Notices and the temporary regulations.[5]

I will give some examples of how this all works. If a U.S. multinational corporation wants to transfer the patent rights for a product to a foreign entity that is classified as an association taxable as a corporation under the check-the-box provisions, that transfer, if it is by capital contribution, would be viewed as a section 367(d) transfer. That means, from a U.S. tax point of view, the transferor would be deemed to receive payments over the useful life of the property equivalent to the arm's-length return, based on the commensurate with income provisions.

From a foreign point of view, the foreign jurisdiction may view that transfer as a capital contribution and may permit the transferee to amortize the costs over the useful life of the patent. So, you might have a mismatch in income from the U.S. and foreign points of view. The notional income deemed received by the U.S. multinational is now treated as foreign income, and there are many good arguments to conclude that the foreign source income qualifies for "look-through" treatment for foreign tax credit purposes, which is very important for U.S. multinational tax planning.

U.S. multinationals were quite concerned with making a section 367 transfer before the recent amendment that changed the source of income for section 367(d) notional payments because the notional income would have been treated as U.S. source income, not a desirable situation.

The check-the-box provisions have expanded tax planning with respect to what are known as "eligible entities," and these are most business entities that are incorporated or organized offshore. You selectively can determine whether that entity from a U.S. tax point of view is to be treated as a transparent entity or as a corporation. If it is a corporation, section 367(d) applies.

If an entity is a single member transparent entity, what does that mean in the context of moving an intangible offshore? It means that you are not moving that intangible to a discrete entity; you are merely moving it to a branch or division of the transferor. From a federal income tax point of view, that should be viewed as a non-event. That is, the movement of an intangi-

[5] I.R.S. Notice 98-11, I.R.B. 1998-6, 9; Notice 98-35, I.R.B. 1998-27, 35; T.D. 8767; Notice 98-11 and T.D. 8767 have been withdrawn.

ble from the home office to the foreign office of the enterprise.

The consequence of doing that is that section 367(d) does not apply. From a foreign point of view, the foreign entity generally would be viewed as a corporation, which has the use or ownership of the intangible and is entitled to the return thereon. From a U.S. point of view, because there has not been an actual transfer, there will not be a deferral of federal income tax when income is earned, in connection with that intangible. By checking-the-box, you lost the benefits of deferral because there has been a transfer merely to a branch of a U.S. enterprise, although from a foreign point of view, the foreign branch is viewed as a foreign corporation.

Whether that is beneficial or detrimental depends on the circumstances. Obviously, if you are in a high tax country, such as most of the European Union countries, whose marginal and effective rates generally are similar to the U.S. rates, whether you obtain deferral generally is not that significant, particularly if the foreign rate is equivalent to the U.S. rate. If the foreign jurisdiction imposes a 35 percent rate on the income earned in connection with the use of the intangible, that income would be reported in the U.S. return subject to a foreign tax credit. In contrast, if you are in a low-tax jurisdiction, then deferral would be important. So, by checking-the-box, you do not gain the benefits of deferral, but you avoid the detriment of a section 367(d) transfer.

Alternatively, cost-sharing also should be considered in a situation where you would rather have an intangible offshore without having a transfer. As mentioned, cost-sharing is an arrangement where two or more parties enter into a written arrangement to share the costs of development and in consideration thereof derive the benefits of the fruits of the research that are undertaken. If one is dealing with a new intangible in a cost-sharing arrangement, it is possible to have a foreign affiliate of the U.S. multinational obtain the foreign rights to the intangible and the returns thereon without implicating any of the outbound transfer rules.

Life becomes much more complex if one is dealing with a pre-existing intangible because the IRS takes the position that a foreign person cannot obtain the rights to use a pre-existing intangible in a cost-sharing arrangement without paying what is

called a "buy-in payment," an amount commensurate with the consideration that was paid to develop the intangible.

The third option of licensing is useful if, for example, the U.S. multinational has the cash flow to fund the research and also is in a situation where it would like to obtain low-tax foreign source income through royalties. If one licenses an intangible, the payment made to the licenser is called a royalty. Generally, the payment should be deductible in the local country and, under U.S. tax treaty policy, the United States seeks to negotiate a low or zero rate on flows of intangibles because we view ourselves as a capital exporting nation.

Both the U.S. multinational and the licensee benefit obtain a return from the intangible. If the royalty payment qualifies for "look-through" treatment for foreign tax credit purposes, then the U.S. multinational advantageously can use these royalties in its foreign tax credit planning.

The following are three techniques that should be considered when one is dealing with the movement of an intangible from a U.S. to a foreign company. These techniques also can be applied where an intangible happens to be owned by a foreign entity and you want to transfer that intangible to a lower tier company or to an affiliate foreign company. This is where check-the-box becomes interesting, particularly before the anti-abuse provisions that were published, because you could transfer an intangible to an affiliate basically tax-free from a U.S. point of view, and you could check-the-box of the transferee and a sister company that was going to manufacture products utilizing that intangible. From the U.S. point of view, payments from the brother/sister corporations were viewed as nothings because they were viewed as payments between different divisions of the same company, which obviously was beneficial from a U.S. point of view because it did not create Subpart F income. The anti-abuse provisions being considered could change the foregoing result.

The effect of these anti-abuse regulations may preclude U.S. multinationals from seeking to minimize their foreign tax. The ostensible rationale for this is that Subpart F, which came into the law in 1962, was meant to prevent perceived abuses through the utilization of foreign corporations and also to encourage international competitiveness.

But the movement of certain flows of income, even though they

may have the opportunity of reducing foreign tax, which generally is viewed as a good business principle from a U.S. point of view, was perceived to be in violation of the precepts of Subpart F, which is a very controversial point and I think will be illustrated further in the remarks of Bill and Karen.

MR. McDANIEL: Well, yes, I guess I cannot resist putting a diagram on the board.[6] Assume a company with two subsidiaries (G1 and G2) that are operating in the same country both in an active technology business and let us say that we create underneath G1 a low tax corporation ("LTC"), which is treated as a corporation in that low tax country.

G2 licenses or transfers a patent down to LTC. Royalties come back to G2. Under the Subpart F rules, that royalty is foreign personal holding company income and is immediately taxed back to the U.S. company. What Alan has just suggested is that if G1 checks-the-box with respect to the low-tax entity, it is a tax nothing now. It is just a division for U.S. tax purposes. The payment therefore goes from G1 to G2.[7] They are located in the same country. They are both engaged in an active trade or business and under the Subpart F rules, this royalty payment is not subject to tax back in the U.S. currently, subject to the anti-abuse provisions.

Bill, let's turn the microphone over to you, please.

Mr. William L. BRICKER: Thank you very much. We have a very, very contemporary topic. The first thing I would like to do is thank everyone for the opportunity to be here. I am going to speak a bit about manufacturing. Before that though, I wanted to mention that I had not seen Alan in a while and he is always very complimentary. He told me at lunch, or he reminded me, that it is a beautiful spring day, 80 degrees and he said I reminded him of the story about the woman who went to the doctor for a physical. The doctor examines her and said unfortunately, she only had six months to live and she was very distraught. She said to him, "Well, what can I do to prolong my life?" The doctor replied, "Well, you could marry a New York tax lawyer." She looked a little perplexed and she said, "Well, doctor what do you mean by that?" He said, "You may not prolong your life, but

6 *See* Paul R. McDaniel, Panel Example I, appended herein as Appendix I, at 105.
7 *See* McDaniel, *supra* note 6, at 106 (Panel Example II).

it will be the longest six months you ever had." Alan told me that at lunch and I do not know what to make of that but we will try to make something of it.

I am going to be a little bit more general than Alan. What I am going to do is focus on a couple of pictures that are in the material that was passed out.[8] The material is up to date. Unfortunately, I was about to distribute it on Tuesday only to learn Tuesday that regulations had been published that modified a great deal of what I am talking about. So, believe it or not, you have it hot off the press.

One of the areas I am focusing on is manufacturing and very specifically, manufacturing under Subpart F. Back in the old days, Alan and I would spend a whole day or two talking about Subpart F. So, to sort of bring everyone up to speed in two minutes takes a little bit of an effort, but let's take a crack at it.

Subpart F was meant to apply to a situation where a U.S. company creates a foreign company that it totally owns.[9] There is no question that this is what we call a "controlled foreign corporation" and we are right into this area called Subpart F.

The Subpart F rules are very involved, but we are told that if this company has what I am going to call bad income, then that income is currently taxed to the U.S. company whether it is distributed or not. When Congress enacted the Subpart F provisions, there was some perception that there could be activities conducted abroad that should be spared from this onerous legislation.

One of those types of activities is manufacturing. Having said that, the question is what is manufacturing? After some 36-37 years of legislation, probably about six or eight cases, endless rulings, and hundred and hundreds of pages of regulations, we still do not really know what manufacturing is. What are we really talking about? Well, to use a realistic example, consider a GE light bulb or Bausch & Lomb sunglasses or contact lenses. It is very possible that they came from your foreign manufacturing company ("ForCo") and were manufactured in Ireland or maybe

8 *See* William L. Bricker, Jr., Section 7701 Check the Box Regulations International Tax Planning for U.S. Taxpayers (Mar. 27, 1998) (unpublished manuscript, on file with the *St. John's Journal of Legal Commentary*).

9 *See* William L. Bricker, Jr., Illustrations, appended herein as Appendix II, at 107 (Subpart F Manufacturing).

in the Far East. Obviously, to the extent that those companies can and do manufacture abroad in jurisdictions that impose little or no tax, it gives them a tremendous ability to self-generate capital. So, beyond the taxing mechanics of what is going on, there are a lot of dollars and cents involved.

The area of what is manufacturing, what is assembly manufacturing, what is conversion manufacturing and so forth, for those of you interested, is a very involved area, and we can certainly go into it, but it is well beyond our program.

In the ordinary course, if we are setting up a foreign manufacturing company we generally are going to want it not to be a hybrid, not to be a flow through, right? We want to keep all those profits offshore and not pay current U.S. tax on them. George Meany used to refer to this as a run-away plant. We were taking jobs from American people, bringing them offshore and the U.S. tax system was paying for it. I guess he is not speaking too much recently.

The area of assembly is very, very involved. Let's assume for the moment that assembly is manufacturing and let's take a second picture.[10] One of the more intriguing areas of tax law—and tax law is intriguing, of course we all agree on that—is the question of contract manufacturing. I bring that up only because that is going to tie right back into this whole area of branches, hybrids, the notice and regulations that Paul mentioned.

The issue has always been whether my wholly-owned foreign company can be considered a manufacturer. If GE manufactures light bulbs in Ireland and then sells them, whatever profit it derives stays in that company. There is no U.S. tax. There are some other issues but there is no U.S. tax.

So, generally manufacturing is considered to be a good thing. It saves you the requirement to bring the profits back into the U.S. The remaining question is whether you can manufacture indirectly or through a contract party instead of directly. The IRS dealt with this issue back in the early 1970's and issued a ruling in 1975. The question that arose is if a controlled foreign corporation ("CFC") contracted with someone to manufacture, and it resulted in products that the CFC sold for a profit, would

10 *See* Bricker, Illustrations, *supra* note 9, at 108 (Subpart F Contract Manufacturing).

that income be considered manufacturing income? Would it be the type of income on which you could legitimately avoid current U.S. tax? In the ruling, the IRS said, "Yes, no problem." In fact, they said the income of the CFC would be manufacturing income. Unfortunately, the director of the taxpayer that requested this ruling is unemployed.

MR. GRANWELL: That is my client.

MR. BRICKER: Yes, I know. Sometimes if you know the answer and you are confident in the answer, you never ask because you can only lose. In this instance, the taxpayer came up with a most surprising result because the IRS said yes, this is manufacturing. That part is fine but guess what? We are going to consider this manufacturer to be your branch. It is going to be considered your branch and, without getting into the idiosyncrasies, that is bad. That is bad because there is a whole area of Subpart F, we call it the branch rule, which is a real problem. So, unfortunately this individual went out for a three martini lunch, celebrating the ruling he had gotten and never realized that he had a major problem.

The IRS took this principle and actually litigated it twice and lost, and as a consequence, the area was a bit uncertain. Tax practitioners generally believed that if you had a contract manufacturer, and you did everything correctly, with some bells and whistles, the net result is the CFC would be considered manufacturing, and as a consequence, you would have sheltered income.

Number two, because the two Tax Court cases had rejected the principle, you would not get caught in this branch rule, something you do not want to be in. You want to be a manufacturer. You do not want to be in the branch rule.

At the end of 1997, just before the two 1998 notices[11] and consistent with the same issue, the IRS came out with a ruling. In the 1997 ruling, which is really consistent with the approach taken in Notice 98-11, the IRS reversed their position. In this instance, to the extent that you are manufacturing through a contract party, we are going to disregard it totally. You do not have a branch. You are not a manufacturer. You are nothing.

The resulting issue is how to deal with branches and extensions of the Subpart F issues? How does this relate to hybrids?

11 I.R.S. Notice 98-5, 1998-3 I.R.B. 49; I.R.S. Notice 98-11, 1998-6 I.R.B. 18.

Let's take one more picture.[12]

The use of hybrids within the Subpart F area can be very, very important. For example, assume we have a Russian operating company.[13] That company has income. It pays tax, maybe or maybe not, Russian style. The net result though is it ends up with income. Under our Subpart F rules, without boring everyone, if that income is paid up, it is generally going to be considered a dividend. If it is paid to another wholly-owned foreign company, it is a problem. It is a problem because it is a passive type of foreign personal holding company income and that is something you do not want to achieve.

Passive foreign personal holding company income will be currently taxed to the U.S. company. You have lost your future. You lose your bonus. You lose your job. It is not good.

One of the benefits of the check-the-box rules and we have all taken on new diagrams—the parlance is that the box means it is a corporation for local purposes and the triangle means it is a flow through entity for U.S. purposes. So, if I make a so-called check-the-box election here, that means the income of the Russian company for my purposes is considered to be income of the Cyprus company and I have no dividend. I can move cash in and out, up and down and not be considered to have a dividend because it is nullity for U.S. tax purposes. It is a single member entity. It is a nullity. I can then have ForCo, or maybe a Cayman company, whatever it may be, make an election so I can flow the money up into ForCo.

Now, if I am operating at a profit, I generally would stop there. What is the result? The result is that this is not Subpart F income. It means I can move money up and down the chain without any adverse U.S. tax consequences. That is a homerun. That is bonus territory.

Now, I can also go one step further which this diagram is showing and that is we are assuming that we make income. We tax planners always make this perverse assumption that businesses make income. However, sometimes they do not make income, right? They make losses. It happens.

If this is the case, that loss now flows all the way up to the

12 *See* Bricker, Illustrations, *supra* note 9, at 109 (Subpart F Planning).

13 *See id.*

U.S. company. So, a loss here for U.S. tax purposes is currently deductible by the U.S. company simply by reason of the check-the-box rules. The check-the-box rules are very helpful under Subpart F. It allows you to move money back and forth in an unusual way. Also, perhaps it gives you an opportunity to perform other types of local tax planning. Intriguingly, for many years, reducing foreign taxes was sort of thought to be generally good. That was generally thought to be very patriotic because if you reduce foreign taxes, ultimately you are going to pay more U.S. taxes because we give credit for foreign income taxes.

The Notice that the IRS published now throws that into question, particularly in the Subpart F area. The bottom line is the IRS has now published regulations and those regulations in sum and substance say that generally this type of use should not be okay. Basically they say if what you are doing is the terrible types of transactions that Alan talked about, that is no good. You cannot do foreign personal holding company income types of planning.

On the other hand, they have left open the area, at least at this point, that you can use check-the-box in the international context to achieve benefits along these lines. The benefits may be limited because it has been rumored that they were going to attack the area of performing services and they were going to include those in the new regulations. The IRS sort of punted on that one, a trial balloon I guess you would call it, because they decided they were not going to address those things now. However, they invited comments. They would love to hear what you and I and other people out here feel about the situation.

Bottom line, the check-the-box regulations were not thought through. They were granted totally in the international area. The IRS has woken up and realized that those terrible people called taxpayers, and those worse people called tax lawyers, have been using this as an opportunity to plan within the Subpart F rules. They decided to carve back. They have taken the first machete and cut back in terms of foreign personal holding company income and they are holding the sword of Damocles above to see how far they are going to go in the future. I hope I did not go too far over.

MR. McDANIEL: Right on time. Thanks a lot. Alan or Karen did you want to make any further comments on this topic?

MR. GRANWELL: Yes, I have a lot of comments about this.

MR. McDANIEL: Besides retaliation, I mean.

MR. GRANWELL: Just one point, none of this stuff is simple, but I am going to bore you with all of this in a summary form. Just in case you are practicing in this area and, as Bill says, you do have losses often times and you go on to check-the-box and bring the losses into the U.S. Recognize that there is a provision called section 1503(d)[14] dealing with dual consolidated losses. If you do things under that particular rule, you will be precluded from collecting that loss in the U.S.

All of this check-the-box stuff sounds very simple, but it implicates many of the sections of the Internal Revenue Code and you have got to think what the corollary consequences are. It happens to be section 1503(d) if you are dealing with losses and I think my comment is if you are doing check-the-box, you have got to look at other sections of the Code.

MR. BRICKER: I would second that and there are other issues too. If you do bring those losses back, we are not going to talk about foreign tax credit planing but there are some significant things you would have to think about in that area as well.

MR. McDANIEL: Thank you, Bill. Karen?

Ms. Karen B. BROWN: In some ways my remarks are going to complement Bill's. He talked about manufacturing, and I am talking about sales. There is a close relationship but I wanted to start out by expressing a bias that I have in all of this. We are looking at hybrid entities and ways in which the anti-abuse rules prevent taxpayers from engaging in certain transactions. I must admit that my bias is that I actually welcome the proposed and temporary regulations to the extent that they are making inroads into deferral of a U.S. tax on foreign income. I am all for it.

Among the panelists, I may be an anomaly. If I had business customers, I might be singing a different tune. I love studying the international tax area but confess to a bias. That is, I think our system should either go one way or the other. Right now, we purport to have a system based on capital-export neutrality, which is expressed in the form of world-wide taxation of income of our U.S. companies so that they are taxed on their income

14 I.R.C. §1503(d) (1998); Treas. Reg. §§ 1.1503-2 to -2A (1998).

wherever it is earned at the same rates. The neutrality functions basically to eliminate tax considerations from business formation decisions. Our multinationals can locate wherever they want, conduct their activities wherever they want, and they still will have to pay tax at U.S. rates.

Now, we do have a big exception to that which everyone on the panel has already talked about. If a U.S. multinational sets up a separate foreign corporation, and that corporation earns a separate income, the parent can defer U.S. tax on that income. I happen to think that that is an unwelcome exception to the neutrality principle. The Subpart F rules relating to manufacturing and sales income have limited ability to prevent deferral of U.S. tax on income of foreign subsidiaries even in the case of abusive transactions.

One type of Subpart F income is passive income. That is, your controlled foreign corporation will be deemed to pay some of its profits back to you subject to U.S. tax if that company has, for example, so-called foreign personal holding company interest and dividend income. The rules dealing with sales and manufacturing income for controlled foreign corporations can be easily—although, as I said, I am not in the real world, so I do not know how easy this is in practice, and I am sure Phil and Alan will have some things to say about this—but can easily be gotten around, if for example, the controlled foreign corporation performs manufacturing or the controlled foreign corporation sells the U.S. parent's products in the country of its incorporation.

These are some really narrow restrictions on what is otherwise a big regime of deferral and I think our system should either have no deferral or complete deferral. That is, go from capital export neutrality to a system of capital import neutrality, which would not tax foreign source income at all. That would obviate the need for these proposed and temporary regulations. It is likely that many would think this too drastic, but I think in a complex world, tinkering with the Subpart F rules is barely scraping the surface of the real problems in the system.

So, I must say that in some ways, I welcome the regulations and in some ways do not. I think as a policy matter, we have got to bite the bullet at some point and decide where we are going to go. Are we going to go for worldwide taxation of foreign source income or are we just going to exempt foreign income from U.S.

tax and allow multinationals to take advantage of tax holidays in foreign countries, developing countries? At some point it would be nice if we could face up to that issue and make the decision on that basis.

What we are left with are all of these complicated rules as demonstrated in Bill's diagrams, and the transactions that Alan discussed regarding planning in light of those rules and the overall complexity as demonstrated by Paul. As you can see, we have really built up a complex world based on partial implementation of capital export neutrality, this kind of tax system is not very helpful.

Apart from the hybrid rules and the Subpart F anti-abuse rules, our foreign tax system already incorporates fundamental rules that support deferral of U.S. tax on income from foreign operations. One rule that invites manipulation on the part of taxpayers is the sourcing rule for inventory sales income.

We currently have a big exception to the inventory sales rules. If you go back to 1986, a big watermark year for tax lawyers, you will recall that income from sales of non-inventory personal property income took on a new sourcing rule that sources income by reference to the residence of the seller. Sales income derived by U.S. corporations would be U.S. source income. A big exception, which still exists, was made for sales of inventory because Congress was worried about the impact of treating all inventory sales income as U.S. income, on the competitive position of U.S. multinationals.

So, the inventory sales loophole remains and that gives our U.S. multinationals the opportunity to plan title passage on sale of goods outside the U.S. even though the negotiation of sales are in the U.S. and even though the sales are ultimately destined to a customer in the U.S., thus creating foreign source income.

What does that do? It allows the multinational to create foreign source income that is not subject to foreign tax. Even though title passes outside of the U.S. there may be no country that is going to tax the sales income particularly if title passes within a country with which the U.S. has a treaty and there is no permanent establishment of the U.S. company in that country. The income is not going to be taxed by a foreign country. The source rule, however, allows U.S. multinationals to create foreign source income, not subject to foreign tax, which can be

thrown into a foreign tax credit basket and blended with higher rate income to allow cross-crediting. The averaging of the non-taxed income with high taxed income helps circumvent the section 904 limit on the foreign tax credit. The limit provides that no foreign tax exceeding the effective U.S. rate of tax may be credited.

Already built into the U.S. foreign tax system are a number of rules, like the sales income source rules, that allow U.S. multinationals to reduce U.S. tax on foreign source income. The Subpart F rules invite similar manipulation as well.

Now, in the preamble to Notice 98-11 and also in the explanation to the proposed and temporary regulations, which were issued this week, the Service talks about two things. One is that there are Subpart F rules that are intended to prevent reduction of U.S. tax on income by moving U.S. operations abroad through a foreign subsidiary that earns foreign source income in a low tax country. The Subpart F rules allow U.S. tax on income earned through a foreign corporation in certain abusive situations.

The other is that we have this new set of entity classification rules that allows U.S. multinationals to check-the-box, and treat an eligible entity as either a corporation, a branch, or a partnership. The Service has said simply that it does not want this ease in entity classification to allow further exploitation of loopholes in the international tax system.

Rules simplifying entity choice are important, but it is also important to recall that existing international tax rules invite abuse. How do you decide whether a transaction takes you across the line? The hybrid regulations seem to be a first attempt to do that and to give us some idea of what the Service thinks is abusive in a particular situation.

I just wanted to talk about a couple of transactions. Actually, I am just about running out of time but there are just a couple of things I wanted to mention and complement what Bill described in the manufacturing area. Now that U.S. multinationals do have this ability to use the check-the-box, there are some good examples of transactions that are typically considered abusive. One has been described in the context of the maquiladora industry—where U.S. multinationals set up companies in Mexico, have production take place in Mexico, and ship the goods back

into the U.S. One of the things that has been proposed is, for example, to set up a maquiladora in Mexico. If it is an eligible single owner entity, you could make an election to treat it as a branch. If you can surmount problems involved in making the election and treating the entity as a branch, would the election allow a taxpayer to create more foreign source income on sales of inventory?

This could be facilitated by the inventory income sourcing rules, which were not changed in 1986. There also remains a big exception for inventory that is manufactured outside the U.S. and sold within the U.S.[15] There is a 50/50 rule that applies for sourcing that income. The 50/50 rule depends on the location of your production assets and the location of sales.[16]

If you are operating through a maquiladora and all your assets are in Mexico, you can classify at least 50 percent of your income as foreign sourced. This would allow the rate averaging and reduction of U.S. tax on foreign source income described earlier. This is one way you could check-the-box rules to get a better result under these section 863(b) regulations.

Is this abusive? I do not think it is. I think the abuse is in the sourcing rule for foreign source income and not in the ability to be able to check-the-box and treat the entity as a branch. I think this is an example of the kind of problems and challenges that are presented in the international tax area where the rules already invite abuse.

I will just briefly mention a couple of other transactions. One is the situation in which you might elect to treat a maquiladora, which would not be treated as a corporation for Mexican purposes, but as a branch for U.S. purposes.

Another is the contract manufacturing situation, referring to Bill's diagram.[17] Suppose you have a U.S. parent, a controlled foreign corporation and then a partnership below that controlled foreign corporation. The new proposed and temporary regulations under section 954 now indicate, as Bill mentioned, that the contract manufacturing activities of a partnership—and this relates to the Brown Group transactions which I will mention

[15] I.R.C. § 863(b) (1998).

[16] Treas. Reg. § 1.863-1 (1998).

[17] *See* Bricker, Illustrations, *supra* note 9, at 108 (Subpart F Contract Manufacturing).

later—can be deemed to be manufacturing activities of the controlled foreign corporation. The Service is going to examine the income at the controlled foreign corporation level and characterize it at that level.

So, the partnership conducts manufacturing activities and we attribute the manufacturing activities of the partnership to the controlled foreign corporation. Then we look at the controlled foreign corporation to determine whether the "same country" exception applies to allow the sales income to escape U.S. taxation.

So, there are some planning opportunities. It is encouraging that the Service provides some certainty. This may be a positive result of the entity classification and anti-abuse rules.

The last thing I wanted to talk about, because I know we are running out of time, is just to mention the Brown Group case, in which the 8th Circuit reversed the Tax Court.[18] That case involved a U.S. parent corporation owning a Cayman Islands controlled corporation which set up a partnership that conducted sales activities on behalf of the U.S. parent. The question was, since the partnership itself was not treated as a related party, whether you could ignore the partnership and instead look at the controlled foreign corporation which is actually receiving a distributive share of the partnership's income to decide whether that income was Subpart F income of the U.S. parent. The 8th Circuit found no Subpart F income.

The Service, of course, was not happy with that result, and issued Notice 96-39, in which it stated its intent to change this rule. Lo and behold in the hybrid anti-abuse rules that were issued this week[19] there is an example in which the Service does—in a situation similar to the Brown group—say that it is going to determine whether or not you have Subpart F income by ignoring the partnership. In essence, it looks at the controlled foreign corporation and attributes the partnership's activities directly to the controlled foreign corporation.

One big question was left open. In the example in the proposed regulations, the controlled foreign corporation does have 80 percent ownership of the partnership, which seems to suggest that there should be Subpart F income. The Service mentions in

18 Brown Group, Inc. v. Commissioner, 77 F.3d 217 (8th Cir. 1996).

19 Prop. Treas. Reg. § 104537-97, 26 C.F.R. parts 1 and 301 (1998).

the explanation that it does want some comments about what happens to a minority owner. Suppose you have a controlled foreign corporation with a minority ownership interest. Assume there is also a brother/sister controlled foreign corporation with an investment in the partnership, does a CFC that owns less than 20 percent of the partnership, have Subpart F income as well? That is something that is left open but seems to me to be carrying the regulations a little bit too far if the minority owner derives Subpart F income. Thank you.

MR. McDANIEL: Thank you all. I want to come back and be sure that we understand where we are now with the new temporary regulations and the positions taken by the IRS. With respect to the transaction that Alan was describing that I have got up here on the board,[20] under the temporary regulations Alan, what will happen to that transaction assuming it is a low tax country and that the payment is deductible in that low tax country?

MR. GRANWELL: Basically, at a very general level, what is going to happen here under the check-the-box in Subpart F prior to the regulation, was nothing, which was a good thing from the U.S. tax planning point of view. We are now going to create Subpart F income because a branch could be viewed as a separate CFC and the income would be viewed as a foreign personal holding company. So, it is going to be a taxable event.

Again, that may not be bad if you have excess foreign tax credits but it eliminates the nothingness of the transaction and makes it a taxable transaction.

MR. McDANIEL: This position has aroused a lot of controversy and like many things in tax law, it depends upon what you are comparing it to. If you are comparing a transaction to the situation in which G1 actually owns a separately incorporated subsidiary in a low tax jurisdiction which is treated as a corporation for U.S. tax purposes, then the payment by low tax to G2 is Subpart F income, currently taxed in the U.S.

So, viewed from that perspective, what the Service has done is place the low tax company in the same situation regardless of whether it is treated as a branch or as a corporation under the check-the-box regulations. From that perspective, there is

20 *See* McDaniel, *supra* note 6, at 106 (Panel Example II).

greater neutrality from the perspective of Subpart F. But as you can see here, there may be no U.S. tax being avoided. It is only a tax overseas that may be perceived as being avoided. If that is your reference point, then the position in the temporary regulations is rather difficult to defend.

MR. GRANWELL: Can I just make two comments on that? There has been some comment that perhaps the Treasury Department may not have the authority to promulgate these rules because there is a branch rule in the foreign base company sales area which is specifically done by statute and then extended by regulations and here, what Treasury and the IRS seem to be doing is extending the branch concept to foreign personal holding company income and potentially the services income. There have been questions about their authority to do that, and this lack of clarity may be one of the reasons there is a legislative proposal, introduced by the Administration, to have Congress adopt a section granting Treasury the authority to promulgate these types of regulations. That is a topic of some contention, as you are mentioning.

I would just like to get back to some of the points Karen was making about potential abuses. I maybe view it from the other point of view. Both Bill and I have been practicing a long time in this area and U.S. multinationals now are seeking to compete in a global arena against foreign multinationals that may have more flexible tax systems. The emphasis may be on trying to figure out how to do that appropriately and save taxes; from the company's point of view, it is trying to do it from a business perspective and all of these rules do not make its life any easier. In fact, it makes its life very complicated.

The bottom line is that U.S. multinationals are trying to sell their goods or services in the most competitive way using whatever legislation is available here and the United States is seeking to potentially penalize the U.S. multinationals for reducing foreign tax. I think a number of practitioners question why that would be the case where the residual income ultimately will be subject to U.S. tax; we should not be viewed as the world's tax policemen.

MR. BRICKER: Now, I will start with just seconding the second point that Alan made, and that is, if income is earned abroad and not taxed, at some point in time when remitted to the U.S. it

will bear tax. Let's assume it is a corporate shareholder so you will end up with 35 percent corporate tax plus of course, state and local taxes.

To the extent that it bears a 35 percent foreign income tax, plus or minus without getting into the mechanics, the U.S. gets nothing. So, on that point, I just think you have to understand the mechanics of the foreign tax credit to appreciate it.

I also agree with the point on competition and I think that goes without saying. I wanted to also point out in the materials there is a reference to a piece that was put together by the Tax Executive Institute where they questioned the ability of the Internal Revenue Service to issue these regulations, and the fact that legislation has been proposed gives you some indication that that is an open question.

I also think that you get into this question of U.S. multinationals, which are forced to deal with the Subpart F rules. The Subpart F rule complexity is beyond comprehension. We are talking about very little pieces in very broad terms. The question of what is manufacturing, illustrated by Karen's point about maquiladoras. I have a Subpart F outline that briefly discusses that for about 12 pages of cites, 12 pages singled space of cases, rulings, regulations, private rulings. It is a very complex area and yet the U.S. company is trying to compete, to minimize its tax abroad to maximize its competitiveness.

So, there are two different perspectives and I appreciate the policy issues, and I also appreciate the practicalities that U.S. companies need to deal with.

MR. GRANWELL: I just want to make one follow-up point with the maquiladora. Basically, that is not a tax issue. It is done for labor and it is not a tax planning issue. It really is not, and so if you frame it in terms of that tax planning issue, I think you are, with all due respect, missing the fact that the major reason why people set up maquiladoras is the labor costs.

MR. McDANIEL: I would only add on to your "ultimately to be taxed back in the U.S.," probably a good many people in this room along with me have made a substantial living on deferring taxes.

MR. GRANWELL: I said ultimately.

MR. McDANIEL: I know. I do not think that we should minimize the benefit of deferral. But that is where we are with

Notice 98-11 and the new temporary regulations.

I would like to come back and re-summarize the effect of the reversal of the 1970's ruling in your case to be sure exactly where we are today and the impact of the reversal of that position in two or three well chosen sentences.

MR. BRICKER: Yes, very simply, up until the reversal which was the '97 ruling, a U.S. company that owned a controlled foreign corporation could manufacture either itself by having the bricks and mortars in plant or under a properly drafted contract could through an independent party, with some bells and whistles being attended to. The ability now to do this through an independent party, even with the proper bells and whistles, has been thrown out by the '97 ruling to the extent you believe it will be upheld. There is— you talked about the amount of controversy, the '97 ruling —

MR. McDANIEL: But before you go —

MR. BRICKER: Okay.

MR. McDANIEL: With what result?

MR. BRICKER: Well, if you cannot manufacture, the consequence is that you will no longer come into the exception under Subpart F for manufacturing and depending on the circumstances, more likely than not you will have Subpart F income and lose deferral.

MR. GRANWELL: Can I just follow up on that? Bill very lucidly explained there was a major reversal, and the way I view that is there are really two issues. One, do you have an attribution of manufacturing which goes into agency concepts and other concepts which that IRS ruling never discussed; basically when you are looking at what occurred in the contract manufacturing situations, you are selling something different than what you gave to the contract manufacturer. So, you may not have Subpart F income in the first place.

The second point as to whether you have a branch goes to a whole separate issue apart from the manufacturing, although that has also been the subject of a lot of dispute as recorded in the tax press. I think, however, that that ruling really is rather controversial. It impinges on agency and other treaty-type concepts and I would suspect that we have not heard the end of that story, and there may well be some serious litigation about the IRS position.

MR. McDANIEL: Karen, did you want to add any comments?

MS. BROWN: Just a final comment because I think we are really out of time now. In response to Alan's point about the maquiladoras, I was not suggesting that this was an abuse of the tax system. I think the abuse was built into the foreign sourcing rules. I think the abuse for the maquiladoras is again, our system of deferral, which allows us to go offshore and use a foreign corporation to defer U.S. tax and to have low cost operations. I know that trying to reduce your tax cost is a business judgment, but I also think it is a labor exploitation problem as well. I mean it is a problem because we go to Mexico and set up maquiladoras to pay people less than $2 an hour to manufacture goods and the U.S. tax system makes it advantageous.

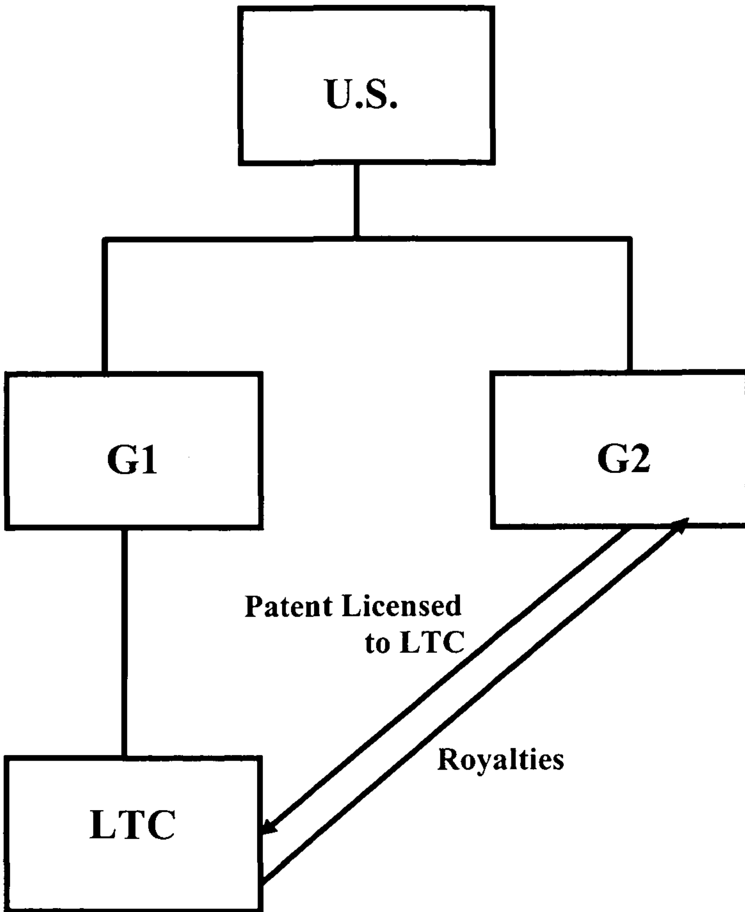
So, I think that is a labor problem and I do not think that is an abusive situation from a tax standpoint. That is already built into our foreign tax system.

MR. GRANWELL: Well, we have the North American trade agreement and now we can go— that is a whole other subject.

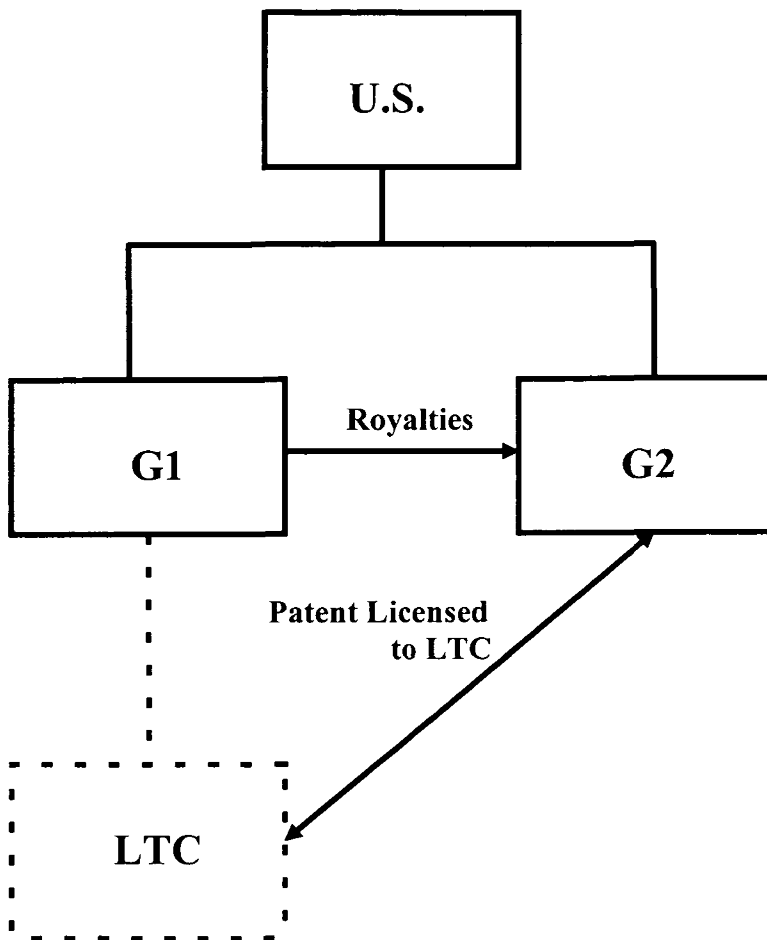
# APPENDIX I

## PANEL EXAMPLE I

PAUL R. MCDANIEL



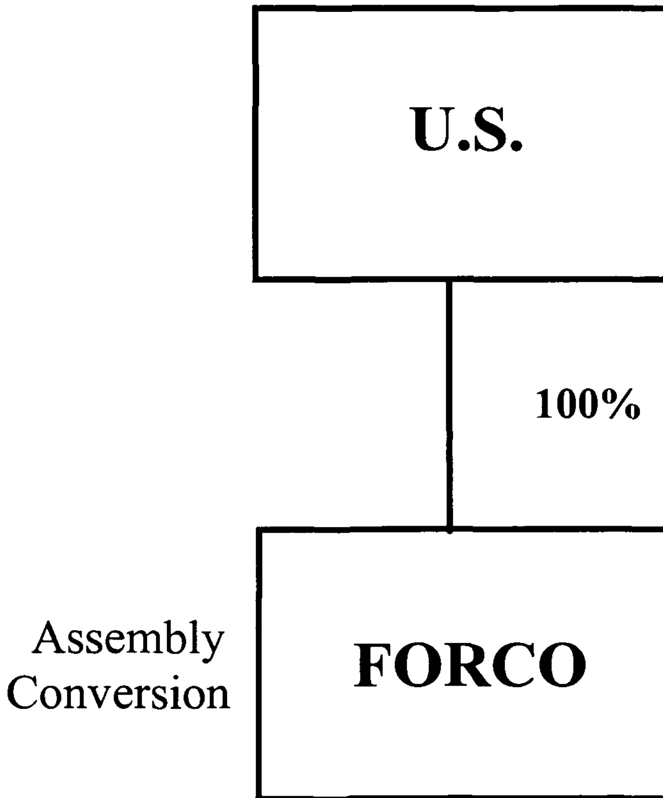
# PANEL EXAMPLE II



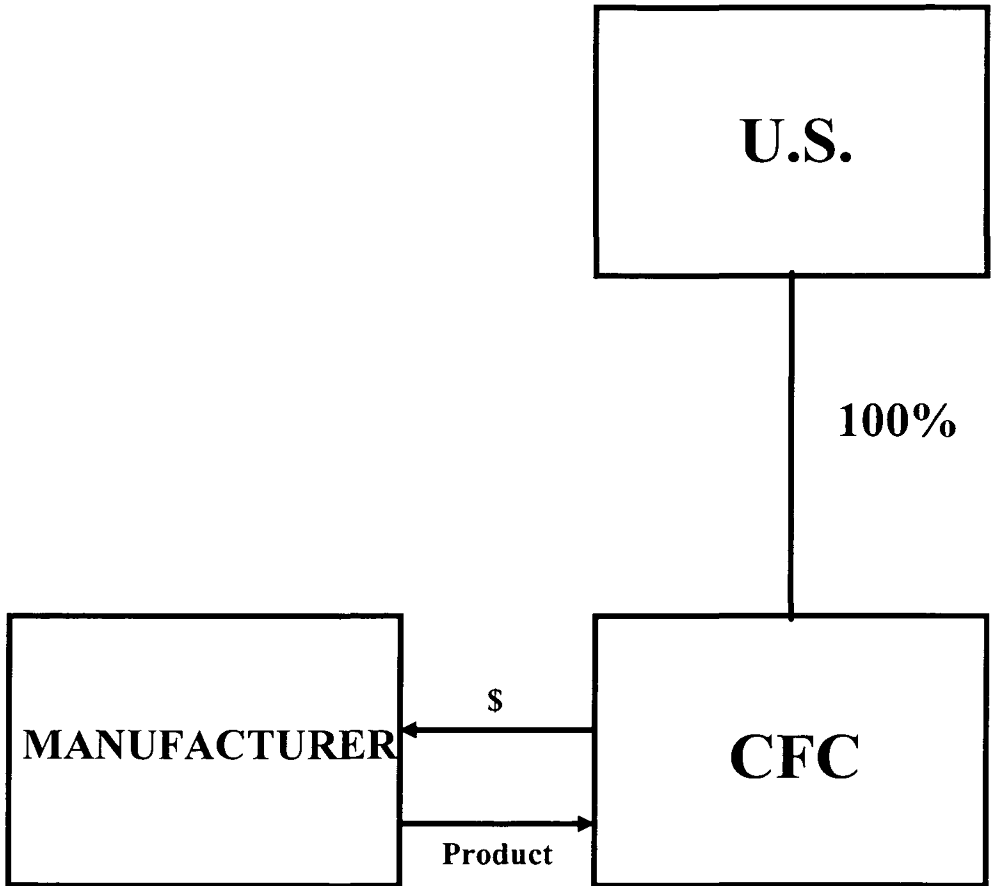
# APPENDIX II

## SUBPART F MANUFACTURING

WILLIAM L. BRICKER, JR.



## SUBPART F CONTRACT MANUFACTURING



## SUBPART F PLANNING