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Treasury Creates a Monster. Australia, Beware the Hybrid Entity!

Abstract

Ten years ago, the United States Treasury Department promulgated Regulations on the income tax classification of business entities. Most business entities, domestic and foreign, may elect for United States tax purposes to be treated as an independent entity, ie, a corporation separate and distinct from its shareholders, or as a transparent organization, either a partnership or a branch depending upon the number of owners. Particularly in the international arena, the 'check-the-box' election has revolutionised the practice of international tax law, not always for the good from the standpoint of sound international tax policy. The possibility of being simultaneously a separate entity for tax purposes under the law of a foreign jurisdiction, while being transparent for United States purposes and vice versa, has created planning opportunities previously beyond reach and frequently in conflict with the purpose of the existing international tax legislation. What, if anything, should be done about these aberrational consequences?

Keywords

income tax, business entities, United States, tax legislation

TREASURY CREATES A MONSTER. AUSTRALIA, BEWARE THE HYBRID ENTITY!

*Philip F Postlewaite**

Ten years ago, the United States Treasury Department promulgated Regulations on the income tax classification of business entities. Most business entities, domestic and foreign, may elect for United States tax purposes to be treated as an independent entity, ie, a corporation separate and distinct from its shareholders, or as a transparent organization, either a partnership or a branch depending upon the number of owners. Particularly in the international arena, the 'check-the-box' election has revolutionised the practice of international tax law, not always for the good from the standpoint of sound international tax policy. The possibility of being simultaneously a separate entity for tax purposes under the law of a foreign jurisdiction, while being transparent for United States purposes and vice versa, has created planning opportunities previously beyond reach and frequently in conflict with the purpose of the existing international tax legislation. What, if anything, should be done about these aberrational consequences?

INTRODUCTION

The check-the-box Regulations were finalized into law on January 1, 1997. They are fast approaching their tenth birthday. Their birth was celebrated by most¹ as a wondrous new addition to the taxing structure of the United States as it was entering the new millennium. Hailed as simplifying the classification issue and producing clarity and ease of administration, it was a modification of tax classification standards about which to be proud. However, a decade later, an assessment of their impact in the international tax arena is not so rosy. While I will address only the areas of the foreign tax credit and tax treaty benefits in this article, other areas have similarly evidenced negative repercussions for international tax policy of the United States attributable to their omnipresence in everyday tax planning.²

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1 There are always a few naysayers of whom the author was one.

2 This essay builds on an earlier analysis of this issue. See P F Postlewaite, 'The Check-the-Box Regulations Turn Ten—Will We Survive Their Teen-Age Years?' (2006) 6 *Journal of Taxation of Global Transactions* 49.

TAX CLASSIFICATION OF BUSINESS ENTITIES

THE CHECK-THE-BOX REGULATIONS

1 History

In 1960, the Service issued the so-called *Kintner* Regulations³ setting forth the criteria for the classification of unincorporated organizations as associations, partnerships, or trusts. The purpose of the Regulations was to counter the results of *United States v Kintner*,⁴ in which an unincorporated organization was classified as taxable as a corporation instead of as a partnership, thereby resulting in its owners being able to obtain benefits then restricted to employees. The Regulations were written with a strong partnership bias. They were based on the 'corporate resemblance' test of *Morrissey v Commissioner*⁵ and detailed six corporate characteristics to be considered in classifying unincorporated organizations. Two of the characteristics were to be considered in distinguishing trusts from corporations and the other four were to be considered in distinguishing partnerships from associations treated as corporations for tax purposes.

Given the partnership bias of the *Kintner* Regulations, it became virtually impossible for an unincorporated organization that wished to be taxed as a partnership not to do so through proper drafting of the organizational and operating agreements. Furthermore, the proliferation of state laws providing for limited liability companies in all 50 states, which the Service ruled were taxable as partnerships, eliminated one of the reasons, limited liability, for an organization to incorporate. As a result, the Treasury and the Service concluded that the rules of the *Kintner* Regulations had become formalistic and, in effect, permitted well-advised taxpayers to choose their taxable status by proper draftsmanship of the formation and operating agreements. A simpler, more flexible approach to the classification issue was sought.

In 1995, the Service announced that it was considering allowing taxpayers to treat unincorporated organizations as partnerships or corporations on an elective basis.⁶ Proposed Regulations §§ 301.7701-1, 301.7701-2, 301.7701-3, and 301.7701-4 were issued in 1996 to replace the corporate resemblance test of the *Kintner* Regulations. They were enthusiastically received as simplifying and liberalizing the entity classification rules and were colloquially dubbed the 'check-the-box' ('C-T-B')

3 Prior Reg §§ 301.7701-1, 301.7701-2, 301.7701-3, and 301.7701-4.

4 216 F 2d 418 (9th Cir 1954).

5 296 US 344 (1935). See generally Willis, Pennell, and Postlewaite, *Partnership Taxation* ch 1 (Warren Gorham & Lamont 6th ed 1997).

6 Notice 95-14, 1995-1 CB 297.

(2006) 16 REVENUE LJ

Regulations. After holding hearings and considering comments, the Treasury finalized the Regulations effective January 1, 1997.

Despite the enthusiastic reception of the new elective regime to replace the corporate resemblance regime, some serious questions have been raised with respect to the validity of the check-the-box Regulations. Perhaps the most serious question is whether the Regulations come within the Treasury's authority under § 7805 to issue interpretive Regulations. Also in question is the authority of the Treasury to in effect determine tax policy by permitting identical organizations to be taxed differently at the choice of the taxpayer, particularly in light of the fact that the Code at §§ 7701(a)(2) and 7701(a)(3) utilizes mutually exclusive definitions of corporations and partnerships. Other questions have been raised, such as whether the *Kintner* Regulations tacitly have been approved by Congress after being in effect for 36 years and surviving many changes in the Code, particularly the adoption of the Internal Revenue Code of 1986, and whether the Supreme Court's determination in *Morrissey*⁷ of what constitutes an 'association' based on corporate resemblance governs. Even the Joint Committee on Taxation has twice considered the need for legislation on the subject and, if needed, the type.⁸

2 Overview

Check-the-box Regulations §§ 301.7701-1, 301.7701-2, and 301.7701-3 completely replaced their prior counterparts, although they contain some similar provisions. They radically alter the classification criteria for tax treatment of an organization as a partnership or a corporation. The corporate resemblance test with its four corporate characteristics—continuity of life, limited liability, centralized management, and free transferability of interests—no longer is applicable.⁹

The overall effect of the check-the-box Regulations is that an unincorporated organization or other arrangement recognized for federal tax purposes as an entity separate from its owners, engaged in business, and not a trust or a *per se* corporation is an 'eligible entity'. An eligible entity with two or more members may elect to be

7 296 US 344 (1935).

8 Joint Committee on Taxation, *Review of Selected Entity Classification and Partnership Tax Issues* (JCS-6-97) April 8, 1997. See Postlewaite and Pennell, 'Partnership Proposals of the Joint Committee—"Houston, We Have a Problem"' 76 Tax Notes 527 (1997). See also Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (Comm Print 2005).

9 An exception is the extent to which limited liability remains pertinent with respect to the default classification of foreign eligible entities.

TAX CLASSIFICATION OF BUSINESS ENTITIES

classified and taxed either as a partnership or as an association taxable as a corporation. An eligible entity with only one member may elect to be classified as an association taxable as a corporation or to be disregarded and taxed to the one member as a sole proprietor or as a branch of the one member owner, thereby obtaining the single one level tax as a partnership rather than the two level tax of the corporation/shareholder format.¹⁰ If the entity does not make an affirmative election as to its tax classification, its tax classification is determined under default provisions.¹¹ The default provisions basically favour non-corporate classification.

Regulation § 301.7701-1 provides a brief summary of the classification procedure and focuses primarily on the method of determining whether an organization or 'arrangement' qualifies as an 'entity' for classification purposes. Regulation § 301.7701-2 provides the method of determining whether an entity is a 'business' entity. Regulation § 301.7701-3 identifies a business entity that is an 'eligible' entity and details the choice of tax classification available to that entity.¹²

Thus, three basic considerations are necessary to determine if an unincorporated organization is entitled to make the classification election:

1. Whether the organization or other arrangement is considered to be an entity for federal tax purposes;¹³
2. If the arrangement is considered to be an entity, whether it is a business entity;¹⁴ and
3. If the arrangement is a business entity, whether it is an eligible entity.¹⁵

3 Entity

The check-the-box Regulations require that, in order for an organization to be entitled to elect its classification for tax purposes, it must be considered an entity separate from its owners for federal tax purposes, not necessarily that it be a partnership.¹⁶

10 Reg § 301.7701-3(a).

11 Reg §§ 301.7701-3(b) and 301.7701-3(b)(2).

12 Regulation § 301.7701-4 identifies what constitutes a trust as distinguished from a business entity.

13 Reg § 301.7701-1(a).

14 Reg § 301.7701-2(a).

15 Reg § 301.7701-3(a).

16 IRC §§ 761(a) and 7701(a)(2) define a 'partnership' as including 'a syndicate, pool, joint venture, or other unincorporated organization, through or by means of which any

(2006) 16 REVENUE LJ

Whether an organization qualifies as an entity is a matter of federal tax law. The status of the organization as an entity under local law is irrelevant.¹⁷

The Regulations do not provide specific criteria for what constitutes an entity. They provide in general terms that: '[a] joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits there from.'¹⁸ The operation of a trade or business or a financial operation or venture and the sharing of profits are essential to the existence of a separate entity.

These provisions make it particularly difficult to determine what constitutes a single owner entity, a concept found throughout the Regulations. Some states permit single owner limited liability companies that presumably come within the Regulation's category. However, beyond this possibility and the possibility that some foreign entities may be single owner entities, the parameters of a single owner entity are difficult to conceptualize in light of the language of the Regulations referring to 'joint ventures', 'contractual arrangements,' and 'division of profits,' all of which at least imply more than one person.

The Regulations also state that a joint undertaking merely to share expenses, such as two people jointly constructing a ditch to drain surface water from their properties, does not create a separate entity. Similarly, joint ownership of property that is kept in repair and rented does not constitute a separate entity. However, if the joint owners of property, eg, an apartment building, in addition to renting space in the building also provide services to the tenants, a separate entity does exist, presumably because the provision of services constitutes a business.¹⁹

It is essential to recognize that these provisions do not pertain to whether the organization is a *partnership* but instead to the issue of the existence of an *entity* that may *elect to be taxed as a partnership*. The requirements for the existence of a partnership are substantially different. However, as discussed later, the check-the-box Regulations may make the technical existence of a partnership irrelevant because

business, financial operation, or venture is carried on, and which is not. . . a corporation or a trust or estate.'

17 Reg § 301.7701-1(a)(1).

18 Reg § 301.7701-1(a)(2). This language is similar to that in the prior Regulation § 301.7701-1(a) defining partnership.

19 The prior Regulation at § 301.7701-3(a) contained similar explanations.

TAX CLASSIFICATION OF BUSINESS ENTITIES

those Regulations define a partnership as a business entity that is not a corporation and has at least two members.²⁰

4 Business Entity

To be able to elect its tax status, an organization that qualifies as an entity also must qualify as a 'business entity,' which the Regulations²¹ define as: '[a]ny entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code.'

The Regulation thus categorises all entities as either business entities or trusts. Whether an entity is classified as a trust, preventing it from being a business entity, depends on the type of trust. The Regulation²² refers to five types of trusts—ordinary trusts, business trusts, investment trusts, liquidating trusts, and environmental remediation trusts—only some of which are treated as trusts rather than business entities. Ordinary trusts are not business entities.²³

Business trusts are not treated as trusts and therefore may qualify as business entities.²⁴ Some arrangements, called business or commercial trusts, are referred to as trusts because of the manner in which title to property is held, but are not treated as trusts under the Code because they are not arrangements simply to protect or conserve property for the beneficiaries. Instead, they are a device for conducting a profit-making business that could have been carried on in another form, ie, as a corporation or a partnership.

An investment trust will not be classified as a trust if there is a power to vary the investment of the certificate holders.²⁵ If the trust has a single class of ownership interests representing beneficial ownership of the trust assets, it will be classified as a trust if there is no power to vary the investment of the certificate holders. If there are multiple classes of ownership interests, the trust will be classified as a business entity unless there is no power to vary the investment of the certificate holders, the trust is

20 Reg § 301.7701-2(c)(1).

21 Reg § 301.7701-2(a).

22 Reg § 301.7701-4.

23 Reg § 301.7701-4(a).

24 Reg § 301.7701-4(b).

25 Reg § 301.7701-4(c).

(2006) 16 REVENUE LJ

formed to facilitate direct investment in the assets of the trust, and the multiple classes of ownership interests are incidental to that purpose.

A liquidating trust is treated as a trust under the Code because it is not formed to carry on a profit-making business. Environmental remediation trusts are treated as trusts if the organization is formed as a trust under state law with the primary purpose of collecting and disbursing funds for environmental remediation of a waste site provided the contributors to the trust have potential liability.²⁶

5 Eligible Entity

A business entity that qualifies as an eligible entity and has two or more members may elect to be classified for tax purposes either as a partnership or as an association taxable as a corporation. An eligible entity that has only one member may elect to be treated as an association or to be disregarded and taxed to the owner.²⁷

An eligible entity is a business entity (ie, an entity that is not classified under the Regulations as a trust) that is not defined in the Regulations as a *per se* corporation in any one of eight categories, other than category (2) referencing associations. Eight categories are defined in the Regulations²⁸ as *per se* corporations, the most relevant of which are:

1. A business entity organised under a Federal or State statute that is referred to as incorporated or as a corporation, body corporate, or body politic;
2. An association as determined under Reg § 301.7701-3; and
3. Certain business entities formed in any one of 80 listed foreign countries,²⁹ with certain specified exceptions, modifications, and clarifications.³⁰

Although a business entity that is an association is listed as a *per se* corporation under category (2) of Reg § 301.7701-2(b), it nonetheless is an eligible entity³¹ presumably because it is an association only because it has so elected for tax purposes. The C-T-B Regulations do not define what constitutes an association other than to say ‘as

26 Reg § 301.7701-4(e).

27 Reg § 301.7701-3(a).

28 Reg § 301.7701-2(b).

29 Reg § 301.7701-2(b)(8)(i).

30 Reg § 301.7701-2(b)(8)(ii)-(v).

31 Reg § 301.7701-3(a).

TAX CLASSIFICATION OF BUSINESS ENTITIES

determined under Reg § 301.7701-3.³² That provision simply states that an eligible entity with two or more members may elect to be classified as an association or as a partnership, and an eligible entity with a single owner may elect to be classified as an association or to be disregarded.³³ Thus, whether an association exists is a matter of choice, not mandate. If a business entity is an association by election, it is taxed as a corporation.

6 Elective classification

An eligible entity (a business entity that is not classified as a *per se* corporation, except as an association) may elect its classification for federal tax purposes. If it has two or more members, it may elect to be classified either as an association, and thus taxed as a corporation, or as a partnership. If the eligible entity has only a single owner, it may elect either to be classified as an association, thereby taxed as a corporation, or to be disregarded as an entity separate from its owner.³⁴

It is not necessary for an entity to affirmatively make a classification election. The classification process is greatly simplified by default classification provisions.³⁵ Similar but different default and election classification rules apply to domestic and foreign entities. A 'domestic entity' is defined by both the Code and the Regulations as one created or organised in the United States or under the laws of the United States or of any state (including the District of Columbia). A 'foreign entity' is defined simply as one that it is not a domestic entity.³⁶

7 Default Classification

The classification process for domestic and foreign eligible entities is governed by default rules in the absence of an affirmative election. Different default rules apply to domestic and foreign eligible entities.

A domestic eligible entity (a domestic business entity that is not a trust or a *per se* corporation, except as an association by virtue of an election) that does not make an election automatically is classified as a partnership if it has two or more members.

32 Reg § 301.7701-2(b)(2).

33 The prior corporate resemblance Reg § 301.7701-2(a)(3) defined an association as an unincorporated organization that had more corporate characteristics than non-corporate characteristics.

34 Reg § 301.7701-3(a).

35 Reg §§ 301.7701-3(b)(2) and 301.7701-3(b)(3).

36 IRC §§ 7701(a)(4) and 7701(a)(5); Reg § 301.7701-1(d).

(2006) 16 REVENUE LJ

Such an entity with a single owner is disregarded as an entity separate from its owner if it does not make an election.³⁷ This default classification is based upon the Treasury's belief as to what the entity members expect. The default classification remains in effect until the entity elects otherwise.³⁸ If the domestic eligible entity is satisfied with its default classification, no election is necessary. A classification election is necessary only if the entity wishes to be classified initially as other than its default classification or wishes to change its classification.

The corporate characteristic of limited liability remains a determinative factor in the default classification of a foreign eligible entity (a foreign business entity that is not a trust or a *per se* corporation, other than an association by virtue of an election). A foreign eligible entity that does not elect otherwise automatically is classified as a partnership if it has two or more members at least one of whom does not have limited liability.³⁹ If all members of such an entity have limited liability, the entity automatically is classified as an association if it does not elect otherwise.⁴⁰ A foreign eligible entity that has a single owner who does not have limited liability automatically is disregarded as an entity separate from its owner, if it does not elect otherwise, and its income is taxed to the owner.⁴¹

For purposes of the default classification of a foreign eligible entity, the Regulations provide that a member has limited liability if he or she does not have 'personal liability' for the debts of or claims against the entity by reason of being a member. A member has personal liability if the creditors of the entity can seek satisfaction of all or any part of the debts of or claims against the entity from the member because of his or her status as a member. If the member has personal liability, the existence of an agreement under which another person assumes the liability or agrees to indemnify the member does not eliminate that personal liability. Whether a member has personal liability is determined solely by the law under which the entity is organised. However, if that law permits the entity to specify in its organizational documents whether a member has personal liability, those documents also may be relevant.⁴²

37 Reg § 301.7701-3(b)(1).

38 Reg § 301.7701-3(a).

39 Reg § 301.7701-3(b)(2)(i)(A).

40 Reg § 301.7701-3(b)(2)(i)(B).

41 Reg § 301.7701-3(b)(2)(i)(C).

42 Reg § 301.7701-3(b)(2)(ii).

TAX CLASSIFICATION OF BUSINESS ENTITIES

8 Affirmative election

As previously discussed, the check-the-box Regulations provide that an unincorporated organization or arrangement that is recognized for federal tax purposes as an entity separate from its owners, is engaged in business, is not a trust or a *per se* corporation (ie, is an 'eligible entity'), and has two or more owners may elect to be classified either as an association which will be taxed as a corporation or as a partnership. If the entity has a single owner, it may elect either to be classified as an association to be taxed as a corporation or to be disregarded as an entity separate from its single owner and be taxed to that owner.

If the entity does not make an election, it will be classified according to specified statutory default rules. Consequently, an eligible entity need not make an affirmative election if it is satisfied with being taxed according to the default statutory classification. An eligible entity needs to make an affirmative election only if it wishes a different original classification or wishes to change its classification.

An eligible entity that wants to obtain a classification other than its default classification, or that wishes to change its classification, must do so by filing with the designated service centre. For the election to be accepted, the entity must supply the information required by the form and by the instructions, including its taxpayer identification number.⁴³ The form must be signed by either (a) each member of the entity who is an owner at the time the election is filed and, if a retroactive effective date is elected, by each person who was an owner between the effective date of the election and the date of its filing or (b) an officer, manager, or member of the entity who is authorized by local law or the organizational documents to make the election.⁴⁴

If an entity elects to change its classification, it generally may not again elect to change its classification within the 60 months succeeding the effective date of the election. However, the Commissioner may permit a subsequent election within the 60-month period if more than 50 percent of the ownership interests in the entity as of the effective date of the subsequent election is owned by persons who did not own any interests in the entity on the effective date of the prior election.⁴⁵

43 Reg § 301.7701-3(c)(1)(i).

44 Reg § 301.7701-3(c)(2).

45 Reg § 301.7701-3(c)(1)(iv).

(2006) 16 REVENUE LJ

9 Tax consequences of a classification change

One obvious tax consequence of any change in the tax classification of an entity for any reason is that after the change the entity will be taxed according to the Code provisions pertaining to the new classification. If a change in the tax classification of an entity occurred under the *Kintner* Regulations, association to partnership or partnership to association, the change was treated as a taxable event, eg, if from association to partnership, as a corporate liquidation.⁴⁶

A partnership can *actually* change to a corporation in one of three ways: (1) the transfer of partnership assets and liabilities to the corporation for stock followed by a distribution of the corporate stock to the partners in liquidation; (2) a liquidation of the partnership by the partners followed by a contribution of the distributed assets subject to liabilities to a corporation in exchange for the stock of the corporation; or (3) a contribution by the partners of their partnership interests to the corporation in exchange for corporate stock resulting in a termination of the partnership and a distribution of the partnership assets to the corporation. Depending on the method selected and the factual particulars of the partnership, different tax consequences may result.⁴⁷

Similarly, a corporation can *actually* be converted to a partnership by (1) the corporation transferring its assets and liabilities to a partnership and distributing the partnership interests to its shareholders in liquidation; (2) the corporation distributing its assets and liabilities to its shareholders in liquidation and the shareholders transferring the assets and liabilities in the formation of a partnership; or (3) the shareholders transferring their corporate stock to a partnership which then liquidates the corporation. Each of those transactions is a taxable event, but the results may differ depending on the factual situation.

The check-the-box Regulations recognize the tax effect of such changes in entity classification. The Regulations describe how elective changes to an entity's classification will be treated for federal income tax purposes.⁴⁸ The Preamble to the Regulations enumerates the various possible changes in classification: (1) a partnership elects to be an association; (2) an association elects to be a partnership; (3) an association elects to be a disregarded entity; (4) a disregarded entity elects to be an association; (5) a partnership converts to a disregarded entity; and (6) a disregarded

46 Rev Rul 63-107, 1963-1 CB 71.

47 In Revenue Ruling 84-111, 1984-2 CB 88, the Service indicated that it would respect the form selected by the taxpayer.

48 Reg § 301.7701-3(g).

TAX CLASSIFICATION OF BUSINESS ENTITIES

entity converts to a partnership. However, the latter two types of alterations involve changes due to the number of members, not an affirmative election.

The Regulation addresses the characterization of such changes for tax purposes. Its Preamble was quick to note that the characterizations provided were selected in an attempt 'to minimize tax consequences of the change in classification and achieve administrative simplicity.' Thus, unaddressed consequences typically should receive a pro-taxpayer interpretation.

If an association elects to be classified as a partnership, it is deemed to distribute its assets and liabilities to its shareholders who, in turn, are deemed to make a contribution of these items to the partnership. If a partnership elects to be classified as an association, it is deemed to contribute all of its assets and liabilities to the association in exchange for stock which, in turn, it distributes to its partners. The association to disregarded entity configuration and vice versa is afforded the treatment one would expect with the election treated as a liquidation or contribution of assets and liabilities, respectively.⁴⁹

THE FOREIGN TAX CREDIT

For the most part, individuals and corporations may be subject to potential taxation in two places: the jurisdiction from which they derive their income (the country of source) and the jurisdiction in which they are organised or resident (the country of residence). Thus, a United States individual or corporation earning \$500 in Germany may be taxed both by Germany (assuming a 40% rate yielding a \$200 tax) and the United States (assuming a 35% rate yielding a \$175 tax). Without relief from one or both of the jurisdictions, the tax bill on \$500 of income would thus be \$375, imposing upon the taxpayer an effective tax rate of 75 percent.

This confiscatory rate of tax would have a particularly deleterious effect on international operations. To prevent double taxation, the United States and its sister countries employ two principal methods by which either the United States or the foreign country relinquishes its claim to tax. The first method of eliminating double taxation is through the execution of tax treaties. Tax treaties generally provide that, for taxing jurisdiction purposes, the country of source yields to the country of residence.⁵⁰ Thus, in the above example, the Germany-United States tax treaty might exempt from

49 Reg §§ 301.7701-3(g)(1)(iii) and 301.7701-3(g)(1)(iv).

50 See Postlewaite and Donaldson, *International Taxation* (4th ed 2003) ch 5.

(2006) 16 REVENUE LJ

German tax any income earned in Germany. By such exclusion, the total tax rate would dip to 35 percent, a far more acceptable tariff.

The second approach is the use of a foreign tax credit, by which the United States extends a dollar-for-dollar credit against its taxes for foreign taxes paid.⁵¹ In contrast to the approach of tax treaties, in the credit context, the country of residence defers to the country of source. Thus, in the above example, a foreign tax credit for the corporation's German tax payments would eliminate the United States tax and yield an overall tax rate of 40 percent. The amount of the credit is linked to the amount of foreign source income derived by the taxpayer.⁵² The credit is available to domestic individuals (residents and citizens) and corporations as well as non-resident individuals and foreign corporations deriving income effectively connected with the conduct of a United States trade or business.⁵³

Tax treaties may also extend a tax credit. An individual or a corporation eligible for the credits of both a treaty and the Code must elect the benefit of one or the other.⁵⁴ In some cases, treaties broaden the benefits of the credit mechanism and thus are the preferred option.⁵⁵

1 Creditable taxes—general principles

The Regulations construct a two-pronged test to determine whether a foreign levy is a creditable tax. The first portion of the Regulations addresses whether a foreign levy qualifies as an income tax for § 901 purposes by determining whether the levy is a tax and whether its predominant character is that of an income tax in the 'United States sense.'⁵⁶ The latter portion of the Regulations addresses rules for determining both the

51 IRC §§ 901 – 908. See generally Postlewaite and Donaldson, *Ibid*, ch 6. The credit is limited in several ways, the most significant being the overall and various limitations of § 904.

52 IRC § 904.

53 *National Cash Register Co v United States* 400 F2d 820 (6th Cir 1968). See also Rev Rul 79-199, 1979-1 CB 246 (treaty tax credit cannot be taken if allocable to § 911 excluded income).

54 See IRC § 906.

55 Belgium, Art 23(2). Such treaty credits may alter the source rules which would otherwise apply for United States tax purposes. Rev Rul 79-206, 1979-2 CB 279 (modification of § 861 source rules by treaty). In some cases, taxes which would not be creditable under the Code may be permissible under a treaty which has a more expansive definition of what constitutes a 'tax'.

56 Reg §§ 1.901-2(a)--1.901-2(d). See also *Wada v Commissioner*, TC Memo 1995-241, 69 TCM 2793 (foreign 'social security' payment not a creditable tax).

TAX CLASSIFICATION OF BUSINESS ENTITIES

amount of tax creditable and the identity of the payor of the tax.⁵⁷ The definitional issue of which payments constitute a tax and which do not permeates the discussion of the foreign tax credit.

1.1 Payor of a tax

Traditionally, a credit has been extended only to the taxpayer incurring a foreign tax liability. A taxpayer incurs a tax liability if the remedies for non-payment run against him or her.⁵⁸ Thus, the imposition of legal liability is the determinative factor with regard to creditability as opposed to who actually pays the tax.⁵⁹ The fact that a withholding agent remits the tax does not deprive the party actually burdened by the tax from qualifying as the taxpayer for credit purposes.⁶⁰ Provided the agent had the right to withhold such funds, the amount of the proceeds withheld constitutes both income to, and a tax payment by, the taxpayer. In essence, the transaction is viewed as though the taxpayer had received the full amount of the proceeds and thereafter personally paid the foreign tax.⁶¹

For example, assume that a United States citizen invested \$1,000 in stock of a French corporation which declared a \$100 dividend. Even though the taxpayer might receive only \$90 because the corporation was required under French law to withhold \$10 as potential tax, she would be considered to have paid the tax since the legal liability for

57 Reg §§ 1.901-2(e)–1.901-2(f).

58 *Biddle v Commissioner* 302 US 573 (1938). Under some circumstances, corporate stockholders may be deemed to have paid taxes incurred by certain subsidiaries. See IRC §§ 902 and 960. See also Rev Rul 87-14, 1987-1 CB 181 (domestic shareholder of Saudi corporation may not claim credit for Saudi income taxes paid by that corporation even though it is the presence of that shareholder which has caused the tax), and Rev Rul 72-197, 1972-1 CB 215 (foreign partnership, treated as an association taxable as a corporation in the United States, was denied a credit for foreign taxes paid by its members).

59 Reg § 1.901-2(f)(2).

60 Reg § 1.901-2(f)(1). See *Nissho Iwai Am Corp v Commissioner* 89 TC 765 (1987); *Norwest Corp v Commissioner* TC Memo 1992-282, 70 TCM 779, affd, 69 F3d 1404 (8th Cir 1995) (Brazilian withholding tax, taxpayers legally liable). See also *Amoco Corp v Commissioner*, TC Memo 1996-159, 71 TCM 2613, affd, 138 F3d 1139 (7th Cir 1998) (Amoco deemed taxpayer for Egyptian tax paid on its behalf by Egyptian government owned corporation pursuant to a 'merged concession agreement').

61 Reg § 1.901-2(f)(2)(ii) examples (1) and (3). In example (3), the foreign country to which tax is owing agrees to assume any tax liability incurred by the taxpayer. Nevertheless, the taxpayer is considered to be in receipt of income and to have paid foreign tax in that amount.

(2006) 16 REVENUE LJ

the tax rested on her. In making the determination of who is the payor of a tax, beneficial interest is controlling. The existence of nominees and agents is ignored.⁶²

1. 2 Amount of tax paid

The Regulations focus on determining the *amount* of foreign tax paid. The scope of the computation is narrow, precluding the availability of the credit for refundable amounts, subsidies, multiple levies, and non-compulsory payments.⁶³ The Regulations limit the creditability of foreign taxes to those taxes which would result from a 'reasonable' application of foreign tax law.⁶⁴ Anything in excess of that standard constitutes a non-compulsory amount for which the credit is not available. Thus, to maximize the potential for creditability, the taxpayer should apply foreign tax law (including applicable tax treaties) so as to reduce foreign income and taxes.⁶⁵ However, a taxpayer is not expected to alter its business form, conduct, or mode of operations in order to demonstrate that an amount is 'compulsory.'⁶⁶

To ensure that a payment is deemed compulsory, the taxpayer should exhaust all 'effective and practical remedies' to reduce the amount of tax paid. A remedy is effective and practical only if the expense of pursuing the remedy 'is reasonable in light of the amount at issue and the likelihood of success.'⁶⁷ The obvious intent of this rule is to restrict the credit to the amount of the taxpayer's actual tax liability. The Regulation refers merely to 'liability under foreign law.' Thus, while it is theoretically possible for a taxpayer to argue that a remedy was not practical because it would not

62 Reg § 1.901-2(f)(2)(ii) example (2).

63 Reg § 1.901-2(e).

64 Reg § 1.901-2(e)(5)(i). An application of foreign tax law is not reasonable if there is actual or constructive notice that the interpretation or application is likely to be erroneous. Accord Tech Adv Memo 8645001 (holding that the 'law on its face' was certain as to the taxpayer's liability).

65 Where the foreign law offers certain elections (eg, depreciation versus expensing an asset), the taxpayer need not elect the most rapid method of recoupment. Reg § 1.901-2(e)(5)(i).

66 Were it not for these rules, a domestic taxpayer would be better able to accumulate foreign income in an effort to bolster the numerator of the § 904 limitation. See also Tech Adv Memo 8645001 (faulting the taxpayer for failure to pursue his remedies). See generally Rev Rul 92-75, 1992-2 CB 197, as clarified by Rev Proc 93-13, 1993-1 CB 482, and by Rev Proc 2002-52, 2002-31 IRB 1 (income of foreign subsidiary allocated to domestic parent under § 482; neither parent nor subsidiary pursued competent authority relief under applicable treaty; amount of foreign taxes considered paid by subsidiary for purposes of § 902 formula reduced).

67 Reg § 1.901-2(e)(5)(i).

TAX CLASSIFICATION OF BUSINESS ENTITIES

have reduced his total foreign and domestic tax bill, the Regulations seemingly would not permit the taxpayer to exercise such a choice.

The Regulations and the examples thereunder are useful tools to shape the contours of the concepts.⁶⁸ If a domestic corporation pays a foreign tax and then discovers through a subsequent court decision that it was entitled to a deduction it did not claim, it must act reasonably and pursue its remedies. If the foreign statute of limitations has not expired and the expense of pursuing the refund is small compared to the tax savings involved, failure to proceed will result in an amount equal to the refund the taxpayer 'could have received' being deemed not to be creditable. This result ensues because that portion of the tax is classified as a non-compulsory payment even if there is a possibility of reversal of that foreign decision by a higher court.⁶⁹

1.3 Subsidies

Given the ingenuity of modern day tax advisers to private industry operating abroad coupled with the desire of foreign governments to maximize their revenues by facilitating the crediting of payments made to them, disguised subsidies are not creditable as foreign tax payments under the Regulations. If a taxpayer makes 'tax payments' to a foreign government which in turn are utilized to provide any direct or indirect benefit to the taxpayer, to a related party, or to any party to the transaction, the amount of which is determined by reference to the tax base, such payments are not creditable.⁷⁰ Such a circular flow of funds or its economic equivalent is not rewarded for tax purposes.

68 See Reg § 1.901-2(e)(5)(ii) example (1) (knowing use of non-arm's-length pricing), example (2) (failure to obtain refund), example (3) (refund claim made but denied, expense of pursuing judicial remedies excessive), example (4) (expired statute of limitations), example (5) (decision to depreciate, rather than expense, assets irrelevant), and example (6) (failure to file refund claim).

69 The assumption is made that the taxpayer had actual or constructive notice of the subsequent decision. Reliance upon competent foreign tax advisers with full disclosure of all relevant facts meets the regulatory standard. Constructive notice arises if a published court decision exists or if a related party is audited by the revenue authorities of a taxing jurisdiction.

70 Reg § 1.901-2(e)(3); *Nissho Iwai Am Corp v Commissioner* 89 TC 765 (1987) (Brazilian withholding tax and related subsidy); *Norwest Corp v Commissioner* TC Memo 1992-282, 70 TCM 779, *affd*, 69 F3d 1404 (8th Cir 1995) (same). See also *Bankers Trust New York Corp v United States* 36 Fed Cl 30 (1996), *revd*, 225 F 3d 1368 (Fed Cir 2000) (Brazilian withholding tax and related subsidy); *Amoco Corp v Commissioner*, TC Memo 1996-159, 71 TCM 2613, *affd*, 138 F3d 1139 (7th Cir 1998) (subsidy not found when benefited third party deemed to be a part of the foreign taxing government).

(2006) 16 REVENUE LJ

A 'subsidy' includes benefits in the form of a rebate, refund, credit, deduction, payment, discharge of an obligation, or any other method that is employed to confer a benefit.⁷¹ Compliance with an official governmental exchange rate for currency is not a prohibited subsidy unless it is tied to transactions giving rise to claims for a tax credit and the economic benefits are broad-based.⁷²

1.4 Predominant character of an income tax

To credit a payment to a foreign country, a taxpayer must show that the payment is an income tax.⁷³ This determination is made independently for each separate foreign levy. In order to constitute a creditable income tax, the levy must be a tax and its predominant character must be that of an 'income tax in the United States sense.'⁷⁴ In order to constitute a tax, the payment must be a compulsory payment to a foreign government which is intended as such.⁷⁵ Fines, penalties, interest, royalties, and charges for specific economic benefits thus do not represent a tax for purposes of the credit. It must be remembered from a policy standpoint that the preferential treatment of a credit is superior typically to that of a deduction. Accordingly, the payment must be more than a payment for which a deduction, such as a royalty payment, would be available and would adequately compensate.

The tax must be designed, similar to most United States taxes, to reach net gain. The Regulations elaborate that the net gain requirement is dependent upon compliance with a three-pronged test—a realization test, a gross receipts test, and a net income test.⁷⁶ Additionally, the tax may not be a 'soak-up' tax. A soak-up tax is one for which liability is dependent upon the availability of the credit against the taxpayer's tax obligation to another country.⁷⁷

71 Reg § 1.901-2(e)(3)(i)(A).

72 Reg §§ 1.901-2(e)(3)(iii) and 1.901-2(e)(3)(iv) example (3). See Rev Rul 84-143, 1984-2 CB 127 (use of official Mexican exchange rate with respect to withholding tax does not result in subsidy).

73 IRC § 901(b). It is well settled that foreign taxes may be credited even if levied upon income which would have been exempt from tax under the Code. Rev Rul 54-15, 1954-1 CB 129. To be distinguished is the § 904 limitation, under which foreign source income taxable under domestic law is the numerator and total taxable income the denominator.

74 Reg § 1.901-2(a)(1)(ii).

75 Reg § 1.901-2(a)(2)(i).

76 Reg §§ 1.901-2(a)(3)(i) and 1.901-2(b).

77 Reg §§ 1.901-2(a)(3)(ii) and 1.901-2(c).

TAX CLASSIFICATION OF BUSINESS ENTITIES

2 Corporate eligibility to utilise the foreign tax credit – domestic stockholders in foreign corporations: § 902

The foreign tax credit is generally allowed only to the taxpayer who paid, or on whose behalf were paid, foreign taxes to a foreign government or possession.⁷⁸ However, a domestic corporation meeting prescribed requirements of stock ownership in a foreign corporation is permitted to claim the credit for foreign taxes paid by that foreign subsidiary attributable to earnings distributed to that domestic shareholder. In essence, the distribution 'piggybacks' to the distributee the amount of foreign taxes incurred in earning such amounts.

The § 902 'deemed paid' provisions have undergone substantial modifications since their enactment. Current law permits a domestic corporation which receives a dividend⁷⁹ from a foreign corporation in any taxable year to take a credit for taxes deemed paid if it owns at least ten percent of the voting stock of the foreign corporation.⁸⁰ For purposes of § 902, the payor foreign corporation is designated a 'first-tier corporation.'

The deemed paid provisions extend to sixth-tier subsidiaries.⁸¹ A first-tier corporation to which dividends are paid by a foreign corporation in which the first corporation owns at least ten percent of the voting stock (a 'second-tier' corporation) is deemed to have paid a portion of the taxes actually paid or accrued by the second-tier corporation.⁸² A second-tier corporation to which dividends are paid by a foreign corporation in which the second-tier corporation owns at least ten percent of the voting stock (a 'third-tier' corporation) is deemed to have paid a portion of the third-tier corporation's taxes.⁸³ The treatment is available similarly through 'sixth-tier' corporations.

78 Reg § 1.901-2(a). See Tech Adv Memo 8409002 (treatment of United Kingdom taxes for foreign tax purposes); *Xerox Corp v United States* 41 F3d 647 (Fed Cir 1994) (United Kingdom advance corporation tax paid by subsidiary creditable under § 902).

79 A dividend is received for purposes of the deemed paid rule when it is unqualifiedly subject to the distributee's demand. Reg § 1.902-1(a)(12).

80 IRC § 902(a). The ten percent stock ownership requirement must be met at the time the dividend is received by the corporation. Reg §§ 1.902-1(a)(1) and 1.902-1(c). See *First Chicago Corp v Commissioner* 96 TC 421 (1991), affd, 135 F 3d 457 (7th Cir 1998) (insufficient ownership when dispersed through subsidiaries).

81 IRC § 902(b).

82 IRC § 902(b); Reg § 1.902-1(a)(3).

83 IRC § 902(b); Reg § 1.902-1(a)(4).

(2006) 16 REVENUE LJ

An additional ownership limitation is imposed for lower-tier subsidiaries. In order to claim the credit for lower-tier corporations, the domestic corporate parent must have at least five percent indirect ownership in those foreign corporations.⁸⁴ In a two-tier arrangement, the percentage of stock owned by the domestic corporation in the first-tier corporation multiplied by the percentage of stock held by the first-tier corporation in the second-tier corporation must equal at least five percent. With a three-tier arrangement, the percentage share held by the domestic corporation and each tier corporation when multiplied together must equal at least five percent. Similar requirements apply in determining the indirect ownership standards for lower-tier subsidiaries.⁸⁵ Examples of this calculation are as follows:

Example 1

Domestic corporation A owns 30 percent of foreign corporation B (first-tier corporation). Corporation B owns 40 percent of foreign corporation C (second-tier corporation). Corporation C owns 50 percent of foreign corporation D (third-tier corporation).

In this case, both the ten percent direct ownership and the five percent indirect ownership requirements are met.

Ten Percent Direct Ownership:

A owns more than ten percent of B (30%)

B owns more than ten percent of C (40%)

C owns more than ten percent of D (50%)

AND

Five Percent Indirect Ownership:

A owns greater than five percent of C (second-tier) through B (first-tier) (30% x 40% = 12%).

84 IRC § 902(b)(2).

85 Corporations below the third-tier may not qualify for this treatment unless the foreign corporation is a Controlled Foreign Corporation and the domestic corporation is a United States shareholder. See IRC § 902(b)(2).

TAX CLASSIFICATION OF BUSINESS ENTITIES

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

Thus, domestic corporation A can claim the foreign tax credit for taxes paid and deemed paid by all three of the tiered corporations.

Example 2

Domestic corporation W owns 25 percent of foreign corporation X (first-tier). Corporation X owns 30 percent of foreign corporation Y (second-tier). Corporation Y owns 40 percent of foreign corporation Z (third-tier).

In this case, although the ten percent direct ownership requirement is met, the five percent indirect ownership requirement is not.

Ten Percent Direct Ownership:

W owns greater than ten percent of X (25%)

X owns greater than ten percent of Y (30%)

Y owns greater than ten percent of Z (40%)

BUT

Five Percent Indirect Ownership:

Although W owns greater than five percent of Y (second-tier) through X (first-tier) ($25\% \times 30\% = 7.5\%$), W owns less than five percent of Z (third-tier) through Y (second-tier) and X (first-tier) ($7.5\% \times 40\% = 3\%$). Therefore, domestic corporation W cannot claim credit for taxes deemed paid by Y (second-tier) for foreign taxes actually paid by Z (third-tier). It can, however, claim the credit for taxes deemed paid by X (first-tier) for foreign taxes actually paid by Y (second-tier).

3 Calculating the Taxes Deemed Paid by Domestic Corporations

In general, a domestic parent corporation cannot claim a credit for foreign taxes paid by its foreign subsidiary unless the subsidiary makes a dividend distribution to the

(2006) 16 REVENUE LJ

parent.⁸⁶ This dividend is viewed under the Code as a manifestation of accumulated profits. It is the payment of the dividend which triggers the deemed paid provisions. The amount of the credit allowable is directly proportional to the size of the dividend as a percentage of available undistributed earnings. The actual computation numerically expressed is:

$$\text{Section 902 Credit} = \text{Foreign Taxes Paid} \times \frac{\text{Dividends Paid}}{\text{Undistributed Earnings} - \text{Foreign Taxes Paid}}$$

In this formula, the § 902 credit is the amount of tax paid by the first-tier corporation which is deemed paid by a domestic corporation. The foreign taxes paid are the foreign taxes paid or deemed paid by the first-tier corporation.⁸⁷ Dividends paid are those paid by the first-tier corporation to the domestic corporation.⁸⁸ Undistributed earnings and foreign taxes paid are those of the first-tier corporation.⁸⁹

The taxes which a first-tier corporation is deemed to have paid through a second-tier corporation (as well as a second-tier through a third-tier) are calculated by applying the same formula.⁹⁰ Lower-tiered subsidiaries also utilise the same formula.

Thus, by way of example, assume domestic corporation X owns 100 percent of foreign corporation Y, formed in Year 1. Assume that Y distributes its first dividend in Year 3 of \$300 at a time in which total undistributed earnings equalled \$1,000. If its foreign tax payments during its period of existence had totalled \$500, the deemed paid credit would total \$300 (\$300/\$1,000 - \$500 x \$500).

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

86 IRC § 902(a).

87 See IRC § 902(a)(1); *Champion Int'L Corp v Commissioner*, 81 TC 424 (1983) acq; Rev Rul 87-72, 1987-2 CB 170.

88 While the term does not include 'gross up' dividends under § 78, it may under some tax treaties. *Carborundum Co v Commissioner* 58 TC 909 (1973) acq.

89 See *United States v Goodyear Tire and Rubber Co* 493 US 132 (1989) (domestic tax principles control determination of accumulated profits). For authority to reduce undistributed earnings by foreign taxes paid or accrued, see Reg § 1.902-1(a)(9)(iii).

90 Reg § 1.902-1(f) example (3). Significant planning opportunities arise in deciding on the jurisdiction in which to house various subsidiaries.

TAX CLASSIFICATION OF BUSINESS ENTITIES

may be available to the distributee corporation as well. The practical significance of the § 902 formula lies in the fact that a domestic corporation, by choosing to enter a foreign market through a subsidiary instead of a branch, will not have entirely forfeited its claim to a foreign tax credit.

4 The § 78 gross-up

When a domestic corporation elects to take the foreign tax credit for taxes paid by a foreign corporation, the amount of taxes deemed paid must be treated and reported as dividend income.⁹¹ That is, the amount of the actual dividends received are 'grossed up' to include an additional, *albeit fictitious*, amount equal to the tax deemed paid on those dividends. The § 78 gross-up prevents the 'over crediting' of foreign taxes.

This statutory approach is an attempt to neutralize the benefits of utilizing a foreign subsidiary rather than a branch for foreign operations. When a foreign branch is utilized, the direct foreign tax credit is available, yet all income is subject to United States tax. The use of a wholly-owned subsidiary instead results in the availability of the tax credit with domestic taxation of the dividend income only. The remainder of the foreign earnings is not subject to domestic taxation. The gross-up concept eliminates this disparity as to distributed earnings of the subsidiary. However, unequal treatment remains in cases of retained earnings.

For example, assume that D, a domestic corporation, establishes H, a Hong Kong subsidiary. H earns \$100 in each of Years 1 and 2, subject to a 17 percent Hong Kong tax rate. H distributes one-half of its after-tax earnings (\$200 minus \$34 tax = \$166 x 50% = \$83) to D. By operation of the § 902 deemed paid credit, absent the § 78 gross-up, D is subject to United States tax on \$83 of income, yet receives a § 902 credit of \$17, the tax on the full \$100 of H's pre-tax earnings (\$34 tax x \$83/\$166). In contrast, if H was a branch of D, D would be entitled to credit the \$17 tax on H's earnings, but D would also be subject to tax on H's full \$100 of earnings. To achieve parity, D is required in the prior example by virtue of the § 78 gross-up to include as additional dividend income \$17 of foreign tax paid by H to Hong Kong.

91 IRC § 78. Only the domestic corporation is affected by § 78, not the other subsidiaries in the chain of ownership. See Tech Adv Memo 8515004 (§ 78 dividend must be included in numerator and denominator of § 904 limitation).

(2006) 16 REVENUE LJ

5 The § 904 limitation on the amount of taxes which may be credited—in general

Once the amount of foreign taxes creditable under §§ 901 - 903 has been ascertained, the taxpayer must examine the § 904 limitations which are imposed upon the credit. That statute provides that the credit is limited to an amount determined under the following formula:⁹²

$$\begin{array}{rcl} \text{Maximum} & & \text{Foreign source} \\ \text{foreign} & = & \text{taxable income} \times \\ \text{tax credit} & & \text{Worldwide} \\ & & \text{taxable income} \end{array} \quad \begin{array}{l} \text{United States} \\ \text{tax on worldwide} \\ \text{income} \end{array}$$

The object of the § 904 limitation is to protect the claim of the United States to tax the domestic source income of its own taxpayers. Thus, the § 904 limitation attempts to effectively limit the credit to the United States tax liability that would be imposed on the taxpayer's foreign source income. For example, assume that a domestic corporation subject to an effective tax rate of 30 percent derives \$40 of income from a domestic source and \$70 of income in a foreign country subject to an effective tax rate of 50 percent (yielding a foreign tax liability of \$35). In the absence of a limitation, the creditable foreign tax (\$35) would completely eliminate any domestic tax otherwise owing (\$33, ie, 30% of worldwide income of \$110). If such were the case, the United States would have completely surrendered its claim to tax. Instead, the § 904 limitation caps the credit at \$21 ($\$70/\$110 \times \33).

Under the § 904 limitation, the tax attributable to the higher foreign tax rate is viewed as a non-creditable cost of investing or conducting business in that country.⁹³ In essence, the statutory approach does not permit any portion of the domestic tax payment attributable to United States source income to be offset by foreign taxes. From a policy standpoint, this is sensible because United States source income does not fall within the category of doubly-taxed income.

Concerning the § 904 limitation, three basic points should be stressed. First, the limitation is based on taxable income. Second, because the limitation is based upon

92 IRC § 904 (a).

93 This effect may be ameliorated somewhat through the carryback and carryover provisions for the foreign tax credit.

TAX CLASSIFICATION OF BUSINESS ENTITIES

taxable income, it necessarily involves the allocation of deductions to foreign source income. Third, the source of income rules control in determining credit.

5.1 The separate computations of the limitation

Various policy considerations have led Congress to specify that the § 904 calculation must be applied separately to special classes of income, often referred to as income 'baskets'. Broadly speaking, the purpose of the separate basket limitation is to ensure that a taxpayer's foreign tax credit is limited to the United States tax imposed on foreign source income by severely restricting a taxpayer's ability to average low-tax foreign source income with high-tax business income in an effort to utilise 'excess' foreign tax credits.

Assume, for example, that C, a domestic corporation, derives foreign business income taxed at a 40 percent rate. C's total taxable income for the year is \$100,000 of which \$25,000 is attributable to the foreign activity. The remaining \$75,000 is attributable to United States projects. C pays \$10,000 in foreign tax. C's tentative tax, assumed to be at a 20 percent rate, without regard to the foreign tax credit is \$20,000. C's residual income limitation would be:

$$\frac{\$20,000 \times 25,000}{100,000} = \$5,000$$

Thus, C may claim a foreign tax credit of only \$5,000, even though it paid \$10,000 in foreign taxes.

However, if C earned \$ 5,000 of interest income from another foreign country which is minimally taxed, eg at five percent, in that country either by statute or tax treaty, C's residual income limitation would be increased to \$6,000 (\$21,000 x \$30,000/\$105,000). This results in \$1,000 more of the foreign taxes being creditable through the generation of the low-taxed foreign source interest income.⁹⁴

To preclude such manipulation of the foreign tax credit limitation, Congress has mandated the use of separate baskets which includes a broad 'other income' or general basket. When the concept of baskets was most in vogue, the baskets totalled nine in number. However, Congress recently reversed course and imposes but two –

94 The domestic tax liability would increase as well because the interest income is worldwide income of the United States taxpayer.

(2006) 16 REVENUE LJ

passive income and all other income. Such categorization precludes the effective use of passive income to increase the numerator of the § 904 limitation for generally high-taxed general business income credit purposes.

5.2 Passive income

Passive income is defined *inter alia* as income which is classified as interest, dividends, royalties, rents, and the like.⁹⁵ The passive income basket is intended to be the general ‘catchall’ basket for low-tax passive income. In addition, any item of passive income which is subject to a significant tax is ‘kicked out’ of the passive income basket into the general income basket.⁹⁶

Expressed as an equation, the § 904(d) passive income limitation is:

	Foreign source		
Maximum	§ 904(d)		United States
passive basket =	<u>passive income</u>	x	tax on worldwide
foreign tax credit	Worldwide		income
	taxable income		

By way of example, assume that a United States individual derives \$100,000 of foreign taxable income with a foreign tax liability of \$40,000 and \$100,000 of domestic taxable income, yielding a worldwide taxable income of \$200,000 subject to an assumed domestic tax rate of 30 percent. In addition, the taxpayer derived \$20,000 of foreign dividend income subject to a treaty rate of five percent (additional foreign tax of \$1,000). Thus, the total domestic tax liability would equal \$66,000 (\$220,000 worldwide taxable income x 30%). In such a case, the separate basket limitations would be applicable. The passive income basket would be the ratio of \$20,000 foreign taxable dividend income to \$220,000 worldwide taxable income which equals approximately nine percent. The ratio is applied to the domestic tax liability of \$66,000, but the credit cannot exceed the actual taxes paid on such income of \$1,000. The overall limitation would be applicable to the remainder of the activity and would give rise to a 45.5 percent ratio (\$100,000 foreign taxable income/\$220,000 worldwide taxable income) applied against the domestic tax liability of \$66,000, yielding a credit of \$30,030. The

95 Additionally, certain property transactions may result in the inclusion of various gains from the sale of income-producing property.

96 IRC § 904(d)(2). Generally, high-taxed income is that which is taxed at rates equal to or in excess of domestic rates.

TAX CLASSIFICATION OF BUSINESS ENTITIES

foreign tax of \$40,000 would exceed the \$30,030 limit and result in a \$9,970 foreign tax credit carryover.

6 Carryback and carryover of excess taxes paid: § 904(c)

The amount of foreign taxes paid or accrued in a taxable year may exceed the foreign tax credit limitation determined under § 904(a). This scenario results in the taxpayer having excess unused foreign tax credits.⁹⁷ On the other hand, the § 904(a) limitation in a given year may exceed the amount of foreign taxes paid, resulting in an 'excess limitation'.⁹⁸ Section 904(c) provides for a carryback and carryover of taxes from taxable years in which the taxpayer incurs excess foreign taxes to years in which the taxpayer has an excess limitation.

The amount of unused foreign taxes in a given year is determined by subtracting the maximum credit allowed under § 904(a) from the taxes paid to all foreign countries and United States possessions.⁹⁹ The unused foreign tax can be carried back one taxable year and forward nine taxable years.¹⁰⁰ The Code establishes the order of years to which the unused foreign tax is to be carried, ie, the first preceding year, then the first, second, third, fourth, fifth, sixth, seventh, eighth, ninth, and tenth succeeding taxable years.¹⁰¹ To the extent that the unused foreign tax is not absorbed by the final carryover years, it is irretrievably lost.

Tax payments carried back or over to an excess limitation year are deemed to be taxes paid in the excess limitation year.¹⁰² The maximum amount of unused foreign tax which can be treated as paid or accrued in the taxable year to which the taxes are carried is the full amount of the unused foreign taxes to the extent a sufficient excess limitation exists in that year to absorb it. In other words, the amount of unused foreign tax treated as paid or accrued in an excess limitation year is the lesser of (1) the amount of unused foreign tax sought to be carried to the excess limitation year or (2) the excess limitation for the year to which the taxes are carried.¹⁰³ The excess limitation in any taxable year is the amount by which the limitation applicable to that year exceeds the sum of (1) taxes actually paid for that year, (2) taxes deemed paid for that

97 Reg § 1.904-2(b)(2)(ii).

98 Reg § 1.904-2(b)(2)(ii).

99 Reg § 1.904-2(b)(2)(ii).

100 IRC § 904(c).

101 IRC § 904(c); Reg § 1.904-2(b)(1).

102 IRC § 904(c); Reg § 1.904-2(b)(2).

103 Reg § 1.904-2(c)(2)(i).

(2006) 16 REVENUE LJ

year, and (3) unused foreign taxes from other years carried to that year with the earliest year considered first.¹⁰⁴

The same basic principles discussed above apply to carrybacks and carryovers of income subject to a separate basket of § 904(d). However, unused foreign tax and the excess limitation must be computed separately for each type of income.¹⁰⁵

TAX PLANNING OPPORTUNITIES -- HYBRID ENTITIES AND THE FOREIGN TAX CREDIT

The United States taxes its domestic persons on their worldwide income. As discussed above, double taxation is alleviated in such settings through the use of the foreign tax credit. Thus, if a taxpayer earned \$100,000 in an Australian business endeavour and paid \$20,000 in Australian income taxes, assuming a 20 percent rate, he could credit those payments against his income tax liability to the United States. Assuming a domestic rate of 30 percent resulting in a tentative tax liability of \$30,000, the taxpayer could credit the \$20,000 of tax paid. Accordingly, he would pay a net amount of \$10,000 in tax to the United States Treasury. If the foreign jurisdiction taxes the income at a higher rate of tax than does the United States, eg, it imposes a 40 percent rate of tax, the United States does not permit a credit for the excess. The taxpayer in the first setting had an 'excess limitation' of \$10,000. In the second situation, the taxpayer had 'excess credits' of \$10,000.

From a planning standpoint, if it were possible, additional foreign taxes paid could still be creditable. If the taxpayer had \$50,000 of foreign income taxed at 20 percent in one jurisdiction and \$50,000 taxed at 40 percent in another, the blended rate would not exceed the domestic rate. Thus, all of the foreign taxes would be creditable. This possibility leads to much of the tax planning that occurs with regard to the foreign tax credit.

Both situations give rise to tax strategies and planning. In the case of an excess limitation, additional income and accompanying tax payments are sought in order to enjoy full utilization of foreign tax credits against the entirety of the domestic tax liability. In the case of excess credits, similar efforts are sought for seeking additional foreign income with a minimum of foreign tax.¹⁰⁶

104 Reg § 1.904-2(c)(2)(ii).

105 IRC § 904(d).

106 It must be remembered that the derivation of foreign income typically results in additional taxes to the United States as it is part of the taxpayer's worldwide income.

TAX CLASSIFICATION OF BUSINESS ENTITIES

An additional focus for tax planning purposes regarding the foreign tax credit is definitional—is the tax imposed on the taxpayer? If a person owns 100 percent of a foreign corporation which pays foreign tax, is the tax imposed on the shareholder? Economically it has that effect because the value of his or her overall investment decreases by the amount of the tax. Nevertheless, the foreign tax credit Regulations require more. One must show a legal liability for the tax.

This concern led to the enactment of the deemed paid credit discussed above. In the corporate context, if a domestic corporation owns ten percent or more of a foreign corporation, it can credit its proportionate share of the foreign taxes paid by the foreign corporation upon the receipt of a dividend. *Importantly, the United States parent corporation in order to avail itself of the subsidiary's tax credits must include the attendant earnings in income.*

Accordingly, historically, effective tax planning from a United States perspective required a focus on each of these factors in an attempt to maximize the use of the foreign taxes paid as a credit. However, with the introduction of the check-the-box Regulations, efforts at maximization of the foreign tax credit, which may have been stymied under prior law, should be revisited to determine whether a conversion of one of the involved enterprises to a disregarded entity or a partnership for tax purposes might bear fruit. Hybrid structures give rise to significant tax planning flexibility regarding the foreign tax credit.¹⁰⁷ Regular hybrid enterprises (transparent for purposes of the tax law of the United States, but treated as a separate entity for foreign tax purposes) and reverse hybrids (separate entity for United States but transparent for foreign) now populate the terrain. The check-the-box Regulations have expanded the number of settings where this issue comes into play because 'the regime has tended to multiply the situations in which there is a mismatch between United States and foreign concepts of whose income is being subjected to the foreign tax.'¹⁰⁸

The determination of the taxpayer with the legal liability for the credit is made more difficult, and potentially more valuable, in hybrid situations.¹⁰⁹ If a United States

107 See generally Bennett, 'Whose Tax Is It Anyway? Foreign Tax Credits in a Check-the Box World,' 83 *Taxes Magazine*—the 57th University of Chicago Tax Conference 35 (2005). See also Postlewaite, Donaldson, and Christians, 'Determining Treaty Eligibility for Hybrid Entities and Their Owners' 3 *Taxation of Global Transactions* 45 (Fall 2003).

108 Bennett, *ibid* 35.

109 *Ibid* 36. The Supreme Court's decision in *Biddle* involved tax paid by an English corporation which was claimed by a United States shareholder in accordance with English

(2006) 16 REVENUE LJ

corporation has a foreign subsidiary (which owns other subsidiaries in a chain of ownership) for which it has elected disregarded entity status for United States tax purposes, it potentially could claim the direct credit for all of the taxes paid by all of the members of the chain by maintaining that, under local law, the disregarded entity bore the responsibility for the taxes.¹¹⁰ In fact, Australia has recently adopted a consolidation approach which may afford claimants a similar opportunity.

The indirect credit permits a credit of these payments as well *but* it is conditioned upon the payment of dividends to the domestic parent corporation from the chain of subsidiaries. Thus, the credits could be made available currently even though the income which generated the credits would not be taken into account until a later taxable year. Aggressive taxpayers would be more than willing to include in their worldwide income the earnings of the disregarded entity if an immediate credit were available for all of the taxes paid by all of the other members of the ownership chain without having to include their earnings in income.

1 C-T-B Election for maximizing available credits

As described above, taxpayers typically have either excess credits or an excess limitation. Rare is the case where a taxpayer's maximum foreign tax credit is identical to the amount of the foreign income taxes imposed. Thus, in both settings, planning opportunities are presented.¹¹¹ Those taxpayers with an excess limitation might consider 'triggering more foreign tax credits onto their US returns without either paying more foreign taxes or creating more excess limitation. Taxpayers in an excess credit position are typically interested in triggering inclusions of low-taxed foreign source income.'¹¹²

law. Thereunder, he was entitled to a credit for his portion of the taxes paid by the corporation. The Court denied the credit, even though the timing of the income inclusion and availability of the credit were in sync, because the United Kingdom corporation was the sole party with liability for the payment of the credit. The issues become even more complex in chain ownership as the issue of whether joint and several liability exists for all members of the ownership chain is confronted.

110 Bennett, *ibid* 37 and Private Letter Ruling 200225032. See also *Guardian Industries Corp v United States*, F 3d, 2006 1 USTC (Fed Cir 2006), finding for the taxpayer where similar structuring was employed.

111 Bennett, *ibid* 38.

112 *Ibid*. Such efforts must also navigate the basket regime of § 904. While low-taxed income can be generated through passive investment, the basket limitation generally prevents the blending of active and passive income.

TAX CLASSIFICATION OF BUSINESS ENTITIES

Such timing efforts can be facilitated through the use of separate subsidiaries and the availability of the check-the-box election.¹¹³ If a domestic parent has a number of subsidiaries, it can release the high-taxed or low-taxed results as needed through the use of such an election. The release of income from a high-taxed jurisdiction will not generate residual tax to the United States since the inclusion of that income, while taxable, will be at a rate lower than the rate at which the foreign tax was imposed. Similarly, release of income from a low-taxed jurisdiction may generate additional domestic tax but, if excess credits are already available, the effect of the inclusion will be minimized.

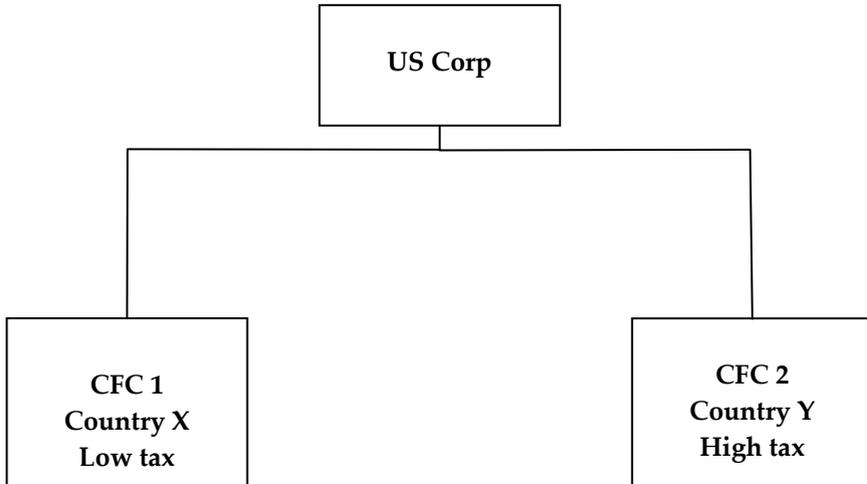
If a subsidiary is available with the desired profile based on the domestic parent's overall tax situation, an election under the check-the-box Regulations to make it a disregarded entity could result in the flooding of the pre-election credit position with the desired tax attributes of the converted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

113 Ibid. Because both subsidiaries are wholly-owned by a United States person, each will be classified as a Controlled Foreign Corporation ('CFC'). Under §§ 951-964, some or all of the earnings of the foreign subsidiaries may be imputed to its United States shareholders if derived from specified types of income deemed by Congress to be abusive. As with all international structuring, designs to maximize the availability of the foreign tax credit may collide with particular features of the CFC safeguard provisions.

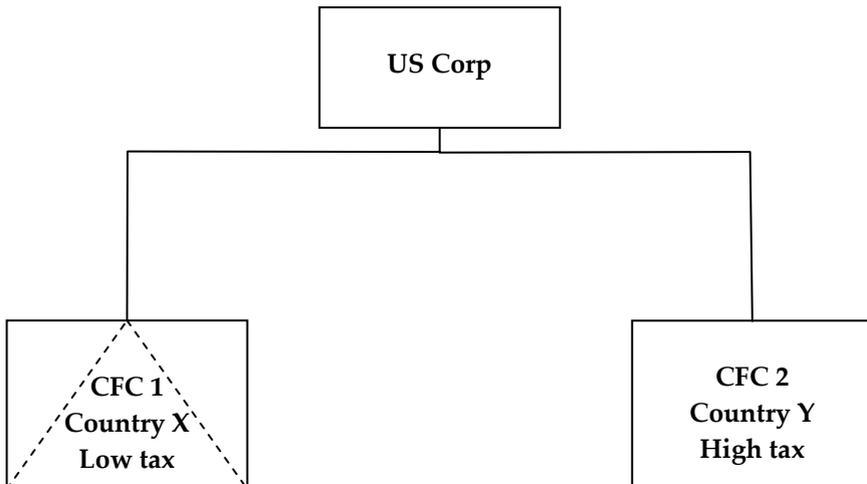
(2006) 16 REVENUE LJ

Diagram 1

Before



After



TAX CLASSIFICATION OF BUSINESS ENTITIES

Such time-release blending of results creates tax planning opportunities. For example, assuming a business structure involving affiliated companies, all of which are CFCs, one based in a high-tax country and the other based in a low-tax jurisdiction, tinkering may prove advantageous for maximizing the availability of foreign tax credits. By having separate enterprises with different taxing climates and earnings profiles, the United States parent corporation through the judicious use of the check-the-box election can instantly mix the results of either of its CFCs with its own. Thus, in the excess credit setting, it may elect to treat to low-taxed affiliate as a disregarded entity. Should an excess limitation exist, the election might be employed for the high-taxed enterprise.¹¹⁴

2 Use of a partnership

While separate enterprises bring some opportunities, they may create Subpart F problems.¹¹⁵ Accordingly, a United States parent corporation may consider instead the use of a partnership vehicle, as illustrated in Diagram 2. This too may be facilitated through a check-the-box election to treat a given subsidiary as a disregarded entity rather than a corporation. By the parent corporation forming two CFCs, one located in a high-tax jurisdiction and the other in a low-tax one, they can be joined together as a partnership to engage in international operations.

By the use of special allocations, eg, 90 percent of the high-taxed earnings and 10 percent of the low-taxed earnings to the high-tax partner and 90 percent of the low-taxed earnings and 10 percent of the high-tax earnings to the low-taxed partner, similar pools of diverse earnings and tax credits as arose in the setting presented in Diagram 1 will be isolated in separate structures. Again, regarding either CFC, the maximization of the utilization of the foreign tax credits would be available for use as needed by the United States parent corporation through the check-the-box election. Additionally, even without an election, actual distributions from either CFC would give rise to § 902 deemed paid credits which would be characterized as high-taxed or low-taxed depending upon the payer.

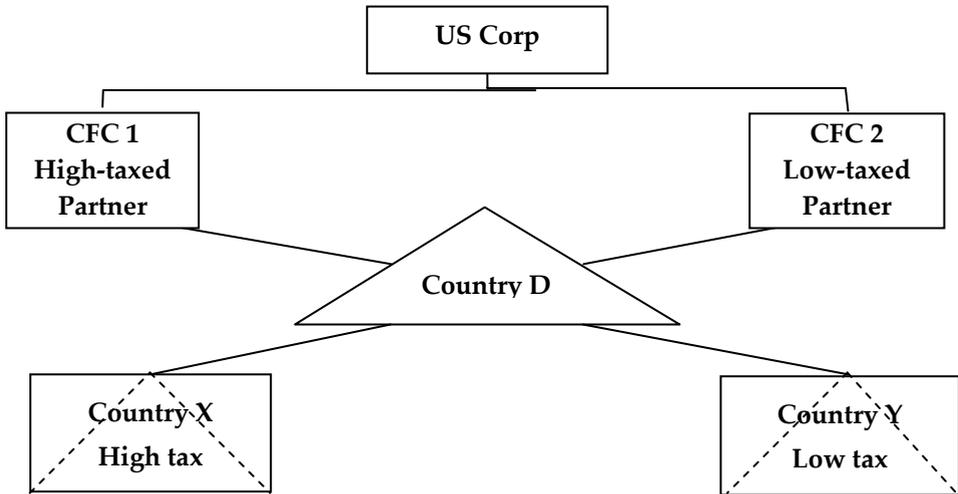
114 Ibid 38-39.

115 Ibid 38. Subpart F of the Code triggers the current imputation of certain income to the United States shareholders of a CFC. See above n 112.

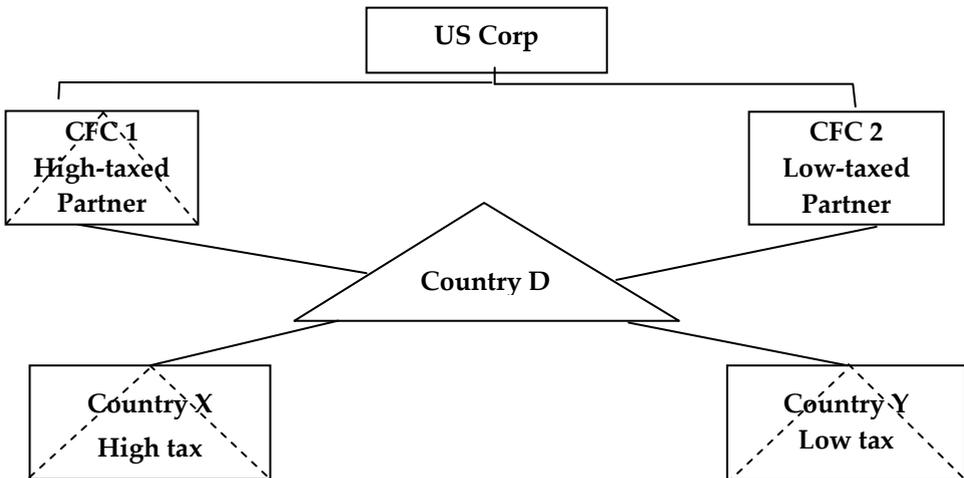
(2006) 16 REVENUE LJ

Diagram 2

Before



After



TAX CLASSIFICATION OF BUSINESS ENTITIES

However, caution must be exercised in employing partnership structures. The use of partnerships in the foreign tax credit area has come under particular scrutiny by the Service and the Treasury. Regulations have been issued which attempt to ensure that potential foreign tax credits flow with the earnings which generated them.¹¹⁶ Thus, the attempt to minimize income inclusion by a partner while maximizing the credits allocated to that partner will be heavily scrutinized and may not be successful. An additional set of regulatory changes is intended to ensure that the determination of whether an allocation is substantial where related parties and chain ownership or consolidation are involved is tested with a focus on *all* of the members.¹¹⁷ This broadened focus will frequently result in the invalidation of the allocation and, accordingly, a reduction in the sought-after tax benefits.¹¹⁸

3 Reverse hybrid structure

For taxpayers with excess limitation issues, reverse hybrid structures could prove valuable.¹¹⁹ As illustrated by Diagram 3, a United States parent corporation could employ a wholly-owned subsidiary which itself owns a wholly-owned subsidiary. The second-tier subsidiary elects reverse hybrid entity status, ie, it is treated as a disregarded enterprise by the foreign jurisdiction but elects to be treated as a separate entity/corporation for United States tax purposes.

Given its status for foreign law purposes, the first-tier subsidiary is legally responsible for the foreign taxes owing and thus is considered to have paid them. However, given the separate entity status of the second-tier enterprise for United States taxing purposes, its income is not attributed to the first-tier subsidiary until actually distributed. However, the second-tier's tax payments are attributable to the first-tier member which can repatriate the earnings and transmit the excess credits via § 902. Thus, taxes available for credit purposes are treated as having been incurred by the first-tier enterprise even though the income of the second-tier subsidiary has not been taken into account and will be deferred until it actually receives a distribution.

116 Reg § 1.704-1T(b)(4)(xi).

117 Prop Reg § 1.704-1(b)(2)(iii)(a)(1) and (2).

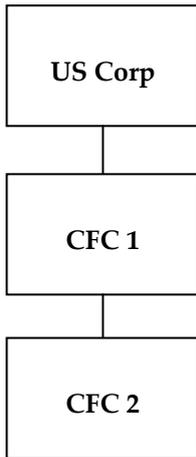
118 See generally Willis, Pennell, and Postlewaite, above n 7, ch 10.

119 Bennett, above n 9, 39-40.

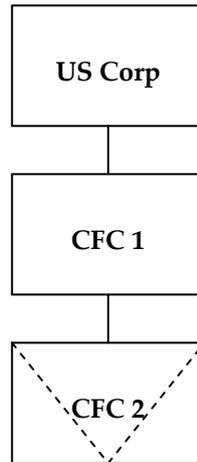
(2006) 16 REVENUE LJ

Diagram 3

Before



After



Accordingly, the first-tier subsidiary can pass tax credits to the domestic parent corporation on income untaxed by the United States through the deemed paid credit mechanism of § 902 by making distributions to the United States parent corporation. Obviously, an important ingredient of this technique is showing that the first-tier subsidiary is responsible for the tax payments of the second-tier enterprise. If the foreign jurisdiction treats the second-tier as a disregarded enterprise, logically the responsibility for the payments should be on the first-tier corporation. However, this technique undercuts the general policy that the credits are to follow the income which generated the tax liability. Accordingly, opposition by the Service should be expected and may be encountered.

4 Foreign consolidation

Similar results to those produced by the reverse hybrid structure can be produced through a consolidation regime.¹²⁰ Much of the same goal as that of Diagram 3 is sought in this effort.

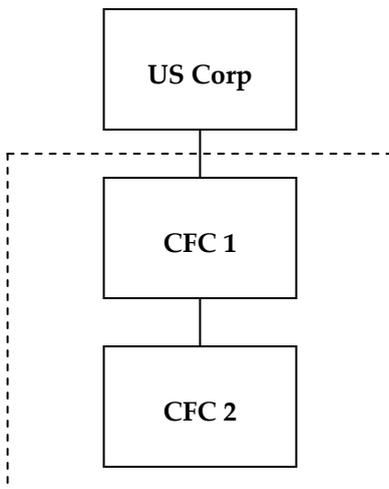
¹²⁰ Ibid 40.

TAX CLASSIFICATION OF BUSINESS ENTITIES

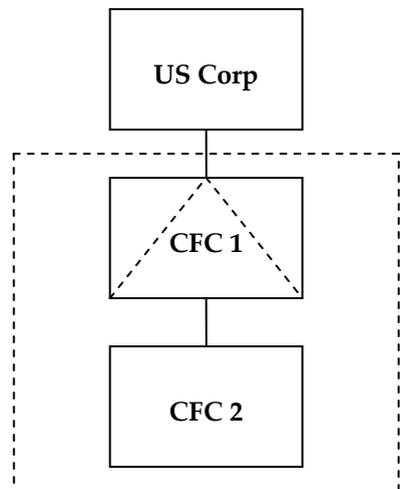
The first-tier and second-tier enterprises are corporations for foreign law purposes and constitute a foreign consolidated group. Again, the first-tier subsidiary, if found to be legally liable for the foreign taxes of the group, will accrue foreign taxes paid by both subsidiaries without taking the income from the second-tier subsidiary into account. By using the check-the-box election, the first-tier subsidiary could be treated as a disregarded entity. Accordingly, the United States parent corporation would be conceptualized as having paid the taxes for both subsidiaries while only taking the income from the first, disregarded subsidiary into account.

Diagram 4

Before



After



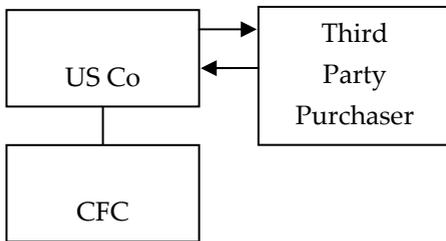
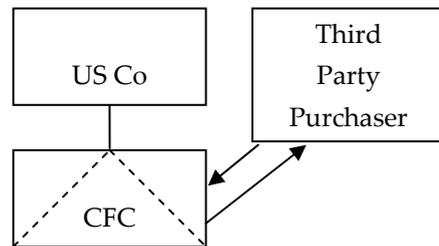
Again, these benefits would appear to be unintended under the tax policy principles behind the foreign tax credit. Tax credits available currently, with the ability to defer income recognition until the lower-tier subsidiary distributes its earnings to the first-tier subsidiary, appear objectionable. One should anticipate attempts by the Treasury and the Service to thwart such efforts.

5 Check-and-sell

The check-and-sell technique has produced significant benefits in the Subpart F area by permitting the avoidance of current imputation of the sales proceeds to the United States shareholders. Similarly, such a technique may afford benefits for purposes of

(2006) 16 REVENUE LJ

effective tax planning regarding the foreign tax credit.¹²¹ As illustrated in Diagram 5, the technique involves a pre-sale election on behalf of the foreign subsidiary to convert its tax status from that of a corporation to that of a disregarded entity.

Diagram 5*Before**After*

The technique may produce benefits, because it may avoid the passive basket limitation. A sale of stock will often trigger passive income and a minimal amount of foreign tax due to treaty or statutory treatment of the income from the sale of capital assets. While a taxpayer is enthusiastic about blending low-taxed income with high-taxed income, the imposition of the basket regime minimizes the taxpayer's ability to do so in many cases.

However, if the check-the-box election is employed pre-sale, the sale is supposedly conceptualized as a sale of business assets. An important requirement for characterizing the sale as an asset sale is that the assets are those of the *parent* company. This would appear to be a difficult task due to the fact that they were utilized as such by a separate entity, ie, the subsidiary. However, on other tax issues, the Service has treated the business of a subsidiary as that of the parent corporation.

¹²¹ *Ibid* 40.

TAX CLASSIFICATION OF BUSINESS ENTITIES

HYBRID ENTERPRISES AND TAX TREATIES

An exploration of the impact of the check-the-box Regulations on the international arena can also be illustrated by a review of the use of hybrid entities and their treatment by the Treasury and the Service with regard to the qualification for tax treaty benefits. Significant attention was given by the regulatory agencies to the use of hybrid structures in the tax treaty area and the availability of treaty benefits where a hybrid structure exists. After studying the matter, Regulations were promulgated instructing as to which parties qualify for what privileges under existing tax treaties.¹²²

In the treaty context, the availability of treaty usage, frequently resulting in the reduction or the elimination of tax, is dependent upon resident status. Such status is available both to individuals and separate entity business enterprises. Significantly, the Treasury's focus on such issues only obliquely addresses the treatment of pure (treated as transparent for both domestic and foreign purposes) partnership entities. In essence, the Regulations acknowledge that if the enterprise is transparent for all purposes, ie, domestically, in the foreign jurisdiction of formation, and in the jurisdiction of residence of each of its members, then the tax treaty, if any, between the United States and the jurisdiction of residence of each member of the enterprise will govern the tax treatment of each member's share of the partnership's investment activity. Thus, as illustrated in Diagram 6, a Canadian partnership, of which all of its members are Canadian residents, receiving a dividend from a United States corporation will not be taxable if it is treated as transparent for purposes of both the United States and the Canadian tax laws. Instead the dividend income will be taxable to the partners who, because they are residents of Canada, will be entitled to treaty benefits.

Three possible variations arise under tax treaties: (1) a resident partnership with all resident partners (for example, a Canadian partnership with only resident Canadian partners); (2) a resident partnership with resident and non-resident partners (for example, a Canadian partnership with resident Canadian partners and resident Brazilian partners); and (3) a resident partnership with all non-resident partners (for example, a Canadian partnership with only resident Brazilian partners).

Under the § 894 Regulations, payments of passive income by a United States payor to a transparent entity in a treaty country qualify for treaty benefits under that treaty only if either the entity itself or the members thereof are subject to current tax on that

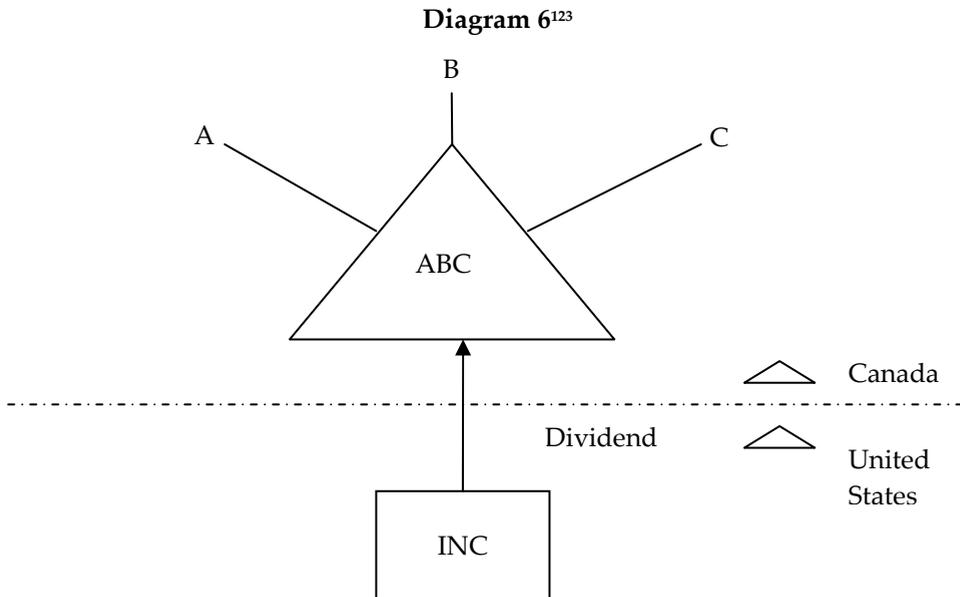
122 See Postlewaite, Donaldson, and Christians, 'Determining Treaty Eligibility For Transparent Entities and Their Owners' 3 *Journal of Taxation of Global Transactions* 11 (2001).

(2006) 16 REVENUE LJ

income under the laws of that country. While the authorizing statute implies that the § 894 Regulations are limited to situations involving hybrid entities, an enterprise classified as a partnership both for United States tax purposes as well as that of a treaty country (commonly referred to as a 'pure partnership') is also subject to the general rule of the Regulations. Moreover, as illustrated in the sections that follow, application of the Regulations yields different results under the three variations of partnerships described above even though they involve a partnership formed in the same country and even if all relevant countries treat the partnership as a partnership for purposes of applying the treaties.

1 Application of tax treaties to partnerships; illustrations

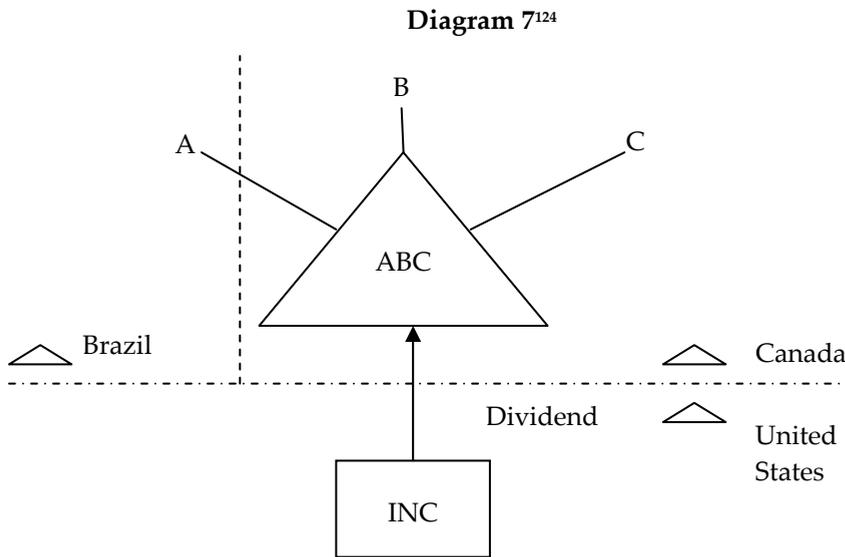
Using the United States-Canada income tax treaty as an example, assume that a Canadian partnership with three resident Canadian partners derives United States passive income. In this partnership structure, as illustrated in Diagram 6, only the partners (not the partnership) would be taxed under Canadian law and only the partners could claim tax treaty benefits.



123 A, B, and C qualify for treaty benefits under the United States-Canada income tax treaty. See Reg § 1.894-1(d)(5) example (2).

TAX CLASSIFICATION OF BUSINESS ENTITIES

The result differs if, instead, a Canadian partnership with two resident Canadian partners and a resident Brazilian partner derives United States source passive income. This variation is illustrated in Diagram 7. As in the first variation, the partnership would not be taxed by Canada. The Canadian partners would be taxed by Canada and they (alone) could claim treaty benefits. The Brazilian partner may also be taxed by Canada, but not on the basis of Canadian residence. Thus, the Brazilian partner could not claim treaty benefits under the United States-Canada income tax treaty.



2 Application of treaty eligibility rules to hybrid entities

In the tax treaty context, the problems described above for partnerships become more acute as the use of hybrid entities has become readily available due to the check-the-box Regulations. The following sections identify the various forms of hybrid entities and introduce some of the complexities that have arisen in the application of treaty eligibility rules to such entities.

124 B and C qualify for treaty benefits under the United States-Canada income tax treaty, but A does not qualify for any treaty benefits because there is no tax treaty between the United States and Brazil.

(2006) 16 REVENUE LJ

3 Identifying hybrid entities and the interpretive problems they pose

As noted above, a 'regular' hybrid entity is one that is treated as transparent for United States tax purposes and as non-transparent for foreign tax purposes. A 'reverse' hybrid entity is one that is treated as non-transparent for United States tax purposes and as transparent for foreign tax purposes. Hybrid entities may give rise to distorted expectations and inequities because, according to the Treasury, 'inappropriate and unintended results' may ensue from inconsistent classifications. Thus, the focal point of the § 894 Regulations is to provide tax treaty interpretation and application rules that take into account the classification conflict between the relevant jurisdictions. However, these rules apply only with respect to items of passive income.

The § 894 regulations provide that in order to derive treaty benefits on income derived or paid from a treaty country, the recipient must be a resident of a treaty country (referenced by the § 894 regulations as the 'applicable-treaty jurisdiction'). Thus, the first step in determining eligibility for treaty benefits involving hybrid entities is to identify the 'recipient' of the passive income. Once the recipient has been properly identified, the second step is to determine whether the recipient is a resident of the applicable treaty jurisdiction. This two-step analysis and the resulting consequences (treaty eligibility for one, some, all, or none of the entity and its owners) is prescribed for all United States tax treaties, including those that do not address transparent entities. Exceptions will arise only if the specific language of a subsequently entered tax treaty provides to the contrary or if a treaty partner evidences that it will not provide a reduced rate to a similarly situated United States resident.

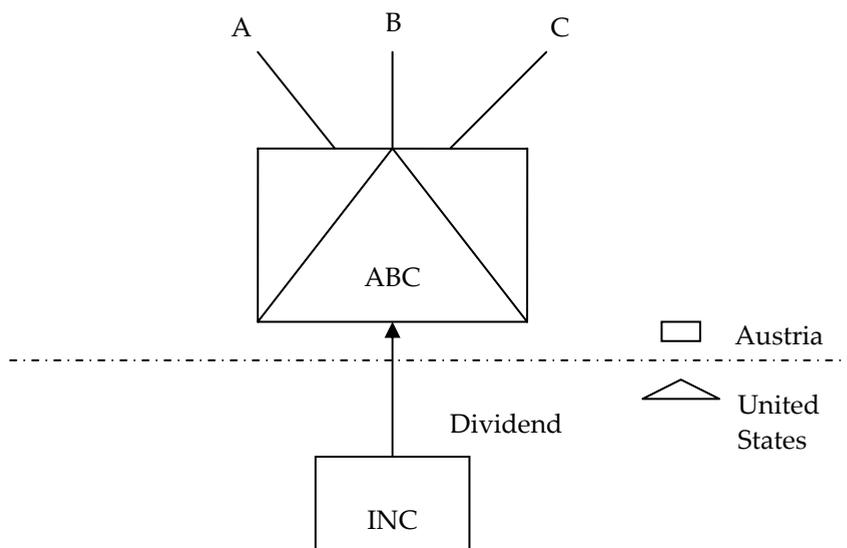
4 Residence requirement for treaty benefits

The overriding concern of the § 894 Regulations is that the party receiving treaty benefits with respect to an item of income be subjected to tax on that income 'as a resident' in the applicable treaty jurisdiction. For example, as illustrated in Diagram 8, if an Austrian entity that is classified as a partnership for United States tax purposes but as a corporation for Austrian purposes derives dividend income from the United States, the § 894 Regulations provide that it is the entity that is the relevant party, rather than its owners. Thus, treaty benefits under the United States-Austrian income tax treaty would be available to the entity only if it is a resident of Austria for purposes of the treaty. This treatment would hold for the entity regardless of the number of its owners and their country or countries of residence. In keeping with the principle of mitigating double taxation (one of the overriding purposes of tax treaties), the reduction in United States tax on the dividend income is granted in recognition of

TAX CLASSIFICATION OF BUSINESS ENTITIES

the fact that its treaty partner, Austria, will tax that income in the hands of the entity because the entity is treated as a separate taxpayer under Austrian law.

Diagram 8¹²⁵



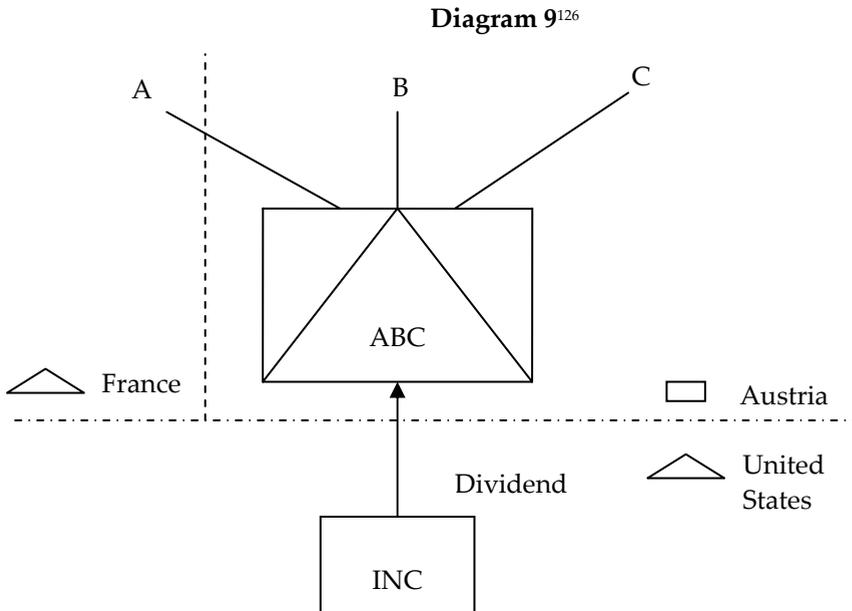
5 Multiple treaty jurisdictions (triangular cases)

The situation becomes more complex when two or more treaty partners of the United States are involved. Assume that the Austrian entity depicted in Diagram 8 has both Austrian and French interest holders. The United States has entered into an income tax treaty with France, similar in scope and coverage to the Austrian treaty. If the Austrian enterprise is treated as a partnership for United States tax purposes, a corporation for Austrian tax purposes, and a transparent entity for French tax purposes, the payment to the entity qualifies for treaty benefits under the United States-Austria treaty, as was the case depicted in Diagram 8. In addition, because France subjects the French owner to current tax on his or her share of income received

125 Since Austria treats ABC (a regular hybrid entity) as a corporation, it is irrelevant that the enterprise is treated as transparent for United States purposes. A, B, and C may have a tax obligation to the United States, but Austria only taxes the entity and not its owners on the receipt of such income. Therefore A, B, and C are not eligible for treaty relief with respect to the receipt by ABC of the dividend income, even though each is treated by the United States as having received their proportionate share of such income. See the treatment of 'A' in Reg § 1.894-1(d)(5) example (3).

(2006) 16 REVENUE LJ

by the entity, the French owner is also entitled to treaty benefits. This situation is illustrated in Diagram 9.



This result is consistent with the underlying treaty purpose of reducing tax rates in the country of source (United States) only if the income is taxed by the applicable treaty jurisdiction(s) (Austria and France). While it superficially appears as though double treaty benefits are granted (once to the entity and once to the French owner), the portion of the income qualifying for double treaty benefits is simultaneously subjected to double taxation (once with respect to the entity and simultaneously to the French owner). The result of the double benefit is to cure the double taxation by Austria and France, rather than to lower or eliminate tax on the transaction altogether.

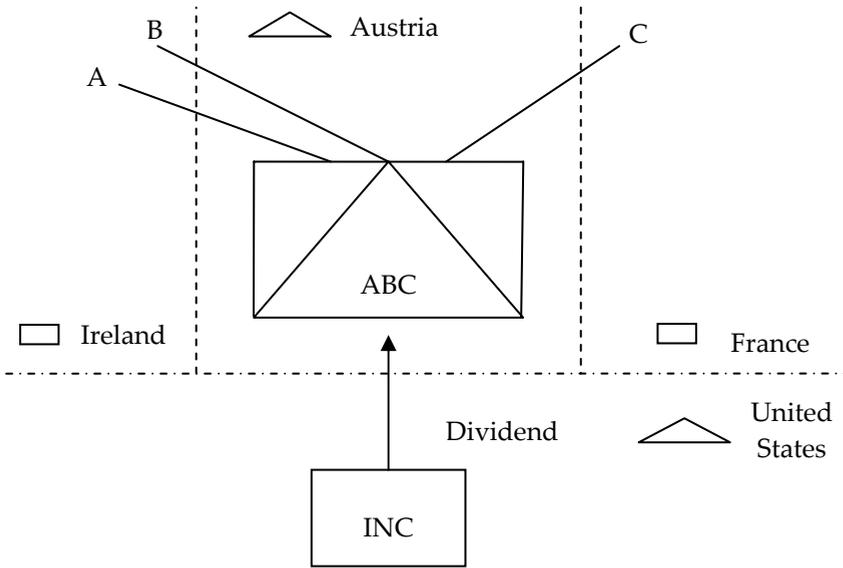
Finally, it is possible in a regular hybrid setting that no party will be entitled to treaty benefits. Because the determination of treaty eligibility involves the treatment of the entity by its jurisdiction of organization and, if the entity is transparent, the treatment of its owners by their respective jurisdictions, tax treaty benefits that would otherwise be

126 Tax treaty benefits arise in both Austria and France because each country has entered into a tax treaty with the United States, ABC (a regular hybrid entity) is treated as non-transparent in Austria and as transparent in France, and both ABC (by Austria) and A (by France, but only with respect to A's distributive share) are taxed currently on the receipt of the dividend by ABC.

TAX CLASSIFICATION OF BUSINESS ENTITIES

available may not be in certain cases. For example, as illustrated in Diagram 10, the use of an entity that is treated as transparent under the rules of the jurisdiction of its formation and for United States tax purposes, but as non-transparent under the rules of the jurisdiction of its owners, will result in the denial of treaty benefits to both the entity and its owners.

Diagram 10¹²⁷



6 Curbing taxpayer abuse

Notwithstanding the flexibility in classification made possible by the check-the-box Regulations, the Service has recently cautioned that it will monitor taxpayer

127 ABC (a regular hybrid entity) is ineligible for treaty benefits under the United States – Austria treaty because it is treated as transparent in Austria. From Austria’s perspective, the income passes through to the owners. However, A and B are ineligible for treaty benefits under the United States – Ireland treaty, and C is ineligible for treaty benefits under the United States – France treaty, because ABC is treated as non-transparent in Ireland and France. From the perspectives of Ireland and France, the income would be taxed at the entity level, and not at the level of the owners, in the absence of a distribution. Thus, despite the fact that each of Ireland, France, and Austria has a treaty with the United States, no benefits will be available since the income will not be taxed currently to a resident of any of the applicable treaties.

(2006) 16 REVENUE LJ

behaviour thereunder and will not hesitate to intervene in cases in which the check-the-box Regulations are used in an abusive fashion. The Service has detected a trend by taxpayers in foreign settings to use both disregarded entities and partnerships in structuring transactions that are 'inconsistent' with the Code or tax treaty provisions.

On January 16, 2003, the Service indicated concern about new hybrid structures, including hybridized instruments (for example, instruments that are treated as debt for United States tax purposes but as equity for foreign tax purposes), which are increasingly being used by foreign taxpayers to 'manipulate tax treaty provisions' to avoid tax on United States source income. The Treasury has indicated that it will continue to examine certain categories of transactions to ensure that the 'substantive rules ... reach the appropriate result notwithstanding changes in entity classification.' To the extent the existing rules do not achieve that goal, the Treasury intends to propose changes that are 'narrow and focused on correcting inappropriate results'.

POSSIBLE REFORMS – CLOSING THE BOX

1 Future corrective measures

Since they came into existence a decade ago, the check-the-box Regulations have reshaped the application and administration of the tax laws.¹²⁸ In no area has this been more the case than that of international taxation. The Regulations allow an enterprise to be treated as transparent in one jurisdiction and as a separate entity in the other—an opportunity far more difficult to accomplish under prior law.¹²⁹ Not only can the enterprise select its classification, but it also possesses the flexibility after the initial election to transform its essence for tax purposes by a mere 'checking of the box' should such prove advantageous.

While generally received enthusiastically and favourably by the practicing bar, others have expressed misgivings over whether the Treasury possessed the requisite authority to even issue such Regulations.¹³⁰ Recently, the matter was confronted by the courts which appear unwilling to overturn the check-the-box Regulations.¹³¹

128 See generally Willis, Pennell, and Postlewaite, above n 7, chs 1, 3, and 21.

129 See generally Postlewaite and Donaldson, above n 49, chs 12 and 21; above n 109.

130 See Postlewaite and Pennell, above n 10, chs 1, 3, and 21; Polsky, 'Can Treasury Overrule the Supreme Court?' 84 BU L Rev 185 (2004).

131 *Litriello v United States*, F. Supp. 2d, 2005-1 USTC 50,385 (WD Ky 2004), which, with questionable legal reasoning but reaching a practical and administratively convenient result after their use for nine years, upheld the Regulations as valid. See also *Dover v Commissioner*, 122 TC 324 (2004), in which the court appeared to defer to their effect,

TAX CLASSIFICATION OF BUSINESS ENTITIES

Even assuming the legitimacy of the check-the-box Regulations, their existence has proven to be at best a nuisance and at worst a catastrophe for the Treasury and the Service. Since their introduction, in addition to litigating the tax effects of an election, the Treasury and the Service have issued administrative pronouncements or proposed Regulations in specific areas to address tax issues attributable to the existence of the check-the-box Regulations.¹³² So pervasive is the use of the check-the-box Regulations that commentators have begun to question how to address the new and complex tax issues arising from their use.¹³³ Interestingly, while commentary on the problems encountered is growing, the proposed solution, if any, is typically couched in remedies that are issue specific. Like the box which Pandora, notwithstanding the admonition of others that such action would change the world dramatically by introducing evil, opened because her curiosity overcame her, the check-the-box Regulations seem to have had a similar seismic impact on the administration of the tax law.¹³⁴

A high level Treasury official is quoted as comparing the check-the-box Regulations to the war in Iraq: 'It was the right thing to do, the concept was correct, the timing was right, but the process was flawed and we didn't give enough thought as to the follow-up.'¹³⁵ Even with this recognition, the Treasury official recommended that the issue of the check-the-box Regulations be revisited but thought any cure to its defects should be piecemeal at best: 'I see the resolution as limiting its application in 'inappropriate cases', enabling the benefits of the current rule to follow as I and many of us intended'.¹³⁶

without insistence upon a concomitant business purpose. In *Dover*, the use of the check-the-box Regulations eliminated \$30,000,000 of Subpart F income, which would have been imputed to the United States shareholders.

132 Above nn 112 and 128.

133 See Yoder, 'International Taxation: Re-Thinking Check-the-Box' 83 *Taxes Magazine*—the 57th University of Chicago Tax Conference 27 (2005).

134 *Ibid*, 28; asserting that the check-the-box Regulations 'are becoming ingrained in the U.S. system for taxing cross-border transactions and operations. . . .They touch virtually every international provision; they are ubiquitous. Their tentacles reach everywhere. . . .The classification regulations overshadow the application of all of the international rules because the consequences of most of the international provisions depend on the classification of the taxpayer.'

135 *Ibid*.

136 *Ibid*.

(2006) 16 REVENUE LJ

While commentators,¹³⁷ Treasury, and the Service have expressed serious concern over the profound influence of the check-the-box rules in particular areas of the law, few, if any, suggest wholesale modification. The irony of this development was placed in vivid relief by a leading commentator.¹³⁸ At a time when the Justice Department, the Treasury, the Service, and the courts are mired in combating the wave of corporate tax shelters and products heavily dependent upon a literal interpretation of the statute by the application of the judicial doctrines of business purpose and economic substance, little effort has been invested in stemming the tidal wave of exaggerated tax consequences which are attributable to a device (check-the-box) of its own making. Even the Tax Court has indicated a willingness to have more finely tailored check-the-box Regulations issued by the Treasury.¹³⁹

A number of alternatives, easy to formulate, potentially more difficult to implement, are available. The check-the-box Regulations could be limited to domestic enterprises. Foreign enterprises could be governed by the default rules currently employed by the check-the-box Regulations for classification with an exclusive focus on limited liability. A second approach would be a broadening of the *per se* list of foreign enterprises to establish symmetrical treatment of foreign enterprises with that imposed on domestic enterprises. Thus, the publicly traded versus privately held distinction which does not apply to domestic enterprises and some foreign jurisdictions could be extended to all. A third approach would emphasize the double level of taxation characteristic of domestic corporations. All foreign enterprises subject to such taxing regimes could be classified as *per se* corporations.

Prior to the check-the-box Regulations, the approach of the Service resulted in an enterprise's classification for domestic purposes mirroring its treatment under foreign law.¹⁴⁰ Thus, while foreign law was considered in determining what characteristics were possessed by the enterprise, the classification was determined by United States principles. Thus, the standard regular hybrid setting, ie, where the enterprise is treated as a partnership for domestic purposes but treated as a corporation for purposes of foreign law, arose infrequently under prior law. The corporate characteristics possessed by the enterprise under the law of the foreign jurisdiction

137 See West, 'Re-Thinking Check-the-Box: Subpart F,' 83 *Taxes Magazine*—the 57th University of Chicago Tax Conference 29 (2005); Bennett, above n 109; 106; Oosterhuis, 'Check-the-Box Planning in Cross-Border Transactions,' 83 *Taxes Magazine*—the 57th University of Chicago Tax Conference 43 (2005).

138 Yoder, above n 134, 29.

139 *Dover v Commissioner*, above n 133.

140 See Rev Rul 73-254, 1973-1 CB 613.

TAX CLASSIFICATION OF BUSINESS ENTITIES

would yield corporate status for domestic purposes. A foreign enterprise treated as a corporation for foreign and domestic purposes could not easily achieve hybrid status. Such “stapled status” prevented many of the tax planning techniques currently in play.

A limiting approach on the fast expanding use of check-the-box with its extreme flexibility in creating hybrid enterprise would be to limit the check-the-box election for domestic enterprises only. Thus, no foreign enterprise would be entitled to check the box.¹⁴¹ Instead, its classification would be dictated by a number of *per se* rules promulgated by the Service and the Treasury, which would be expanded dramatically to ensure *per se* corporate treatment for many enterprises entitled to select their classification of choice. Thus, without the elective feature, but with a retention of the current default rules, foreign entity classification would be governed by its members’ immunity from liability. If all members of the entity were insulated from liability, corporate classification would be imposed. If not, partnership or disregarded entity status would be appropriate.

Another approach would be an expansion of the *per se* categories with regard to foreign enterprises. Inexplicably, the line drawn for domestic purposes, ie, that incorporation under state law precludes the ability to elect, is more restrictive than it is for some foreign purposes.¹⁴² The *per se* list of foreign enterprises is frequently

141 The Joint Committee recently proposed narrowing the election for foreign enterprises but only with regard to foreign entities with a single member and a separate business unit for which corporate status would be mandated. See Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (Comm Print 2005).

142 This is surprising because the first notice from the Treasury and the Service about extending the check-the-box Regulations to foreign enterprises suggested a greater degree of symmetry. Notice 95-14 provides that ‘the Service and Treasury are considering simplifying the classification rules for foreign organizations in a manner consistent with the approach. . .for domestic organizations.’ Furthermore, the Notice questioned whether such an enactment might expand the number of hybrid entities. If so, should the proposed check-the-box Regulations safeguard against such possibilities? Additionally, the Notice suggested that much of the safeguarding against such abuse might take place in the tax treaty context. Other than the default classification rules for foreign and domestic entities, the check-the-box Regulations apply similarly in foreign and domestic settings. Nevertheless, the Preambles to the Proposed Regulations and the final Regulations indicated substantial uncertainty as to whether such opportunities for hybrid treatment might be exploited and cautioned that the Service and the Treasury: ‘will continue to monitor carefully the uses of partnerships in the international context and will issue appropriate substantive guidance when partnerships are used to achieve results that are

(2006) 16 REVENUE LJ

limited to publicly traded enterprises. Privately held foreign enterprises possessing similar structure and governance to the *per se* enterprises are nevertheless able to check the box. Yet, with respect to domestic enterprises, the public versus private distinction does not exist.

By way of example, for the United Kingdom and the Netherlands, the *per se* list of corporate enterprises is limited to the Public Limited Company and Naamloze Vennootschap. All other enterprises authorized by the business law of those jurisdictions may elect freely their status for United States tax purposes. If the list of *per se* corporations for foreign jurisdictions were expanded to more closely approximate that of the United States, the number of enterprises which could elect hybrid status might be reduced dramatically.

The current imbalance between the domestic check-the-box rules and the foreign rules is distorted in other ways as well. Many countries do not even appear on the list, suggesting that any enterprise in those jurisdictions, even publicly traded enterprises, could elect partnership or disregarded entity status for United States tax purposes. Furthermore, other countries on the list, primarily those of South America, do not possess the flexibility enjoyed by their European counterparts. The *per se* enterprise for most Latin American countries is the Sociedad Anonima. No distinction between public and private corporate status is recognized for those jurisdictions. All such entities are *per se* organizations, similar to the treatment by the United States for enterprises incorporated therein.

Finally, for classification purposes, a foreign enterprise might be classified on the basis of its tax treatment by the foreign jurisdiction. If the enterprise is subject to a system of two-level taxation, it might be deemed a *per se* corporation in an endeavour to foster parity between the domestic classification and foreign classification rules.

CONCLUSION

As the check-the-box Regulations enter their tenth year, it is an appropriate time at which to survey their growth and to determine whether we all will survive their teenage years. The effective use of the check-the-box Regulations frequently produces results at dramatic variance with the principles and policies behind the availability of the foreign tax credit. Accordingly, consideration of their repeal or contraction for use by foreign enterprises should be given serious consideration.

inconsistent with the policies and rules of particular Code provisions or of US tax treaties.’
See West, above n 139, 30.

TAX CLASSIFICATION OF BUSINESS ENTITIES

There are tremendous pressures to retain the status quo. Approaching their tenth birthday, the check-the-box Regulations are bristling with confidence, secure in their ability to withstand judicial scrutiny as a legitimate member of the regulatory entourage, and fending off occasional concerns given the inertia that has accompanied their embrace by the practising tax bar.

Proponents of their retention¹⁴³ emphasize their simplicity and certainty as advancing the tax system from a policy standpoint. The choice of business form has historically been an individual one and facilitating such a choice should not be a matter for concern. Piecemeal remedies will only cause a return to the pre-existing complexity which governed the classification issue. While such assertions may be potentially unassailable in a domestic context, the ability to be two things at once is not addressed by such explanations.¹⁴⁴ However, proponents argue that if cross border arbitrage occurs, it is not of great importance and the fact that such ability may come at a financial cost to another jurisdiction is not a concern of the United States.¹⁴⁵

Those commentators willing to even acknowledge potential for abuse through their use limit their reform proposals to the areas which, to date, have been discovered to produce less than ideal circumstances, frequently incompatible with the tax policy origins of the statute which is being circumvented.¹⁴⁶

However, as documented above, the reach and distortion of the check-the-box Regulations is extreme. The mere fact that a single checking of the box instantaneously transformed \$30,000,000 of Subpart F income, which would have been currently imputed to the corporation's United States shareholders, into an immune state of existence augers for a contrary conclusion. The problem requires dramatic and

143 See Yoder, above n 134, 28.

144 Ibid.

145 See West, above n 138, 33-34. Focusing upon their use in Subpart F, he categorizes the potential reactions to the check-the-box Regulations as (1) they produce appropriate results, (2) they raise concerns, and (3) the concerns are greater in scope and emanate from our compromised approach to international taxation through the failure of the United States to either adopt a territorial system of taxation or adopt a system of current taxation of all foreign income.

146 See West, above n 138, 33; Bennett, above n 109, 41; Oosterhuis, above n 139, 50. Oosterhuis suggests the use of a parallel structure in evaluating whether unintended results arise. He notes the difficulty in adding the fullness of the transaction that would have taken place.

(2006) 16 REVENUE LJ

immediate attention. Are the fundamental policy goals of many of the international taxing provisions undercut by the mere existence of the check-the-box Regulations?¹⁴⁷

It certainly appears that this is the case in many (most?, all?) settings. What could be more formulaic than the mere filing of an election which can transform a transparent enterprise into a separate one and vice versa.¹⁴⁸ It is time to close the box!

The lesson for Australia is to be forewarned of the dangers of such hydra-headed monsters. They are more than they appear and, like the Trojan Horse, should be left outside the city walls. Only trouble can come from letting them in.

147 Yoder, above n 134, 28.

148 See West, above 139, 34; where he suggests among the possible alternative solutions the repeal of the check-the-box Regulations either in the case of international issues or for all tax purposes. Of course, such efforts in either context create the problem of developing other classification standards.