

FLORIDA TAX REVIEW

VOLUME 7

2005

NUMBER

WHATEVER HAPPENED TO SUBPART F? U.S. CFC LEGISLATION AFTER THE CHECK-THE-BOX REGULATIONS

by

Lawrence Lokken

I. INTRODUCTION	187
II. DEVELOPMENT OF CFC LEGISLATION	189
III. SUBPART F AFTER CHECK-THE-BOX REGULATIONS	195
<i>A. Check-the-Box Regulations</i>	195
<i>B. Check-the-Box Schemes</i>	198
<i>C. Is There a Problem?</i>	201
<i>D. Solutions</i>	203
1. <i>Examples 1 and 2</i>	203
2. <i>Example 3</i>	206
3. <i>Other Check-the-Box Schemes</i>	208
IV. CONCLUSIONS	210

WHATEVER HAPPENED TO SUBPART F?
U.S. CFC LEGISLATION AFTER THE CHECK-THE-BOX REGULATIONS

by

*Lawrence Lokken**

I. INTRODUCTION

The U.S. Congress, in 1962, enacted provisions commonly known as subpart F,¹ under which U.S. shareholders of controlled foreign corporations (CFCs) are taxed on their ratable shares of some corporate income, whether or not distributed. A U.S. shareholder is a U.S. person who owns at least 10% of a foreign corporation's voting stock, directly, indirectly, or constructively.² A foreign corporation is a CFC if more than 50% of its stock, by vote or value, is so owned by U.S. shareholders.³

Apart from subpart F, the United States taxes shareholders on corporate income only as it is distributed to them as dividends.⁴ Because domestic corporations are taxed on their worldwide incomes,⁵ the lack of a shareholder-level tax on undistributed corporate income does not insulate this income from

* Lawrence Lokken is Hugh Culverhouse Eminent Scholar and Professor of Law at the University of Florida College of Law. The author thanks Philip R. West of Steptoe & Johnson, Washington, DC, who commented on an earlier version of this paper at the International Tax Symposium and provided much helpful advice. For Mr. West's analysis of the issues discussed in this article, see Philip R. West, *Re-Thinking Check-the-Box: Subpart F*, 83 *Taxes* 29 (March 2005). The author also thanks Dr. Jan Sedemund, Rechtsanwalt, of KPMG Deutsche Treuhand-Gesellschaft AG, Köln, Germany, for help on issues of German law.

1. The provisions are subpart F of part III of subchapter N of chapter 1 of subtitle A of the Internal Revenue Code.

2. IRC § 951(b). See IRC § 7701(a)(30) ("United States person" includes U.S. citizens and residents, domestic corporations and partnerships, and certain estates and trusts).

3. IRC § 957(a), discussed in 3 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates & Trusts* ¶ 69.2 (Warren, Gorham & Lamont rev. 3d ed. 2005) [hereinafter Bittker & Lokken]. See IRC § 7701(a)(5) (corporation is foreign if it is organized under laws of a jurisdiction other than the United States, a U.S. state, or the District of Columbia).

4. IRC §§ 61(a)(7); 301(c)(1).

5. IRC § 61(a). Domestic corporations are, however, allowed credit for income taxes paid to foreign countries. IRC § 901, discussed Bittker & Lokken, *supra* note 3, ¶ 72.1.

U.S. taxation. However, a foreign corporation is subject to U.S. tax on only income effectively connected with the conduct of a trade or business in the United States and certain income from U.S. sources, even if its shareholders are U.S. persons.⁶ Thus, apart from subpart F, the United States imposes no tax on foreign income of U.S.-owned foreign corporations until it is distributed to the shareholders or the shareholders sell their shares.

Subpart F limits, but does not eliminate, this deferral opportunity. As described more fully in Part II of this article, a principal reason for the enactment of subpart F was to curb U.S. companies' ability to shelter income from taxation in tax haven countries. However, evidence collected by Altshuler and Grubert indicates that subpart F has not, in recent years, been effective in preventing U.S. multinational enterprises from using corporations organized in countries commonly considered to be tax havens as vehicles for sheltering large amounts of income from significant taxation by any country.⁷ In particular, they conclude that the United States' adoption of the so-called check the box regulations in 1996 has allowed U.S. multinational enterprises to significantly reduce the effective rates of taxation of their non-U.S. incomes. They estimate that "in 2002 U.S. companies paid \$7 billion less in host country taxes compared to 1997 by using intercompany payments deductible in the paying country but exempt from tax in the recipient."⁸ As shown in Part III, the check-the-box regulations facilitate structures accomplishing such no-tax results.

The purpose of this article is to explore means by which the originally-intended function of subpart F could be reclaimed from the inroads allowed by the check-the-box regulations. The article is not intended to contribute to the growing literature on whether U.S. tax policy should be to broaden or narrow the scope of subpart F.⁹ The Treasury, in adopting the check-the-box

6. IRC §§ 881, 882. See Bittker & Lokken, *supra* note 3, ¶ 67.1.1.

7. Rosanne Altshuler & Harry Grubert, *The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies*, 7 Fla. Tax Rev. 152 (2005).

8. *Id.* at 171.

9. For arguments for broadening subpart F, see J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 Fla. Tax Rev. 299 (2001); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Deferral: Consider Ending It Instead of Expanding It*, 86 Tax Notes 837 (Feb. 7, 2000); Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. Rev. 455 (1999). For arguments for narrowing subpart F, see National Foreign Trade Council, *Foreign Income Project, International Tax Policy for the 21st Century* (2001).

regulations, did not intend to alter the policies reflected in subpart F.¹⁰ My purpose in this article is only to determine whether the balance between deferral and current taxation, unintentionally upset by the regulations, may feasibly be restored.

II. DEVELOPMENT OF CFC LEGISLATION

Soon after taking office, President Kennedy submitted a message to Congress advocating a general elimination of the deferral privilege with respect to income originating in developed countries and income of tax haven entities.

To the extent that these tax havens and other tax deferral privileges result in U.S. firms investing or locating abroad largely for tax reasons, the efficient allocation of international resources is upset, . . . and profits are retained and reinvested abroad which would otherwise be invested in the United States. Certainly since the post-war reconstruction of Europe and Japan has been completed, there are no longer foreign policy reasons for providing tax incentives for foreign investment in the economically advanced countries.¹¹

Although generally not requiring immediate taxation of undistributed earnings of CFCs from developing countries, the President's recommendations would have eliminated "the tax haven device anywhere in the world, even in the underdeveloped countries, through the elimination of tax deferral privileges for those forms of activities, such as trading, licensing, insurance, and others, that typically seek out tax haven methods of operation."¹² If these changes reduced "the rate of expansion of some American business operations," the President concluded, the "reduction would be consistent with the efficient distribution of

10. See PS-43-95, 1996-1 CB 865 (referring, in proposing check-the-box regulations, to "the increased flexibility under local law" in shaping attributes of business organizations and resulting artificiality of historical distinctions between corporations and other forms of business organization), discussed in Bittker & Lokken, *supra* note 3, ¶ 85.4.

11. Message from the President of the United States Relative to our Federal Tax System (Apr. 20, 1961), reprinted in H.R. Doc. No. 87-140 at 8-9 (1961).

12. *Id.* at 9. Countries not among the developed nations of the world are now usually called "developing countries," implying, optimistically and surely contrary to fact, that all of them are progressing toward development. President Kennedy used the term "underdeveloped countries," implying a desire that they be more developed. Subpart F used more neutral terminology, "less developed countries." IRC § 955 (before amendment in 1976).

capital resources in the world . . . and fairness to competing firms located in our own country.”¹³

In a statement to the House Ways and Means Committee, Treasury Secretary Douglas Dillon stressed one of the two principal themes of the President’s message: the policy that later became known as capital export neutrality. “To avoid the artificial encouragement to investment in other advanced countries as compared with investment in the United States, we propose that American corporations be fully taxed each year on their current share in the undistributed profits realized by subsidiary corporations organized in economically advanced countries.”¹⁴ Secretary Dillon contrasted this policy with the policy that later became known as capital import neutrality:

Either we tax the foreign income of U.S. companies at U.S. rates and credit income taxes paid abroad, thereby eliminating the tax factor in the U.S. investor’s choice between domestic and foreign investment: or we permit foreign income to be taxed at the rates applicable abroad, thereby removing the impact, if any, which the tax rate differences may have on the competitive position of the American investor abroad. Both types of neutrality cannot be achieved at once. I believe that reasons of tax equity as well as reasons of economic policy clearly dictate that in the case of investment in other industrialized countries we should give priority to tax neutrality in the choice between investment here and investment abroad.¹⁵

Congress, being unpersuaded by the case for an undiluted policy of capital export neutrality, generally rejected the administration’s call to end deferral of undistributed CFC profits earned in economically advanced countries. In shaping the legislation that became subpart F, however, it accepted the recommendation to eliminate deferral of tax haven earnings. The Senate Finance Committee, commenting on the 1962 bill by which subpart F was enacted, noted that

The House bill . . . did not eliminate tax deferral generally, but instead was concerned primarily with what had been referred to as “tax haven” devices. To accomplish this result the House bill in general sought to end tax deferral for income derived by

13. Message from the President of the United States Relative to our Federal Tax System (Apr. 20, 1961), reprinted in H.R. Doc. No. 87-140 at 9 (1961).

14. Staff of House Comm. on Ways & Means, 1 Legislative History of H.R. 10650, 87th Cong., The Revenue Act of 1962 at 126 (Comm. Print 1967) (Statement of Hon. Douglas Dillon, Secretary of Treasury, Before the Committee on Ways and Means of the House of Representatives, on the President’s Message on Taxation, May 3, 1961).

15. *Id.* at 70.

U.S. controlled foreign corporations from insurance abroad of U.S. risks; for certain foreign investment income of these corporations; for their income from foreign sales subsidiaries which are separately incorporated from their manufacturing operations; and . . . earnings . . . indirectly brought back to the United States without full payment of U.S. tax.¹⁶

In these broad outlines, the House bill was accepted by the Senate and enacted into law.

Twenty-four years later, the Staff of the Joint Committee on Taxation summarized the policies underlying subpart F as follows:

16. S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted at 1962-3 CB 703, 784-85. Senator Eugene J. McCarthy objected:

[T]he controlled foreign corporations provision erects a barrier to the achievement of vital national objectives, namely the expansion of trade and an improvement in our balance-of-payments position. We cannot promote either of these related objectives through a restrictive policy which, in the hope of correcting tax abuses, slashes with a broad sword at America's overseas subsidiaries. . . .

There are controlled corporations which have been established in foreign countries primarily, if not solely, for purposes of tax avoidance here in the United States. It is also true that some of these subsidiaries probably serve no real purpose as far as the interests of the United States are concerned. We should not throw the baby out with the bath water but should reconsider the means by which we undertake to correct abuses. . . .

. . . [Subpart F's] approach to overseas income is far too complex in its administration, far too selective in its application, and far too uncertain in its effects.

Id. at 1057. Senators Carlson, Bennett, Butler, Curtis, and Morton found subpart F "truly amazing" and predicted that "normal trade relations will be seriously disturbed." Id. at 1059. On the other hand, Senators Douglas and Gore argued for legislation at least as broad as the President had recommended:

The best and indeed the only sure way to achieve substantial equity, guard against the untoward weakening of American industry and assist in the solution of the balance-of-payments problem through taxation is to tax American taxpayers annually on income and profits earned anywhere in the world. . . .

This entire section [of the bill containing subpart F], embodying as it does the tax haven approach, ought to be deleted and have substituted therefor the complete removal of the deferral privilege.

Id. at 1126-27.

It has long been the policy of the United States to impose current tax when a significant purpose of earning income through a foreign corporation is the avoidance of tax. Such a policy serves to limit the role that tax considerations play in the structuring of U.S. persons' operations and investments. Because movable income earned through a foreign corporation could often be earned through a domestic corporation instead, Congress believed that a major motivation of U.S. persons in earning such income through foreign corporate vehicles often was the tax benefit expected to be gained thereby. Congress believed that it was generally appropriate to impose current U.S. tax on such income earned through a controlled foreign corporation, since there is likely to be limited economic reason for the U.S. person's use of a foreign corporation. Congress believed that by eliminating the U.S. tax benefits of such transactions, U.S. and foreign investment choices would be placed on a more even footing, thus encouraging more efficient (rather than more tax-favored) uses of capital.¹⁷

The Treasury stated more recently:

Subpart F was enacted by Congress to limit the deferral of U.S. taxation of certain income earned outside the United States by foreign corporations controlled by U.S. persons. Limited deferral was retained after the enactment of subpart F to protect the competitiveness of controlled foreign corporations (CFCs) doing business overseas. . . . This limited deferral furthers the objective of allowing a CFC engaged in an active business, and located in a foreign country for appropriate economic reasons, to compete in a similar tax environment with non-U.S. owned corporations located in the same country. . . .

U.S. international tax policy seeks to balance the objective of neutrality of taxation between domestic and foreign business enterprises (seeking neither to encourage nor to discourage one over the other), while keeping U.S. business competitive. Subpart F strongly reflects and enforces that balance¹⁸

17. Staff of Joint Comm. on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986 at 964-65 (Comm. Print 1987).

18. TD 8767, 1998-1 CB 875. I do not, in this paper, undertake a comprehensive analysis of the relative merits of capital export neutrality and capital import neutrality, but I cannot resist a brief comment on the Treasury's reference to "the

A common theme in all of these explanations is that the intended target of subpart F is not low foreign tax rates. If a CFC is actively engaged in business in a low-tax country, income of this business is not usually subpart F income. The intended target is instead income that has been channeled into a low-tax environment that has no substantial economic connection with the income.

Two categories of CFC earnings are taxed directly to U.S. shareholders: subpart F income and earnings invested in U.S. property. Subpart F income is principally a collection of types of income that Congress found susceptible to tax haven manipulation, including the following:

1. Income from insuring risks outside the CFC's country of incorporation.¹⁹

2. Passive income, which the statute refers to as foreign personal holding company (FPHC) income, including dividends, interest, royalties, rents, net gains on sales and exchanges of property productive of passive income, net gains from commodities transactions, net foreign currency gains, and income from notional principal contracts.²⁰

3. Income from sales of goods purchased from or sold to or on behalf of related persons if the goods are neither produced nor sold for use in the country in which the CFC is organized.²¹

objective of allowing a CFC engaged in an active business, and located in a foreign country for appropriate economic reasons, to compete in a similar tax environment with non-U.S. owned corporations located in the same country.” The idea that U.S. taxation of the income of CFCs somehow affects the competitive position of U.S. companies in foreign countries is a common theme of tax lobbyists for these companies. It is usually presented as being so obvious as not to require explanation. See, e.g., National Foreign Trade Council, Foreign Income Project, International Tax Policy for the 21st Century 12–14 (2001).

The idea is, however, based on assumptions that are far from obvious. Assume *X Corp.*, a Delaware corporation, has a subsidiary in country *F*, *FC*, which produces and sell goods in country *F*. A U.S. tax on *FC*'s undistributed profits, imposed on *X Corp.*, would affect *X*'s competitive position in country *F* only if it were to be reflected in lower wages paid or higher prices charged by *FC* because, in country *F*, *X* and *FC* only compete in the markets for labor and goods. On the other hand, if the tax only impacts corporate profits, it only affects *X*'s ability to compete in the markets for capital, and if *X* and *FC* obtain their equity capital in the United States, the tax has no effect on the competitive position of *X* or *FC* in country *F*. Classical economists believed that taxes on corporate profits are borne by shareholders alone, but modern economists have entertained the possibility of these taxes being borne, to some extent, by labor and consumers as well. Neither theory or empirical analysis has, however, yielded a definitive answer to the question.

19. IRC § 953, discussed in Bittker & Lokken, *supra* note 3, ¶ 69.3.

20. IRC § 954(c), discussed in Bittker & Lokken, *supra* note 3, ¶ 69.4.

21. IRC § 954(d), discussed in Bittker & Lokken, *supra* note 3, ¶ 69.5.

4. Income from services performed for or on behalf of a related person outside of the country under the laws of which the CFC is organized.²²

5. Income from shipping operations in foreign commerce.²³

6. Income from processing, transporting, or distributing oil or gas.²⁴

Also, income of any character may be subpart F income if the CFC engages in certain activities proscribed by Congress, such as paying illegal bribes or kickbacks, participating in an international boycott, or doing business in a country on bad terms with the United States.²⁵ Subpart F income is the sum of all of the foregoing or, if less, the CFC's earnings and profits for the year.²⁶

CFC earnings other than subpart F income are taxed directly to U.S. shareholders if they are invested in "United States property," such as shares or debt instruments issued by a U.S. affiliate of the CFC or real property located in the United States.²⁷ Moreover, if a CFC accumulates earnings that are not taxed to U.S. shareholders as subpart F income or as earnings invested in U.S. property, a U.S. shareholder's gain on selling stock of the CFC is treated as a dividend to the extent of the earnings attributable to the stock sold.²⁸

The United States was the first country to enact CFC legislation, but about 25 other countries have since adopted such legislation.²⁹ The basic compromise made by the U.S. Congress in 1962 – to curb tax haven abuses without eliminating deferral of all CFC income – has guided the development of most CFC legislation in other countries.³⁰ In pursuing this goal, however,

22. IRC § 954(e), (before repeal in 2004 by Pub. L. No. 108-357, § 415, 118 Stat. 1418), discussed in Bittker & Lokken, *supra* note 3, ¶ 69.6.

23. IRC § 954(f), discussed in Bittker & Lokken, *supra* note 3, ¶ 69.7.

24. IRC § 954(g), discussed in Bittker & Lokken, *supra* note 3, ¶ 69.8.

25. IRC § 952(a), discussed in Bittker & Lokken, *supra* note 3, ¶ 69.10.

26. IRC §§ 952(a), 952(c), discussed in Bittker & Lokken, *supra* note 3, ¶ 69.10.

27. IRC §§ 951(a)(1)(B), 956, discussed in Bittker & Lokken, *supra* note 3, ¶ 69.11.

28. IRC § 1248, discussed in Bittker & Lokken, *supra* note 3, ¶ 69.14.

29. For a survey of CFC legislation as of 2001 and 1997, see Int'l Fiscal Ass'n, *Limits on the Use of Low-Tax Regimes by Multinational Business: Current Measures and Emerging Trends*, Cahiers De Droit Fiscal Int'l, vol. LXXXVIb (2001); Sandler, *Tax Treaties and Controlled Foreign Company Legislation: Pushing the Boundaries* (Kluwer 2d Ed. 1998).

30. In its 1998 report on harmful tax competition, the OECD suggested that countries might consider adopting CFC legislation as a means of defending their systems of residence taxation against erosion by tax haven schemes. Organisation for Economic Cooperation and Development, *Harmful Tax Competition: An Emerging Global Issue* (OECD 1998). Several countries have since adopted CFC legislation, at least partially in response to the OECD report.

many countries have used approaches in their CFC legislation quite different from that of the U.S. subpart F.

The first countries to follow the U.S. lead on such legislation were Canada and Germany, in 1972. The Canadian and German legislation generally follows the approach of the U.S. legislation. In each case, the legislation identifies particular kinds of income as tax haven income and taxes resident shareholders on only these types of CFC income. This approach might be called a tainted income approach.

Beginning with Japan in 1978 and the United Kingdom in 1984, most countries adopting CFC legislation have used what might be called a tainted entity approach, under which the legislation and related administrative actions identify corporations to be considered tax haven companies and tax resident shareholders on all income of these corporations, regardless of its source or nature.

The tainted income and tainted entity approaches both have strengths and weaknesses. Proponents of a tainted income approach may point to the fact that the income tax laws of virtually every country have tax haven features. For example, the U.S. rule exempting portfolio interest income of foreign investors from U.S. withholding tax makes the United States attractive as a tax haven for some foreign investors in debt securities (e.g., U.S. Treasury obligations).³¹ An approach based on a sorting of countries between tax haven countries and other countries may therefore miss tax haven schemes utilizing entities resident in countries not generally considered to be tax havens. On the other hand, a tainted income approach is vulnerable to tax planners' creativity in crafting schemes that effectively shelter income in tax haven countries without the income falling within any of the categories of tainted income. Legislation based on a tainted entity approach may avoid this trap by taxing resident shareholders on all income shifted to an entity resident in a tax haven country, regardless of its character.

III. SUBPART F AFTER CHECK-THE-BOX REGULATIONS

A. Check-the-Box Regulations

U.S. income tax law generally recognizes only two types of business entities: corporations, which are taxable entities and the income of which is potentially subject to tax a second time when distributed to shareholders, and partnerships, which are fiscally transparent in the sense that they are not taxed but their income is attributed to their members as recognized for federal tax purposes. This duality applies to foreign as well as domestic entities. A

31. For the portfolio exemption, see §§ 871(h), 881(c), discussed in Bittker & Lokken, *supra* note 3, ¶ 67.2.2.

business entity organized under the laws of or resident in a foreign country is thus, for U.S. income tax purposes, either a corporation or a partnership.

Outside of the arena of taxation, the world is considerably more complex, as the Internal Revenue Code recognizes in defining “corporation” to include, “associations” and “joint stock companies,” in addition to entities generally known as corporations.³² The Supreme Court decided in 1935 that the term “associations,” which the Code does not define, should be interpreted to encompass any organization that resembled a corporation, as commonly understood, more than it resembled any other form of organization recognized by the tax law.³³ The Treasury embraced this decision by regulations that identified four corporate characteristics considered most useful in distinguishing corporations from partnerships: continuity of life, centralized management, limited liability, and free transferability of interests.³⁴ Under the regulations existing immediately before the Treasury adopted the check-the-box regulations, a business entity exhibiting three or four of these characteristics was a corporation, while an entity not having more than two of the characteristics was a partnership.³⁵

The corporate resemblance test was always difficult to apply, but this difficulty took on the character of futility with the emergence of the limited liability company (LLC). Unknown in the United States 30 years ago but now recognized by all 50 of the states, the LLC is a very flexible form of business organization.³⁶ All members of an LLC enjoy immunity from personal liability for debts of the entity, but under the laws of most states, other corporate characteristics exist or do not exist at the members’ convenience. An LLC may, but need not be, centrally managed, its life may be fixed by the members’ agreement, and each member’s ability to transfer his or her interest in the entity may also be determined by agreement. The members’ choices on these matters, while potentially important, likely do not usually go to the essence of the entity’s nature. LLC laws thus provide the corporate characteristic probably most highly prized – limited liability for all members, while allowing the members to couch their operating agreement in terms suiting their tax convenience without significantly affecting their business relationship.

32. IRC § 7701(a)(3).

33. *Morrissey v. CIR*, 296 US 344 (1935).

34. See *Bittker & Lokken*, *supra* note 3, ¶ 85.3.2.

35. Reg. § 301.7701-2(a)(3) (before amendment in 1996).

36. See, e.g., Keatinge, Ribstein, Hamill, Gravelle & Connaughton, *The Limited Liability Company: A Study of the Emerging Entity*, 47 *Bus. Lawyer* 375 (1992)

The Treasury saw the check-the-box regulations as doing little more than giving legal sanction to the practical reality of electivity.³⁷ Under the regulations, which were adopted in 1996 and became effective as of the beginning of 1997,³⁸ an entity organized under the corporation laws of a U.S. state, or under the laws of a foreign country analogous to state corporation laws, is a corporation for U.S. tax purposes.³⁹ Any business entity not encompassed by this per se rule may elect to be either a corporation or fiscally transparent.⁴⁰ A fiscally transparent entity is a partnership if it has two or more owners. If it has only one owner, it is disregarded as an entity separate from its owner, and the owner is deemed to own all of the entity's assets and to be the obligor of all of its liabilities. Although the emergence of the LLC was the precipitating fact, the regulations allow any entity other than a per se corporation to elect its status. An ordinary partnership may, for example, elect to be a corporation for U.S. tax purposes.

Apart from the regulations' implications for international income, the Treasury's judgment about the effects of the regulations was probably correct. Taxpayers and the IRS experienced considerable difficulty in applying the corporate resemblance test, and given that the test usually allowed well-advised taxpayers to structure their unincorporated business entities to be either corporations or partnerships, as they chose, the resources spent on applying the test were largely wasted. By substituting an election for that test, the Treasury simplified this aspect of the tax law without sacrificing any substantial governmental interest being served by the resemblance test.

However, the check-the-box regulations revolutionized the U.S. international tax practice. The laws of many other countries allow entities similar to the LLC, but they often classify these entities as corporations for tax purposes. For example, the *Gesellschaft mit beschränkter Haftung* (GmbH) is one of the principal forms of business organization in Germany.⁴¹ The owners of a GmbH enjoy immunity from liability for debts of the entity, but a GmbH is not centrally managed, and whether it has the other corporate characteristics cited in the corporate resemblance regulations depends on the owners' operating agreement.⁴² A GmbH is, however, considered a corporation for purposes of German taxation.⁴³

37. See PS-43-95, 1996-1 CB 865.

38. TD 8697, 61 Fed. Reg. 66,584 (Dec. 18, 1996), reprinted in 1997-1 CB 215.

39. Reg. § 301.7701-2(b)(1), (8).

40. Reg. § 301.7701-3(a).

41. See, e.g., <http://en.wikipedia.org/wiki/GmbH>, last visited 17 November 2005.

42. See GmbH Gesetz.

43. Körperschaftsteuergesetz § 1(1).

A GmbH that is a partnership or disregarded entity for U.S. tax purposes, but a corporation for German tax purposes, is an example of a hybrid entity. Although it was possible for a GmbH to be a hybrid entity under the corporate resemblance regulations,⁴⁴ the check-the-box regulations make hybrid status as easy as filling out a one-page form.⁴⁵ The regulations allow the same ease of achieving hybrid status for entities organized in other countries that have entities analogous to the U.S. LLC and treat them as corporations for local tax purposes.

The regulations make it equally easy to create a so-called reverse hybrid entity – an entity that is fiscally transparent under the laws of a relevant foreign country but is classified as a corporation for U.S. tax purposes.⁴⁶ For example, if a U.S. multinational enterprise causes two of its corporate members to organize a partnership to make an investment or carry on an activity in a foreign country, that country likely treats the partnership as fiscally transparent. If the partnership elects to be an association taxable as a corporation for U.S. tax purposes, it is a reverse hybrid entity.

B. Check-the-Box Schemes

Taxpayers have learned to use hybrid entities to defeat the application of subpart F. Three examples are given below.

44. Rev. Rul. 93-4, 1993-1 CB 225, declared obsolete by Rev. Rul. 98-37, 1998-2 CB 133.

45. The regulations' facilitation of hybrids did not come as a surprise to the Treasury. In its first official indication that it was considering a wholly elective system, the Treasury said:

An elective approach could expand the potential that exists under the current classification regulations for hybrid structures. The Service and Treasury are considering whether it is appropriate to address inconsistent classification in any rules to be proposed and also are considering how the tax benefits or detriments that may result from inconsistent classification can be addressed through the tax treaty process. . . .

. . . . Because any change in the existing classification regulations is intended generally to simplify the rules without resulting in a substantial change in the classification of unincorporated organizations, the Service and Treasury must consider whether an elective approach should be modified with respect to foreign organizations.

Notice 95-14, 1995-1 C.B. 297, 298.

46. The term "reverse hybrid entity" appears in a few regulations. See, e.g., Reg. § 1.894-1(d)(2).

Example 1. DelCo, a Delaware corporation, produces and sells widgets in the United States and elsewhere using valuable technology that it has developed. Foreign rights to this technology are owned by an entity organized under the laws of country *H*, which has no income tax and in which no significant operations of the DelCo group are located. The country *H* entity (*IPCo*) is owned by a corporation (*OPCo*) that is organized under the laws of country *L* and is wholly owned by DelCo. *OPCo* licenses the technology from *IPCo*, uses it in producing and selling widgets, and pays royalties for this use to *IPCo* equal to 5% of *OPCo*'s revenues from these sales. The corporate income tax rate in country *L* is 35%, but the royalty that *OPCo* pays to *IPCo* is deductible in determining *OPCo*'s country *L* taxable income. Country *L* imposes a withholding tax of 10% on *IPCo*'s royalty income. Because *IPCo* is subject to no tax in its home country, the net effect of the royalty payments is to reduce income tax on an amount equal to the royalties from 35% (the additional country *L* tax *OPCo* would pay if it had no deduction for royalty expense) to 10% (the country *L* withholding tax on the royalties).

IPCo elects to be a disregarded entity for U.S. tax purposes, and *OPCo* is therefore deemed to own the assets and owe the liabilities of *IPCo*. Since an entity cannot license property to itself or collect royalties from itself, the license agreement between *IPCo* and *OPCo* is disregarded for U.S. tax purposes. As viewed for U.S. tax purposes, income of the *OPCo/IPCo* entity derives solely from producing and selling goods. None of it is subpart F income.⁴⁷

Example 2. This example is the same as example 1, except that the parent-subsidiary relationship between *IPCo* and *OPCo* is reversed. DelCo is sole owner of *IPCo*, which is a corporation for tax purposes in all relevant countries, and *IPCo* is sole owner *OPCo*, which licenses technology owned by *IPCo*, uses it in producing and selling widgets, and pays royalties for this use to *IPCo* equal to 5% of its revenues from these sales. *OPCo* elects to be a disregarded entity, and *IPCo* is therefore considered, for U.S. tax purposes, to own the assets and be the obligor of the liabilities of *OPCo*. Since *IPCo* is deemed to be both the owner and the user of the technology, the licence agreement and the royalties paid under it are disregarded for U.S. tax purposes.

47. In a variation on Example 1, *IPCo* is wholly owned by *LCo*, another subsidiary of DelCo, that is organized under the laws of country *L* (the country in which *OPCo* is incorporated and operates) and is classified as a corporation for U.S. tax purposes. Because *IPCo* is also a disregarded entity in this variation, its technology is considered owned by *LCo*, the license to *OPCo* is deemed made by *LCo*, and the royalties are treated as though paid by *OPCo* to *LCo*. *LCo* is a CFC, and its royalty income is within the general definition of FPHC income under § 954(c)(1)(A). However, the royalties are excepted by § 954(c)(3)(A) because they are received from a related corporation for the use of property within the country (country *L*) under the laws of which the CFC is organized.

As in Example 1, the license arrangement reduces the worldwide tax burden on income represented by the royalties from 35% to 10%, but because the check-the-box election causes the royalties to disappear for U.S. tax purposes, no CFC has subpart F income.

Example 3. FlorCo, a Florida corporation, produces and sells gadgets in the United States and elsewhere. Its operations in foreign country *G* are conducted by a wholly owned subsidiary, *GCo*, which is organized under the laws of and managed within country *G*. FlorCo and one of its domestic subsidiaries (*DS*) are the partners of a partnership (*PRS*) organized under the laws of country *G*. *PRS* lends \$1,000 to *GCo* at 10% interest. Country *G* taxes *GCo* on its income at 35%, but it allows *GCo* a deduction for its annual interest payment to *PRS* of \$100. *PRS* is a pass-through entity for country *G* purposes. Its partners, not being resident in country *G*, are subject to country *G* tax only on income from sources in country *G*; because the interest payment to *PRS* is from country *G* sources, country *G* imposes a 10% withholding tax on it.⁴⁸

For U.S. tax purposes, *PRS* elects to be classified as a corporation. *PRS* is a CFC.⁴⁹ Its income, interest, would normally be foreign personal holding company (FPHC) income and hence subpart F income.⁵⁰ However, interest received by a CFC from a related person is not FPHC income if the related person is a corporation organized under the laws of the same country as the CFC and uses a substantial part of its assets in a trade or business located in that country.⁵¹ *PRS* is a related person with respect to *GCo*,⁵² *GCo* and *PRS* are organized under the laws of the same foreign country (country *G*), and *GCo* interest income is therefore not FPHC income, and none of the income of *GCo* or *PRS* is subpart F income.

48. If country *G* has an income tax treaty with the United States that forbids source-based withholding taxes on interest, as many U.S. treaties do, there may be no withholding tax on the interest. However, if the treaty follows the U.S. Model Income Tax Convention of September 20, 1996, treaty benefits are denied by article 4(1)(d), which states that income “derived through an entity that is fiscally transparent under the laws of either Contracting State” is considered income of “a resident of a State [only] to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.” Since the income of *PRS* is, for U.S. tax purposes, considered income of only *PRS*, an entity that the United States does not treat as a U.S. resident, neither *PRS* nor its owners qualify for treaty benefits with respect to the interest income.

49. If, for example, FlorCo and *DS* have equal interests in *PRS*, each of them is a U.S. shareholder under § 951(b), and *PRS* is wholly owned by U.S. shareholders.

50. IRC § 954(c)(1)(A).

51. IRC § 954(c)(3)(A)(i).

52. IRC § 954(d)(3) (person is related to CFC if it and CFC are controlled by same person or persons; control is ownership of more than 50% of the interests, directly, indirectly, or constructively).

C. Is There a Problem?

The IRS has identified situations such as those in the Examples as circumventions of subpart F.⁵³ In these cases, U.S. companies structure transactions and investments to divert income of types normally caught by subpart F (royalties and interest) into tax haven entities. In Examples 1 and 2, the recipient entity is organized in a country easily identified as a tax haven. In Example 3, the recipient is organized in a country that is not generally a tax haven, but it functions as a haven entity because of the conflicting treatments of the entity under the tax laws of country *G* and the United States. Although each of the examples exhibits tax haven sheltering of the kind intended to be attacked by subpart F, a strategic check-the-box election prevents any of the enterprise's income from being subpart F income.

Some commentators have argued that the results in the Examples are not inconsistent with the aims of subpart F.⁵⁴ The essential compromise reflected in subpart F is an objective to curb tax haven sheltering without denying tax deferral to income from active business operations in low-tax countries. In the Examples, DelCo and FlorCo carry on active businesses in foreign countries, and the devices that they employ to minimize foreign taxes may be seen as devices to lower the effective rate of tax on income from these businesses. Although the countries in which the businesses are carried on have nominal income tax rates of 35%, they allow the effective rate to be reduced through the devices employed by DelCo and FlorCo.⁵⁵ Because these countries

53. See, e.g., Notice 98-11, 1998-1 CB 433.

54. See, e.g., Cooper, Melcher & Stretch, Suddenly Saving Foreign Taxes Is Abusive? An Untenable Proposal, 79 Tax Notes 885 (May 18, 1998); Gannon, Calianese, Layden, Moreland & Seo, Subpart F, Hybrid Entities, and Other Little Things, 79 Tax Notes 473 (Apr. 27, 1998), reprinted in 16 Tax Notes Int'l 1467 (May 4, 1998); Leblang, Deferred Gratification: A More Rational Approach for Taxing U.S. Multinationals, 27 Tax Mgmt. Int'l J. 539 (1998); New York State Bar Ass'n Tax Section, Notice 98-11: Tax Treatment of Hybrid Entities, 79 Tax Notes 877 (May 18, 1998), reprinted in 16 Tax Notes Int'l 1669 (May 25, 1998); Tax Executives Institute, Hybrid Arrangements Notice "Poor Tax Policy," 16 Tax Notes Int'l 1003 (Mar. 30, 1998). See also Avi-Yonah, U.S. Notice 98-11 and the Logic of Subpart F: A Comparative Perspective, 16 Tax Notes Int'l 1797 (Jun. 8, 1998); Tillinghast, An Old-Timer's Comment on Notice 98-11, 78 Tax Notes 1739 (Mar. 30, 1998); Yoder, Subpart F in Turmoil: Low-Taxed Active Income under Siege, 77 Taxes 142 (Mar. 1999).

55. The device illustrated by Example 1 would likely not work if country *L* had CFC legislation, and the device illustrated by Example 3 might be frustrated by a rule that an entity is taxable by country *G* as a corporation, even though it would normally be fiscally transparent, if more than one half of the interests in the entity are owned by

tolerate the reductions in their taxes resulting from these devices, they are somewhat lower-tax jurisdictions than appears from their nominal rates.

The argument does not, in my opinion, succeed in squaring the results in the Examples with the purposes of subpart F. In Example 1, if *IPCo*, the entity receiving the royalties, elected to be a corporation for U.S. tax purposes, rather than a disregarded entity, it would be a CFC, and its income would be subpart F income, even though the economic consequences of the transactions would be the same as in the original example. Similarly, in Example 2, if *OPCo*, the payor of the royalties, elected to be a corporation for U.S. tax purposes, the royalties it pays to *IPCo* would be subpart F income of *IPCo*. Royalties from a related corporation are excluded from FPHC income, and hence subpart F income, only if they are paid for the use of property within the country in which the CFC is organized.⁵⁶ This same-country exclusion does not apply in Example 1 or Example 2, even if *IPCo* and *OPCo* are corporations for U.S. tax purposes, because the licensee, *OPCo*, does not use the technology in the country in which *IPCo* is organized. The same-country exclusion evidently derives from Congress' conclusion that if a CFC receives royalties based on uses of intellectual property in the country in which it is organized, the choice of the CFC's place of organization and the choice of the CFC as the vehicle for holding the intellectual property are likely based on economic factors, not tax minimization goals, and taxation of the royalties is determined by the tax policies of the country that is the situs of the economic activity from which the income derives (use of the intellectual property). The existence of this narrowly framed exclusion is evidence that Congress did not intend that royalties (or other passive income) received from a related person that is actively engaged in business should generally fall outside the subpart F regime.⁵⁷

The device in Example 3 utilizes a statutory same-country exclusion: the exclusion of interest that a CFC receives from a related corporation that is incorporated in the same country as the CFC and uses a substantial part of its assets in a trade or business located in that country.⁵⁸ However, the results the device achieves surely fall outside the intended scope of the exclusion. The assumption evidently underlying the exclusion is that if a CFC receiving

persons resident for tax purposes in a country or countries that treat the entity as a corporation for tax purposes.

56. IRC § 954(c)(3)(A)(ii).

57. According to the Treasury, the results in Example 1 are "contrary to the policies and rules of subpart F" because "one of the purposes of subpart F is to prevent CFCs from converting active income that is not easily moveable and is earned in a jurisdiction in which a business is located for non-tax reasons, into passive, easily moveable income that is shifted to a lower tax jurisdiction primarily for tax avoidance." TD 8767, 1998-1 CB 875.

58. IRC § 954(c)(3)(A)(i).

interest and the related payor of the interest are both resident in the country in which the payor is actively carrying on business, that country's system of residence-based taxation will apply to all income of both entities; if the level of taxation is low, the case is simply one of doing business in a low-tax country, a situation subpart F is not intended to cover. In Example 3, however, the recipient of the interest, *PRS*, is not taxed as a resident of the country in which it is organized because, under the laws of that country, it is fiscally transparent. *PRS* is not taxed as a resident of the United States either because, for U.S. tax purposes, it is a foreign corporation. Thus, although *PRS* is owned by U.S. persons, is organized in country *G*, and its income is from sources in country *G*, its income is not taxed on a residence basis by either country.

The policy of the same-country exclusions might be seen as one of waiving U.S. residence-based taxation under subpart F of income that is likely subject to residence-based taxation in the country in which the income derives, directly or indirectly, from active business operations. Avoiding residence-based taxation in all countries is not consistent with policies underlying any aspect of subpart F.⁵⁹

D. Solutions

The Examples illustrate devices exploiting differences between U.S. rules for classifying entities for tax purposes and equivalent rules of foreign countries. In Example 1, *IPCo* is considered a corporation under the tax laws of country *L*, the residence country of *OPCo*, the user of *IPCo*'s intellectual property and the payor of the royalties received by *IPCo*, but is a disregarded entity for U.S. tax laws, while, in Example 2, *OPCo* is a corporation under country *L* law but is a disregarded entity for U.S. tax purposes. In Example 3, *PRS* is a corporation for U.S. tax purposes and a partnership under the tax laws of country *G*. As noted earlier, the check-the-box regulations facilitate such inconsistencies.

1. Examples 1 and 2.

Soon after adopting the regulations, the Treasury began reacting to devices exploiting them. It has proposed, but not yet adopted, regulations

59. According to the Treasury, subpart F is intended "to prevent CFCs (including those engaged in active businesses) from structuring transactions designed to manipulate the inconsistencies between foreign tax systems to inappropriately generate low- or non-taxed income on which United States tax might be permanently deferred." Notice 98-11, 1998-1 CB 433, I.

targeting transactions of the kind illustrated by Examples 1 and 2.⁶⁰ In order for the proposed regulations to apply, a CFC must own a disregarded entity that is treated as a corporation under the laws of a relevant foreign country, the CFC must make a payment to or receive a payment from the entity, and this payment must be disregarded for U.S. tax purposes and treated, under the tax laws of a relevant foreign country, as a payment between separate entities.⁶¹ If the payment has the effect of reducing foreign taxes and would be FPHC income, were it not disregarded for U.S. tax purposes, nonsubpart F income of the CFC equal to the payment is recharacterized as subpart F income.

The proposed regulations would apply in Example 1 because (1) *OPCo*, a CFC, owns a disregarded entity (*IPCo*), (2) *IPCo* is classified as a corporation under the laws of a relevant foreign country (country *L*, where *OPCo* is organized and does business), (3) *OPCo* makes payments to *IPCo* (the royalties), (4) these payments have the effect of reducing foreign taxes (without the deduction for the payments, *OPCo* would pay country *L* tax at 35% on the amount of the payments; with the payments, this amount is only subject to a country *L* withholding tax of 10%), and (5) the payments would be FPHC income if *IPCo* were a corporation for U.S. tax purposes. Under the proposed regulations, income of *OPCo* on sales of goods equal to the royalties would be recharacterized as FPHC income.

The proposed regulations would also apply in Example 2 because (1) *IPCo*, a CFC, owns a disregarded entity (*OPCo*), (2) *OPCo* is taxed as a corporation under the laws of a relevant foreign country (country *L*, where it is organized and does business), (3) *OPCo* makes payments to *IPCo* (the royalties), (4) the deduction allowed to *OPCo* for these payments under country *L* law have the effect of reducing foreign taxes, and (5) the payments would be FPHC income if *OPCo* were a corporation for U.S. tax purposes. Under the proposed regulations, income on *OPCo*'s sales of goods equal to the royalties would be considered FPHC income.

It is not clear that if the Treasury adopted the proposed regulations as final regulations, the courts would uphold them as a valid construction of the statutes. Under the proposed regulations, items that are not otherwise within any category of subpart F income would be recharacterized as FPHC income. Nothing in the statutes explicitly authorizes this recharacterization. The Code

60. Prop. Reg. § 1.954-9. The regulations were initially promulgated in 1998 as temporary regulations, then withdrawn under political pressure, and finally reissued in 1999 as proposed regulations, with the promise that they generally would not become effective until five years after they were adopted as final regulations. For this history and more on the details of the proposed regulations, which are greatly simplified here, see Bittker & Lokken, *supra* note 3, ¶ 69.13.1.

61. Prop. Reg. § 1.954-9(a).

defines FPHC income dividends, interest, royalties, and several other specifically-described items of gross income.⁶² It does not authorize the Treasury to classify other types of income as FPHC if necessary to avoid circumvention of the congressional purposes of subpart F.

The problem is one of entity classification and might better be attacked on the basis of entity classification. In Examples 1 and 2, the royalties disappear for U.S. tax purposes because the payor (*OPCo*) and the payee (*IPCo*) are deemed to be the same person. The proposed regulations derive from a belief that the separate existence of these entities cannot be ignored for purposes of subpart F because doing so obscures the fact that FPHC income does, in substance, exist. Rather than denying disregarded entity status, however, they would taint particular income as a substitute for the income that would be FPHC if payor and payee were considered separate entities. The statutory basis for this approach seems weak.

The Treasury's power to promulgate regulations on entity classification should provide adequate authority to correct the problem. Moreover, the problem is exacerbated, if not created, by the check-the-box regulations, and if the check-the-box regulations are valid,⁶³ the authority under which they were issued should allow the Treasury, by further regulations, to require corporate status for an entity normally within the elective regime of the regulations.

The Treasury might therefore consider reformulating the proposed regulations as amendments to the check-the-box regulations, providing that when the conditions for the application of the proposed regulations are satisfied, the entities making and receiving the relevant payment, which is called a "hybrid branch payment," must both be treated as a corporation for all U.S. tax purposes, regardless of any election made by or for the entity. In Examples 1 and 2, this approach would treat *IPCo* and *OPCo* as corporations for all U.S. tax purposes, *IPCo* would be a CFC, and its royalty income would be FPHC income.

It may be objected that this approach would go beyond the proposed regulations, affecting income other than hybrid branch payments. However, this consequence does not seem inappropriate since the problem arises from the classification of the payor or payee of a hybrid branch payment. To prevent small hybrid branch payments from determining the status of an entity for which fiscal transparency is overall unobjectionable, the Treasury could carve out an exception to the suggested rule, allowing fiscal transparency for an entity

62. IRC § 954(c)(1).

63. For an argument that the regulations are not valid, see Gregg Polsky, *Can Treasury Overrule the Supreme Court?* 84 B.U. L. Rev. 185 (2004). But see *Littriello v. US*, 2005-1 USTC (CCH) ¶ 50,385 (WD Ky. 2005) (finding regulations valid).

making or receiving hybrid branch payments if these payments are less than the lesser of 5% of the entity's gross income or \$1 million.⁶⁴

2. Example 3.

Neither the Treasury nor the IRS has formally responded to devices structured along the lines of Example 3, perhaps because they became aware of these transactions after they had formulated their response to transactions of the kind illustrated by Examples 1 and 2 and endured the ensuing political storm.

The solution to the Example 3 problem may be simpler than that to the issue posed by Examples 1 and 2. By statute or regulations, Congress or the Treasury might provide that for purposes of the statutory same-country exclusions,⁶⁵ the term "a corporation created or organized under the laws of the same foreign country" only includes an entity that is a corporation for purposes of the tax laws of both the United States and that "same foreign country." This rule would deny the same-country exclusion in Example 3, where *PRS*, an entity treated as a partnership for foreign tax purposes but as a corporation for U.S. tax purposes, receives interest income from a related corporation organized under the laws of the same foreign country. Without the benefit of the exclusion, the interest would be FPHC income and therefore potentially subpart F income.

Regulations adopting this solution might be attacked on the ground that the definitions prescribed by section 7701(a), including the definition of "corporation" under which the check-the-box rules were adopted, apply wherever the defined terms are "used in this title" (title 26 of the United States Code, the Internal Revenue Code), except "where . . . otherwise distinctly expressed or manifestly incompatible with the intent thereof . . ." Nothing in the statutory same-country rules "distinctly express[es]" an intention that the section 7701(a) definition of "corporation" should not apply. Arguably, applying the same-country rules with the section 7701(a) definition, which makes no reference to an entity's status under foreign tax law, is not "manifestly incompatible" with the rules' intent. If so, a special definition of "corporation" for purposes of those rules contradicts section 7701(a).

Although Congress did not spell out its reasons for including the same-country rules in subpart F, the policy most readily inferred from the rules supports a regulation adopting the suggested rule. Congress probably assumed that if a corporation is organized in a country in which it carries on a trade or business or in which it uses intellectual property and pays dividends, interest,

64. Compare IRC § 954(b)(3)(A).

65. IRC § 954(c)(3)(A).

rents, or royalties to a related CFC organized under the laws of the same country, the recipient will likely be subject to the same regime of residence taxation with respect to the payment as is the payor with respect to its business income. If the country taxes both the payor and payee on a residence basis with respect to the item, a low effective rate of tax on the item can be explained as a result of doing business in a low-tax country, not as an exploitation of a tax haven device. However, this assumption holds true only if the “same country” taxes the recipient CFC as a corporation. The assumption is contrary to fact if the recipient is a partnership under the tax laws of that country and its partners are not residents of the country and are therefore not subject to residence taxation in the country. In that case, treating the CFC as a “corporation” for purposes of the same-country exclusions is “incompatible with the intent” of the exclusions.

Whether the section 7701(a) definition of “corporation” is, in this context, “*manifestly* incompatible” with the intent of the exclusions is perhaps a matter of judgment. The courts, however, traditionally defer to the Treasury’s judgment on issues addressed by regulations on which competent analysts may reasonably disagree. The Supreme Court has held that “a court may not substitute its own construction of statutory provision for a reasonable interpretation made by the administrator of an agency.”⁶⁶ One court has said: “if we conclude the statute is either ambiguous or silent on the issue, we . . . examine the reasonableness of the regulation. If the regulation is a reasonable reading of the statute, we give deference to the agency’s interpretation.”⁶⁷

However, a court should enter into this inquiry only if “the plain meaning of the text . . . supports . . . the regulation” and should find a regulation invalid if the plain meaning of the text “opposes” the interpretation prescribed by the regulation.⁶⁸ Arguably, the Supreme Court might say that because the text of the statutory same-country exclusions provides no indication of the underlying policy, the plain meaning of the statutes requires that the exclusions be applied with the section 7701(a) definition of “corporation.” Against this argument, it might be noted that the words in section 7701(a), “manifestly incompatible with the intent,” indicates that Congress wanted purpose to play a larger role than would be the case under a “plain meaning” inquiry.

If the Treasury considers the risk of the suggested regulation being held contrary to the plain meaning of the statutory text to be unacceptably high, it should ask Congress for legislation adopting the rule.

66. *Chevron USA, Inc. v. Natural Resources Defense Council, Inc.*, 467 US 837, 844 (1984).

67. *Bankers Life & Cas. Co. v. U.S.*, 142 F3d 973, 983 (7th Cir. 1998).

68. *Id.* At 983.

3. Other check-the-box schemes

The solutions suggested above leave one significant question unanswered: Even if they succeed in bringing income of the types illustrated by the Examples back within the ambit of subpart F, will they be equally successful in frustrating other check-the-box schemes for defeating subpart F, including schemes not yet conceived? The question is not easily answered.

Moreover, check-the-box schemes also plague other areas of international tax policy. Assume two U.S. members of a U.S.-based multinational enterprise organize a partnership under the laws of foreign country Z, where the partnership actively carries on business and which imposes tax on the resulting income at 35%. If the partnership is fiscally transparent under the laws of country Z but elects to be a corporation for U.S. tax purposes, the U.S. tax results are as follows: Under the so-called technical taxpayer rule, the U.S. partners are entitled to credit for the country Z tax on the partnership's income if they are the persons "on whom [country Z] law imposes legal liability for such tax."⁶⁹ However, since the partnership is a corporation for U.S. tax purposes and its income is not subpart F income, the income is subject to U.S. tax only as it is distributed to the partners. As a result, the country Z taxes are immediately creditable, even if U.S. taxation of the income burdened by these taxes is indefinitely deferred,⁷⁰ a result contrary to the policy of the foreign tax credit to alleviate double taxation.

To respond more comprehensively to check-the-box schemes, the Treasury might consider two amendments to the check-the-box regulations, one to curb uses of hybrids and the other to address reverse hybrids:

Hybrid rule:

An entity is mandatorily classified as an association, taxable as a corporation, for all U.S. tax purposes unless (1) U.S. persons do not own more than 10% of the interests in the entity, directly or indirectly,⁷¹ or (2) the entity is fiscally transparent under the laws of the country in which it is organized, each country in which it carries on business, and

69. Reg. § 1.901-2(f)(1).

70. See Mary C. Bennett, *Whose Tax Is it Anyway? Foreign Tax Credits in a Check-the-Box World*, 83 *Taxes* 35 (Mar. 2005).

71. Indirect ownership should be determined by treating interests owned by foreign entities as owned ratably by their owners. See IRC § 958(a)(2).

each country that allows a deduction for any payment to the entity.⁷²

The reasons for the exceptions to the rule are as follows: If U.S. persons do not own more than 10% of the interests in an entity, directly or indirectly, the United States' tax interest in the entity is probably not sufficient to force corporate classification. If the entity is fiscally transparent under the laws of all relevant foreign countries, it is not a hybrid entity.

Under this rule, *IPCo* would be a corporation for U.S. tax purposes in Example 1 and *OPCo* would be a corporation in Example 2, regardless of any election made under the check-the-box regulations, because (1) the entity is indirectly owned by a U.S. person (*DelCo*) and (2) it is not fiscally transparent under the laws of country *L*, which is the source of the royalties and allows deductions for them.

This rule would also frustrate some devices for separating creditable taxes from the income on which the taxes are imposed. Assume *USCo*, a Delaware corporation, manufactures and sells fidgets in foreign country *Z*. Manufacturing operations are organized as one country *Z* company, sales operations as another such company, and a third country *Z* company, which is directly owned by *USCo*, is sole owner of the manufacturing and sales companies. The three country *Z* entities are taxable as corporations under country *Z* law, but are not per se corporations under the check-the-box regulations. The entities elect to file on a consolidated basis under country *Z*'s fiscal unity regime, which makes the group parent liable for the entire tax on the group's income. Under the present regulations, *USCo* may elect to treat the country *Z* holding company as a disregarded entity for U.S. tax purposes, while treating the manufacturing and sales companies as corporations for these purposes. As a result, *USCo* may claim credit for all country *Z* taxes on the income of the country *Z* group, but the income of the manufacturing and sales companies is taxable to *USCo* only as the companies distribute the income to the holding company. Under the proposed rule, the holding company would be a corporation for U.S. tax purposes because it is owned by a U.S. person (*USCo*) and it is not fiscally transparent under the laws of the country in which it is organized.

72. A de minimis exception to the latter portion of the test could be included, under which payments deductible under the laws of countries treating the entity as not fiscally transparent would be disregarded if, in the aggregate, they do not exceed the lesser of 5% of the entity's gross income or \$1 million. See IRC § 954(b)(3)(A).

Reverse hybrid rule:

An entity is fiscally transparent for all U.S. tax purposes with respect to each U.S. person who would be a U.S. shareholder,⁷³ were the entity a corporation for U.S. tax purposes, if it is fiscally transparent under the laws of the country in which it is organized, a country in which it carries on business, or a country that allows a deduction for a payment to the entity.⁷⁴

Under this rule, *PRS*, the reverse hybrid entity in Example 3,⁷⁵ would be a partnership for U.S. tax purposes, as it is under the tax laws of country *G*, because (1) both of its partners (FlorCo and its domestic subsidiary) would be U.S. shareholders if *PRS* were a corporation for U.S. tax purposes and (2) *PRS* is fiscally transparent under the laws of country *G*, where it is organized and which allows deductions for payments to *PRS* (its interest income).

This rule would also frustrate some devices for separating creditable taxes from income on which the taxes are imposed. For example, if two U.S. members of a U.S.-based multinational enterprise organize a partnership under the laws of foreign country *Z*, where the partnership actively carries on business and which imposes tax on the resulting income at 35%, the rule would preclude the partnership from being classified as a corporation for U.S. tax purposes if it is fiscally transparent under the laws of country *Z*. If the entity is treated as a partnership for U.S. tax purposes, U.S. partners would be allowed credit for taxes on the partnership's income, but the United States would also tax them on this income.

IV. CONCLUSIONS

The Treasury's adoption of the check-the-box proved to be a very troubling development for international tax policy. This paper explores how the regulations facilitated devices that divert income into the shelter of tax havens while steering clear of subpart F. As a result of these devices, subpart F has fallen increasingly short of the goal of curbing tax haven sheltering. The paper suggests that with relatively small changes in the regulations and the subpart F statutes, Congress and the Treasury could go far toward restoring subpart F

73. See IRC § 951(b) (U.S. shareholder is U.S. person owning at least 10% of foreign corporation's voting stock, directly, indirectly, or constructively).

74. A de minimis exception to the latter portion of the test could be included, under which payments deductible under the laws of countries treating the entity as not fiscally transparent would be disregarded if, in the aggregate, they do not exceed the lesser of 5% of the entity's gross income or \$1 million. See IRC § 954(b)(3)(A).

75. *Supra* text accompanying note 48.

to its intended scope. Congress and the Treasury should take these steps promptly.