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DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL

PART THREE: PROVISIONS RELATED TO THE TAXATION OF CROSS-BORDER INCOME AND INVESTMENT

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of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of the revenue provisions related to the taxation of cross-border income and investment that are included in the President's fiscal year 2010 budget proposal, as submitted to the Congress on May 7, 2009.[2] For each provision, there is a description of present law and the proposal (including effective date), a reference to relevant prior budget proposals or recent legislative action, and an analysis of policy issues related to the proposal.

The U.S. rules governing the taxation of cross-border income reflect a series of choices regarding the appropriate tax base, i.e., the income upon which U.S. tax should be imposed. In broad terms, through bilateral tax treaties and the domestic tax laws of many developed and lesser developed countries, the principal right to tax cross-border business income has generally been assigned (through reduction in or elimination of source-country withholding taxes) to the source country (the country in which the income is derived), and the principal right to tax cross-border passive or portfolio investment income has generally been assigned to the residence country of the recipient of the income. Part One of this pamphlet discusses the manner in which the U.S. rules reflect and implement this allocation with respect to business income, and the manner in which the Administration's proposals would change those rules. Part Two of this pamphlet discusses the existing U.S. rules for the enforcement of residence-based taxation of portfolio investment income earned offshore and the Administration's proposals to change those rules.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment* (JCS-4-09), September 2009. For part two of the document, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Two: Business Tax Provisions* (JCS-3-09), September 2009. For part one of the document, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal*; *Part One: Individual Income Tax and Estate and Gift Tax Provisions* (JCS-2-09), September 2009.

The staff of the Joint Committee on Taxation has provided estimates of the revenue effects of each of the provisions described herein. See, Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal as Described by the Department of the Treasury, May 2009*, (JCX-28-09), June 11, 2009.

[2] See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2010: Analytical Perspectives* (H. Doc. 111-3, Vol. III), p. 268. See also Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, May 2009.

PART ONE: REFORM OF INTERNATIONAL TAX PROVISIONS

This Part One discusses the Administration's proposals relating to the taxation of international business income. Section I addresses proposals that relate to the determination of the taxable income base that is subject to current U.S. tax. Section II addresses proposals that relate to the determination of the amount of such current U.S. tax and, in particular, the extent to which foreign tax credits will be permitted to offset U.S. tax liability.

I. DETERMINING THE U.S. TAX BASE

There are two alternative mechanisms for a taxpayer's country of residence to cede to another country in which the taxpayer derives income (the source country) the primary jurisdiction to tax that income: (i) taxation of foreign source income earned by the country's residents, coupled with relief for foreign taxes paid on that income, or (ii) exemption of foreign source income from tax. The U.S. Federal tax rules reflect the first alternative. Thus, the United States employs a "worldwide" tax system, under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provides relief from double taxation.[3] The discussion that follows focuses on the treatment of foreign source income earned by domestic corporations.

The U.S. system of worldwide taxation extends both to income earned directly by a U.S. corporation and to income earned through an entity, whether a corporation or a pass-through entity such as a partnership. However, U.S. taxation of active foreign business income earned by a domestic parent corporation indirectly through a foreign corporate subsidiary is generally deferred until the income is distributed as a dividend to the domestic corporation. This favorable "deferral" rule is circumscribed by certain anti-deferral rules, including subpart F of the Code,[4] under which U.S. shareholders of certain foreign corporations are subject to U.S. tax on a current basis (or are assessed an interest charge for deferred U.S. tax) on certain categories of passive or highly mobile income derived through those foreign corporations.[5] To mitigate double taxation of foreign source income, the United States allows a domestic corporation to claim a credit for foreign income taxes paid directly or indirectly by a foreign corporation in which it has at least a 10-percent ownership stake, subject to certain limitations.[6]

The combination of worldwide taxation with deferred taxation of much active business income earned through foreign corporations creates three categories of taxable income: (1) U.S. source income, which with limited exceptions (for example, for certain portfolio interest that

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[3] As of today, the majority of the other OECD countries have chosen the second alternative, i.e., exemption, though typically in combination with residence-based taxation of passive or highly mobile income. This situation has led to a number of proposals for the adoption of a dividend exemption system in the United States. See, e.g., U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (December 20, 2007) (hereafter, U.S. Department of the Treasury, *Approaches to Improve Competitiveness*); President's Advisory Panel on Federal Tax Reform, Simple*, Fair, and Pro-Growth: Proposal to Fix America's Tax System* (Washington, D.C., 2005) (hereafter, President's Advisory Panel on Federal Tax Reform, *Proposal to Fix America's Tax System*); Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (January 27, 2005) (hereafter, Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*).

[4] Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[5] Certain income provisionally subject to the anti-deferral rules of subpart F may be thought of as active business income. The subpart F rules include exceptions for certain categories of this income, such as for royalties derived from an unrelated person in the active conduct of a trade or business. However, those rules include no general exception for active business income.

[6] The foreign tax credit rules are discussed in Section II below.

escapes inclusion under subpart F), is currently taxed, (2) foreign source income that is currently taxed, either by virtue of having been earned directly or because it is includible under subpart F, and (3) foreign source income on which U.S. tax is deferred. Under any income tax, the opportunity for deferral of income recognition can lower a taxpayer's tax liability. As a result, any system involving deferral creates incentives to reduce the amount of income that is subject to current taxation and increase the amount that benefits from deferral. More specifically, taxpayers benefit to the extent that expenses can be attributed to U.S. source income, and to the extent that income can be treated as foreign source active (i.e., non-subpart F) income. If taxpayers choose investments that benefit from deferral, even if they are less profitable, over higher-earning investments that produce currently taxable income, this choice may have the collateral effect of changing the domestic rate of growth of income.[7] Section I.A. discusses these incentives in more detail.

A domestic corporation may incur deductible expenses, such as interest, that are related to income eligible for deferral. Present law provides detailed rules for the allocation of expenses between U.S. source and foreign source income. These rules do not, however, affect the timing of the expense deduction; rather, for a domestic corporation they apply principally for purposes of determining the foreign tax credit limitation. Thus, a domestic corporation may claim a current deduction, even for expenses that it incurs to produce tax-deferred income through a foreign subsidiary. As a result, the amount of tax imposed on currently taxable income may be inappropriately reduced; at the same time, the incentive to make tax-deferred investments offshore is increased by the absence of a limitation on deduction of the related expenses. The Administration's proposal to address these distortions with regard to expense allocation is discussed in Section I.B.

The transfer pricing rules of section 482 are designed in part to prevent the inappropriate characterization of domestic source income as foreign source income on which U.S. tax is deferred through transactions between related U.S and foreign entities.[8] In particular, section 482 provides that the income with respect to any transfer (or license) of certain intangible property to a related person must be commensurate with the income attributable to the intangible property. Section 367(d) provides comparable rules for transfers of intangible property in a nonrecognition transaction. Empirical evidence suggests, however, that U.S. multinationals shift income to low-tax foreign jurisdictions − in particular through the transfer of valuable intangible assets to low-tax subsidiaries without adequate compensation − leading many to question the effectiveness of the current transfer pricing rules. The Administration's proposal to address this issue, and certain other alternatives, are discussed in Section I.C.

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[7] The distortions inherent in the U.S. deferral rules are discussed in more detail in Joint Committee on Taxation, *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment* (JCX-55-08), June 25, 2008, and in the discussion of tax-induced structural distortions in Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012* (JCS-02-08), October 31, 2008.

[8] Transfer pricing rules also are relevant in the determination of the amount of a taxpayer's subpart F income.

Section 163(j) limits the ability of a foreign-controlled domestic corporation to reduce U.S. taxable income through the payment of excessive interest to a foreign affiliate. This practice is commonly referred to as "earnings stripping" or "income stripping" on the basis that it removes U.S. source earnings from the U.S. tax base to a foreign, typically lower-tax jurisdiction. Section I.D. describes the Administration's proposal to impose stricter limits on the ability of an "inverted" corporation (that is, a formerly domestic corporation that became a foreign corporation through a reincorporation or other "inversion" transaction) to reduce U.S. tax on the income derived by its U.S. subsidiaries through earnings stripping transactions.

A. Deferral and the Distortion of Investment Choice

U.S. taxation of active foreign business income earned by a domestic corporation through a foreign corporate subsidiary is generally deferred until the income is distributed as a dividend. This favorable "deferral" rule is circumscribed by the rules of subpart F,[9] which require 10-percent-or-greater U.S. shareholders of a controlled foreign corporation (a "CFC")[10] to include currently their pro rata shares of certain categories of passive or highly mobile income earned by the CFC, whether or not that income is distributed to the shareholders.[11] While the current inclusion requirement may mitigate the incentive to shift those categories of income offshore, a substantial incentive for income-shifting remains with respect to other types of active business income.

The benefit of deferral

The principal advantage of deferral is the ability to retain low-taxed earnings in a foreign subsidiary and invest them on a pre-U.S. tax basis. Suppose that a U.S. taxpayer in the 35-percent tax bracket owns a CFC that earns $100 of income today and that the U.S. taxpayer defers that income for five years by re-investing it in the CFC, such that the CFC can invest the money and earn a 10 percent return per year.[12] The taxpayer would then have $161.05 and pay tax of $56.37 on repatriation, for an after-tax income of $104.68. Suppose also that there is another U.S. taxpayer who has access to an equivalent investment opportunity, but cannot defer tax because this taxpayer's investment opportunity is located in the United States. This taxpayer receives $100 in income today, pays tax of $35, and has only $65 to invest. The taxpayer invests that amount at an after-tax rate of 6.5 percent, i.e., a 10 percent pre-tax rate less 35 percent tax on the earnings each year. At the end of five years, this taxpayer will only have $89.06. The result is a difference of $15.62 in economic wealth between the taxpayer who could defer the income for five years (and whose deferred income in turn compounded at 10 percent per year) and the otherwise identically-situated taxpayer who was required to pay tax on the income immediately (and whose after-tax income thus compounded at just 6.5 percent per year).

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[9] Sections 951-964.

[10] A CFC is defined generally as a foreign corporation with respect to which 10-percent U.S. shareholders own more than 50 percent of the combined voting power or total value of the stock of the corporation.

[11] Income subject to current inclusion under subpart F includes, among other categories, insurance income, foreign personal holding company income (generally certain types of passive investment income), income from certain sales or services transactions involving a related person, and income attributable to certain oil and gas activities. Temporary exceptions apply (until 2010) under which certain income that is derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business (so-called "active financing income") is not treated as subpart F income. In addition, so-called "look-through rules" temporarily provide (until 2010) that dividends, interest, rents, and royalties received by one CFC from a related CFC are not treated as subpart F income to the extent attributable or properly allocable to non-subpart F income of the payor.

[12] To simplify, this example assumes there is no foreign tax on the earnings of the foreign corporation. The example also assumes that the CFC uses the investment to generate income not subject to subpart F.

Effect on investment decisions

The example above is analogous to the choice a U.S. taxpayer faces when considering whether to make an investment in an active enterprise in the United States or in a country in which the income tax rate is zero. In such a case, the taxpayer would pay income tax annually on income earned from an investment located in the United States, at a 35-percent rate, as was the case with the second taxpayer in the preceding example. If the U.S. taxpayer were to make an investment in a country with a zero tax rate, and chose to liquidate the investment and repatriate the earnings after five years, paying residual U.S. income tax at that time, it would be the equivalent of the investment available to the first taxpayer in the preceding example. The overseas investment would be the preferred choice.

The example has the same implication if one were to assume that the U.S. taxpayer started the analysis with $100 of income earned in its overseas subsidiary. The taxpayer could consider an investment in the United States or reinvesting the proceeds overseas. To invest in the United States the taxpayer would have to repatriate the foreign earnings. After paying the residual U.S. income tax, the taxpayer would have $65 to invest in the United States and the earnings on the investment would be subject to annual U.S. taxation. If the taxpayer reinvested the earnings in the foreign subsidiary, the initial investment would be $100 and the earnings would grow free of annual taxation. If the rates of return on the two possible investments were the same, the overseas investment would be the preferred choice.

Moreover, the disparity in after-tax effects described above also implies that there are overseas investments that earn less than 10 percent per annum that would dominate the 10 percent investment in the United States on an after-tax basis. Assume that a U.S. taxpayer has $100 to invest. All else equal, compared to undertaking an investment in the United States that has an expected annual return of 10 percent, if the U.S. taxpayer located an investment in a country with an income tax rate of zero, and the investment has an expected annual return of 9.50 percent, this latter investment would produce a superior outcome for the U.S. taxpayer.[13] Deferral distorts the investment choice when it creates an incentive to choose an investment that yields a lower pre-tax rate of return over an investment that yields a higher pre-tax rate of return. When the lower earning investment is chosen, society as a whole loses the opportunity for greater total income. Economists would label such an outcome a social welfare loss from an inefficient allocation of investment.

The example is simplified by the choice of a zero tax rate in the foreign country. More generally, the greater the foreign effective marginal tax rate, the closer the rate of return on the offshore investment must be to the rate on the U.S. investment to yield a superior after-tax

[13] The U.S.-sited investment, which is subject to annual taxation, earns a net return of 6.35 percent. Compounded for five years, this investment will be worth $137. The foreign investment, which earns 9.5 percent and is not subject to foreign tax, will compound at 9.5 percent and be worth $157.42 at the end of five years. Upon repatriating the income, the U.S. taxpayer must pay a 35-percent tax on the $57.42 of income, leaving the U.S. taxpayer with $137.32. When compared to a domestic investment that can be expected to return 10 percent per annum, the break-even rate of return on an offshore investment on which the income can be deferred for five years is 9.44 percent.

return. As the foreign tax rate approaches the U.S. tax rate, the distortion approaches zero. However, the longer the residual U.S. income tax is deferred, the less the foreign investment has to earn relative to a U.S. based investment and the greater the distortion.[14]

Investment decisions are distorted in multiple dimensions

A U.S.-based multinational enterprise must make investment decisions across several different dimensions: invest dollars in the United States or abroad; if investment is to occur abroad, determine in which country the investment should occur; decide whether earnings that accrue abroad should be repatriated to the United States or should be reinvested abroad. Certain investment options offer the possibility of deferral of U.S. income tax liability. Other investment options imply current U.S. income taxation.

The tax analysis described above may be only part of a broader evaluation that U.S. firms engage in when considering whether to invest in the United States or abroad. Many non-tax factors, such as labor costs, environmental and other non-tax regulations, and proximity to customers, may be important as well. The relative importance of tax and non-tax considerations may vary among different kinds of investments. Investments requiring relatively low expenditures on tangible capital or labor, including investments in intellectual property, may be more sensitive to tax rates than investments in plants and other operations that are closely tied to the economic environments in the localities in which those investments are made.

In sum, the policy of deferral for many types of foreign-source active income creates incentives to invest offshore and allow earnings to accumulate, even where the choice is between a lower-earning offshore investment compared to a higher-earning U.S. opportunity. The inefficient allocation of investment that results is not solely between dollars invested in the United States and dollars invested abroad, but also misallocation among investments abroad. Because the distortion arises from the differential between a foreign tax rate and deferred

[14] As an illustration of these points, in the example above, if the deferral were for 10 years, and the foreign tax rate were zero throughout that period, an offshore investment with an expected annual return of as low as 8.92 percent would produce a superior outcome for the U.S. taxpayer. If the deferral were for 20 years, an offshore investment with an expected annual return of as low as 8.26 percent would produce a superior outcome for the U.S. taxpayer.

Considering a five-year deferral period, if the foreign host country imposed an income tax on the earnings of the U.S. taxpayer's investment at a 10 percent rate, an offshore investment with an expected annual return of as low as 9.59 percent would produce a superior outcome for the U.S. taxpayer. If the foreign host country imposed an income tax on the earnings of the U.S. taxpayer's investment at a 20 percent rate, an offshore investment with an expected annual return of as low as 9.75 percent would produce a superior outcome for the U.S. taxpayer.

An alternative way to think about the tradeoff between the deferral period, the foreign tax rate, and the break-even rate of return on a deferred offshore investment is as follows: The longer the period of deferral, the lower the effective residual U.S. tax rate. In fact, permanent deferral would create an effective rate of residual tax equal to zero. Thus, as deferral increases, the effective total tax rate (U.S. residual tax plus foreign host country tax) that the U.S. taxpayer faces approaches the foreign host country tax rate. Consequently, as deferral increases, the break-even return on a deferred offshore investment declines and approaches the rate of return on the foreign investment net of the foreign host country tax.

payment of the U.S. residual tax, a U.S. taxpayer may choose to locate an investment in lower-tax country A rather than higher-tax country B, to take advantage of the fact that country A's lower tax rate allows the U.S. taxpayer to better exploit the benefit of deferral of U.S. residual income tax.

Lastly, in analyzing the possibility of repatriating foreign earnings to the United States, the taxpayer must first pay residual U.S. income tax on the repatriated earnings and then pay U.S. tax annually on future earnings. In comparison to continued deferral abroad, the U.S. taxpayer may forgo repatriation of earnings, even if, on a pre-tax basis, there were greater earnings potential from investment in the United States. This "lock-out" effect can lead to large sums of money being held outside the United States.

The empirical evidence

Most empirical research substantiates the expected negative relationship between a foreign country's tax rate and U.S. outbound investment.[15] Indeed, data show that at the end of 2004 the approximately 75,000 U.S.-controlled CFCs (which filed IRS Form 5471) reported accumulated earnings and profits abroad of approximately $1 trillion.[16] While many other variables influence the location of investments, these same data show that accumulated earnings and profits of U.S.-controlled CFCs in Ireland, a relatively low tax country, exceeds the sum of the accumulated earnings and profits of U.S.-controlled CFCs in the United Kingdom and Germany, both higher tax countries, with substantially larger populations and markets.

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[15] A growing body of empirical work examines the responsiveness of foreign investments made by U.S. taxpayers to foreign tax rates. One of the first such studies was Harry Grubert and John Mutti, Taxes, Tariffs and Transfer Pricing in Multinational Corporate Decision-Making, 73 *Review of Economics and Statistics* (May, 1991). They examined the responsiveness of outbound direct investment in plant, property, and equipment by U.S. taxpayers to foreign country average tax rates in 33 host country locations and found a significant negative statistical relationship, i.e., the lower the host country's average tax rate, the greater the investment by the U.S. taxpayer. In a later study Grubert and Mutti found comparable results when examining the outbound investments in over 60 countries by over 500 U.S. taxpayers. Harry Grubert and John Mutti, Do Taxes Influence Where US Corporations Invest? 53 *National Tax Journal* (December, 2000). Using similar data, but different empirical specifications, Rosanne Altshuler, Harry Grubert, and T. Scott Newlon, Has US Investment Abroad Become More Sensitive to Tax Rates? in James R. Hines, Jr., (editor), *International Taxation and Multinational Activity* (Chicago: University of Chicago Press), 2001, find similar results. Using different data encompassing all nonbank affiliates of nonbank U.S. corporations, James R. Hines, Jr. and Eric M. Rice, Fiscal Paradise: Foreign Tax Havens and American Business, 109 *Quarterly Journal of Economics* (February 1994), find an even stronger negative statistical relationship between foreign tax rates and outbound investment by U.S. taxpayers.

The preceding studies used cross-sectional analysis, that is, they examined the effect of taxes on location of investment by examining data on different taxpayers and investments in one year. Mihir A. Desai, C. Fritz Foley, and James R. Hines, Jr., Foreign Direct Investment in a World of Multiple Taxes, 88 *Journal of Public Economics* 2727 (December 2004), undertake a panel study. In this study they examine the outbound investments of U.S. taxpayers in the manufacturing sector, tracking the same taxpayers over the period 1984 to 1992. They report statistical relationships similar to those found in the cross-sectional studies cited.

[16] Unpublished data tabulated by the Statistics of Income Division, Internal Revenue Service from Form 5471 for controlled foreign corporations. The data were collated from Form 5471 filed with some 11,000 tax returns. The data compile the accumulated earnings and profits for approximately 75,000 U.S. CFCs.

Recent data compiled relating to the one-time 85-percent dividends received deduction permitted in section 965 provides possible further evidence of magnitude of the potential distortion of investment decisions. The 85-percent dividends received deduction had the effect of reducing the highest U.S. marginal tax rate on repatriated earnings from 35 percent to 5.25 percent. The preliminary data show that approximately $360 billion in dividends were repatriated on 2004 corporate income tax returns.[17] These repatriations exceed the annual average of prior year repatriations of foreign earnings by more than $250 billion. While without further analysis it is inappropriate to conclude that taxes alone would have kept $250 billion or more deferred offshore, the magnitude of repatriations is suggestive of the magnitude of the amount of investment dollars subject to potentially distorted economic choices. A question is whether the repatriation of large amounts of earnings under section 965 led to increased investment in the United States. High U.S. corporate tax rates relative to the tax rates in many other industrialized countries, among other factors, may cause U.S. firms to reinvest repatriated earnings (under section 965 or more generally) abroad.[18]

Additional ramifications from the geographic misallocation of investment

Once a U.S. taxpayer makes an investment offshore whose income qualifies for deferral, the benefit of deferral creates incentives to report as much income as possible as qualifying income. An increase in the amount of income that can be attributed to a low-tax jurisdiction is equivalent to increasing the pre-tax return to the offshore investment, magnifying the distortion of investment choice.[19] Thus, deferral may create what may be called “second order” distortions of taxpayers’ choices. Rules created to protect the policy of deferral for active income or the determination of taxpayers subject to the worldwide regime may result in economically inefficient business structures or investment decisions as taxpayers try to qualify their income as the result of an active offshore business. For example, as discussed further in Section I.C., deferral places tremendous pressure on the determination of transfer prices under section 482. In addition, as discussed further in Section II below, a U.S. taxpayer that has undertaken an investment in a high-tax country may plan another investment in a low-tax country in order to use foreign taxes paid in the high-tax country (in excess of the amount of U.S. tax payable on earnings in the high-tax country) to offset U.S. tax on income earned in the low-tax country (a practice known as “cross-crediting”). This can extend the benefit of deferral to investments in high-tax host countries. In such a case, the policy of deferral in conjunction with the operation of the foreign tax credit rules creates second order distortions of the taxpayer’s investment decisions.

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[17] Melissa Redmiles, The One-Time Received Dividend Deduction, *Statistics of Income Bulletin*, 27, Spring 2008.

[18] See also Dhammika Dharmapala, C. Fritz Foley and Kristin J. Forbes, Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act, National Bureau of Economic Research Working Paper 15023 (June 2009). Dharmapala, Foley and Forbes find that funds repatriated under section 965 were used predominantly for shareholder payouts, mainly through share repurchases.

[19] For an example of this point, see Harry Grubert and Joel Slemrod, The Effect of Taxes on Investing and Income Shifting to Puerto Rico, 80 *Review of Economics and Statistics* 365 (August 1998). Grubert and Slemrod examine the interaction of income shifting and the investment decision.

Alternatives

Potential solutions to the distortions created by the present law deferral regime include an exemption system, in which active foreign income is fully exempt from U.S. taxation, and the opposite, a full inclusion system. There have been several proposals in recent years for a dividend exemption system in the United States.[20] Although the details differ, all of these proposals generally provide that income earned abroad by a domestic corporation would fall into one of two categories: (1) active foreign income earned by a foreign branch or repatriated as a dividend from a foreign subsidiary, which would generally be exempt from U.S. tax; and (2) all other income, including passive income and non-dividend payments such as interest and royalties received from foreign subsidiaries, which would be included in income by the domestic corporate shareholder on a current basis.

Under a full inclusion system, all foreign source income is currently taxed, without regard to the active or passive character of the income and regardless of whether the earnings are repatriated. A number of academics and tax professionals,[21] as well as some members of Congress,[22] have advocated the adoption of a full inclusion system in the United States. Although there is no prevailing view regarding the mechanism that should be used to implement a full inclusion system, there seems to be agreement that a full inclusion system would include two basic features: (1) U.S. shareholders of a foreign corporation (at least those satisfying a certain ownership threshold) would be taxed currently on their shares of the foreign corporation's income, and (2) the foreign tax credit would be retained in some form to mitigate double taxation of foreign source income.

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[20] See, e.g., Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*; U.S. Department of the Treasury, *Approaches to Improve Competitiveness*; President's Advisory Panel on Federal Tax Reform, *Proposal to Fix America's Tax System*; Michael J. Graetz and Paul W. Oosterhuis, Structuring an Exemption System for Foreign Income of U.S. Corporations, 54 *National Tax Journal* 771, 781. Although these proposals are commonly referred to as "dividend exemption" systems, they contemplate exemption of active income earned by domestic corporations through foreign branches as well.

[21] See, e.g., Edward D. Kleinbard, Throw Territorial Taxation From the Train, 48 *Tax Notes International* 63 (April 2, 2007); Robert J. Peroni, J. Clifton Fleming Jr. and Stephen E. Shay, Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 *SMU Law Review* 455, 497 (1999) (hereafter, Peroni, Fleming and Shay, Getting Serious About Curtailing Deferral); Reuven S. Avi-Yonah, The Logic of Subpart F: A Comparative Perspective, 79 *Tax Notes* 1775 (June 29, 1998); Robert A. Green, The Future of Source-Based Taxation of the Income of Multinational Enterprises, 79 *Cornell Law Review* 18 (November 1993). See also American Bar Association, Report of the Task Force on International Tax Reform, 59 *Tax Lawyer* 649 (2006) (hereafter, American Bar Association, Report of the Task Force on International Tax Reform) at 731-735 (describing and evaluating, but not endorsing, a full inclusion regime).

[22] In 2007, Senator Kerry introduced a bill that, among other things, generally requires U.S. shareholders of CFCs to include in income on a current basis their pro rata shares of all the income of the CFCs. The bill provides an exception for a CFC's property and services income derived in the active conduct of a business serving customers in the CFC's country of residence. See S. 96, 110th Cong., 1st Sess. (Jan. 4, 2007), section 101. In 1992, Representatives Dan Rostenkowski and Bill Gradison proposed a full inclusion regime in the Federal Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, 102d Cong. (2d Sess. 1992). The first serious call for rolling back deferral came from President Kennedy in 1961. Message from the President of the United States Relative to Our Federal Income Tax System, April 20, 1961, reprinted as H.R. Doc. No. 87-140, at 6-7. As originally proposed, the subpart F rules would have applied to all CFC earnings.

Both of these alternatives would reduce the current disincentive to repatriate low-taxed foreign earnings, but would do so through vastly different mechanisms. Under either approach, the repatriation tax is eliminated, and there is no longer any U.S. tax motivation to keep low-taxed foreign income offshore. The effects of the two alternatives on the initial locational decision are not clearly equivalent, however, and the two options differ materially in other respects.[23]

The Administration's proposals would not alter the basic structure of the present rules for taxation of foreign direct investment, and in particular their deferral feature. Instead, three of those proposals, discussed below, focus on clarifying and strengthening the rules for determining the U.S. taxable income base in order to prevent inappropriate minimization of currently taxable income. A series of complementary proposals, discussed in Section II, seek to ensure that, once the amount of taxable income is determined, an appropriate amount of U.S. tax is paid.

[23] For further discussion, see Joint Committee on Taxation, *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment* (JCX-55-08), June 25, 2008.

B. Proposal to Defer Deduction of Expenses Related to Deferred Income

Background and Present Law

Present law provides detailed rules for the allocation of deductible expenses between U.S. source income and foreign source income. These rules do not, however, affect the timing of the expense deduction. Rather, in the case of expenses incurred by a domestic corporation, they apply principally for purposes of determining the foreign tax credit limitation, which is computed by reference to the corporation's U.S. tax liability on its taxable foreign source income in each of two limitation categories.[24] Consequently, those rules primarily affect only those taxpayers that may not be able to fully utilize their foreign tax credits because of the foreign tax credit limitation. A domestic corporation may claim a current deduction, even for expenses that it incurs to produce tax-deferred income through a foreign subsidiary. The resulting mismatch between the timing of income recognition and the deductibility of expenses further incentivizes taxpayers to make tax-deferred investments offshore.

An analogous situation arises in connection with the allocation of expenses between exempt and non-exempt income in an exemption, or territorial, tax system. In fact, the effect of failing to allocate expenses against exempt foreign source income has been described as facilitating negative effective tax rates for overseas investments, by permitting taxpayers to earn income in low-tax foreign countries while claiming the related deductions in the United States.[25] As a consequence, recent proposals for the adoption of an exemption system in the United States have stressed the increased importance of expense allocation rules and the need to ensure that expenses attributable to the production of exempt foreign income do not inappropriately reduce U.S. tax on domestic source or other non-exempt income.[26] Under present law, the failure to

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[24] Secs. 901 and 904. As discussed in more detail in Section II, this limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income. The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year in each limitation category to the taxpayer's total taxable income for the year. This requires a taxpayer to allocate and apportion expense deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category, on the other. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year in the relevant limitation category, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years. Sec. 904(c). A taxpayer may also choose to deduct, rather than credit, foreign taxes under section 164. Expense allocation between U.S. and foreign-source income is required even in years when the taxpayer deducts foreign taxes in order to compute the overall foreign loss allocation and recapture, even though the section 904 limitation is not directly relevant in determining tax liability in such a year. See Treas. Reg. secs. 1.904(f)-1(b) and 1.904(f)-2T(c)(1).

[25] Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," in *Fundamental Tax Reform: Issues, Choices and Implications,* edited by John W. Diamond and George R. Zodrow, 2008 MIT Press, Cambridge (hereafter, Grubert and Altshuler, Corporate Taxes in the World Economy), p. 328. For a numerical illustration, see Michael J. Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expenses," IBFD, *Bulletin for International Taxation*, November 2008, p. 486.

[26] See, e.g., President's Advisory Panel on Federal Tax Reform, *Proposal to Fix America's Tax System*; Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*. But see U.S.

allocate expenses appropriately to income on which tax is deferred (perhaps indefinitely) can have an effect similar to that of the failure to attribute expenses to exempt income.

Description of Proposal

The proposal defers deductions for expenses (other than research and experimentation expenditures) of a U.S. person that are properly allocated and apportioned to foreign-source income to the extent the foreign-source income associated with the expenses is not currently subject to U.S. tax. The amount of expenses properly allocated and apportioned to foreign-source income generally would be determined under current Treasury Regulations. The amount of deferred expenses for a particular year would be carried forward to subsequent years and would be combined with foreign-source expenses for that year before applying the proposal in that year.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2010.

Analysis

Overview

The proposal eliminates a U.S. person's ability to deduct currently expenses that are related to foreign-source income on which U.S. tax is deferred; instead the deduction for those expenses would be deferred until the income to which they relate is subject to U.S. tax. By more closely matching the timing of expense deductions with income inclusion, the proposal would reduce the incentive under present law for a U.S. multinational corporation to derive income through foreign subsidiaries in low-tax jurisdictions. The proposal does not address, however, the effect of the present deferral regime on a U.S. multinational corporation's decision whether to repatriate foreign earnings. Moreover, because it does not apply to research and experimentation expenses, the proposal may have little effect on existing incentives to shift certain intangibles-related income offshore and may treat U.S. firms in certain industries differently from U.S. firms in other industries.

Effect on investment location

As described previously, present law permits current deductions for expenses that produce foreign income on which U.S. tax is deferred. These deductions enhance the benefits of the existing deferral regime by yielding low (and in some cases negative) effective tax rates on that income. To the extent the benefits of deferral are enhanced, the distortions associated with deferral can be expected to increase. For example, deferral may distort investment choices by causing a U.S. taxpayer to prefer a foreign investment with a lower pre-tax rate of return to a U.S. investment with a higher pre-tax rate of return. The taxpayer will have a similar incentive

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Department of the Treasury, *Approaches to Improve Competitiveness* (proposing dividend exemption system without allocation of interest expense).

to reinvest abroad the earnings generated by the foreign investment. Second-order distortions include a taxpayer's incentive to engage in abusive transfer pricing practices to maximize the amount of income treated as being derived in low-tax or zero-tax jurisdictions. To the extent the allowance of a current deduction for expenses related to the foreign investment reduces (or turns negative) the effective tax rate on the investment, the distortions just described are magnified.

By deferring the deduction of expenses related to tax-deferred foreign income, the proposal would eliminate the reduction of effective tax rates on foreign investment under present law by the allowance of current deductions for related expenses. To the extent that differentials between effective tax rates on foreign investment and on U.S. investment are reduced, the distortion of the choice of where to invest, the United States or abroad, and the related second-order distortions may be lessened. This effect would be greatest when the choice is between the United States and a low-tax or a zero-tax jurisdiction.

If the proposal has the effect of reducing incentives to invest abroad rather than in the United States, it is possible in theory that investment in the United States by U.S. taxpayers may increase. Because, however, empirical research has not produced definitive conclusions about the effect of foreign direct investment on U.S. labor productivity, wages, and aggregate national income,[27] the proposal's effects on these features of the U.S. economy are uncertain.

The proposal does not directly address the deferral regime's distortion of the repatriation decision. Although the proposal may make investment in foreign jurisdictions less attractive, to the extent a U.S.-based multinational undertakes that investment, the U.S.-based multinational

[27] Empirical studies have attempted to examine whether foreign direct investment is a substitute for or complement to domestic investment. More than a decade ago the President's Council of Economic Advisors concluded, "On a net basis, it is highly doubtful that U.S. direct investment abroad reduces U.S. exports or displaces U.S. jobs." Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office), February 1991, p. 259. The report also surveys some of the evidence on the economic effects of outbound investment. Generally, empirical studies find either no effect or a positive effect of overseas production in a host-county market on home-country exports to that market. One survey of the empirical literature reports that, on average, studies find one dollar of overseas production by U.S. affiliates generates $0.16 of exports from the United States. Robert E. Lipsey, Outward Direct Investment and the U.S. Economy, in Martin Feldstein, James R. Hines, Jr., and R. Glenn Hubbard (eds.), *The Effects of Taxation on Multinational Corporations* (Chicago: University of Chicago Press), 1995. In later research, Lipsey reaches similar conclusions. Robert E. Lipsey, Home and Host Country Effects of FDI, in Robert E. Baldwin and L. Alan Winters (eds.), *Challenges to Globalization* (Chicago: University of Chicago Press) 2004, pp. 333-379. The evidence does, however, suggest that overseas production displaces certain types of domestic production, as the parent firm shifts to more capital intensive and skill intensive domestic production. Lipsey, Home and Host Country Effects of FDI.

There is no definitive conclusion about the effect of outbound investment on U.S. employment. The same survey concludes, "[T]he evidence suggests that the effect of overseas production on the home-country labor market involves the composition of a firm's home employment rather than the total amount. That change in composition is mainly a shift toward more managerial and technical employment . . . ." Lipsey, Outward Direct Investment and the U.S. Economy, p. 31. One study does find some substitution of foreign labor for U.S. labor but characterizes the degree of employment substitution as low between domestic and foreign affiliates, finding greater labor substitution between employees in different developing countries. S. Lael Brainard and David A. Riker, Are U.S. Multinationals Exporting U.S. Jobs? in David Greenway and Douglas Nelson, eds., *Globalization and Labour Markets*, Elgar, 2001. However, most of the evidence on this subject examines individual industries rather than aggregate economic effects.

will face the same general barrier to repatriating earnings that it faces under present law — the fact that it will be subject to residual U.S. tax on those earnings, subject to possible reduction by a foreign tax credit. A taxpayer may be encouraged to repatriate earnings under the proposal if doing so would allow the taxpayer to take foreign-related deductions that previously had been deferred. If, however, the proposal is analyzed in combination with the Administration's proposal to determine the amount of the foreign tax credit on a blended basis (described below), in some circumstances taxpayers may face a greater tax burden on repatriation than they do under present law.[28]

Treatment of interest expense

Interest expense represents a significant portion of the deductions affected by the proposal. Other significant deductions affected by the proposal are headquarters-type (stewardship[29] or supportive) expenses and general and administrative expenses.[30] A third significant category, research and experimentation expenses, is excluded from the scope of the proposal.

As a consequence, the proposal would have a disproportionate effect on U.S.-based multinationals that have relatively high degrees of U.S. borrowing to fund offshore operations, most notably firms in the financial sector. At the same time, the inclusion of interest expense within the scope of the proposal is essential to its purpose. The fungibility of money exacerbates the distortions arising from the fact that present law permits a current deduction for expenses associated with tax-deferred income. Because money is fungible, it is very difficult, if not impossible, to determine the purpose of any particular borrowing. For the same reason, a U.S. multinational can choose to locate its borrowing in the country where the interest expense deduction will produce the highest tax benefit, i.e., the country with the highest tax rate and the fewest restrictions on deductibility. The fact that a U.S.-based multinational can claim a current

[28] See George K. Yin, "Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers," *Tax Notes*, 118, (Jan. 7, 2008), p. 178. See also Martin A. Sullivan, "Economic Analysis: FTC Proposal Puts Brakes on Earnings Coming Home," *Tax Notes Int'l*, 54, (June 1, 2009), p. 717.

[29] Stewardship expenses are incurred by one company for oversight functions performed for the company's own benefit as an investor in a related company. They include expenses to facilitate compliance by the corporation with reporting, legal or regulatory requirements, as well as other "duplicative activities" and "shareholder activities." Treas. Reg. sec. 1.861-8(e)(4)(ii). Stewardship expenses are generally allocated to dividends received, or to be received, from subsidiaries. Treas. Reg. sec. 1.861-8(e)(4)(ii). Supportive functions are those expenses necessary to operate a corporation but which are not necessarily related to any one entity or group of entities; they include overhead, supervisory and general and administrative expenses. Treas. Reg. sec. 1.861-8(b)(3). In general, if supportive function expenses relate to deductions that can more readily be allocated to gross income, they can be allocated along with those other deductions; alternatively, these expenses may be allocated on any reasonable basis to property or activities that generate gross income. *Ibid*.

[30] Internal Revenue Service statistics compiled for 2004 (the most recently available data) indicate that interest expense represented 38.2% of total apportionable expenses, research and experimentation expenses represented 12.2%, and "other" expenses represented 49%. IRS Statistics of Income Table 1.-U.S. Corporation Income Tax Returns with a Foreign Tax Credit, 2004: Total Assets, Income, Taxes, and Credits, and Foreign Income, Deductions, and Taxes by Major and Selected Minor Industry, available at http://www.irs.gov/pub/irssoil04itOlmi.xls. The balance of 0.9% is attributable to taxpayer reporting differences.

U.S. tax deduction for borrowing to invest in low-taxed countries increases the after-tax return of those investments above their pre-tax returns and encourages investments that would not otherwise be made. Moreover, the enhanced benefit of the interest deduction increases the already significant tax advantage of debt rather than equity for financing investments.[31]

The proposal may overcorrect for these problems, however, unless the worldwide allocation rules for interest expense are permitted to take effect as scheduled in 2011. Under present law, interest expense is generally allocated and apportioned based on the taxpayer's ratio of foreign or domestic (as applicable) assets to its worldwide assets.[32] All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.[33] However, foreign corporations are generally excluded from the affiliated group for this purpose.[34] The result is that the allocation under present law does not take into account the extent to which foreign members of the group may have borrowed outside the United States to finance their own operations. Instead, the present rules assume that debt incurred by U.S. group members disproportionately funds the operations of foreign subsidiaries and over-allocate interest expense to foreign source income (an effect commonly referred to as "water's edge fungibility"). The effect of these rules is to understate the taxpayer's foreign tax credit limitation.[35]

The American Jobs Creation Act of 2004 ("AJCA")[36] modified the interest expense allocation rules to permit a U.S. affiliated group to elect to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis, i.e., as if all domestic and foreign affiliates are a single corporation (an approach commonly referred to as "worldwide fungibility"). Under the election, interest expense incurred by U.S. group members is apportioned to foreign source income generally only to the extent that the amount of the worldwide group's interest expense that would be apportioned to foreign source income based on the worldwide group's asset ratios exceeds the amount of interest expense incurred by foreign group members. The new rules are expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign source income, to the extent that the group borrows offshore as well as in the United States.

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[31] For a more detailed discussion of these problems, see Michael J. Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expenses," IBFD, *Bulletin for International Taxation*, November 2008, p. 118.

[32] Section 864(e)(2); Temp. Treas. Reg. sec. 1.861-9T.

[33] Sec. 864(e)(1) and (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2).

[34] Secs. 864(e)(5) and 1504(b)(3).

[35] It should be noted, however, that the Treasury regulations under section 861 provide that affiliated group members that are financial corporations (generally banks, bank holding companies, savings and loans and similar institutions) are treated as a separate affiliated group for apportionment purposes, which mitigates the effect of water's edge fungibility to some degree for groups that include these corporations. Treas. Reg. sec. 1.861-11T(d)(4).

[36] Pub. L. No. 108-357, sec. 401.

The Administration's proposal is not explicit, however, about whether the worldwide election, which under present law is scheduled to be available starting with a taxpayer's first taxable year beginning in 2011, remains unchanged under the proposal. Because the proposal is effective for taxable years beginning after 2010, and because the proposal is silent on the treatment of other provisions of the Code, it can reasonably be concluded that the proposal assumes that the worldwide interest allocation rules would take effect as provided in present law. If that were not the case, however, the overallocation of interest expense to foreign source income under the present "water's edge" allocation rules would result in overstatement of the amount of interest expense subject to deferral − an effect that could be more costly than understatement of the foreign tax credit limitation if the taxpayer's offshore investments are located in relatively low-tax countries.[37]

Exclusion of research and experimental expenses

The proposal does not apply to deductions for research and experimentation expenses. In a very broad sense, this exclusion can be viewed as consistent with the Administration's budget proposal to make the research and experimentation tax credit permanent: this credit provides an incentive for conducting research activities in the United States, and excluding research costs from the scope of the proposal might be seen as necessary to avoid undermining the policy of a permanent research and experimentation credit.

On the other hand, this exclusion may undermine the proposal's policy objective of reducing the tax incentive for U.S. businesses to shift income overseas. As described in Section I.C. below, empirical evidence suggests that U.S. multinational corporations engage in aggressive transfer pricing practices to shift income to low-tax jurisdictions. Research further suggests that a substantial portion of this income shifting may be attributable to the transfer out of the United States of valuable intangible assets without adequate compensation in the form of royalties or other payments. If deductions for research and experimentation expenses related to the production of low-taxed foreign income are not deferred until the related income is subject to U.S. tax, the proposal may have no effect on U.S. firms' incentives to shift income from intangibles to low-tax jurisdictions.

One explanation for the exclusion of research and experimentation expenses from the scope of the proposal may be that those expenses are viewed as always relating to income that is in fact taxed in the United States. Under this view, expenses for U.S. research and experimentation that generates valuable intangible property are associated with taxable royalties paid by foreign subsidiaries to their U.S. corporations for the use of that property and with other taxable amounts such as payments required under the transfer pricing rules when the intangible property is sold to a related foreign person. This view, that research and experimentation expenses relate to taxable royalties and similar income, is the basis for the rule in the Bush

[37] There have been a number of recent proposals to postpone the date on which the worldwide interest allocation rules will take effect, and even to eliminate those rules. Most recently, H.R. 3200, The America's Affordable Health Choices Act of 2009, introduced in the House of Representatives on July 14, 2009, would postpone the effective date of the worldwide interest allocation rules to taxable years beginning after December 31, 2019.

Administration Reform Panel's dividend exemption proposal under which research and experimentation expenditures are not apportioned to exempt foreign-source income.[38] To the extent that U.S. research and experimentation expenses relate to foreign-source income that is taxed in the United States, then it would seem appropriate not to defer a deduction for those expenses.

There may, however, be two related problems with this view. First, as described above, empirical research suggests that an inappropriately low amount of taxable royalty income is being paid to U.S. firms in exchange for intangible property developed in the United States. Thus, while research and experimentation expenses may relate to taxable royalty income, that income is understated for U.S. tax purposes.[39] As a result, the economic value of the U.S. tax deduction is implicitly overstated.[40] Second, related research also suggests that royalties that are paid to U.S. firms are largely sheltered from U.S. tax through the use of excess foreign tax credits generated by highly taxed dividend income.[41] The Administration's budget proposal (described below) to determine the amount of a taxpayer's foreign tax credit on a blended basis, however, may substantially address this problem of cross-crediting.

In view of the possibility that the exclusion of research and experimentation expenses may undermine the objective of reducing the incentive for investment in low-tax jurisdictions, one question is whether the proposal could be modified to include research and experimentation expenses without reducing incentives for the conduct of research in the United States. One possibility might be to modify the manner in which research and experimentation expenses are apportioned for foreign tax credit limitation purposes. Present law generally provides an exclusive apportionment of 50 percent of the deduction for research and experimentation expenses to the geographic source where the activities that account for more than 50 percent of the deduction are performed.[42] Under this rule, if the United States is the predominant location for a firm's research, 50 percent of the deduction for research and experimentation expenses is

[38] President's Advisory Panel on Federal Tax Reform, *Proposal to Fix America's Tax System*, p. 241.

[39] One study suggests that royalties represent less than half of the contribution that U.S. parent research and development makes to the income of foreign subsidiaries. See Grubert and Altshuler, Corporate Taxes in the World Economy, p. 327.

[40] The Administration's budget proposal to limit shifting of income through intangible property transfers (described below) may, to some extent, address the concern that the taxable royalty income may be inappropriately low.

[41] Grubert and Altshuler, Corporate Taxes in the World Economy, p. 327.

[42] See Treas. Reg. section 1.861-17(b)(1). Research and experimental expenses are allocated to all income reasonably connected with the relevant broad SIC code product categories. A fixed percentage of the expenses is apportioned directly to U.S. or foreign source gross income based on where the majority of the research and experimentation activities were performed, and the residual amounts are apportioned based on either sales (including sales of related and unrelated parties that license intangibles from the taxpayer) or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios. Sec. 864(e)(1) and (6); Temp. Treas. Reg. sec. 1.861-14T(e)(2). The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns; these rules exclude foreign corporations from an affiliated group. Secs. 864(e)(5) and 1504.

apportioned to the United States. Apportionment to U.S.-source income is desirable for taxpayers because that apportionment does not have the effect of reducing a taxpayer's foreign tax credit limitation. Thus, if research and experimentation expenses were included in the expense suspension proposal, consideration could also be given to increasing, above 50 percent, the amount of those expenses apportioned for foreign tax credit purposes based on where the related activities are performed.

Distortion of residence choice

The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier "parent" corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of any State. All other corporations (i.e., those incorporated under the laws of foreign countries) are generally treated as foreign. Only domestic corporations are subject to tax on a worldwide basis. Foreign corporations are taxed only on income that has sufficient nexus in the United States.

To understand the implications of this distinction, consider two corporations: a U.S. corporation and a foreign corporation. Assume the corporate income tax rate everywhere outside the United States is 25 percent. Absent deferral, the income earned by the U.S. corporation from operations in the United States is taxed at the prevailing U.S. corporate tax rate, generally 35 percent, and the income earned by a U.S. corporation from operations outside the United States also is taxed at 35 percent. The income of the foreign corporation from operations in the United States is taxed at the prevailing U.S. corporate income tax rate, 35 percent, just as is the income earned by the U.S. corporation. On the other hand, the income earned by the foreign corporation from operations outside the United States is taxed at 25 percent.

All else equal, the foreign corporation has a higher after-tax cash flow than the U.S. corporation. Shareholders, regardless of residence, would view the shares of the foreign corporation as more valuable as the foreign corporation could pay higher dividends from its after-tax income. As a result, to maximize shareholder value, a corporation's choice of residence may be determined by tax considerations in addition to considerations such as liability protection, shareholder rights, and other concerns.[43]

As described in more detail in Section I.D. below, U.S. firms in the recent past sought to take advantage of the differential treatment of U.S. and foreign domiciled top-tier companies through inversion transactions. AJCA included provisions designed to curtail inversion transactions. AJCA did not, however, address the choice of residence available to new enterprises. As a result, even post-AJCA law contains powerful tax incentives for a new firm to opt out of U.S. residence for its top-tier entity.

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[43] Joel Slemrod and Reuven Avi-Yonah, "How Should Trade Agreements Deal with Income Tax Issues?" *Tax Law Review,* 55 (2002), p. 533. Slemrod and Avi-Yonah write, "[T]his system is no more efficient than in a domestic context taxing corporations with names beginning with the letters A through K at one rate, while taxing at a higher rate those with names beginning with L through Z (and not allowing name changes)," p. 542.

The economic distortion created consists of two components. First, an enterprise that in the absence of the prevailing tax policy would have naturally chosen to incorporate in the United States, chooses to incorporate elsewhere. This decision creates a "second order" distortion in that by incorporating outside the United States the U.S. tax base is reduced. The diminution of the U.S. tax base may result in higher taxes elsewhere in the economy. Increasing other taxes will increase the economic distortions inherent in those other taxes.[44]

To the extent the proposal increases the effective U.S. tax rate on foreign investment by U.S. firms, firms with U.S. and overseas operations will have an added incentive to conduct their overseas operations not through foreign subsidiaries of U.S. resident firms but instead through firms that are owned by foreign persons.[45] If this incentive were strong, it would be possible that after some number of years, the only significant business operations carried out through U.S.-headed firms would be U.S. business operations. Assuming, however, that anti-inversion rules are effective, U.S. firms generally would incur significant tax costs for migrating their existing operations into foreign-headed firms. Consequently, if the proposal increased greatly the incentive to conduct foreign operations through foreign-headed groups, a possible scenario would be that existing U.S.-headed businesses would remain U.S. owned and new foreign business operations would be organized with foreign corporations as the parent entities. Under this scenario, the proposal would impose additional U.S. tax on existing capital but, perhaps after a transition period, would fail to capture returns from new capital investment.

On the other hand, the existing U.S. worldwide tax regime has long created a disincentive to conduct foreign operations through U.S.-headed firms. In spite of this disincentive — which predated and served as the impetus for the enactment in AJCA of the anti-inversion rules — U.S. multinational corporations have accounted and still account for a significant portion of cross-border economic activity.[46] A possible explanation is that non-tax reasons for organizing global operations under a U.S. parent corporation dominate the tax consequences of doing so. Regardless, that in response to the proposal firms may conduct new foreign operations through entities organized in foreign jurisdictions may not be so much an argument against the proposal

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[44] As a backstop to the erosion of the U.S. worldwide tax base that could occur under such "inverted start ups" and other inversion transactions, the Joint Committee on Taxation staff recommended altering residency tests within the policy of worldwide taxation. See Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*.

[45] This analysis assumes that firms will have the ability to conduct foreign operations through firms organized in jurisdictions that do not impose tax on worldwide income. Many countries, including most of the major trading partners of the United States, have adopted territorial taxing regimes. See Joint Committee on Taxation, *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment* (JCX-55-08), June 25, 2008, pp. 44-49.

[46] In 2007, nonbank U.S. multinational firms were associated with 49 percent of all U.S. exports of goods and 37 percent of all U.S. imports of goods. Kevin B. Barefoot and Raymond J. Mataloni, Jr., "U.S. Multinational Companies: Operations in the United States and Abroad in 2007," *Survey of Current Business*, August 2009, 89:8, Table 3, page 68.

as it may be a suggestion of the malleability of corporate residence based on the U.S. place-of-incorporation rule.[47]

To the extent the proposal has the effect of encouraging new foreign business operations to be conducted through foreign-headed rather than U.S.-headed firms, this effect could be exacerbated if the proposal were enacted in combination with other proposals described below such as the proposal to determine the foreign tax credit on a blended basis.[48]

Technical considerations

The proposal does not clearly address several technical questions. First, the proposal is not clear in its treatment of expenses that are, under present law, definitely related and allocable entirely to a class of gross income that is subject to current U.S. taxation. For example, the proposal does not specify whether expenses that are related to the operating income of a foreign branch of a U.S. corporation are grouped with other expenses, such as interest and stewardship, in determining the amount of expenses not allowed as a deduction in a particular year.[49] Excluding expenses that generate income subject to current U.S. taxation from the scope of the proposal would not seem to violate the basic policy rationale of the proposal — to match the timing of expense recognition and income inclusion.

A related issue raised by the proposal is the application of present law allocation and apportionment principles in determining the amount of deductions that are potentially deferred. The proposal states that expenses are to be deferred to the extent that foreign-source income associated with the expenses is not currently subject to U.S. tax. It does not, however, explain how to determine the deductibility of allocated and apportioned expenses that are associated with foreign-source income that is currently subject to U.S. tax. Thus, after expenses are allocated and apportioned to foreign-source income under the proposal, it is not clear whether a sub-apportionment of those expenses must be made to allocate such expenses among different categories of that foreign-source income. A U.S. corporation with foreign subsidiaries may have various kinds of foreign-source income. It may, for instance, derive directly royalty income and income from section 863(b) export sales. It may also derive dividend income from its controlled foreign corporations and subpart F income in respect of its ownership of those corporations. To the extent expenses are related to foreign-source income of the first sort (royalty income or

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[47] Section 7701(a)(4), (5). Some commentators and legislators have argued that this place-of-incorporation rule should be replaced by a rule under which a corporation is resident in the jurisdiction in which it is managed and controlled. See Joint Committee on Taxation, *Options to Improve Compliance and Reform Tax Expenditures,* p. 182; S. 506, 111th Cong., 1st Sess. (Sen. Levin), section 103; H.R. 1265, 111th Cong., 1st Sess. (Rep. Doggett), section 103. This change in the residence rule would be a significant departure from a long-established formal rule and as such would merit careful analysis.

[48] It may be appropriate, therefore, in this context to reconsider the present law rules for determining corporate residency.

[49] For a detailed discussion of this issue and other technical concerns related to this proposal, the proposal to determine foreign tax credits on a blended basis, and the proposal to restrict the availability of foreign disregarded entities, see Robert B. Stack, Danielle E. Rolfes, Joshua T. Brady, and John D. Bates, Recent International Tax Proposals Raise Technical Issues, *Tax Notes* (August 3, 2009), pp. 451-70.

section 863(b) sales income derived directly by the U.S. parent corporation), an argument could be made that a deduction for those expenses never should be deferred, because the income to which the expenses relate always is currently taxed in the United States. This argument would be similar to the argument described above for excluding from the proposal expenses related to the operating income of a foreign branch. On the other hand, to the extent expenses are related to foreign subsidiary income, which is subject to U.S. tax only if paid as a dividend or included in U.S. income under subpart F, expenses should be subject to deferral to the extent the associated income of the subsidiary is not subject to current U.S. tax. Thus, a sub-apportionment among different categories of that foreign-source income would provide a mechanism for currently deducting those expenses associated with income directly derived by the U.S. parent and prorating the deduction for income earned by foreign subsidiaries.

An alternative approach to the one just described would group together all expenses related to foreign-source income of every sort — both foreign-source income derived through controlled foreign corporations and foreign-source income derived directly by a U.S. parent corporation — and defer deductions for those expenses to the extent that foreign-source income is not currently taxed in the United States. This latter approach, reflected in H.R. 3970, the Tax Reduction and Reform Act of 2007,[50] is administratively simpler and has the virtue of avoiding potential arguments between taxpayers and the IRS about whether certain foreign-related expenses should be apportioned to one category of income rather than to another. On the other hand, the latter approach may be viewed as less accurate in carrying out the matching principle that underlies the proposal.

Another technical consideration is the manner in which foreign-source income on which U.S. tax is deferred should be computed. While the universe of foreign-source income on which U.S. tax is deferred for purposes of this proposal would presumably include the non-previously taxed earnings of a CFC or noncontrolled section 902 corporation (i.e., a 10/50 company), it is unclear whether such non-previously taxed earnings would be determined on a consolidated basis, with elimination of the effects of intercompany transactions, or as the sum of separately-computed company results. Implicit in this question are technical issues such as: (1) the treatment of transactions between two foreign subsidiaries for purposes of determining the earnings of each that are includible as foreign subsidiary income not currently subject to tax, and (2) the treatment of deficits, including whether the earnings deficit of one foreign subsidiary should offset the positive earnings of other foreign subsidiaries.[51]

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[50] H.R. 3970, introduced on October 25, 2007 by House Ways and Means Committee Chairman Charles Rangel.

[51] A related question is the treatment of income that would otherwise be foreign source, but that is recharacterized under section 904(f) as U.S. source income by virtue of the taxpayer having had an "overall foreign loss," or OFL, in an earlier year. If a taxpayer experiences an OFL for a taxable year, the taxpayer is required under section 904(f) to treat as U.S. source income a portion (generally no more than 50 percent) of any foreign source income earned in later years, in order to "recapture" the OFL. The effect is to reduce the taxpayer's foreign tax credit limitation in the subsequent years. The rationale for the recapture is that the OFL has offset U.S. source income in the year generated, thereby reducing the U.S. tax collected with respect to U.S. source income in that earlier year. The U.S. fisc would not be made whole when the taxpayer subsequently earned foreign source income if the U.S. taxes on that income were completely offset by foreign tax credits.

Other technical considerations include the following: (1) the need for currency translation rules for determining the non-previously taxed CFC and 10/50 corporation earnings on which U.S. tax is deferred and (2) whether the earnings of entities below the sixth-tier that are not included in the section 902 qualified group should be excluded from the computation of foreign-source income on which U.S. tax is deferred.[52]

Tax reporting requirements would also necessarily increase under the proposal. Under present law, annual information reporting relating to earnings and profits ("E&P") is required only with respect to CFCs. Under the proposal, however, the E&P of every CFC and 10/50 company will affect the computation of deductions that must be deferred as a result of being attributable to foreign-source income not currently subject to U.S. tax, regardless of the amount of actual or deemed distributions. Thus, it will likely be necessary to provide for additional information reporting with respect to 10/50 companies so that the IRS can verify the accuracy of this computation.

Moreover, although E&P and foreign tax information with respect to 10/50 companies is already required under present law in order to compute deemed-paid credits, apply the look-through rules to dividends paid by 10/50 companies and, in many cases, to apportion interest expense in calculating the foreign tax credit limitation,[53] this information can be difficult to obtain if U.S. shareholders do not control the company. Under existing Treasury regulations, a U.S. shareholder must track E&P and foreign tax information for a CFC or 10/50 company beginning only with the first taxable year in which the computation of E&P is significant for U.S. tax purposes with respect to its controlling domestic shareholder.[54] Under present law, this computation often is not significant until the controlling domestic shareholder is required to include income in respect of the CFC or 10/50 company. However, as E&P would be a key component in the computation of the amount of deductions attributable to foreign-source income on which U.S. tax is deferred, this information would likely be significant under the proposal for all CFCs and 10/50 companies for every year.

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[52] See sec. 902(b)(2)(B)(iii). Under present law, CFCs below the sixth tier of ownership (from the United States) are not considered part of the section 902 qualified group.

[53] The Tax Reform Act of 1986 (Pub. L. No. 99-514) created a separate foreign tax credit limitation category for dividends from 10/50 companies. As enacted, this limitation applied on a corporation-by-corporation basis. The Taxpayer Relief Act of 1997 (Pub. L. No. 105-34) added a new section 904(d)(4), which required that the foreign tax credit limitation applicable with respect to each 10/50 company be determined based on the underlying E&P from which the 10/50 company paid a dividend, for E&P accumulated in post-2002 taxable years. Any dividends paid during post-2002 years from E&P accumulated in pre-2003 years were, in general, assigned to a single 10/50 dividend basket, rather than to a separate basket for each 10/50 company as in the past. Section 904(d)(4) was then further modified by AJCA (Pub. L. No. 108-357) to extend look-through treatment to post-2002 dividends paid out of pre-2003 E&P.

[54] See Treas. Reg. sec. 1.964-1(c)(6), which generally provides that a foreign corporation that is a CFC or 10/50 company is not required to make an election to adopt a taxable year or method of accounting until the first taxable year in which the computation of its E&P is significant for U.S. tax purposes with respect to its controlling domestic shareholder(s). The regulation provides a list of events that are deemed significant for this purpose, including the shareholder's use of the tax book value method of interest expense apportionment and a distribution (either an actual dividend or a deemed dividend under subpart F) from the foreign corporation to its shareholders with respect to its stock.

Prior Action

No prior action.

C. Proposal to Limit Shifting of Income through Intangible Property Transfers

Background and Present Law

As described in Section I.A. above, under present law taxpayers can defer indefinitely the U.S. taxation of many types of active foreign source income earned through CFCs by reinvesting these earnings outside of the United States. This deferral opportunity provides a strong incentive for U.S.-based multinationals to shift as much income as possible to lower-tax jurisdictions. Within a group of related entities,[55] there are often no market pressures that impose market pricing on transactions between the related parties, and goods and services are transferred at self-derived prices. Absent transfer pricing rules, the lack of external market forces would permit multinational groups to shift income inappropriately among group members. Thus, the United States has extensive rules designed to preserve the U.S. tax base by ensuring that income properly attributable to the United States is not shifted to an offshore controlled party through the misuse of transfer pricing.

Section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits or allowances among related business entities when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's length standard as the method for determining whether allocations are appropriate. Thus, the regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length. In 1986, Congress added the second sentence of section 482, which provides that the income with respect to any transfer (or license) of certain intangible property to a related person must be commensurate with the income attributable to the intangible property. Section 367(d) provides a related rule under which compensation, in the form of an imputed royalty stream, is required for an offshore transfer of intangible property in the context of an otherwise tax-free reorganization transaction. Despite these rules, however, and the substantial resources devoted by the IRS to their enforcement, empirical evidence suggests that inappropriate income shifting, particularly in the case of income attributable to intangibles, continues to erode the U.S. tax base.

Empirical evidence

Empirical evidence indicating that U.S. multinationals continue to shift income to low-tax foreign jurisdictions has led many to question the effectiveness of the current transfer pricing rules. Most recently, the General Accountability Office ("GAO") reported in 2008 that the average tax rates on the foreign operations of U.S. multinationals vary considerably by country, and that most of the countries studied with relatively low average tax rates have income shares significantly larger than their shares of the business measures least likely to be affected by inappropriate income shifting

[55] The term "related" as used herein refers to relationships described in section 482, which applies to "two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests."

practices: physical assets, compensation and employment. The GAO found that the opposite relationship holds for most of the high tax countries that it studied.[56]

In 2007, a Treasury Department study of the effectiveness of the transfer pricing rules examined the relationship between CFC profitability (measured by the ratio of operating profits to sales) and the statutory tax rate of the CFC's jurisdiction.[57] In general, if a multinational group is engaging in non-arm's-length pricing to shift income to low-tax jurisdictions, one would expect to observe higher CFC profitability in low-tax jurisdictions and lower CFC profitability in high-tax jurisdictions, assuming other factors are equal.[58] Using information from tax filings for the years 1996, 2000 and 2002, the study found an inverse relationship between pre-tax profitability and tax rates.[59] In other words, the data generally showed that pre-tax operating margins are higher in low-tax countries and lower in high-tax countries.[60] Based on this analysis, the Treasury study concluded that there is some potential for income shifting under the current regulations, and that this potential is perhaps most acute with respect to cost sharing arrangements involving intangibles. The Treasury study acknowledges, however, that many factors affect profitability, and that while the results are consistent with income shifting, a more refined empirical analysis is necessary to isolate income shifting through non-arm's-length pricing.

The Treasury study's findings are consistent, however, with those of empirical studies conducted by economists, beginning in the early 1990s and continuing through today, which

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[56] United States Government General Accountability Office, "U.S. Multinational Corporations, Effective Tax Rates Are Correlated with Where Income Is Reported," Report to the Committee on Finance, U.S. Senate, August, 2008.

[57] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 2007, (hereafter, U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*), citing Michael McDonald, "Income Shifting from Transfer Pricing: Further Evidence From Tax Return Data," *OTA Technical Working Paper 2*, July 2008. This report was issued in response to a direction from Congress in 2004 that the Treasury Department conduct a study of the effectiveness of the transfer pricing rules and compliance efforts related to cross-border transfers and other related-party transactions. Congress requested that the study focus particularly on transactions involving intangible assets, service contracts and leases that may be used improperly to shift income out of the United States. AJCA sec. 806.

[58] U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, p. 57.

[59] *Ibid*., p. 58. See also Martin A. Sullivan, "Extraordinary Profitability in Low-Tax Countries," *Tax Notes*, (August. 25, 2008), p. 724 (analyzing IRS Statistics of Income Bulletin data for 2004 on related foreign corporations and concluding similarly that manufacturing subsidiaries of U.S. corporations in low-tax countries have high profitability, while manufacturing subsidiaries in high-tax countries have low profitability).

[60] U.S. Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, p. 57. For purposes of the study, operating profits were defined as pre-tax earnings, excluding interest income and interest expense. *Ibid*. "The measure is based on 'earnings and profits' and is intended to approximate 'book' operating profits for tax purposes." *Ibid*. Financial CFCs and CFCs with losses were excluded. *Ibid*., note 72.

include controls for various non-tax factors.[61] For example, one study using aggregated country-specific data and adjusting for financial structure and capital employed, found evidence of sensitivity of profitability to local country tax rates.[62] A second study, using firm-level data based on public (non-tax) filings of publicly traded companies, found evidence of income shifting out of or into the United States correlated with tax-rate differentials between the United States and foreign jurisdictions, taking into account company characteristics such as research expenditures and advertising (as proxies for intangibles), interest expense and number of employees.[63] A 2006 study comparing Treasury data for manufacturing subsidiaries in 1996 and 2000 indicates that income shifting has increased.[64] While not conclusive evidence of income shifting through non-arm's-length pricing, these studies are consistent with what one would expect to find if companies are engaging in inappropriate income shifting.

In 2003, another study examined the sources of income shifting, focusing on the role of intangible assets.[65] The study used firm-level data from 1996 corporate tax filings (supplemented by data from public filings), and controlled for U.S. parent and CFC non-tax characteristics. Like previous studies, this study found an inverse relationship between local statutory rates and reported earnings. More specifically, however, this study found that "about half of the observed difference in profitability between high and low tax countries seems to be accounted for by the shifting of income derived from industrial intangibles."[66]

The conclusions reached by the Treasury and in other studies regarding the role of intangibles in income shifting are not surprising. Transfer pricing issues involving high-value intangibles are particularly difficult to resolve, due to the unique nature of those assets. Transactions involving these assets generally are not readily comparable to other third party transactions. In fact, some analysts concluded that the transfer of valuable intangible assets to

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[61] *Ibid.*, pp. 59-62. See also, Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location," *National Tax Journal,* 221, Vol. LVI, No.1, Part 2, (March 2003) p. 226 (hereafter, Grubert, Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location) (citing several studies); Reuven S. Avi-Yonah and Kimberly A. Clausing, "A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project," *Public Law and Legal Theory Working Paper Series,* Working Paper No. 85 (June 2007) (hereafter, Avi-Yonah and Clausing, A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation).

[62] James R. Hines, Jr. and Eric Rice, "Fiscal Paradise: Foreign Tax Havens and American Business," *Quarterly Journal of Economics,* 109 (February 1994), p. 149.

[63] David Harris, Randall Morck, Joel Slemrod, and Bernard Yeung, "Income Shifting in U.S. Multinational Corporations," in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod, eds., Studies in International Taxation, (Chicago: University of Chicago Press), 1993.

[64] Grubert and Altshuler, Corporate Taxes in the World Economy, pp. 339-340.

[65] Grubert, Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location.

[66] *Ibid.*, p. 229. The other half of income shifting appears to be accounted for by financing strategies (i.e., the allocation of debt between high- and low-tax countries). *Ibid.*, pp. 230-231. The study does not provide information concerning the countries from which income is being shifted. *Ibid.*, p. 229.

low-tax subsidiaries without adequate compensation (such as through appropriately priced royalties) is probably one of the most important income-shifting methods.[67]

The difficult problem presented by intangibles is further illustrated by data involving Ireland, which currently taxes active business income at a 12.5 percent rate. Another analysis reports that information from Treasury 2002 tax files for certain CFCs in manufacturing indicates that the ratios of pre-tax profits to sales are almost three times higher in Ireland on average than the mean ratio of pre-tax profits to sales for all such CFCs.[68] According to the authors, "these 'excess' profits presumably reflect the fact that very valuable intellectual property is located in Ireland and the royalties paid back to the United States, while significant, do not fully reflect" the contribution of the U.S. parent.[69]

Transfers of intangible property to foreign affiliates

A U.S. person that develops or purchases intangible property can make that intangible property available to a foreign affiliate generally in one of four ways. The first is through an outright transfer of all substantial rights in the intangible property, either by sale or through a non-recognition transaction, e.g., a capital contribution of the intangible property to the affiliate in an exchange that meets the requirements of section 351, or an exchange made pursuant to a plan of reorganization that is described in section 361. The second is through a license of the intangible property, in which the U.S. person transfers less than all substantial rights in the intangible property to the foreign affiliate.[70] The third is the provision of a service using the intangible property, rather than a transfer of the property.

In the fourth, intangible property is made available to cost sharing arrangements, rather than transferred in whole or in part. In a typical cost sharing arrangement, a U.S. company and one or more foreign affiliates make resources available and contribute funds (through a combination of cash and existing intellectual property rights) toward the joint development of a new marketable asset. The U.S. company makes available all or a substantial portion of the rights to use existing intellectual property, and the foreign affiliates (typically organized in low-tax jurisdictions) typically contribute cash. The arrangement provides that the U.S. company will own legal title to, and all U.S. marketing and production rights in, the developed property, and that the other party or parties will have rights to all marketing and production for the rest of the world. Reflecting the split economic ownership of the newly developed asset, no royalties are paid between cost sharing participants when the product is ultimately marketed and sold to

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67 Grubert and Altshuler, Corporate Taxes in the World Economy, p. 337.

68 *Ibid.*, p. 341.

69 *Ibid.*, p. 341. The paper states, parenthetically, that "[p]arallel regressions for royalties and profits indicate that only about one-third of the contribution of parent's research and development to CFC profits on average is paid back as royalties."

70 The significance of the retained residual rights depends, in part, on the length of the license term as well as any restriction (express or implied by the taxpayer's conduct) on any potential competing use of the retained rights in the area of use belonging to the licensee.

customers. However, the U.S. company may receive a buy-in payment [71] (such as intercompany royalties or a lump sum payment at the outset) from the other cost sharing participants with respect to its "platform" contribution.[72]

The mechanism used for transferring intangible property to a foreign affiliate dictates whether the compensation received by the U.S. person in the transaction will be evaluated (and potentially made taxable) under section 482 or section 367(d). Generally, a license or a sale of intangible property, or the provision of a service that uses intangible property, will be evaluated under section 482 (including the commensurate with income principle discussed below). An exchange of intangible property in connection with certain nonrecognition transactions will be evaluated under section 367(d), which departs from the general nonrecognition rules of sections 351 and 361 to require that the transferor of intangible property include imputed income from annual payments over the useful life of the intangible, as though the transferor had sold the intangible in exchange for contingent payments. The appropriate amounts of those imputed payments are determined under section 482 and the regulations thereunder; however, Treasury regulations specifically exempt transfers of foreign goodwill or going concern value from the income recognition provisions of section 367(d).[73]

Section 482 and the commensurate with income principle

With regard to intangible property, section 482 provides as follows:

> In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.[74]

This sentence, added in 1986, was intended to address two inherent difficulties in applying the arm's length standard with respect to transfers of unique, high-profit potential (or "high-value") intangibles. The first is that taxpayers that develop high-value intangibles rarely, if ever, transfer that property to third parties; as a result, it is particularly difficult to determine the terms under which an arm's length transfer of the property might have occurred. Second,

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[71] Present regulations refer to "buy-in payments" as "PCT payments," i.e., payments for platform contribution transactions. Temp. Treas. Reg. sec. 1.482-7T(b)(ii). The more common term, "buy-in payment," is used herein.

[72] A platform contribution is any resource, capability, or right that the U.S. company has developed, maintained or acquired outside of the cost sharing arrangement, that is made available to the cost sharing arrangement, and that is reasonably anticipated to to contribute to the development of cost-shared intangibles. Temp. Treas. Reg. sec. 1.482-7T(c)(1).

[73] Temp. Treas. Reg. sec. 1.367(d)-1T(b).

[74] Under section 936(h)(3)(B), intangible property means: (1) any patent, invention, formula, process, design, pattern, or know-how; (2) copyright, literary, musical or artistic composition; (3) trademark, trade name, or brand name; (4) franchise, license or contract; (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; and (6) any similar item; where such item has substantial value independent of the services of an individual.

transfers to related parties normally do not involve the bona fide shifting of economic risk that would occur in transactions between unrelated parties. As the legislative history explains:

> … A recurrent problem is the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables. … In addition, a parent corporation that transfers potentially valuable property to its subsidiary is not faced with the same risks as if it were dealing with an unrelated party. Its equity interest assures it of the ability ultimately to obtain the benefit of future anticipated or unanticipated profits, without regard to the price it sets. The relationship similarly would enable the parent to adjust its arrangement each year, if it wished to do so, to take account of major variations in the revenue produced by a transferred item. … In many cases firms that develop high profit-potential intangibles tend to retain their rights or transfer them to related parties in which they retain an equity interest in order to maximize their profits. The transferor may well be looking in part to the value of its direct or indirect equity interest in the related party transferee as part of the value to be received for the transfer, rather than to "arm's length" factors. Industry norms for transfers to unrelated parties of less profitable intangibles frequently are not realistic comparables in these cases.[75]

The "commensurate with income" principle was intended to address these problems by shifting the focus of transfer pricing analysis to the income actually derived from exploitation of the transferred intangible, and away from the identification of questionably comparable third-party transactions. In particular, Congress intended that compensation for intangibles be determined by taking into account actual profit experience, and that pricing adjustments be made upon "major variations" in the annual amounts of revenue. The legislative history explains this further:

> … Where taxpayers transfer intangibles with a high profit potential, the compensation for the intangibles should be greater than industry averages or norms. … The committee does not intend, however, that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. The committee intends that consideration also be given the actual profit experience realized as a consequence of the transfer. Thus, the committee intends to require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible. …[76]

The Conference Report for the 1986 Act also directed the IRS to conduct a comprehensive study of the transfer pricing rules, and the IRS published its findings on

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[75] H. R. Rep. No. 99-426 (hereafter, House Report 99-426), p. 425.

[76] *Ibid.*, pp. 425-26.

December 5, 1988, in a Notice commonly referred to as the White Paper.[77] Although the legislative history to the 1986 Act did not address the relationship between the commensurate with income principle and the arm's length standard, the White Paper characterizes the commensurate with income principle as a clarification of prior law that it is consistent with the arm's length standard.[78] An important consequence of this conclusion, reflected in subsequently issued Treasury regulations, was that comparable third-party transactions would continue to play a role in determining appropriate transfer prices, at least in the case of "normal intangibles."[79] Normal intangibles were described as intangibles that are widely available to producers (such as the technology employed in pocket calculators, digital watches or microwaves) and for which "exact" comparables are more common. The White Paper concludes that in the case of high-value intangibles, uncontrolled party transactions involving comparable intangibles "almost never exist."[80]

The White Paper also acknowledges Congress's intent that actual profit experience be taken into account in determining the appropriate transfer price, and that periodic adjustments be made to reflect substantial changes in intangible income. However, in an apparent effort to reconcile the periodic adjustment requirement with the arm's length standard, the White Paper identifies three situations where adjustments should not be required: (1) the taxpayer demonstrates that it has comparable long-term, non-renegotiable contractual arrangements with third parties;[81] (2) the taxpayer demonstrates that events occurred subsequent to the license agreement that caused unanticipated profitability, the license contained no provision pursuant to which uncontrolled parties would have adjusted the license, and uncontrolled parties would not have included such a provision; and (3) the taxpayer demonstrates that an increase in intangible income is attributable solely to activities performed, and economic costs and risks borne, by the transferee.[82] As described further below, the Treasury regulations implementing the commensurate with income principle include similar limitations on the requirement to make periodic adjustments.

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[77] H.R. Conf. Rep. No. 99-841, pt. 2 (hereafter Conference Report 99-841), II-638, and Notice 88-123, 1988-2 C.B. 458 [hereafter, the *White Paper*].

[78] *Ibid*., p. 472. The *White Paper* bases this conclusion on a statement in Conference Report 99-841 that income from a transferred intangible should be divided based on the relative economic contributions of the parties. The *White Paper* states that this approach is consistent with what unrelated parties do and concludes from this that the general goal of the commensurate with income requirement is "to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's length transfer of the intangible."

[79] *Ibid*., p. 473.

[80] *Ibid*. However, the *White Paper* states that in the rare instance in which there is a true comparable for a high-profit intangible, the transfer price must be set on the basis of the comparable, because that remains the best measure of how third parties would allocate intangible income.

[81] The *White Paper* notes that, in the case of a high-profit intangible, the third-party transaction generally would need to be an "exact comparable."

[82] *Ibid*., pp. 477-478.

Section 482 regulations for transfers of intangible property

Treas. Reg. sec. 1.482-4, issued in 1994, sets forth the basic rules for determining income in connection with a transfer of intangible property. It provides generally that the arm's length consideration for the transfer of an intangible in a controlled transaction (i.e., a transaction between related parties) must be commensurate with the income attributable to the intangible, and it requires taxpayers to apply one of four methods to meet this requirement.[83]

Comparable uncontrolled transaction method

The first of these is the comparable uncontrolled transaction ("CUT") method, which evaluates the amount charged for an intangible in a controlled transaction by reference to the amount charged in a comparable uncontrolled transaction (i.e., a transaction between unrelated parties).[84] The regulations provide that if an uncontrolled transaction involves the transfer of the *same* intangible under the same, or substantially the same, circumstances as the controlled transaction (i.e., an exact comparable), the CUT method generally is the most direct and reliable measure of the arm's length result for a controlled transaction.[85] Exact comparables are rare, however, in the case of high-value intangibles. If an exact CUT cannot be identified, uncontrolled transactions that involve the transfer of comparable intangibles under comparable circumstances (i.e., inexact comparables) may be used to apply the CUT method, but the reliability of the method will be reduced. The regulations require that a taxpayer consider whether the intangible that is the subject of the uncontrolled transaction has "similar profit potential" to the taxpayer's intangible in determining whether the uncontrolled transaction is comparable.[86] However, this method does not otherwise consider or directly reflect the income attributable to the taxpayer's intangible.

Comparable profits method

The remaining methods do require an examination of the income actually derived from the transferred intangible. They differ, however, in the extent to which they rely on comparable uncontrolled transactions. The comparable profits method evaluates the amount charged in a controlled transaction by comparing the operating profit of the "tested party" (generally, the licensee) to the operating profits of uncontrolled taxpayers that engage in similar business activities under similar circumstances. For example, where a U.S. parent company licenses an

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[83] The regulation also permits the use of other unspecified methods, which must take into account the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. Treas. Reg. sec. 1.482-4(d)(1). A taxpayer must apply any method, whether specified or unspecified, in accordance with the overall requirements of Treas. Reg. sec. 1.482-1, including its best method, comparability analysis and arm's length range rules.

[84] Treas. Reg. sec. 1.482-4(c)(1).

[85] Treas. Reg. sec. 1.482-4(c)(2)(ii). Circumstances between the controlled and uncontrolled transactions will be considered substantially the same if there are at most only minor differences that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made.

[86] Treas. Reg. sec. 1.482-4(c)(2)(iii)(B)(1)(ii).

intangible to a foreign manufacturing subsidiary, the royalty payable by the subsidiary to the parent is evaluated under this method by comparing the operating profit of the subsidiary to the operating profits of comparable uncontrolled manufacturers. If the subsidiary's profit level differs meaningfully from the profit levels of the uncontrolled manufacturers, the royalty rate paid by the subsidiary is adjusted as necessary to bring the profit level within an acceptable range of those levels. In effect, this method limits the extent to which income from the intangible can be retained by the licensee to the amount that an uncontrolled licensee would be permitted to retain; the remainder of that income is required to be paid to the licensor through the royalty.[87]

Comparable profit split method

The regulations also provide two profit split methods, under which the relative values of each controlled party's contribution to the combined profit from use of the intangible are used to determine an arm's length "profit split." The arm's length charge for the intangible is the amount required to achieve the appropriate split of the combined profits. The comparable profit split method relies exclusively on external market data to determine the appropriate profit split; thus, the combined operating profits of controlled taxpayers are split based on the split of combined operating profits of uncontrolled taxpayers with similar transactions and activities in the relevant business activity.[88]

Residual profit split method

In contrast, the residual profit split method relies on external transactions principally in order to determine the amount appropriately allocable to routine contributions and, in some cases, to determine the split of residual nonroutine return amongst the parties.[89] Under this method, income is first allocated to the routine contributions of the controlled parties (including contributions of routine intangibles) based on market returns, and the residual income is then allocated based on the relative value of each party's contribution of nonroutine property.

Periodic adjustments

Treas. Reg. sec. 1.482-4(f)(2) addresses the periodic adjustments that may be required to comply with the commensurate with income requirement. It provides that when an intangible is transferred in a transaction that covers more than one year, the consideration charged for each taxable year may be adjusted by the IRS (in the context of an examination of that year) to ensure that it is commensurate with the income from the intangible. The regulation also provides, however, that no adjustment will be required in the following circumstances (subject to the taxpayer's meeting certain additional requirements): (1) the taxpayer established its initial transfer price relying on a CUT involving the same intangible, (2) the actual profits for the tax

[87] Treas. Reg. sec. 1.482-5, including Example (4).

[88] Treas. Reg. 1.482-6; Temp. Treas. Reg. sec. 1.482-6T(c)(2)(ii)(D).

[89] "Routine" contributions (including routine intangibles) are generally contributions for which it is possible to identify market returns. Temp. Treas. Reg. sec. 1.482-6T(c)(3)(i)(A).

year do not exceed 120 percent of the prospective profits that were foreseeable at the time the transaction was entered into, (3) the actual profits exceed 120 percent of those foreseeable at the time the transaction was entered into, but only as a result of unforeseeable events beyond the control of the taxpayer, or (4) for the first five years of the transaction, actual profits do not exceed 120 percent of the prospective profits that were foreseeable at the time the transaction was entered into.[90]

Temporary regulations on cost sharing arrangements

Conference Report 99-841 states that the commensurate with income requirement was not intended to preclude "the use of certain bona fide research and development cost sharing arrangements" to the extent that those arrangements are consistent with the purpose of the requirement that the allocation of income among the parties reasonably reflect the actual economic activity undertaken by each.[91] To meet this objective, the Conference Report contemplates that a cost-sharer will bear its portion of all research and development costs (including costs spent on successful and unsuccessful products within an appropriate product area), and that the allocation of costs is generally proportionate to profit.[92]

The present rules governing cost sharing arrangements are provided in temporary Treasury regulations issued in December, 2008.[93] The regulations provide detailed rules for evaluating the compensation derived by each party for its contribution to the arrangement, including in particular the buy-in payments made by cost sharing participants that contribute only money to a participant that makes a platform contribution. For this purpose, the regulations adopt an "investor model," under which each participant is viewed as making an aggregate investment attributable to both its ongoing share of the intangible development costs and its external contributions (pre-existing assets that the parties bring to the arrangement) for purposes of achieving an anticipated return determined on the basis of an appropriate discount rate that takes into account the risk of the intangible development activity.

The regulations provide five methods for valuing buy-in payments, within the context of the investor model: (1) the comparable uncontrolled price method, which references a

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[90] In a recent Advisory Memorandum, the IRS explained the retrospective approach on the basis that the phrase "commensurate with the income attributable to the intangible" refers generally to the operating profits that the taxpayer would reasonably and conscientiously have *projected* at the time it entered into the controlled transaction." AM-2007-07, issued on March 23, 2007, pp. 3, 12 (emphasis added.). The Advisory Memorandum states that both the legislative history and the *White Paper* expressed concerns about the ability of the IRS to examine, after the fact, taxpayers' expectations regarding potential profits. The Advisory Memorandum concludes that the intention of the commensurate with income requirement is to give the IRS a presumptive basis for making periodic adjustments, which taxpayers could then rebut, for example by showing that the actual results were beyond the control of the taxpayer and could not reasonably have been anticipated at the time of the transaction.

[91] Conference Report 99-841, II-638.

[92] *Ibid*.

[93] Temp. Treas. Reg. sec. 1.482-7T.

comparable cost sharing arrangement with an uncontrolled party;[94] (2) the income method, which examines the present value of the projected income from the contributing participant's best realistic alternative;[95] (3) the acquisition price method, which references the acquisition price of a contributed intangible that was recently acquired in an arm's length transaction;[96] (4) the market capitalization method, which references the parent company's stock market capitalization, increased for its liabilities as of the buy-in date and reduced for the value of tangible property and non-covered intangibles;[97] and (5) the residual profit split method, which applies only where more than one participant makes significant, nonroutine contributions.[98] In addition, unspecified methods are available.

The regulations generally permit the IRS to make periodic adjustments to buy-in payments if the IRS determines that the payor's "actually experienced return ratio" ("AERR") is outside a specified "periodic return ratio range." The regulations provide a number of exceptions, however, under which no adjustment is required. For example, where failure to fall within the periodic return ratio range is due to extraordinary events beyond the participants' control that could not be reasonably anticipated at the time of the buy-in, or where the AERR would fall within the periodic return ratio range if the AERR were recomputed with certain specified adjustments (such as adjustments to reflect delayed exploitation of the intangible), no adjustment is required. In addition, no adjustment is required where the same platform contribution is made to an uncontrolled party on substantially similar terms as the controlled transaction, and the requirements of the CUT method are satisfied.[99]

Description of Proposal

The proposal clarifies that the definition of intangible property for purposes of sections 367(d) and 482 includes workforce in place, goodwill and going concern value. The proposal also clarifies that in a transfer of multiple intangible properties, such properties may be valued on

[94] Temp. Treas. Reg. sec. 1.482-7T(g)(3).

[95] Temp. Treas. Reg. sec. 1.482-7T(g)(4). The projected income from the best realistic alternative is determined using either a CUT method that projects the royalties the contributing participant would have demanded if it had developed the future intangible on its own and licensed that future version, or a comparable profits method. On September 27, 2007, the IRS issued a Coordinated Issue Paper which stated that the income method is generally the best method for valuing initial buy-in payments. *Coordinated Issue Paper Addresses Cost Sharing Arrangement Buy-In Adjustments*, Section III.B., LMSB-0400907-62 (September 27, 2007), available at http://www.irs.gov/businesses/article/0,,id=174320,00.html (hereafter, *2007 IRS Coordinated Issue Paper*).

[96] Temp. Treas. Reg. sec. 1.482-7T(g)(5). The acquisition price of the intangible is derived from the price paid for the stock or assets of a target that owned the intangible.

[97] Temp. Treas. Reg. sec. 1.482-7T(g)(6).

[98] Temp. Treas. Reg. sec. 1.482-7T(g)(7). Under the residual profit split method, the residual divisional operating profit or loss of each participant (after allocations of market returns to routine contributions, operating cost contributions and intangible development cost contributions) is allocated based on the relative value of its nonroutine contribution, determined by reference to external benchmarks or the capitalized cost of development.

[99] Temp. Treas. Reg. sec. 1.482-7T(i)(6)(vi)(A).

an aggregate basis where doing so achieves a more reliable result. The proposal also clarifies that intangible property must be valued at its highest and best use, as such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

Effective date.−The proposal is effective for taxable years beginning after December 31, 2010.

Analysis

The proposal does not modify the basic approach of the existing transfer pricing rules with regard to income from intangible property. Instead, its scope is limited to clarification of certain definitional and methodological issues that have arisen in IRS examinations of the value attributed to intangible property at the time it is transferred offshore. These issues are discussed further below, followed by a more general discussion of other potential changes to address more fundamental issues with the existing transfer pricing rules.

Clarification of the definition of intangible property

In recent years, two areas in particular have been the focus of increased transfer pricing audits and proposed adjustments with respect to transfers of intangible property. The first is the adequacy of the buy-in payment for existing intangible property made available to controlled affiliates pursuant to cost sharing arrangements; these cases are typically evaluated by the IRS under section 482.[100] The second is the adequacy of compensation paid by a CFC for intangible property transferred in connection with the recent wave of outbound restructurings of U.S. manufacturing operations that preceded the expiration of the section 936 possessions credit rules; these cases are typically evaluated by the IRS under sections 367(d) and 482.[101]

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[100] Cost sharing buy-in payments were designated as a Tier I compliance issue on April 5, 2007. See "Industry Director Directive #1 on Transfer of Intangibles Offshore/ §482 Cost Sharing Buy-in Payment," LMSB Control No: LMSB-04-0307-027, available at http://www.irs.gov/businesses/article/0,,id=169313,00.html. The IRS initiated the tiering of compliance issues in 2007 with the issuance of new Rules of Engagement for examiners to follow when investigating tax disputes involving large corporations. These Rules are intended, in part, to "promote consistent tax treatment between similarly situated taxpayers or cases." Part 4. Examining Process, Chapter 51. LMSB Examinations, Section 1. Rules of Engagement (April 1, 2007) (the "Rules") reprinted at "IRS Unveils Rules of Engagement for Industry Issue Focus Approach to Compliance," *Tax Notes Today,* 84-02, (April 30, 2007). The Rules prioritize specific compliance issues on a tiered basis according to prevalence across industry lines and the level of compliance risk presented. Tier I includes issues of high strategic importance that have a significant impact on one or more industries.

[101] Section 936 exit strategies were designated as a Tier I compliance issue on February 2, 2007. See "Industry Director Directive on Section 936 Exit Strategies," LMSB Control No.: LMSB-04-0107-002, available at http://www.irs.gov/businesses/corporations/article/0,,id=167555,00.html; see also Notice 2005-21, 2005-1 C.B. 727. In a typical post-section 936 conversion, the U.S. taxpayer contributed mature Puerto Rican business operations to a CFC in exchange for shares in the CFC, or reincorporated a Puerto Rican subsidiary as a CFC in a non-taxable reorganization under section 368(a)(1)(F). These operations often consisted of property, plant and equipment, workforce in place and other assets physically located in Puerto Rico but owned by a U.S. section 936 company. The 936 company either owned, or had the right to use, intellectual property comprising both foreign and domestic rights, and often exploited both U.S. and rest of world markets. As the benefit of the section 936 possessions credit

IRS audits of these transactions frequently involve disputes regarding whether goodwill, going concern value and workforce in place are intangible property for which compensation must be provided. Both sections 367(d) and 482 reference the definition of intangible property provided in section 936(h)(3)(B), but those items (among others) are not expressly included in that definition. Taxpayers, therefore, have taken the position that transfers of such property are not compensable.[102]

The IRS view, however, is that any workforce in place, goodwill and going concern value that may exist (the existence of these items is itself often disputed by the IRS) are intangible property under section 936(h)(3)(B), because they constitute "similar items" under section 936(h)(3)(B)(vi). In particular, the IRS position is that goodwill, going concern value and workforce in place must be "similar items" because they are like the listed items;[103] moreover, Congress arguably envisioned goodwill and going concern value as "similar items" because the legislative history of section 367(d) contemplates an exclusion of foreign goodwill or going

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came to an end, these operations were transferred offshore in order to replace the section 936 tax credit with deferral benefits. For a discussion of the conversion of section 936 companies to CFCs, legislative proposals related to the expiration of section 936, and broader tax matters related to the U.S. possessions, see Joint Committee on Taxation, *An Overview of the Special Tax Rules Related to Puerto Rico and an Analysis of the Tax and Economic Policy Implications of Recent Legislative Options* (JCX-24-06), June 23, 2006.

[102] See e.g., Memorandum in Support of Petitioner's Motion for Partial Summary Judgment, *Veritas vs. Commissioner*, No. 12075-06 (T.C. filed June 26, 2006) (hereafter Veritas *Memorandum in Support of Petitioner's Motion for Partial Summary Judgment*) ("Because the statutory and regulatory definitions do not encompass goodwill and going concern value, such intangibles also are not compensable under section 482." *Ibid*., p. 62); David Bowen, "Full-Value Methods: Has the IRS Finally Hurled the Holy Hand Grenade? A Critical Analysis of the Scope of §§482, 367(d), and 936(h)(3)(B) in Relation to Goodwill, Going Concern Value, and Workforce in Place," *Tax Management Int'l Journal,* 37, (January 11, 2008), p. 3 (hereafter " Bowen, Full-Value Methods: Has the IRS Finally Hurled the Holy Hand Grenade?) ("These matters combine to suggest that the IRS's current positions and thinking regarding goodwill, [going concern value], and workforce in place are questionable at best, and more likely, are simply wrong."); and Molly Moses and Rita McWilliams, "Obama Budget's Revenue Raisers Include Marked Change in Treatment of Intangibles," *BNA Daily Tax Report* (May 18, 2009) (hereafter, Moses and McWilliams, Obama Budget's Revenue Raisers Include Marked Change in Treatment of Intangibles) (summarizing comments made by Tom Zollo of KPMG LLP that "the legislative history of Section 367(d) clearly indicates that goodwill and going concern value are not intangibles meant to be taxed on the outbound transfer of a U.S. trade or business.").

[103] See Treas. Reg. sec. 1.482-4(b)(6), which states that "an item is considered similar to those listed … if it derives its value not from its physical attributes but from its intellectual content or other intangible properties." See also, Bowen, Full-Value Methods: Has the IRS Finally Hurled the Holy Hand Grenade?, p. 24; and Joseph L. Andrus and Irving H. Plotkin, "PKN Alert United States - President Obama's proposal to limit shifting of income through intangible property" (May 22, 2009), available at http://www.publications.pwc.com/DisplayFile.aspx?Attachmentid=2102&Mailinstanceid=11212 (hereafter, *PKN Alert* - President Obama's proposal to limit shifting of income through intangible property) ("The IRS has responded by arguing, particularly in the context of cost sharing buy-in payments and conversion of former section 936 possessions corporation subsidiaries to CFC status that the foreign goodwill and going concern exception is very narrow, and that most intangible assets fall within the scope of the laundry list definition, at least as 'any similar items.' TAM 200907024 provides the most elaborate description of the IRS position under section 367(d)…Numerous additional matters raising the same issue - the definition of intangible property and the treatment of goodwill - are currently under active audit.").

concern value that would otherwise have been unnecessary.[104] Alternatively, for transactions to which section 482 applies, even if these items were not treated as intangibles within the meaning of section 936(h)(3)(B), the IRS could be expected to argue that their transfer must nonetheless be fully compensated under the general rules of section 482 (which is not limited to compensation of intangible property). In addition, where intangible property is made available in conjunction with the provision of services, the IRS argues that it must be fully compensated under section 482, even though there is no separate transfer.[105] The distance between the two positions is great – whereas the IRS sees the issue as a question of determining the arm's length pricing of such transactions, taxpayers deny that any price is required in the first place.[106]

With regard to goodwill and going concern value, audit disputes concern both the threshold treatment of these items as intangibles and, to the extent that such treatment is required, the scope of the exception under section 367(d) for foreign goodwill or going concern value. Particular questions in this regard include how to distinguish foreign goodwill or going concern value from U.S. goodwill and going concern value, where both are transferred,[107] and whether foreign goodwill or going concern value is an attribute of foreign operations that develops over time. The IRS asserts that foreign goodwill or going concern value has no present value at the start-up of foreign operations.[108]

Another area of contention is whether the exceptions from compensation under section 367(d) must be imputed to transfers of intangibles under section 482. Taxpayers have made this assertion (even though neither the section 482 statute, legislative history nor the regulations

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104 The legislative history of section 367(d), however, does not clearly articulate Congressional intent in this regard. See e.g., David R. Hardy, "Assignment of Corporate Opportunities − The Migration of Intangibles," *Tax Notes,* 100 (July 28, 2003), p. 535 (hereafter Hardy, Assignment of Corporate Opportunities − The Migration of Intangibles).

105 The IRS position is that economically equivalent contributions with embedded intangible property (i.e., non-routine services) must also be compensated under the first sentence of section 482. See Preamble to Prop. Treas. Reg. sec. 1.482-9, *Explanation of Provisions*, sec. A.1. Prop. Treas. Reg. Preamble 9-10-2003, *Treatment of Services Under Section 482; Allocation of Income and Deductions From Intangibles,* 68 FR 53447 [REG-146893-02, REG-115037-00]; RIN 1545-BB31, 1545-AY38 ("The Treasury Department and the IRS believe that the transfer pricing rules should reach similar results in the case of economically similar transactions, regardless of the characterization or structuring of such transactions."); cf. *Hospital Corp. of America v. Comm'r*, 81 T.C. 520, pp. 596-602 (1983) (notwithstanding the Court's earlier rejection of the Government's intangible transfer argument, it awarded a 75% split to compensate the U.S. group for services provided to the CFC). From this vantage point, the second sentence concerning the transfer or license of intangible property is viewed as supplementing the first sentence of section 482, rather than operating as the exclusive basis for taxing transfers of intangible property.

106 This issue is under consideration by the Tax Court in *Veritas v. Comm'r,* No. 12075-06 (T.C. filed June 26, 2006).

107 See Moses and McWilliams, Obama Budget's Revenue Raisers Include Marked Change in Treatment of Intangibles (summarizing comments made by Tom Zollo regarding recent audit experience).

108 See e.g., "LMSB Procedures for Program Action Cases (PACs) on Tax Return Preparers," LMSB-04-0108-001 (February 13, 2008) reprinted at *Tax Notes Today,* 36-42, (February 22, 2008) ("The definition of foreign goodwill or going concern value requires a business operation conducted outside of the United States." *Ibid.*, *Background*); see also, *2007 IRS Coordinated Issue Paper*, section III.E.1.

make reference to this exception) on the basis that sections 482 and 367(d) must be read together, because the transactions to which they apply are economically similar and should receive similar tax treatment. This has led to disputes regarding whether foreign goodwill or going concern value may be transferred implicitly in a non-compensable section 367(d) transfer that occurs contemporaneously, and in tandem, with a section 482 transfer, where the taxpayer has not undertaken the legal formalities of a section 351 or 361 non-recognition transaction.[109]

With regard to workforce in place, audit disputes include both whether it is a "similar item" under section 936(h)(3)(B)(vi) and, if so, whether it is a component of goodwill or going concern value or a separately identifiable asset. Some taxpayers argue that, if it exists at all (as an intangible beyond its physical element), workforce in place is a component of goodwill and going concern value and, consequently, transfers of a foreign workforce in place is non-compensable under section 367(d).[110] In contrast, the IRS takes the position that any identifiable intangible with substantial value independent of the services of any particular individual is, by definition, not goodwill or going concern value.[111] Thus, any workforce in place (such as a research and development team that is made available − whether by transfer or through a service commitment − to a cost sharing arrangement) which has substantial value independent of the services of any individual member of that workforce also has an intangible component that is distinct from goodwill and going concern value and compensable by the person for whose benefit it is used.[112]

The only definition of workforce in place in the Code and regulations is set forth in the regulations under section 197, which define it as a separate asset that includes "the composition of a workforce (for example, the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes."[113] Prior to the promulgation of these regulations,[114] the

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[109] See e.g., *Veritas Memorandum in Support of Petitioner's Motion for Partial Summary Judgment* (intangible property made available for use by cost sharing parties pursuant to a cost sharing agreement; based on the record, it appears that none of the legal formalities necessary to execute a section 351 or 361 non-recognition transaction were completed with respect to the transfer to Veritas Ireland of goodwill and going concern value in the foreign markets).

[110] See e.g., "Audit Guidelines Related to Section 936 Conversion Issues, Attachment to Industry Directive on Section 936 Exit Strategies Audit Guidelines Related to Section 936 Conversion Issues," Step 2.d., available at http://www.irs.gov/businesses/corporations/article/0,,id=167559,00.html; see also, *2007 IRS Coordinated Issue Paper,* Section III.E., ("Taxpayers may improperly classify workforce in place as foreign goodwill and going concern value or take the position workforce in place may be transferred tax free. Workforce in place is an intangible asset for purposes of section 936(h)(3)(b) and must be analyzed: 1) under section 367(d), if transferred offshore under sections 351 or 361; or 2) under section 482 in the case of all other controlled transactions.").

[111] See sec. 936(h)(3)(B), flush language and Treas. Reg. sec. 1.482-4(b)(6); see also, *2007 IRS Coordinated Issue Paper*, Section III.E.1.

[112] See e.g., *2007 IRS Coordinated Issue Paper*, Section III.E.3; Notice of Proposed Rulemaking and Notice of Public Hearing Section 482: Methods to Determine Taxable Income in Connection With a Cost Sharing Arrangement, 2005-2 C.B. 625, 627 (hereafter 2005 Proposed Section 482 CSA Regulations).

[113] Treas. Reg. sec. 1.197-2(b)(3).

Tax Court held that workforce in place "is not separate and distinct from going concern value" because it is not a wasting asset.[115] Recently issued cost sharing regulations treat workforce in place as separately compensable if the U.S. parent's workforce in place is reasonably expected to contribute to the development of cost-shared intangibles; in this situation, the workforce in place is considered a platform contribution for which the foreign subsidiary must compensate the U.S. parent.[116]

The proposal would resolve certain of these disputes by clarifying that goodwill, going concern value and workforce in place are intangible assets within the meaning of section 936(h)(3)(B), and that workforce in place is a separately identifiable asset (and thus, by implication, ineligible for the foreign goodwill or going concern value exception under section 367(d)). While the proposal states that it is intended to clarify present law, some commentators have expressed the view that the proposal represents a significant change to present law.[117] Although that question may have relevance to the resolution of disputes under present law, it seems clear that the proposal, if enacted, would establish that the compensable proportion of the value inherent in many outbound transfers of intangibles would be larger under the proposal than the amount believed by many to be compensable under present law.

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[114] Section 197 was enacted on August 10, 1993, Pub. L. No. 103-66. Treas. Reg. sec. 1.197-2(b)(3) was issued on Jan. 20, 2008. T.D. 8865, 2000-1 C.B. 589.

[115] *Ithaca Indus. v. Comm'r*, 97 T.C. 253, pp. 271-272 (1991). However, between the issuance of the Tax Court decision in *Ithaca Indus.* and that of the Court of Appeals, the U.S. Supreme Court decided *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993). While the Court of Appeals in *Ithaca Indus.* affirmed the decision of the Tax Court, it did so because it believed that the useful life of an assembled workforce such as Ithaca's has no reasonably ascertainable life. The Court of Appeals noted that, following the decision in *Newark Morning Ledger*, "… it is no longer appropriate to classify an intangible asset based on its resemblance to the classic conception of goodwill or going-concern value, and Ithaca's deduction cannot be denied on that basis." 17 F.3d 684, 687 (4th Cir. 1994). See also *First Pennsylvania Banking & Trust Co. v. Comm'r*, 56 T.C. 677, p. 690 (1971) (workforce in place "formed a part of the going-concern value which was purchased").

[116] Temp. Treas. Reg. sec. 1.482-7T(g)(2)(vii)(B), *Example 1*, part (ii). A platform contribution is "any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the [cost sharing arrangement]) that is reasonably anticipated to contribute to developing cost shared intangibles…" Temp. Treas. Reg. sec. 1.482-7T(c)(1).

[117] See e.g., Moses and McWilliams, Obama Budget's Revenue Raisers Include Marked Change in Treatment of Intangibles. Some of these commentators have also stated that adding goodwill and going concern value to the definition of intangible property under section 936(h)(3)(B) will necessarily obsolete the exception for foreign goodwill or going concern value set forth in Temp. Treas. Reg. sec. 1.367(d)-1T(b); James P Fuller, "U.S. Tax Review," *Tax Notes Int'l,* 54, (June 1, 2009), p. 776. This conclusion is predicated, however, on the position that specifically identifying goodwill and going concern value as intangible property under section 936(h)(3)(B) will be a change in the law, rather than a clarification of present law, because only a change in the law would obsolete the (earlier-promulgated) regulation. The description of the proposal as a clarification of (and not as a change to) present law suggests that the proposal is not intended to revoke the exception. In any event, the question could easily be addressed by incorporating an explicit exception for transfers of foreign goodwill or going concern value in the implementing legislation, if Congress wishes to preserve the exception.

Valuation issues in general

A second set of audit issues arise in situations where the taxpayer agrees that a compensable intangible asset has been transferred offshore, but the IRS believes that the taxpayer has not applied the most reliable valuation techniques.[118] In certain cases, for example, a taxpayer may have an incentive to value intangible properties individually, on an asset-by-asset basis, without reflecting the enhanced value that may arise from their interrelationship. The IRS disputes this asset-by-asset valuation approach where it leads to unreliable results (as may the case when the individual assets are closely related), asserting that the individual pieces cannot be reliably valued because the relevant intangible property is the complex comprised of the related parts.

In other cases, a taxpayer may assert an amount as an arm's length result without also considering realistic alternatives to the transaction actually undertaken. By failing to consider realistic alternatives, the taxpayer may inappropriately minimize compensation by assuming that an uncontrolled taxpayer at arm's length would be willing to engage in a particular transaction, even if an available alternative would yield a greater economic return.[119]

The Treasury regulations under section 482 require that the "arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result."[120] Taxpayers must use not only the best method, but also the most reliable application of that method.[121] "Aggregation" and "highest and best use" refer to the application of valuation concepts that, when used in appropriate circumstances, improve the reliability of the applicable best method.[122]

Valuation − aggregation

The Treasury regulations under section 482 provide that multiple transactions may be considered in the aggregate if doing so provides the most reliable means of determining the arm's length consideration for the controlled transaction.[123] Consider, for example, a pharmaceutical company that makes 10 patents (each of which is a critical, unique component in

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[118] See e.g., Tech. Adv. Mem. 200907024 (Feb. 13, 2009) (hereafter TAM 200907024).

[119] See e.g., 2005 Proposed Section 482 CSA Regulations, p. 633.

[120] Treas. Reg. sec. 1.482-1(c)(1).

[121] *Ibid.*

[122] It should be noted that section 482 presently makes no reference to valuation principles, other than the commensurate with income principle, and that the arm's length standard is itself only regulatory. If these proposals are adopted, consideration should be given to whether the implementing legislation should also set forth certain broader principles in order to provide context for these more specific rules.

[123] Treas. Reg. sec. 1.482-1(f)(2)(i), in conjunction with the best method rule of Treas. Reg. sec. 1.482-1(c)(1). Even if aggregation were not expressly provided by the regulations, arguably it would still be implicit in Treas. Reg. sec. 1.482-1(c)(1), which requires taxpayers to use not only the best method, but also the application of a particular method (assuming that there is more than one possible application) that provides the most reliable result.

the manufacture of its blockbuster drug, ABC) available to a cost sharing arrangement. Those patents could be valued, for purposes of determining an appropriate buy-in payment, on either an asset-by-asset approach, or by an aggregation approach. Taxpayers often take the position that it is sufficient to value intangible property on an asset-by-asset basis; in this example, each individual patent may have only marginal value when considered in isolation. When considered in aggregate (particularly in light of the success of the ABC drug), the valuation may be materially higher than the sum of the individual patents.

The question presented in aggregate valuation cases is whether the enhanced value that, in some situations, results from the interrelation of intangible assets can be attributed properly to the underlying intangible assets. In the cost sharing context, this enhanced value will result in a greater buy-in payment. In the context of an outbound reorganization, the improper attribution of this enhanced value to foreign goodwill or going concern value will, in many cases, understate the actual value of the underlying intangible assets and result in inadequate compensation under section 367(d).[124]

The IRS addressed the issue of asset-by-asset valuation in Technical Advice Memorandum 200907024 (the "TAM").[125] In the TAM, the taxpayer had argued that identifiable intangibles (in that case, separate contracts between the taxpayer and a large number of foreign agents in numerous countries) must be valued separately (and not in the aggregate) for purposes of applying section 367(d), and that the residual value of the businesses (in this case, 97 percent of the total value) must be attributed to non-compensable foreign goodwill or going concern value. The IRS rejected this position, stating that it was "more reliable to determine the arm's length consideration for that transfer of a [network of] contracts by considering the separate contracts 'as a whole' because they are 'so interrelated.'[126] The IRS concluded that the bulk of the value was properly attributable to the network, and not to foreign goodwill or going concern value.[127]

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[124] In the context of section 367(d), taxpayers may also argue that requiring taxable compensation for the value of synergies among different intangibles is, in effect, to impose a tax on the value of the opportunity to conduct a business overseas, which, it is argued, has not previously been taxable under the principles of Section 367. See e.g., *Hospital Corp. v. Comm'r*, 81 T.C. 520, 590 (1983) (no section 367 ruling was required because the petitioner did not transfer property to its foreign affiliate when the petitioner presented the affiliate with an opportunity to enter into a contract); Hardy, Assignment of Corporate Opportunities – The Migration of Intangibles, pp. 532-539.

[125] TAM 200907024, p. 14.

[126] *Ibid.*

[127] Although this specific question has not been previously litigated, a petition recently filed with the Tax Court by First Data Corporation suggests that Western Union (which was spun off from First Data Corporation in 2006) is challenging an adjustment by the IRS on this issue. *First Data Corp. v. Comm'r*, No. 007042-09 (T.C. filed Mar. 20, 2009) ("The value attributable to the fact that agent relationships had been assembled into an ongoing business is separate and distinct from the value of the contracts themselves and represents foreign goodwill or foreign going concern value, which is not subject to section 367(d)."), p. 22.

The proposal would confirm that the additional value that results from the interrelation of intangible assets can be properly attributed to the underlying intangible assets in the aggregate, where doing so yields a more reliable result. As noted in the TAM, this approach is consistent with Tax Court decisions in cases outside of the section 482 context, where collections of multiple, related intangible assets were viewed by the Tax Court in the aggregate.[128] It is also consistent with the position taken in the recently issued cost sharing regulations.[129] Because section 367(d) valuation issues are resolved by reference to section 482 principles,[130] this clarification would have implications for section 367(d) transactions as well as for sales, licenses and transfers made in conjunction with cost sharing arrangements.

Valuation − highest and best use

This section first describes the highest and best use principle, which is a component of the fair market value standard as that standard has developed through case law, principally in connection with the valuation of land for purposes of the estate and gift tax and charitable deduction provisions. It next describes the realistic alternative principle articulated in the Treasury regulations under section 482, which bears a strong similarity to the highest and best use principle. The section concludes by comparing the two.

The proposal would clarify that, for purposes of sections 482 and 367(d), intangible property (a) must be valued at its highest and best use, (b) as it would change hands between a willing buyer and a willing seller, (c) neither being under any compulsion to buy or to sell and (d) both having reasonable knowledge of the relevant facts. This statement generally corresponds to the fair market value standard,[131] as articulated in Treasury regulations for

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[128] See TAM 200907024, pp. 14-16 (citing *Kraft Foods Co. v. Comm'r*, 21 T.C. 513 (1954) (thirty-one related patents must be valued as a group and the useful life for depreciation should be based on the average of the patents' useful lives); *Standard Conveyor Co. v. Comm'r*, 25 B.T.A. 281, p. 283 (1932) ("[I]t is evident that it is impossible to value these seven patents separately. Their value, as in the case of many groups of patents representing improvements on the prior art, appears largely to consist of their combination."); *Massey-Ferguson, Inc. v. Comm'r*, 59 T.C. 220 (1972) (taxpayer who abandoned a distribution network of contracts with separate distributorships was entitled to an abandonment loss for the entire network in the taxable year during which the last of the contracts was terminated because that was the year in which the entire intangible value was lost)).

[129] See Temp. Treas. Reg. sec. 1.482-7T(g)(2)(iv) (if multiple transactions in connection with a cost sharing arrangement involve platform, operating and other contributions of resources, capabilities or rights that are reasonably anticipated to be interrelated, then determination of the arm's length charge for platform contribution transactions and other transactions on an aggregate basis may provide the most reliable measure of an arm's length result).

[130] Temp. Treas. Reg. sec. 1.367(d)-1T(c)(1).

[131] Section 482 applies the arm's length standard. It can be understood as a variation of the fair market value concept, but notably is not expressed in terms of fair market value. Instead, a related party transaction is said to meets the arm's length standard "if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances." Treas. Reg. sec. 1.482-1(b)(1). The section 482 regulations make very limited references to fair market value, and do so in narrow contexts: see Treas. Reg. secs. 1.482-5(d)(6) (operating assets may be measured by their net book value or their fair market value); 1.482-7T(d)(3)(iii)(A)(3) and 1.482-

numerous purposes throughout the Code.[132] The first component, however, that the property be valued at its highest and best use, is not defined by regulation[133] but instead has been established through case law dealing principally with land valuations.[134] Early cases often involved condemnation proceedings by eminent domain, based on claims that the relevant government was violating the Fifth Amendment of the U.S. Constitution by not providing just

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7T(d)(3)(iii)(A)(4) (referencing the fair market value of underlying stock in the context of analyzing stock options for purposes of establishing intangible development costs); 1.482-7T(g)(7)(iii)(C)(2) (the relative values of the related participants' non-routine contributions must be determined so as to reflect the most reliable measure of an arm's length result; relative values may be measured by external market benchmarks that reflect the fair market value of such non-routine contributions).

[132] See, e.g., Treas. Reg. 20.2031-1(b) (estate tax).

[133] The only references to "highest and best use" are found in Treas. Reg. secs. 1.170A-14(f), *Example 2* ("[T]he highest and best use of Greenacre is as a subdivision of 40-acre tracts."), 1.170A-14(h)(3)(ii) (describing factors that may impact the fair market value - including the highest and best use - of property in the context of a perpetual conservation easement), 1.170A-14(h)(4), *Example 2* ("At its highest and best use…"), *Example 7* ("At its highest and best use, for home development…") and *Example 12* ("Restricted to its current use, which is its highest best use without making changes to the façade…"). Despite extensive case law, the Code, Treasury regulations and other administrative guidance make only limited direct references to the highest and best use concept. In determining the value of a decedent's gross estate, section 2032A (under certain specific conditions and subject to certain limitations) permits an executor to elect to value qualified real property that passes to a qualified heir on the basis of its qualified use in farming (or a trade or business other than farming) rather than on the basis of its highest and best use. However, this section does not define highest and best use. Treas. Reg. sec. 1.170A-14(h)(3)(ii) (valuation of perpetual conservation restrictions) provides some insight on the application of highest and best use concept in the context of determining fair market value that is consistent with existing case law, but again, the term is not defined ("If before and after valuation is used, the fair market value of the property before contribution of the conservation restriction must take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use... Additionally, if before and after valuation is used, an appraisal of the property after contribution of the restriction must take into account the effect of restrictions that will result in a reduction of the potential fair market value represented by highest and best use but will, nevertheless, permit uses of the property that will increase its fair market value above that represented by the property's current use..."). From an administrative perspective, Rev. Proc. 79-24, sec. 3.02. provides that, when valuing vacant land, the detailed analyses of comparable property sales should consider the extent to which highest and best use of the comparable property is similar to that of the property being valued. Similarly, the Internal Revenue Manual provides that examiners must consider the application of appraisal principles and techniques, including the highest and best use theory, when valuing leasehold interests with respect to the retail industry. Internal Revenue Manual 4.43.1.4.3.1 "Valuation Techniques" (January 1, 2002).

[134] See, e.g., *Olson v. United States*, 292 U.S. 246 (1934) ("Just compensation includes all elements of value that inhere in the property, but it does not exceed market value fairly determined. The sum required to be paid the owner does not depend upon the uses to which he has devoted his land but is to be arrived at upon just consideration of all the uses for which it is suitable. The highest and most profitable use for which the property is adaptable and needed or likely to be needed in the reasonably near future is to be considered, not necessarily as the measure of value, but to the full extent that the prospect of demand for such use affects the market value while the property is privately held." *Ibid*., 255, citing *Boom Co. v. Patterson*, 98 U.S. 403, 408, *Clark's Ferry Bridge Co. v. Public Service Comm'n*, 291 U.S. 227, 2 Lewis, Eminent Domain, 3d ed., § 707, 1233 and 1 Nichols, Eminent Domain, 2d ed., § 220, 671) and *Cameron Development Co. Inc. v. U.S.*, 145 F.2d 209 (5th Cir. 1944) (hereafter *Cameron Development v. U.S.*).

compensation.[135] Later cases also involve the valuation of land for federal tax purposes, such as establishing the appropriate charitable deduction,[136] the value of an estate[137] and even in the context of section 482.[138] Thus, highest and best use is typically described as "the reasonably probable and legal use of vacant land or an improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value. The four criteria the highest and best use must meet are legal permissibility, physical possibility, financial feasibility, and maximum profitability."[139]

In determining what constitutes the highest and best use, courts have identified several criteria. First, there must be a proven demand for the use (or the product that the land produces) at the relevant date.[140] Second, a highest and best use is evidenced by a market premium, such that a willing buyer would pay more for the property based on that higher and better use than it

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[135] Martin Weinstein, "To Give or Not to Give: Determining the Highest and Best Use of Real Property for Charitable Donations," *Virginia Tax Review, 12*, (Summer, 1992), pp. 102-103.

[136] See e.g., *Stanley Works v. Comm'r*, 87 T.C. 389 (hereafter *Stanley Works v. Comm'r*) (easement donated to charitable organization), *Great Northern Nekoosa Corp. v. U.S.*, 711 F.2d 473 (1st Cir. 1983) (hereafter *Great Northern Nekoosa v. U.S.*) (property donated to the State of Maine) and *Dorsey v. Comm'r*, T.C. Memo 1990-242 (façade easement donated to Historic Corporation).

[137] See e.g., *Estate of Lehmann v. Comm'r*, T.C. Memo 1997-392 (hereafter *Estate of Lehmann v. Comm'r*).

[138] See e.g., *Procacci v. Comm'r*, 94 T.C. 397 (IRS appraisal expert was unable to indicate what the highest and best use of the property in the context of a related party lease). With respect to valuations of property other than land, the highest and best use principle has been applied to sales of corporate subsidiaries, taking into account synergistic buyers, which "would not only achieve cost savings but would also increase sales." *BTR Dunlop Holdings, Inc. v. Comm'r*, T.C. Memo 1999-377, *40 (hereafter *BTR Dunlop v. Comm'r*). In *BTR Dunlop,* the lead argument was under section 311(b) (which requires a fair market value analysis for purposes of determining gain to a distributing corporation on distributions of appreciated property; sec. 311(b)(1)(B)). While section 482 was an alternate argument, it was not addressed by the court (other than its statement that the appropriate standard for section 482 allocations by the IRS "with respect to fair market value is arm's length dealing between taxpayers unrelated by ownership or control." *BTR Dunlop v. Comm'r*, *14-15).

[139] This definition is found in the Glossary to the "IRS Valuation Training for Appeals Officers," Coursebook, which is an unofficial training guide (Rev. May, 1997) (referencing the <u>Dictionary of Real Estate Appraisers</u>) available at http://www.fvginternational.com/documents/tax/misc_tax/IRS_Training_Manual_Appeals_Officers.pdf (hereafter *IRS Valuation Training for Appeals Officers*); see also, <u>The Appraisal of Real Estate</u>, 13th edition (Appraisal Institute, Chicago, IL), 2008, (highest and best use is "the reasonably probable and legal use of vacant land or improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value.") and International Valuation Standards, 3.4, available at http://www.romacor.ro/legislative/07-ivs1.pdf (highest and best use is the "most probable use of an asset which is physically possible, appropriately justified, legally permissible, financially feasible, and which results in the highest value of the asset valued.").

[140] *Cameron Development v. U.S.* ("The proof offered by appellant, measured by these settled standards, did not establish that the property was available for use as a source of supply of shell marl [for use in road construction]. No evidence was offered to prove that any market existed, or was reasonably likely to exist in the near future, at which this shell could be profitably sold. No showing was made that any purchaser was willing to pay any more for the land, because of its shell deposits, than its market value as pasture land." *Ibid*., p. 210).

would pay for the property in its current use.[141] Third, such premiums cannot be speculative, such that the taxpayer must be able to demonstrate that a willing buyer would pay an amount in excess of the value of the property's current use.[142] Fourth, value unique to the owner is not compensable.[143] Fifth, the claimed highest and best use must be legally possible (taking into account restrictions established in a deed,[144] by statute — such as historic preservation laws — or through zoning regulations)[145] and economically feasible[146] at the relevant date.

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[141] See e.g., *U.S. v. 320.0 Acres of Land*, 605 F.2d 762 (5th Cir. 1979) (hereafter U.S. v. *320.0 Acres*) ("Thus, 'just compensation' is not limited to the value of the property as presently used, but includes any additional market value it may command because of the prospects for developing it to the 'highest and best use' for which it is suitable." *Ibid.*, p. 781).

[142] See e.g., *Stanley Works v. Comm'r* (where evidence was provided that utility companies would pay a premium for property that was instead donated to a conservation group, the court was "satisfied that, at the time the easement was conveyed to the HVA, there was a reasonable probability the Stanley Works property would be developed as a pumped storage plant in the reasonably near future." *Stanley Works v. Comm'r*, p. 408) and *Great Northern Nekoosa v. U.S.* (court discounted taxpayer's claim that property had value as a hydroelectric plant where the federal government had already designated it as a possible part of a well-defined national wildlife and scenic river system, such that, if the parcel did become part of the system, it could not be used for a hydroelectric power plant. *Great Northern Nekoosa v. U.S.*, p. 475).

[143] See e.g., *U.S. v. 320.0 Acres*, p. 782 ((at trial, landowners had been precluded from introducing evidence that the subject properties were suitable for cabin sites or other construction purposes) citing *Kimball Laundry Co. v. U.S.*, 338 U.S. 1 (1943) (in *Kimball Laundry*, the United States brought a condemnation proceeding against a laundry company to enable it to take over the laundry's plant for Army personnel during World War II. "[In] view… of the liability of all property to condemnation for the common good, loss to the owner of nontransferable values deriving from his unique need for property or idiosyncratic attachment to it … is properly treated as part of the burden of common citizenship." *Ibid.*, p. 5)) and *U.S. v. Miller*, 317 U.S. 369 (1943) (with respect to the condemnation of a strip across the landowner's property, "…strict adherence to the criterion of market value may involve inclusion of elements which, though they affect such value, must in fairness be eliminated in a condemnation case, as where the formula is attempted to be applied as between an owner who may not want to part with his land because of its special adaptability to his own use, and a taker who needs the land because of its peculiar fitness for the taker's purposes. These elements must be disregarded by the fact finding body in arriving at 'fair' market value.").

[144] See e.g., *Estate of Lehmann v. Comm'r* (property subject to a 99-year ground lease to a hotelier could not be valued for estate tax purposes based on what would otherwise have been its highest and best use, which was as an office building).

[145] See e.g., *Great Northern Nekoosa v. U.S.* (hydroelectric plant was not the highest and best use where the property already designated for possible inclusion in national wildlife and scenic river system), *Stanley Works v. Comm'r* ("Legal restrictions on the use of property are relevant in determining whether an alleged use of property is reasonably probable." *Stanley Works v. Comm'r*, p. 402 (citing *Great Northern Nekoosa v. U.S.*); environmental opposition to the construction of a hydroelectric plant on the property likely would not have been so great as to preclude its licensing or construction. *Great Northern Nekoosa v. U.S.*, p. 408) and *Dresser v. Comm'r*, T.C. Memo 1956-54 (failed attempts to rezone property from residential to a general business district prior to donation precluded the determination that commercial was the highest and best use for purposes of establishing the value of the donation); but see *Stanton v. Comm'r*, T.C. Memo 1980-300 (current agricultural zoning did not preclude determination that commercial development was the highest and best use).

[146] See e.g., *Losch v. Comm'r*, T.C. Memo 1988-230 (possible addition to building subject to the donation of a preservation easement disregarded, in part due to lack of evidence supporting its economic feasibility) and *Van*

With respect to transfers of intangible property, however, the application of highest and best use has not been well developed judicially. One exception is *Provitola v. Comm'r*,[147] in which the Tax Court considered the value of a software program its developer had donated to his alma mater for purposes of determining the developer's charitable deduction. The Commissioner's valuation expert considered three potential methods of valuing the software (replacement cost, market or comparable sales, and capitalization or income). The Commissioner's expert concluded that the highest and best use of the software was to generate a stream of net income, and that the best indicator of its value was the expected size of the income stream. The court agreed with this expert, and held that the taxpayer's donation had no value (because there was no anticpated income stream).[148]

At least one treatise on intellectual property has stated that "reasonable potential uses of property must be considered in any valuation,"[149] but the Internal Revenue Manual does not appear to incorporate by direct reference the highest and best use principle with respect to intangible property.[150] There is little practical guidance, therefore, on the application of the highest and best use principle with respect to intangible property.

Perhaps as a consequence, some commentators have suggested that the proposal may be intended to codify the realistic alternative principle, a similar concept set forth in the regulations under section 482 that is expressly applicable with respect to (among other things) intangible property.[151] The realistic alternative principle is reflected in Temp. Treas. Reg. sec. 1.482-

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Zelst v. Comm'r, T.C. Memo 1995-396 (although minerals may have been present, mining of property not economically feasible on the donation date).

[147] T.C. Memo 1990-523 (U.S. Tax Ct., 1990).

[148] In the context of charitable contributions, development of future case law should be limited (if not non-existent) due to the enactment of section 170(m) in AJCA. Pursuant to section 170(m), charitable deductions for contributions of intellectual property are limited to the lesser of adjusted tax basis in the property, or the fair market value of the property, plus additional amounts of qualified donee income.

[149] Gordon Smith and Russell Parr, "Intellectual Property: Valuation, Exploitation and Infringement Damages," *Valuation Principles*, (2005), Chapter 7.1, p. 145.

[150] See "Intangible Property Valuation Guidelines," *Internal Revenue Manual,* 4.48.5, (July 1, 2006). See also *IRS Valuation Training for Appeals Officers,* Lesson 13, "Valuing Intangible Assets." The lesson on intangibles in this unofficial training book makes no reference to highest and best use. References to highest and best use are limited to the definition set forth in the glossary, references in Rev. Rul. 85-99, attached thereto as Exhibit 16.2 (regarding valuations where there is a donor-imposed restriction on use for property contributed to charity), and as a basis for making adjustments to valuation based on the income approach (one of the basic valuation methods described in the training book) if the subject property is not being used at its highest and best use.

[151] See *PKN Alert* - "President Obama's proposal to limit shifting of income through intangible property" ("While rather vague, this change would seem to be directed at requiring, as do the cost sharing regulations, that taxpayers take into account their 'reasonably available' business opportunities in valuing intellectual property.") and Molly Moses, "Practitioners Debate Impact of Obama Transfer Pricing Proposals," *Transfer Pricing Report*, 18, (May 28, 2009), p. 49 (summarizing comments by John Peterson of Baker & McKenzie that "…the 'highest and best use' concept seemed to be 'aiming in the direction' of the realistic alternative and income method approaches in the cost sharing regulations…").

1T(f)(2)(ii), which provides that the Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance, but that the Commissioner may also consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. Treas. Reg. sec. 1.482-4(d)(1) further provides that, as with specified methods, unspecified methods should reflect a consideration of the realistic alternatives to the actual transaction in connection with a transfer of intangibles. Similar rules apply with respect to unspecified methods for transfers of tangible property,[152] cost sharing arrangements[153] and intercompany services.[154] Although the examples in the regulations emphasize the analysis of available, but not undertaken, internal transactions entirely within the controlled party group,[155] the realistic alternative principle is not limited to such transactions. [156]

Each of these regulations is predicated on the principle that a taxpayer will only enter into a particular transaction if none of its realistic alternatives is economically preferable to the transaction under consideration. As a result, they provide the IRS with the ability to determine an arm's length price by reference to a transaction (such as the owner of an intangible using it to make a product itself) that is different from the transaction that was actually completed (such as the owner of that same intangible licensing the manufacturing rights and then buying the product from the licensee). Simply stated, the realistic alternatives principle assumes that taxpayers act in an economically rational manner and uses this assumption as the basis for identifying transfer pricing that does not reflect an arm's length result.[157] For example, if a taxpayer claims income

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[152] Treas. Reg. sec. 1.482-3(e)(1).

[153] Temp. Treas. Reg. sec. 1.482-7T(g)(2)(iii).

[154] Treas. Reg. sec. 1.482-9 (h). See also Treas. Reg. sec. 1.482-1(d)(3)(iv)(H) and 1.482-3(b)(2)(ii)(B)(8).

[155] See Treas. Reg. secs. 1.482-1(f)(2)(iii)(B) *Example,* 1.482-4(d)(2)(ii) *Example* and 1.482-3(e)(2) *Example;* and Temp. Treas. Reg. secs. 1.482-7(g)(2)(iv)(B) *Examples*.

[156] See Treas. Reg. sec. 1.482-9(h) *Example* (Where the Commissioner determines that an intragroup service transaction involving password-controlled internet access to software is comparable to a similar arm's length transaction involving the sale of, and uncontrolled access to, software through a download or the transfer of a diskette, the similar arm's length transaction may be considered for purposes of determining whether the intragroup transaction achieves an arm's length result).

[157] For purposes of achieving an arm's length result under section 482, it is not necessary to prove that a transaction would or could ever occur between unrelated persons. See Treas. Reg. secs. 1.482-1(b)(1) ("A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the result that *would* have been realized *if* uncontrolled taxpayers had engaged in the same transactions under the same circumstances (arm's length result)") (emphasis added), 1.482-1(d)(3(ii)(B)(1) ("In evaluating the economic substance, greatest weight will be given to actual conduct of the party… ") and 1.482-1T(f)(2)(ii)(A) ("The Commissioner will evaluate the result of a transaction as actually structured by the taxpayer unless its structure lack economic substance."); see also Organisation for Economic Cooperation and Development, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," I-4, ¶ 1.10, (2001) (hereafter, OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations) ("A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake.") and Organisation for Economic Cooperation and Development, "Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment 19 September 2008 To 19 February 2009," ¶208,

of only $100x under one pricing method, but the Service can demonstrate that a realistic alternative available to the taxpayer would have generated $1,000x, the only possible conclusion to be drawn is that the $100x is not an arm's length price. The taxpayer, dealing at arm's length, would not settle for less than $1,000x. Otherwise, the taxpayer would be an irrational economic actor − a possibility that is rejected under basic economic and valuation theory.

In making its determination, the Commissioner evaluates any available internal comparables (actual transactions between the taxpayer and third parties) and external comparables (actual transactions between uncontrolled parties), as well as the return to the property owner that could have been realized if the property owner had taken an alternative, but realistic, course of action in deploying the asset internally. If, when considering these data points it is determined that the transfer price of a non-existent internal transaction differs materially from the transfer price of the actual controlled party transaction, the Commissioner may conclude that the taxpayer's transfer pricing of the actual transaction does not reflect an arm's length result.

"Realistic alternative" was first adopted as an expressly articulated principle in 1994, following IRS defeats in *Bausch & Lomb v. Comm'r,*[158] *Eli Lilly v. Comm'r,*[159] and *G.D. Searle & Co. v. Comm'r*.[160] Similar to positions taken in *Eli Lilly*[161] and *G.D. Searle*,[162] in *Bausch & Lomb* the IRS disputed the comparability of the uncontrolled transactions proffered by the taxpayer, and argued that the Irish licensee of the "spin cast" method of manufacturing soft contact lenses was only entitled to a contract manufacturer return because its U.S. parent, the licensor, would not have been willing to pay an independent third party much more than the cost of producing the contact lenses itself. This so-called "make or buy" argument[163] was rejected by

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available at http://www.oecd.org/dataoecd/59/40/41346644.pdf (hereafter, OECD, Business Restructurings: Discussion Draft for Public Comment") ("…the mere fact that a related party arrangement is not seen between independent parties does not in itself mean that it is not arm's length" (citing paragraph 1.10, OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations)).

[158] 933 F.2d 1084 (2d. Cir. 1991).

[159] 856 F.2d 855 (7th Cir. 1988) (hereafter *Eli Lilly v. Comm'r*).

[160] 88 T.C. 252 (1987) (hereafter *G.D. Searle v. Comm'r*).

[161] "The Commissioner, by insisting that an arm's length transferee would have been confined to the role of a contract manufacturer, implies that Lilly P.R.'s only legitimate role was the role of a firm with which Lilly might have contracted for the production of Darvon in the absence of sections 351 and 931. *Eli Lilly v. Comm'r*, pp. 863-864.

[162] "In essence, respondent's allocations of more than 92 percent of SCO's gross income from operations for the 1974 and 1975 taxable years ignore the transfer of the intangibles to SCO and allocates all SCO's net income derived from such intangibles to petitioner, with the exception of a token amount intended to compensate SCO solely for its function as a 'contract manufacturer.' " *G.D. Searle v. Comm'r*, p. 341; "[R]espondent abused his considerable discretion under section 482 by failing to recognize the transfer of the intangibles and treating SCO as merely a contract manufacturer…" *G.D. Searle v. Comm'r*, p. 367.

[163] See George Carlson, Laurie Dicker, Christopher Giosa, Gerald Godshaw, Laura Harrington, Martin Sullivan, and John Venuti, "Déjà vu All Over Again: The New Section 482 Regulations*," Tax Notes,* (Feb. 1, 1993),

the court. However, the example provided in the Treasury regulations (issued subsequently) to illustrate the realistic alternative rule for intangible property involves similar facts —specifically, the license of a proprietary process for making a product ("Longbond") from a U.S. company to its foreign subsidiary.[164] The example demonstrates that, in determining whether consideration paid with respect to the license is arm's length, the IRS may expressly consider (subject to the best method rule) the U.S. company's alternative of producing and selling "Longbond" itself.[165]

Arguably, the realistic alternative principle in the section 482 regulations is similar to the highest and best use principle of the fair market value standard in that both require consideration of property uses that may yield a greater return than the current use. In this regard, it is relevant that highest and best use case law requires consideration of reasonably probable and legal uses of the property, so long as the alternative is physically possible, appropriately supported, and financially feasible as of the date of the appraisal. It does not require consideration of that which is only theoretically possible, such that taxpayers would be expected to extensively hypothesize and analyze speculative uses. In other words, one could conclude that the alternatives that need to be considered in a highest and best use valuation are those which are realistic with respect to the controlled parties.

On the other hand, the OECD Transfer Pricing Guidelines (the "Guidelines") appear to draw a distinction between the realistic alternative principle and the highest and best use principle, and explicitly reject the latter. For example, the OECD's general guidance for analyzing comparability under the arm's length standard incorporates the realistic alternative concept, stating that "[i]ndependent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive."[166] Similarly, in the context of business restructurings, a recent OECD has discussion draft concludes that the factors relevant to determining whether a transfer is an arm's length transaction include "the options that would have been realistically available to the transferor and transferee at arm's length, based on the rights and other assets of each at the outset of the restructuring, that determine the profit / loss potential of either."[167]

In contrast, the Guidelines expressly reject the application of the highest and best use concept in the context of intangible property, stating that "an associated enterprise is not required to pay an amount for the purpose or use of intangible property that is based on the highest or

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p. 611 and Steven Hannes, "An Evaluation of IRS's 1993 Transfer Pricing And Related Penalty Proposals: Round Three," *Tax Notes,* (Feb. 15, 1993), p. 936.

[164] Treas. Reg. sec. 1.482-4(d)(2)(ii). See also Treas. Reg. sec. 1.482-1(f)(2)(ii)(B), *Example* (incorporating by reference the analysis in the example set forth in Treas. Reg. sec. 1.482-4(d)(2)(ii)).

[165] See also Temp. Treas. Reg. sec. 1.482-7(g)(2)(iv)(B), *Examples*.

[166] "OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," I-12, ¶1.15.

[167] "OECD, Business Restructurings: Discussion Draft for Public Comment," ¶66.

most productive use when the property is of more limited usefulness to the associated enterprise, given its business operations and other relevant circumstances."[168] However, the Guidelines provide no explanation for the differing treatment.

One distinction between the two principles is the very existence of the highest and best use case law: as described earlier, highest and best use has extensive judicial history in the context of land valuations (even though there is no comparable history with respect to transfers of intangible property), while the realistic alternative principle of section 482 has never been expressly applied by a court or interpreted by the IRS in any type of administrative pronouncement (other than in the various regulations themselves). A well-developed body of law is often advantageous to both taxpayers and tax administrators, because it can provide relative certainty as to outcome in a variety of factual circumstances. In this case, however, the fact that the highest and best use case law developed in contexts so different from a controlled-party transfer of intangible property − principally real property cases involving issues of eminent domain or the value of a charitable contribution − could complicate, rather than simplify, tax administration efforts in some circumstances.

For example, some taxpayers may argue that, under highest and best use case law (citing to *Kimball Laundry Co. v. U.S.*[169] and *U.S. v. 320.0 Acres of Land*[170]), value unique to the owner is not compensable. In the case of intangibles owned by a multinational group, this value may reflect the synergies uniquely available to an integrated enterprise which may not be observable in the external market and which have not historically been relevant in land use cases. Indeed, the principal concern of Congress in 1986 was the inability of available market "comparables" to reflect the true value of an intragroup transfer.[171] Thus, legislation should ensure that the IRS

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[168] "OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," VI-11, ¶6.15.

[169] 338 U.S. 1 (1943).

[170] 605 F.2d 762 (5th Cir. 1979).

[171] In conjunction with the enactment of the commensurate with income principle, the House Committee on Ways and Means Report identified, as a "fundamental problem," the fact that the relationship between related parties is different from that of unrelated parties." H.R. Rep. No. 99-426, p. 423. H.R. Rep. No. 99-426 refers to observations by some that multinational companies operate as an economic unit, and not as if they were unrelated to their foreign subsidiaries. Id. It also notes that a parent corporation that transfers potentially valuable property to its subsidiary is not faced with the same risks as if it were dealing with an unrelated party. More specifically, the H.R. Rep. No. 99-426 states "[i]ts equity interest assures it of the ability ultimately to obtain the benefit of future anticipated or unanticipated profits, without regard to the price it sets. The relationship similarly would enable the parent to adjust its arrangement each year, if it wished to do so, to take account of major variations in the revenue produced by a transferred item." *Ibid*. H.R. Rep. No. 99-426 goes on to state that, because transfers to related parties do not involve the same risks as transfers to unrelated parties, there is a powerful incentive to establish a relatively low royalty without adequate provisions for adjustment as the revenues of the intangible vary. *Ibid*., p. 425. H.R. Rep. No. 99-426 identifies as a recurrent problem the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables. *Ibid*., pp. 423-424. The Ways and Means Committee concluded that, because of the "extreme difficulties" in determining whether arm's length transfers between unrelated parties are comparable, it was appropriate to require payments made on a transfer of an intangible to a foreign affiliate to be commensurate with the income attributable to the intangible. *Ibid*., 425. H.R. Rep. No. 99- 426 states that the commensurate with

continues to have the ability not only to consider those transactions available to the controlled parties (even if such transactions are not undertaken between uncontrolled parties), but not undertaken, but also the ability to take into account the unique capabilities that the controlled parties contribute to the transaction. This would ensure that the highest and best use principle is not unduly restrictive based on the application of existing case law.

Other possible approaches

The proposal would address several definitional and methodological issues, thereby improving the administration of the existing transfer pricing rules. As described earlier, however, a number of commentators have concluded that misuse of the transfer pricing rules, in particular with respect to intangible property, substantially erodes the U.S. income tax base. It is possible that other proposals included in the Administration's budget — in particular those relating to the deferral of expense deductions, foreign tax credit blending, and the treatment of single member foreign entities — will sufficiently reduce the benefits of deferral that incentives for inappropriate income shifting will decline. However, as discussed further in the analysis of those proposals, they would have uneven effects.

This raises the question of whether the Administration's proposal would sufficiently address misuse of the transfer pricing rules, or whether broader reform of the existing transfer pricing rules is necessary.[172] For example, it may be appropriate to examine the extent to which the existing transfer pricing regulations appropriately implement the commensurate with income principle and to refine or clarify that principle as necessary. The 1986 legislative history suggests several areas for review.

The first is taxpayer use of the CUT method with respect to transfers of unique, high-value intangibles in the absence of adequately comparable uncontrolled transactions. Treasury

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income requirement is intended to make it clear that industry norms or other unrelated party transactions do not provide safe harbor minimum prices. Id. It states that the compensation for the intangibles should be greater than industry averages or norms when taxpayers transfer intangibles with a high profit potential. *Ibid*.

[172] In this regard, some commentators have suggested replacement of the arm's length standard with "formulary apportionment," i.e., the apportionment of taxable income among jurisdictions based on a formula that takes into account one or more factors, such as capital, payroll and sales, located in each jurisdiction. Supporters of formulary apportionment argue that it would better reflect the globally integrated nature of international business, and that the reliance on the distinction between legal entities under the arm's length standard is artificial. See e.g., Avi-Yonah and Clausing, A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation, p. 4; Michael C. Durst, "A Statutory Proposal for U.S. Transfer Pricing Reform," *Tax Notes Int'l*, (June 4, 2007), p. 1016. Other analyses suggest, however, that formulary apportionment may offer no clear advantage over separate accounting, in that formulary apportionment can produce incentives for multinational businesses to shift routine activities abroad and to change the degree to which they depend on outside suppliers. See e.g., Rosanne Altshuler and Harry Grubert, "Formula Apportionment: Is It Better than the Current System and Are There Better Alternatives?" *Oxford University Centre for Business Taxation*, Working Paper No. 901, 2009, available at http://users.ox.ac.uk/~mast1732/RePEc/pdf/WP0901.pdf. Moreover, it is frequently noted that formulary apportionment would require substantial international consensus with regard to the composition of the formula to ensure that income is not taxed in multiple countries, or in none at all.

regulations have increasingly restricted the use of this method,[173] requiring instead the use of income-based and other methods when sufficiently comparable transactions are not available. However, future legislation could consider additional measures that would further ensure that the CUT method is used only where there are appropriate comparable transactions (for example, in the case of unique intangible property, an "exact" comparable involving the same intangible), as well as endorse the present use of income-based methods (and other methods that do not rely on comparable transactions) in circumstances where comparable uncontrolled transactions are unavailable.

A second area for potential review is the circumstances in which the regulations require periodic adjustments of income from intangible property in order to take into account actual profit experience. The present Treasury regulations for intangible property and cost sharing examine actual profit experience in order to evaluate whether the taxpayer's pricing of the transaction reflected the profits that could reasonably have been anticipated at the time the transaction was entered into. If actual profit experience falls outside of a specified range from the taxpayer's profit projections at the time of the initial transaction, then the IRS may adjust the pricing of the transaction.[174] Thus, the IRS considers actual results as possible evidence of the information that should have been available to the parties and, therefore, should have initially informed the pricing of the transaction. Further, Treasury and the IRS have publicly stated that actual profit results falling outside the specified range will not automatically trigger an adjustment; rather, it will precipitate further investigation into the facts and circumstances giving rise to the variance.[175] The legislative history of the commensurate with income standard suggests, however, a more determinative role for actual profit experience when there is a significant variance between expected and actual profits.[176]

Finally, the appropriateness of respecting cost sharing arrangements among related parties could be reconsidered. Evidence suggests that cost sharing arrangements similar to those described in the regulations exist infrequently among unrelated parties.[177] Consistent with the

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[173] See, e.g., Temp. Treas. Reg. secs. 1.482-7T(g)(3) and 1.482-7T(g)(4)(A), (B) and (C).

[174] Treas. Reg. sec. 1.482-4(f)(2) (intangible property) and Temp. Treas. Reg. sec. 1.482-7T(i)(6)(v)(B) (cost sharing).

[175] See e.g., Lisa M. Nadal, "Cost-Sharing Periodic Adjustments Not Automatic, Official Says," *Tax Notes Today,* 30-2, (February 18, 2009) (citing comments from Michael McDonald, Financial Economist at Treasury and Robert Weissler, Senior Counsel, APA program, IRS Office of Associate Chief Counsel (International)).

[176] The House Committee on Ways and Means Report states, for example: "Thus, the committee intends to require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible. The bill is not intended to require annual adjustments when there are only minor variations in revenues. However, it will not be sufficient to consider only the evidence of value at the time of the transfer. Adjustments will be required when there are major variations in the annual amounts of revenue attributable to the intangible." H.R. Rep. No. 99-426, pp. 425-426.

[177] For example, the IRS noted in the preamble to the 2005 proposed cost sharing regulations that "[c]omment letters and other information available to the Treasury Department and IRS have provided limited information on third-party arrangements that are asserted to be similar to cost sharing arrangements. Typically, in the context of discussion concerning the current § 1.482-7 regulations, information has been provided on certain arrangements involving cost plus research and development or government contracts, which, while no doubt arm's

1986 legislative history, the cost sharing regulations seek to establish an arm's length price for these arrangements, even though comparable arrangements rarely occur between uncontrolled parties. Arguably, however, the existence of a regulatory framework establishing the terms under which internal cost sharing arrangements will be respected may unintentionally encourage U.S.-based multinational groups to develop intangible property offshore and to shift the economic ownership of developed intangible property to CFCs. The recently issued temporary cost sharing regulations are intended to mitigate abusive cost sharing practices, but do so within the context of the existing framework. Examining the extent to which the existing framework may unintentionally encourage the development of intangible property offshore, and reconsidering the extent to which internal cost sharing arrangements should be recognized in the absence of comparable arrangements between unrelated parties, could suggest a new, more limited framework.

Prior Action

No prior action.

length transactions, are not viewed by the Treasury Department and IRS as analogous to cost sharing arrangements." 2005 Proposed CSA Regulations, 626.

D. Proposal to Limit Earnings Stripping by Expatriated Entities

Background and Present Law

A U.S. corporation with a foreign parent may reduce the U.S. tax on the income derived from its U.S. operations through the payment of deductible amounts such as interest, rents, royalties, premiums, and management service fees to the foreign parent or other foreign affiliates that are not subject to U.S. tax on the receipt of such payments.[178] Generating excessively large U.S. tax deductions in this manner is known as "earnings stripping." Although foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of such payments if they are from sources within the United States, this tax may be reduced or eliminated under an applicable income tax treaty.

Although the term "earnings stripping" may be broadly applied to the generation of excessive deductions for interest, rents, royalties, premiums, management fees, and similar types of payments in the circumstances described above, more commonly it refers only to the generation of excessive interest deductions.[179] In general, earnings stripping provides a net tax benefit only to the extent that the foreign recipient of the interest income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the interest, i.e., the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax. That may be the case if the country of the interest recipient provides a low general corporate tax rate, a territorial system with respect to interest, or reduced taxes on financing structures.

Earnings stripping limitations

Present law limits the ability of foreign corporations to reduce the U.S. tax on the income derived from their U.S. subsidiaries' operations through earnings stripping transactions. If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for "disqualified interest" paid or accrued by a corporation in a taxable year is generally disallowed to the extent that the payor's "net interest expense" (i.e., the excess of interest paid or accrued over interest income) exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, depreciation, amortization, and depletion).[180] Disqualified interest includes interest paid or accrued to (1) related parties when no Federal income tax is imposed with respect to such interest;[181] or (2) unrelated parties in certain instances

[178] It is also possible for U.S.-controlled corporations to reduce their U.S. taxable income by making excessive deductible payments to foreign corporations that they control. In general, however, this type of tax planning is greatly limited by the anti-deferral rules of subpart F.

[179] Herein, except when noted otherwise, "earnings stripping" refers to the generation of excessive interest deductions.

[180] Sec. 163(j).

[181] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate

in which a related party guarantees the debt ("guaranteed debt"). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of excess limitation in a subsequent tax year. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

Corporate inversion transactions

The United States employs a "worldwide" tax system, under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Foreign corporations are taxed by the United States only on income that has sufficient nexus to the United States. As a consequence, the U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier "parent" corporation of the group is domestic or foreign. Tax rates vary by country, and not all countries choose a worldwide system of income taxation. Thus, depending upon its particular circumstances, a multinational group may be able to increase the after-tax returns to its investments by locating its parent corporation outside the United States.

For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of any State.[182] All other corporations are generally treated as foreign.[183] Thus, the place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of other factors that might be thought to bear on a corporation's "nationality," such as the location of the corporation's management activities, employees, business assets, operations, revenue sources, the exchanges on which the corporation's stock is traded, or the residence of the corporation's shareholders.

Until recently, some U.S. multinational groups sought to take advantage of the differential treatment of U.S. and foreign domiciled top-tier companies through transactions commonly referred to as "inversions." A U.S. parent corporation could reincorporate in a foreign jurisdiction, potentially without any exit tax to compensate the U.S. for the loss of future tax revenue from the departing company. Under prior law, these inversion transactions could produce a variety of tax benefits, including the removal of a group's foreign operations from U.S. tax jurisdiction and, as discussed further below, the potential for reduction of U.S. tax on U.S.-source income through subsequent "earnings stripping" transactions (e.g., large payments of deductible interest or royalties from a U.S. subsidiary to the new foreign parent). It was not always clear, however, whether these inversions had a significant non-tax purpose or effect, or

of tax imposed without regard to the treaty, reduced by the rate of tax under the treaty, bears to the rate of tax imposed without regard to the treaty. Sec. 163(j)(5)(B).

[182] Sec. 7701(a)(4).

[183] Sec. 7701(a)(5).

whether the corporate group had a significant business presence in the new country of incorporation.

AJCA included provisions designed to curtail inversion transactions.[184] Most significantly, AJCA added new section 7874 to the Code. That section defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. In an inversion transaction, a U.S. parent company is replaced with a foreign parent. The first type of inversion is a transaction in which (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003;[185] (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50-percent ownership, does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. Section 7874 denies the intended tax benefits of this type of inversion ("80-percent inversion") by deeming the top-tier foreign corporation to be a domestic corporation for all tax purposes, notwithstanding any other provision of the Code or a tax treaty.

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if a 60-percent ownership threshold is met, then a second set of rules applies to the inversion ("60-percent inversion"). Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level "toll charges" for establishing the inverted structure are not generally offset by tax attributes such as net operating losses. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, generally without offset by any tax attributes (e.g., net operating losses). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.[186]

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[184] Pub. L. No. 108-357, sec. 801(a) (2004).

[185] A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

[186] Under section 7874, inversion transactions include certain partnership transactions. Specifically, the provision applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership if, after the acquisition, at least 60 percent (or 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met.

In both types of inversions, the domestic corporation (or partnership) that becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity after March 4, 2003, or any U.S. person related to such a domestic corporation (or partnership), is referred to as an "expatriated entity."[187]

AJCA did not, however, address the choice of residency available to *new* enterprises. As a result, even post-AJCA law contains tax incentives for a new firm to opt out of U.S. residence for its top-tier entity. This decision creates a distortion in that, by incorporating outside the United States, the new enterprise reduces the U.S. tax base. In addition, the diminution of the U.S. tax base may result in higher taxes elsewhere in the economy, thereby increasing the economic distortions inherent in those other taxes.[188]

Description of Proposal

The proposal tightens the earnings stripping deduction limitations as applied to expatriated entities. Under the proposal, expatriated entities may not utilize the 1.5-to-1 debt-to-equity ratio safe harbor. In addition, the 50-percent of adjusted taxable income threshold for the limitation is reduced to 25 percent with respect to disqualified interest other than interest paid to unrelated parties on guaranteed debt. The 50-percent of adjusted taxable income threshold generally continues to apply to interest on guaranteed debt. The carryforward for disallowed interest is limited to 10 years and the carryforward of excess limitation is eliminated.

An expatriated entity is defined by applying the rules of section 7874 and the regulations thereunder as if section 7874 were applicable for taxable years beginning after July 10, 1989.[189] This special rule does not apply, however, in the case of an 80-percent inversion in which the top-tier foreign corporation is treated as a domestic corporation for all tax purposes under section 7874.

Effective date.–The proposal is effective for interest paid or accrued in taxable years beginning after December 31, 2010.

Analysis

The number of corporation inversion transactions prior to the enactment of section 7874 led some, including the Department of the Treasury, to question the efficacy of the present-law

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[187] Sec. 7874(a)(2).

[188] As a backstop to the erosion of the U.S. worldwide tax base that could occur as a result of such "inverted start ups" and other inversion transactions, the Joint Committee on Taxation staff has recommended altering residency tests within the policy of worldwide taxation. See Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*.

[189] This rule aligns the applicability of the inversion rules with the effective date of the original earnings stripping provision. The earnings stripping rules (section 163(j)) are generally applicable to instruments issued after July 10, 1989, with a grandfather rule for acquisitions made (or subject to a binding contract) on or before July 10, 1989.

earnings stripping rules.[190] In the case of some prominent, pre-AJCA corporate inversions, it appeared that the earnings stripping benefit achieved when a U.S. subsidiary paid deductible amounts to its new foreign parent or other foreign affiliates constituted the primary intended tax benefit of the inversion transaction, which should not have been the case if the earnings stripping rules had been functioning properly.[191] Thus, AJCA required the Secretary of the Treasury to submit a report to the Congress by June 30, 2005, examining the effectiveness of the earnings stripping provisions of present law, including specific recommendations as to how to improve the provisions of the Code applicable to earnings stripping.[192] The report, which was submitted to Congress on November 28, 2007,[193] is discussed in more detail below.[194]

In summary, however, the Treasury Report concludes that "[t]here is strong evidence that [inverted corporations] are stripping a significant amount of earnings out of their U.S. operations and, consequently, it would appear that section 163(j) is ineffective in preventing them from engaging in earnings stripping."[195] In reaching this conclusion, the report largely relies on an outside study of 12 inverted corporations[196] and a supplemental Treasury Department analysis of

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[190] See, e.g., U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals*, p. 104 (2003) ("Under current law, opportunities are available to reduce inappropriately the U.S. tax on income earned from U.S. operations through the use of foreign related-party debt. Tightening the rules of section 163(j) is necessary to eliminate these inappropriate income-reduction opportunities."); Office of Tax Policy, Department of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications*, Part VII.A (2002) (hereafter, U.S. Department of the Treasury, *Corporate Inversion Transactions*) ("The prevalent use of foreign related-party debt in inversion transactions is evidence that [the rules of section 163(j)] should be revisited.").

[191] See, e.g., U.S. Department of the Treasury, *Corporation Inversion Transactions*, Part VII.A; Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02), June 5, 2002, pp. 3-4.

[192] Pub. L. No. 108-357, sec. 424 (2004). The report also includes AJCA-mandated studies on transfer pricing and U.S. income tax treaties. Pub. L. No. 108-357, sec. 806(a), (b) (2004).

[193] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*. Throughout the remainder of this part, "Treasury earnings stripping report" is used to refer to chapter II of this Treasury Report, which specifically addresses earnings stripping, while "Treasury income tax treaty report" is used to refer to chapter IV of this Treasury Report, which specifically addresses U.S. income tax treaties.

[194] Subsequent to the issuance of its Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties, the Treasury Department's Office of Tax Analysis issued a paper that focuses solely on earnings stripping using the same 2004 dataset. The report reaches some of the same general conclusions as the Report with respect to its comparison of foreign-controlled domestic corporations to domestic-controlled corporations. Harry Grubert, *Debt and the Profitability of Foreign-Controlled Domestic Corporations in the United States, OTA Technical Working Paper 1*.

[195] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, p. 26.

[196] Jim A. Seida and William F. Wempe, "Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion," *National Tax Journal* 57 (2004): 805-28 (hereafter, Seide and Wempe, Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion). Seide and Wempe found that the 12 inverted corporations had a significantly larger increase in foreign income and a significantly larger decrease in U.S. profit margin and effective tax rate than a control group of corporations. Seide and Wempe also more closely examined

payments declared on Form 5472.[197] The Treasury earnings stripping report also concludes, however, that the evidence that foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive,[198] and that it is not possible to determine with precision whether section 163(j) is effective generally in preventing earnings stripping by foreign-controlled domestic corporations.[199] Consistent with those conclusions, the proposal would change the earnings stripping rules for expatriated entities only. By eliminating the debt-equity safe harbor,[200] reducing the adjusted taxable income threshold from 50 percent to 25 percent for interest on related-party debt, limiting the carryforward of disallowed interest to 10 years, and eliminating the carryforward of excess limitation, the proposal significantly strengthens rules that appear ineffective in preventing certain recent earnings stripping arrangements in the context of corporate inversion transactions.[201]

<u>Earnings stripping by foreign-controlled domestic corporations–the conclusions of the Treasury report</u>

The Treasury earnings stripping report presents three separate analyses using tax data to test whether foreign-controlled domestic corporations are engaging in earnings stripping outside the context of inversion transactions. First, the report examines the relative profitability of

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four inverted corporations for which detailed information on the levels of intercompany debt and interest and fee expense were readily available, and found that these levels increased significantly post-inversion. Moreover, for three of those four corporations, information could be determined regarding the geographic location of these attributes, and with respect to those three, most of the long-term debt, interest, and fee expense was attributable to the U.S. operations. U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties,* pp. 21-22.

[197] Form 5472 is an information return of (1) a U.S. corporation owned 25 percent or more by one foreign person, or (2) a foreign corporation engaged in a trade or business within the United States. Such reporting is required under sections 6038A and 6038C. Form 5472 includes information on cross-border payments, including fees, interest, and royalties, between the reporting corporation and foreign-related persons.

[198] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties, p.* 25.

[199] *Ibid*., at p. 26.

[200] The Treasury earnings stripping report notes that all of the four more closely examined inverted corporations in the study by Seide and Wempe appear to be within the 1.5 to 1 debt-to-equity safe harbor. U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties,* p. 23; see also Seide and Wempe, Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion, p. 821.

[201] The Treasury Report acknowledges that section 806 of AJCA requires the Treasury Department to conduct a study of the effectiveness of the provisions of AJCA relating to corporate expatriation, including the formulation of recommendations on improving the effectiveness of those provisions. The Treasury Department intends to separately issue to the Congress the report on that study. Nonetheless, the Treasury Report states that "section 7874 appears to have been successful in curtailing inversion transactions by large, publicly traded corporations." U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, p. 3.

foreign-controlled domestic corporations and domestic-controlled corporations by comparing the ratios of net income to total receipts, concluding that foreign-controlled domestic corporations are generally less profitable than their domestic-controlled counterparts.[202]

Second, the Treasury earnings stripping report compares the ratios of "operating income" to total receipts for foreign-controlled domestic corporations to the corresponding ratios for domestic-controlled corporations. Operating income is defined as net income plus interest expense, depreciation, and similar items, and minus interest income, dividends, and royalties received. The report finds that, after adjusting for these items, foreign-controlled domestic corporations are generally more profitable than their domestic-controlled counterparts.[203] The data in this part of the study show that domestic-controlled corporations have greater interest expense as a proportion of total receipts than do foreign-controlled domestic corporations.[204]

It is unclear whether these findings with respect to profitability tend to support or refute the proposition that foreign-controlled domestic corporations engage in earnings stripping. Some might argue that even if the findings with respect to operating income suggest that foreign-controlled domestic corporations in the nonfinancial and, more specifically, the manufacturing sectors are more profitable than comparable domestic-controlled corporations before interest income and expense (and other non-operating items) are taken into account, the data presented do not identify how much of the interest income is received from, and interest expense is paid to,

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[202] *Ibid*., p. 13. These analyses were separately performed for the nonfinancial and financial sectors. In addition, a separate analysis was done for the manufacturing industry, which is a component of the nonfinancial sector.

[203] *Ibid*., pp. 15-16. These analyses were separately performed for the nonfinancial and manufacturing sectors. The Treasury earnings stripping report's measure of operating income is reduced by non-interest expenses, such as research and experimentation, stewardship, and State and local taxes, that the taxpayer must allocate or apportion to foreign-source income for foreign tax credit purposes. Because by definition the foreign-source income associated with these expenses is generally excluded from operating income, adding back such expenses may provide the basis for a more valid comparison between foreign-controlled domestic corporations and domestic-controlled corporations.

[204] See *ibid.,* p. 15, table 2.2. This data, particularly the ratio of interest paid to total receipts, may suggest that foreign-controlled domestic corporations are not engaged in earnings stripping. However, it should be noted that it would be possible for a domestic-controlled corporation and a foreign-controlled domestic corporation to have similar interest expense burdens but have dissimilar reasons underlying their equivalent burdens. For example, a domestic-controlled corporation is more likely than a foreign-controlled domestic corporation to incur significant interest expense in the United States that may be linked (or, in technical terms of the Code, allocable or apportionable) to foreign-source income (and such income may be currently includible in U.S. taxable income or deferred), reflecting that foreign-controlled domestic corporations are more likely to incur interest expense solely for the purpose of financing economic activity conducted in the United States, while domestic-controlled corporations often incur interest expense in connection with the financing of both domestic and foreign entities in the overall corporate group. The same data issue may exist with respect to the interest expense and cash flow analysis set forth in Table 2.3 of U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, p. 18.

foreign-related parties, and, therefore, it is difficult to conclude that foreign-controlled domestic corporations are engaging in earnings stripping rather than utilizing third-party debt.[205]

Third, the Treasury earnings stripping report analyzes the relationship between interest expense and cash flow.[206] The report determines that, on average, foreign-controlled domestic corporations in the nonfinancial sector and the manufacturing industry have interest expense relative to cash flow that is virtually the same as comparable domestic-controlled corporations. The report also determines that foreign-controlled domestic corporations in these sectors are less likely to be above the section 163(j) threshold of 50 percent of adjusted taxable income than are comparable domestic-controlled corporations.[207] In the financial sector, the report determines that foreign-controlled domestic corporations in some industries appear to have significantly higher interest expense relative to cash flow than their domestic-controlled counterparts. However, the Treasury earnings stripping report states that "the comparison is not completely unambiguous and it is difficult to draw firm conclusions from the data because of the possibility of alternative explanations and the problems with using domestic-controlled corporations as a comparison group."[208]

Thus, the Treasury earnings stripping report concludes that the evidence that foreign-controlled domestic corporations are engaged in earnings stripping is not conclusive,[209] and that it is not possible to determine with precision whether section 163(j) is effective in preventing earnings stripping by foreign-controlled domestic corporations.[210] The Treasury Department recommends gathering additional information from taxpayers relating to earnings stripping to determine whether it would be appropriate to modify the proposal with respect to foreign-controlled domestic corporations. Accordingly, on November 28, 2007, the Treasury Department and the IRS issued a proposed tax form, Form 8926, *Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information*, to gather additional

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205 Unfortunately, the Treasury earnings stripping report does not analyze the data from Form 5472 regarding interest payments from foreign-controlled domestic corporations to their foreign owners (i.e., disqualified interest). That analysis might have shed some light on the extent of any earnings stripping.

206 The numerator, interest paid, used by the Treasury Department in Table 2.3 of U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, p. 18, takes into account interest expense linked to deferred income (both foreign- and domestic-source income), while neither cash flow nor total receipts, the alternative denominators, reflects this deferral. This asymmetry may affect the comparison of results for foreign-controlled domestic corporations and domestic-controlled corporations.

207 *Ibid.,* p. 19.

208 *Ibid.,* p. 21.

209 *Ibid.,* p. 25.

210 *Ibid.,* p. 26.

information from corporate taxpayers relating to the determinations and computations under section 163(j).[211]

Discussion of wider points raised by Treasury earnings stripping report

Effects of debt financing

Like any business, a foreign corporation has the option of financing its U.S. subsidiaries through equity or some combination of debt and equity. There are certain advantages to utilizing some degree of debt financing–for example, debt financing may allow a business to raise funds at a lower cost (for example, the return to investors may be lower because debt is a less risky investment than an equity investment in the same business) and without surrendering ownership. Depending on the differences between the U.S. tax rate and the rate of tax imposed on the recipient of the interest by the applicable foreign country, the use of substantial debt financing, even if not rising to the level of earnings stripping, may facilitate lowering the rate of U.S. tax on the U.S. operations, thereby lowering the foreign parent corporation's overall tax rate on its worldwide operations. Moreover, even if the full 30-percent U.S. withholding tax is imposed upon the interest payment, there remains a five-percent taxpayer-favorable difference, if the interest expense is deductible at the highest U.S. corporate rate of 35 percent. In addition, the interest recipient may be able to take a credit for the U.S. withholding tax, in whole or in part, against its tax in the applicable foreign country, or the interest may be tax-exempt in such country. Although a foreign tax credit might also be available for withheld taxes on a dividend and the underlying U.S. corporate tax, in general there is a greater possibility of double taxation in the case of dividends paid by foreign-controlled domestic corporations to their parents than in the case of interest. Moreover, debt principal may be repaid on a tax-free basis, while redemption of equity by a foreign parent is generally treated as a dividend distribution unless the corporation paying the dividend has no earnings and profits.[212]

Studies have determined that, with some exceptions, greater investment is linked to overall higher labor compensation.[213] The Treasury earnings stripping report suggests that income shifting may support increased investment into high-tax jurisdictions (such as the United

211 Proposed Form 8926 has been issued in draft form and is available on the IRS website at http://www.irs.gov/pub/irs-dft/f8926--dft.pdf. See also Announcement 2007-114, 2007-50 I.R.B. 1176. In August 2006, the Staff of the Joint Committee on Taxation presented to then-Chairman Grassley and Ranking Member Baucus of the Senate Committee on Finance a report that includes a proposal to gather taxpayer information relating to the operation of section 163(j), similar to that of proposed Form 8926. See Joint Committee on Taxation, *Additional Options to Improve Tax Compliance*, August 3, 2006, pp. 41-43 (released by the Senate Committee on Finance on October 19, 2006, and available on the Senate Committee on Finance website at http://finance.senate.gov/press/Gpress/2005/prg101906.pdf).

212 See secs. 301 and 302(d). If certain narrow exceptions are met, the distribution may be treated as a distribution in exchange for the stock. See sec. 302(b).

213 Recent references to this linkage include David L. Brumbaugh, Congressional Research Service, *Tax Treaty Legislation in the 110th Congress: Explanation and Economic Analysis* (CRS Report RL34245), p. 8 (2008).

States) by lowering the effective tax rate.[214] Whether the ability of U.S. businesses to pay interest to related foreign debt-holders should be further abated may be part of a larger policy discussion that balances revenue and other needs in an international context.[215] It is difficult to determine the optimal rate of U.S. tax on foreign-controlled domestic corporations (or conversely, the appropriate level of leverage) that would maximize the overall economic benefit to the United States. However, the best way to encourage increased investment in the United States (by foreign or domestic investors) is to increase the after-tax return to investment, and that outcome is more efficiently achieved by, for example, lowering the U.S. corporate income tax rate than by narrower policies such as the facilitation of earnings stripping.

Earnings stripping and tax treaties

Earnings stripping generally provides a net tax benefit only to the extent that the foreign recipient of the interest income is subject to a lower amount of foreign tax on such income than the net value of the U.S. tax deduction applicable to the interest, i.e., the amount of U.S. deduction times the applicable U.S. tax rate, less the U.S. withholding tax. That may be the case if the country of the interest recipient provides a low general corporate tax rate, a territorial system with respect to interest, or a special tax regime for financing structures, and if that country has entered into a tax treaty with the United States that provides a reduced U.S. withholding tax rate on interest.

Thus, the applicable foreign tax rate and the U.S. withholding tax rate on the interest payment are two factors that affect the ability of foreign-controlled domestic corporations to effectively engage in earnings stripping. These two factors are interrelated. While a low foreign tax rate relative to the U.S. rate is critical to effective earnings stripping, if the general foreign tax rate is zero, it is not likely that the United States would now enter into a tax treaty with that foreign country that lowers the U.S. withholding tax rate on interest. Therefore, such a foreign corporation may attempt to utilize a U.S. tax treaty with another foreign country to obtain a lower U.S. withholding tax rate. This practice is known as treaty shopping.[216]

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[214] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties,* p. 24. Existing empirical research does not address this question. *Id*. The linkage between foreign investment and labor compensation requires that a number of things be held constant–for example, that any potential loss of revenue associated with income shifting not also "crowd out" investment in the United States by either domestic or foreign investors.

[215] Notwithstanding that the two issues have historically been analyzed separately, a recent paper suggests that the determination of allowable interest deductions in the inbound and outbound contexts be coordinated through a multilateral agreement under which each country would allocate interest deductions to assets on a uniform worldwide basis and allow a proportionate amount of interest expense to be deducted against income earned domestically, without regard to where the borrowing occurs. The effect of such a system would be to deny interest deductions only when borrowing in one country is disproportionately higher than in the rest of the world. Michael Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expenses," IBFD, *Bulletin for International Taxation* 62 (November 2008): 486.

[216] Treaty shopping is not limited to withholding on interest payments. A person may engage in treaty shopping to obtain other benefits under a U.S. tax treaty, for example, to lower withholding on royalty or dividend

As described in detail in the Treasury income tax treaty report issued with the Treasury earnings stripping report, the Treasury Department has taken significant steps since 2000 to combat treaty shopping by negotiating new and stricter limitation-on-benefit ("LOB") provisions with several U.S. treaty partners, as well as including a similar new LOB provision in the United States Model Income Tax Convention of November 15, 2006. These stricter LOB provisions include a series of complex objective tests to determine whether a resident of a treaty country is sufficiently connected economically to that country to warrant receiving treaty benefits.[217]

Limitation of the scope of the proposal to expatriated entities

As discussed elsewhere in this document, certain of the Administration's other proposals may reduce somewhat the incentive that may exist under present law for certain U.S. persons to make investments outside of the United States, instead of within the United States, because of the more favorable U.S. tax treatment available for such foreign investments.[218] The same proposals may make corporate structures with a domestic parent relatively less attractive than corporate structures with a foreign parent because those proposals are more likely to raise the U.S. tax liability for the domestic parent structure than for the foreign parent structure. This proposal may counteract some of the U.S. tax advantage perceived to exist for foreign parent structures vis-à-vis domestic parent structures by significantly reducing opportunities for certain foreign parent structures (specifically, those involving domestic parent structures that inverted) to reduce their U.S. tax liability by engaging in earnings stripping using deductible interest. However, the effectiveness of this counterbalancing may be limited due to the fact that the proposal applies only to certain expatriated entities and not to, for example, newly established foreign-controlled domestic corporations.

Section 7874 appears to have significantly reduced the opportunity for domestic-controlled corporations to engage in earnings stripping by engaging in new inversion transactions.[219] However, both incentive and opportunity remain for foreign-controlled domestic

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payments, or to exempt income from a U.S. trade or business that is not attributable to a permanent establishment in the United States.

[217] See *ibid*., pp. 78-82.

[218] See, for example, the analysis of the Administration's proposals to defer deduction of expenses related to deferred income (section I.B), to determine the foreign tax credit on a pooling basis (section II.A), and to reform business entity classification rules for foreign entities (section II.B).

[219] U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* states, "[s]ection 7874 appears to have been successful in curtailing inversion transactions by large, publicly traded corporations." *Ibid.,* p. 3. Recently, however, the IRS and Treasury Department issued temporary and proposed regulations addressing the application of section 7874 in certain circumstances. T.D. 9453, 74 Fed. Reg. 27,920 (June 12, 2009) (temporary regulations); 74 Fed. Reg. 27,947 (June 12, 2009) (proposed regulations). The preamble to the temporary regulations states that the IRS and Treasury Department have become aware of certain transactions that are intended to avoid section 7874, but that they believe present the same policy concerns that prompted the enactment of section 7874. Thus, the temporary and proposed regulations clarify that such transactions are still within the scope of section 7874. In particular, the temporary and proposed regulations address transactions that utilize multiple foreign corporations to make acquisitions of substantially all of the

corporations, corporations that engage in 60-percent inversions, and corporations that inverted on or before March 4, 2003, to engage in earnings stripping. The proposal would further restrict earnings stripping for corporations that engage in 60-percent inversions and the pre-March 3, 2003 inverters,[220] but not for the much larger group of foreign-controlled domestic corporations that have not inverted.

Although recent legislative and treaty developments have removed some significant opportunities for earnings stripping, and notwithstanding that the Treasury earnings stripping report does not conclusively determine that foreign-controlled domestic corporations that are not expatriated entities are engaging in earnings stripping, some argue that, as a matter of tax policy, the earnings stripping rules should treat foreign-controlled domestic corporations in the same manner as expatriated entities because both types of corporations have the same incentives and capabilities to erode the U.S. tax base, and may do so in the same manner. Proponents of this argument observe that it should not be surprising that the available information clearly demonstrates that expatriated entities are engaging in earnings stripping because expatriated entities comprise an easily-identifiable subclass of foreign-controlled domestic corporations and have demonstrated a propensity for aggressive tax planning. Proponents of stricter across-the-board earnings stripping rules also argue that there is sufficient evidence of earnings stripping to justify implementing such a regime, and that significant erosion of the U.S. tax base will continue until the earnings stripping rules are strengthened for all foreign-controlled domestic corporations.

Others agree with the conclusion of the Treasury earnings stripping report that there is insufficient evidence to justify legislative action outside the context of inversions at this time, and that it would be more prudent to await the receipt and analysis of taxpayer data on earnings stripping submitted through the new Form 8926. Proponents of this view may also believe that the implementation of the new form should increase compliance with section 163(j). In response, some argue that it will be at least several years before careful analyses can be performed on any data submitted through Form 8926, and that there is currently sufficient concern and anecdotal evidence regarding earnings stripping by foreign-controlled domestic corporations to justify strengthening the substantive earnings-stripping rules now, while continuing to analyze data as it becomes available.

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properties held by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership, transactions involving one foreign corporation acquiring substantially all of the properties of multiple domestic corporations or partnerships, and transactions involving an insolvent domestic corporation in which the creditors of the corporation claim not to be shareholders.

[220] Some might argue that it is unfair to impose an additional tax burden on corporations on the basis of transactions occurring in part prior to the time the transactions were addressed by the Code. However, the proposal would be effective only with respect to interest paid or accrued in taxable years beginning after December 31, 2010. Therefore, it is not retroactive in effect.

Other types of earnings stripping

The proposal does not address earnings stripping transactions involving the payment of deductible amounts (by expatriated entities or foreign-controlled domestic corporations) other than interest (e.g., rents, royalties, reinsurance premiums, and service fees), or the payment of deductible amounts by taxpayers other than corporations. These transactions also may erode the U.S. tax base, and thus some argue that a more comprehensive response to earnings stripping is needed. The Treasury Department's examination of payments declared on Form 5472 by seven expatriated entities suggests that, although the majority of earnings stripping by expatriated entities is through interest, some earnings stripping occurs through royalties.[221] Indeed, as opportunities for stripping earnings in the form of interest are reduced, taxpayers may find it increasingly attractive to strip earnings through other means. On the other hand, earnings stripping may be more readily achieved through the use of debt than through other means.[222]

Prior Action

The President's fiscal year 2009 proposal contained an identical earnings stripping proposal. The President's fiscal year 2005, 2006, 2007, and 2008 budget proposals contained a similar proposal, except that it would have applied regardless of whether an inversion had occurred. The President's fiscal year 2004 budget proposals contained a different earnings stripping proposal that would have modified the safe harbor provision, reduced the adjusted taxable income threshold, added a new disallowance provision based on a comparison of domestic to worldwide indebtedness, and limited carryovers.

In 2008, the House passed a provision providing that the amount of U.S. withholding tax imposed on a deductible payment made to a foreign-related party may not be reduced under a U.S. treaty unless such withholding tax would be reduced under a U.S. treaty if such payment were made directly to the foreign parent corporation.[223] In 2007, the House passed a similar, but somewhat broader provision providing that the amount of U.S. withholding tax imposed on a deductible payment made to a foreign-related party may not be less than the amount which would be imposed if the payment were made directly to its foreign parent corporation.[224] Both of these provisions would apply to all deductible payments to foreign-related parties, and not solely to interest.

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[221] *Ibid.,* at p. 22.

[222] The Treasury Department notes that loading up a foreign-controlled domestic corporation with a disproportionate amount of debt in order to engage in earnings stripping does not generally require any real movement of assets or a change in the business operations of the corporation. In contrast, the use of royalties or other deductible payments may result in a change in tax position but also may require a real change in business operations. See *ibid.,* p. 7 & n.1.

[223] H.R. 6275, 110th Cong. sec. 203 (2008). This provision was identical to one introduced by the Chairman of the Committee on Ways and Means in 2007. H.R. 3970, 110th Cong. sec. 3204 (2007).

[224] H.R. 2419, 110th Cong. sec. 12001 (2007).

In 2006, the Senate passed a provision applicable to certain expatriated entities that would have eliminated the safe harbor and reduced the present-law threshold of 50 percent of adjusted taxable income to 25 percent for both net interest expense and excess limitation.[225]

There were also three pre-AJCA legislative proposals relating to earnings stripping. In 2004, the Senate passed a provision that would have tightened the interest stripping rules for corporations that had engaged in certain inversions. For these corporations, the proposal would have eliminated the debt-to-equity safe harbor, reduced the threshold for excess interest expense to 25 percent of adjusted taxable income, and modified the excess limitation threshold so that 25 percent of adjusted taxable income over a corporation's net interest expense for a year could be carried forward three years.[226]

A 2003 Senate proposal provided a special exception for any corporation that was subject to the earnings stripping rules as a result of a related-party guarantee if the taxpayer could establish to the satisfaction of the Secretary of the Treasury that it could borrow a substantially similar amount of money without the guarantee.[227]

A 2002 House proposal would have strengthened the earnings stripping rules regardless of whether the corporation entered into an inversion transaction. The proposal would have eliminated the debt-to-equity safe harbor and would have reduced the threshold for excess interest expense from 50 percent to 35 percent of adjusted taxable income. Disallowed interest could be carried over for five years, but excess limitation could not be carried over. The proposal added an additional rule that would generally disallow related-party interest expense to the extent that the U.S. subsidiaries of a foreign parent were more highly leveraged than the overall worldwide corporate group. Disallowed interest and excess limitation could not be carried forward. The amount of total interest expense disallowed would be the greater of the current-law disallowance rule as modified by the proposal, or the additional interest-disallowance rule.

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[225] H.R. 4297, 109th Cong. sec. 441 (2006); see H.R. Rep. No. 109-455, at 245-50 (2006).

[226] S. 1637, 108th Cong. sec. 441(d)(2) (2004).

[227] S. 1475, 108th Cong. sec. 255 (2003).

II. DETERMINING THE APPROPRIATE AMOUNT OF U.S. TAX

Introduction

As described previously in section I, if business income is taxed in the country in which it is derived (the source country) rather than in the country of residence of the taxpayer deriving the income (the residence country), the residence country has two broad options for relieving its tax on the foreign business income of its domestic taxpayers. A residence country may simply exempt foreign-source income from home country taxation (an exemption, or "territorial" system). Alternatively, a residence country may tax foreign-source income but give a credit against home country taxation for foreign tax paid on that income (a worldwide system). Most countries have variations of exemption systems. The United States has a worldwide system, although the U.S. tax on active foreign earnings derived through foreign subsidiaries is generally deferred until those earnings are repatriated in the form of a dividend distribution. To relieve double taxation, the United States grants a credit (subject to limitations) for foreign taxes paid on foreign earnings, both "directly" by the domestic taxpayer (for example, on the income of a foreign branch) and "indirectly" by a foreign subsidiary, to the extent the subsidiary's earnings are distributed.[228]

The basic structure of the U.S. rules reflects several competing considerations. The first, reflected in the general rule of worldwide taxation and the granting of the foreign tax credit, is to ensure that a taxpayer's choice whether to invest in the home country or abroad is not affected by tax considerations. Thus, for instance, if the U.S. tax rules were completely neutral, those rules would not distort a U.S. multinational corporation's decision whether to invest in the United States or, for example, in Latvia.[229]

Complete neutrality would require, however, both an unlimited foreign tax credit and full inclusion of all foreign earnings. Assume, for example, that a U.S. multinational corporation has operations in the United States and Japan. For simplicity, assume initially that the corporation carries out its Japanese operations directly through a branch rather than through a separate foreign subsidiary (a controlled foreign corporation). The corporation has $1 million of U.S.-source income and $1 million of Japanese-source income, for total income worldwide of $2 million. Assume the U.S. tax rate is 35 percent, and the Japanese tax rate is 50 percent. Consequently, before the foreign tax credit, the U.S. tentative tax liability is $700,000 (35 percent of $2 million). The Japanese tax liability is $500,000 (50 percent of $1 million). An unlimited foreign tax credit would allow the corporation a credit against its tentative U.S. tax liability for the entire $500,000 Japanese tax. After this $500,000 credit, the corporation would pay $200,000 in U.S. tax and $500,000 in Japanese tax, for a total tax liability of $700,000 on $2

[228] Secs. 901, 902 and 960.

[229] This policy of neutrality as to the location of investment is usually referred to as capital export neutrality. Two competing policies have been offered. Under capital import neutrality, investment into a country from all other jurisdictions is taxed in the same manner. Capital import neutrality would be achieved if all countries had pure exemption systems. Under capital ownership neutrality, tax systems of countries around the world would not distort patterns of ownership of capital investments. Capital ownership neutrality could be achieved if all countries either adopted pure worldwide systems or adopted pure exemption systems.

million of worldwide income. As a result of this full foreign tax credit, the U.S. corporation would be subject to tax on its worldwide income at the U.S. 35-percent rate. The corporation would be in the same position it would have been in had its income been entirely U.S. source.

An unlimited foreign tax credit, however, would permit U.S. taxpayers to use the credit to offset U.S. tax on U.S. (rather than foreign) source income. In the example above, the U.S. tax on Japanese-source income is $350,000 (35 percent of $1 million). An unlimited foreign tax credit for the $500,000 of Japanese tax would permit the corporation to eliminate this $350,000 of U.S. tax on Japanese-source income and an additional $150,000 of U.S. tax on U.S. income. Stated differently, if the United States allowed an unlimited foreign tax credit, other countries could increase their tax rates on U.S. taxpayers' earnings in those countries without increasing those taxpayers' worldwide burdens; the only party made worse off would be the U.S. fisc. If, for instance, in the example above Japan raised its tax rate on U.S. corporations investing in Japan to 70 percent, the corporation with $1 million of Japanese-source income would pay $700,000 of Japanese tax, would eliminate entirely its U.S. tentative tax liability of $700,000, and would have $700,000 of worldwide (Japanese) tax liability, the same amount of tax it would be liable for had it invested only in the United States.

The foreign tax credit limitation of present law reflects this second consideration, preservation of the U.S. tax base, by allowing the foreign tax credit in broad terms to offset only U.S. tax on foreign source income.[230] Thus, in the preceding example, present law permits the corporation to credit only $350,000 of Japanese tax (the U.S. 35-percent tax rate multiplied by the corporation's $1 million of Japanese-source income) against its tentative U.S. tax liability of $700,000. After the $350,000 foreign tax credit, the corporation has a worldwide tax liability of $850,000, comprised of $500,000 of Japanese tax and $350,000 of U.S. tax. The corporation ends up paying tax on its Japanese-source income at the Japanese tax rate –$500,000 of tax is 50 percent of $1 million of income – and its overall tax rate on its worldwide income, 42.5 percent, is higher than the 35-percent rate that would have applied if all its income had been U.S. source.

Given the absence of an unlimited foreign tax credit, a taxpayer that invests abroad in a high-tax jurisdiction may pay a higher rate of tax on its worldwide income than it would pay if it operated only in the United States. The taxpayer's investment decision therefore may be distorted. The ability to defer U.S. taxation of active foreign earnings, though, is an opposing distortion. As discussed previously in Section I, complete neutrality would require that the foreign business income of U.S. taxpayers be subject to full U.S. taxation as the income was earned (together with, as discussed above, an unlimited foreign tax credit). In fact, however, U.S. taxation of foreign business income derived through foreign subsidiaries is delayed until the income is paid to the U.S. parent corporation. The deferral regime was originally intended to provide a degree of neutrality between the U.S. taxation of active foreign earnings and the tax treatment of those earnings by the source country. Deferral of U.S. tax on foreign-source income permits U.S. multinational companies to reduce, in the extreme case to zero, the present value of their future U.S. tax liabilities on foreign income. A U.S. multinational corporation deriving income in a foreign jurisdiction effectively pays tax on that income at the foreign rate if it defers

[230] See section 904.

U.S. tax indefinitely. The ability to defer U.S. tax on foreign earnings thus may mitigate substantially, or in the case of low-taxed foreign earnings affirmatively reverse, the distortion in favor of domestic investment that the foreign tax credit limitation might be seen to create when viewed in isolation.

The deferral regime does not apply to certain types of passive and highly mobile income for which deferral of U.S. tax could result in a complete absence of taxation, due to the ease with which that income can be located in low or no-tax jurisdictions. In those cases, the anti-deferral rules of subpart F of the Code and the passive foreign investment company ("PFIC") rules preserve the U.S. tax base by requiring current inclusion of the income at the time it is earned (or, in the case of the PFIC rules, achieve a similar result by imposition of an interest charge).

The basic construct of the international tax rules has remained the same since the 1960s, but a growing body of economic analysis of its inherent structural distortions has prompted increasing interest in the consideration of structural alternatives, including exemption and full inclusion regimes. Three relatively new features of the current rules — the elective (or "check-the-box") entity classification rules since 1997, the CFC look-through rules since 2006, and the existence of only two foreign tax credit limitation categories since 2007 — have exacerbated those distortions over the last decade and complicate the analysis. Each of these features greatly facilitate the selective repatriation of both earnings and foreign taxes in a manner designed to increase available foreign tax credits after the operation of the foreign tax credit limitation. A simple credit maximization strategy might involve, for example, repatriating highly taxed foreign earnings and using credits generated by this highly taxed income to offset U.S. tax on other lightly taxed foreign income (so-called "cross-crediting"). More complex maximization strategies involve the use of hybrid entities to separate foreign tax credits from the related, deferred foreign source income, or to create foreign tax credits with respect to income that is not taxable in the United States, in order to use those credits to shelter other currently taxable foreign source income. In addition, the availability of hybrid entities has facilitated avoidance of the anti-deferral rules in connection with certain foreign tax minimization strategies that enhance the benefits of deferral. Some analysts have argued that as a result of deferral and selective repatriation strategies, some U.S. taxpayers may have a lower worldwide tax burden than they would have if the U.S. adopted an exemption system.[231]

The President's budget proposals include a number of provisions intended to restrict manipulation of the foreign tax credit limitation and the anti-deferral rules. Section II.A. below describes two proposals that address the present structure of the foreign tax credit limitation, and Section II.B. describes three proposals that address the use of the elective entity classification rules to facilitate selective repatriation of foreign taxes or to avoid taxation of income under

[231] See, e.g., Rosanne Altshuler and Harry Grubert, "Where Will They Go If We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations," *National Tax Journal*, Vol. LIV, No. 4 (December 2001), p. 16. The American Bar Association Task Force noted that the substantial cross-crediting permitted under existing law is one of several reasons why the U.S. tax rules are more generous to investment in high-tax countries than under an exemption regime; in particular, under an exemption system excess tax credits from high-tax countries cannot be used as credits against tax on other income. American Bar Association, Report of the Task Force on International Tax Reform, p. 77.

subpart F. The description and analysis of these proposals is preceded in each section by a detailed discussion of the U.S. present law rules relevant to the President’s proposals.

A. Structure of the Foreign Tax Credit Limitation

Present law foreign tax credit rules: a detailed description

Subject to the limitations discussed below, a domestic corporation is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed or included in the domestic corporation's income under subpart F.[232]

Creditable foreign taxes

A foreign tax credit is available only for foreign income, war profits, and excess profits taxes, and for certain taxes imposed in lieu of such taxes. Other foreign levies generally are treated as deductible expenses. Treasury regulations under section 901 provide detailed rules for determining whether a foreign levy is a creditable income tax. In general, a foreign levy is considered a creditable tax if it is substantially equivalent to an income tax under U.S. tax principles. Under the present Treasury regulations, a foreign levy is considered a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and it is not compensation for a specific economic benefit provided by a foreign country.[233]

Dual-capacity taxpayers

A taxpayer that is subject to a foreign levy and also receives a specific economic benefit from the foreign country is considered a "dual-capacity taxpayer."[234] Treasury Regulations addressing payments made by dual-capacity taxpayers were developed in response to the concern that payments which purported to be income taxes imposed on U.S. oil companies by mineral-owning foreign governments were at least partially, in substance, royalties or some other business expense.[235] To the extent that a taxpayer meets the definition of a dual-capacity taxpayer, the taxpayer may not claim a foreign tax credit for the portion of the foreign levy that is paid for the specific economic benefit.[236] A "specific economic benefit" is broadly defined as an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on

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[232] Secs. 901, 902, and 960. A similar rule applies under section 1295(f) with respect to income that is includible under the PFIC rules.

[233] Treas. Reg. sec. 1.901-2(a)(2)(i).

[234] Treas. Reg. sec. 1.901-2(a)(ii).

[235] Testimony of Treasury Secretary Schultz, *Hearings on "Windfall" Excess Profits Tax before the House Committee on Ways and Means*, 93rd Cong., 2d Sess. 151 (1974).

[236] Treas. Reg. sec. 1.901-2(a)(2)(i).

substantially the same terms to the population of the country in general.[237] An example of a specific economic benefit includes a concession to extract government-owned petroleum. Other examples of economic benefits that may be specific if not provided on substantially the same terms to the population in general, include property; a service; a fee or other payment; a right to use, acquire or extract resources, patents, or other property that a foreign country owns or controls (as defined within the regulations); or a reduction or discharge of a contractual obligation.

Treasury regulations under section 901 require that a dual-capacity taxpayer must establish, like other taxpayers, that the foreign levy meets the requirements of sections 901 or 903.[238] Additionally, a dual-capacity taxpayer must establish the amount of the levy that is a tax, pursuant to either a facts and circumstances method or a safe harbor method.[239] Under the facts and circumstances method, a separate levy is creditable to the extent that the taxpayer establishes the amount that is not paid as compensation for the specific economic benefit based on all the relevant facts and circumstances.[240] For purposes of applying the facts and circumstances method, there is no requirement under present law that the foreign country have a generally imposed income tax.

Instead of applying the facts and circumstances method, the taxpayer may choose to apply the safe harbor method on a country-by-country basis.[241] The portion of a qualifying levy that is a tax is determined under the safe harbor method by applying a formula. If the foreign country has a generally imposed income tax, the dual-capacity taxpayer may credit the portion of the levy that application of the generally imposed income tax would yield (provided that the levy otherwise constitutes an income tax or an in lieu of tax). The balance of the levy is treated as compensation for the specific economic benefit.[242] If the foreign country does not generally impose an income tax, the portion of the payment that does not exceed the applicable U.S. federal tax rate, applied to net income, is treated as a creditable tax.[243] In general, a foreign tax is

[237] Treas. Reg. sec. 1.901-2(a)(2)(ii)(B).

[238] Treas. Reg. sec. 1.901-2A(b)(1).

[239] Treas. Reg. sec. 1.901-2A(b).

[240] Treas. Reg. sec. 1.901-2A(c)(2).

[241] A taxpayer may make an election to use the safe harbor method with respect to one or more foreign states. Such election applies to the year of the election and to all subsequent taxable years unless the election is revoked. The election is made by the common parent and applies to all members of the affiliated group. See Treas. Reg. sec. 1.902-2A(d).

[242] Treas. Reg. sec. 1.901-2A(d) and (e). Detailed rules are provided for determining the amount that imposition of the generally applicable tax to the dual-capacity taxpayer would yield, based on the taxpayer's gross receipts, costs and expenses, and other factors.

[243] Treas. Reg. sec. 1.901-2A(e)(5).

treated as generally imposed for this purpose even if it applies only to persons who are not residents or nationals of that country.[244]

After the promulgation of the regulations, many dual-capacity taxpayers elected the safe harbor method for determining what portion, if any, of the separate foreign levy they paid would be treated as a creditable income tax. However, in 1999, the Tax Court in *Exxon Corp. v. Commissioner* determined that the entire amount of the petroleum revenue tax paid by Exxon to the U.K. government did not constitute compensation for a specific economic benefit and would thus qualify as tax for purposes of the foreign tax credit.[245] The Court considered that Exxon entered into an arm's length licensing agreement with the U.K. government to gain access to the North Sea oil fields prior to the enactment of the petroleum revenue tax, and determined that Exxon's right to explore, develop and exploit petroleum resources was dependent on the licensing agreement and payment of license fees under that agreement and not in exchange for payment of the tax. After the taxpayer's victory in *Exxon*, anecdotal evidence suggests that a significant number of dual-capacity taxpayers revoked their safe harbor elections and adopted the facts and circumstances method to argue for tax treatment for the entire amount of the qualifying levy.

Limitation of the foreign tax credit

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[246] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[247]

The U.S. foreign tax credit limitation provisions historically have included rules that restrict cross-crediting in order to preserve the U.S tax base. In its most restrictive (or theoretically purest) form, the limitation would function on an item-by-item basis, so that foreign tax imposed on any item of income could offset only the U.S. tax on that item. Historically, however, the actual limitation rules have operated instead with respect to more administrable groupings of similar items of income.

[244] See Treas. Reg. sec. 1.903-1(b)(3), Ex. 4.

[245] *Exxon v. Commissioner*, 113 T.C. 338 (1999). See also *Philips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995).

[246] Secs. 901 and 904.

[247] Sec. 904(c).

Thus, the present foreign tax credit limitation must be applied separately for income in two different categories (referred to as "baskets"), passive category income and general category income.[248] Passive category income generally includes (with certain exceptions including when income is earned as part of an active business) investment income such as dividends, interest, rents, and royalties.[249] General category income is all income that is not in the passive category. Because the foreign tax credit limitation must be applied separately to income in these two baskets, credits for foreign tax imposed on income in one category cannot be used to offset U.S. tax on income in the other category.

Income that would otherwise constitute passive income is treated as general category income if it is earned by a qualifying financial services entity (and certain other requirements are met).[250] Passive income is also treated as general category income if it is high-taxed (i.e., if the foreign tax rate is determined to exceed the highest rate of tax specified in section 1 or 11, as applicable).[251] Dividends (and subpart F inclusions), interest, rents, and royalties received by a United States shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividend or other payment was made.[252] Dividends received by a 10 percent corporate shareholder from a foreign corporation that is not a CFC are also categorized on a look-through basis.[253]

Under the present two-basket system, substantial cross-crediting opportunities exist with respect to general category income of different types and from different countries. Thus, tax on income from a high-tax country in one category can be credited against U.S. tax on income in the same category derived in a low-tax jurisdiction. Moreover, the very broad general limitation category encompasses a wide variety of types of active business income that may be taxed at very different effective rates − even within the same country. As described further below, selective repatriation strategies permit taxpayers to manipulate foreign earnings and foreign taxes in a manner that maximizes these opportunities.

[248] Sec. 904(d). Separate foreign tax credit limitations also apply to certain categories of income described in other Code sections. See e.g., sections 901(j), 904(h)(10) and 865(h).

[249] Sec. 904(d)(2)(B). Passive income is defined by reference to the definition of foreign personal holding company income in section 954(c), and thus generally includes dividends, interest, rents, royalties, annuities, net gains from certain property or commodities transactions, foreign currency gains, income equivalent to interest, income from notional principal contracts, and income from certain personal service contracts. Exceptions apply for certain rents and royalties derived in an active business and for certain income earned by dealers in securities or other financial instruments. Passive category income also includes amounts that are includible in gross income under section 1293 (relating to PFICs) and dividends received from certain DISCs and FSCs.

[250] Sec. 904(d)(2)(C) and (D).

[251] Sec. 904(d)(2)(F).

[252] Sec. 904(d)(3).

[253] Sec. 904(d)(4).

From 1986 through 2004, however, the foreign tax credit basket rules were significantly more restrictive than the present rules: income was divided into nine, rather than two, categories that were intended to group particular types of income thought to be taxed at similar effective foreign rates. The nine-basket rules replaced preexisting rules, in effect from 1976 to 1986, under which the foreign tax credit limitation was applied on an overall basis; during various periods prior to 1976, the limitation was applied on foreign country by foreign country basis (the "per-country limitation"), an overall basis, or a combination of the two. Although the per-country limitation permitted cross-crediting of foreign taxes paid on different types of income from a single country, the effect was nonetheless more limited than permitted under present law due to uniformity (in general) of tax bases and tax rates within a country.[254]

Special rule for foreign oil and gas income

A special limitation applies with respect to taxes on combined foreign oil and gas income, prior to the application of the foreign tax credit limitation discussed above.[255] This special limitation, initially adopted prior to the "dual-capacity taxpayer" regulations discussed above, was similarly intended to address the concern that payments made by oil companies to many oil-producing nations were in fact royalties disguised as tax payments.[256] Additionally, the rules were intended to prevent the crediting of high foreign taxes on foreign oil and gas income against the residual U.S. tax on other types of lower-taxed foreign source income.[257]

Under this special limitation, amounts claimed as taxes paid on combined foreign oil and gas income are creditable in a given taxable year (if they otherwise qualify as creditable taxes) only to the extent they do not exceed the applicable U.S. tax on that income. The applicable U.S. tax is determined for a corporation as the product of the amount of such combined foreign oil and gas income for the taxable year and the highest marginal tax rate for corporations.[258] Any excess foreign taxes may be carried back to the immediately preceding taxable year and carried forward 10 taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess limitation with regard to combined foreign oil and gas income in a carryover year.[259] Amounts that are not limited under section 907 (relating to combined foreign oil and gas income

[254] As noted by the American Bar Association Task Force, Switzerland, which has substantial differences in cantonal taxes, is an example of an exception from this general rule. American Bar Association, Report of the Task Force on International Tax Reform, p. 775.

[255] Sec. 907.

[256] Joint Committee on Taxation, *Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-82), December 31, 1982, sec. IV.A.7.a, footnote 63.

[257] H.R. Conf. Rep. No. 103-213 (1993), p. 646.

[258] Sec. 907(a). For an individual, the limitation is the product of the amount of such combined foreign oil and gas income for the taxable year and a fraction, the numerator of which is the tax against which the credit under section 901(a) is taken and the denominator of which is the taxpayer's entire taxable income.

[259] Sec. 907(f).

discussed above) are included in the general basket or passive basket (as applicable) for purposes of applying the section 904 limitation.

As discussed further below under the analysis of the "Proposal to Modify the Tax Rules for Dual Capacity Taxpayers," for pre-2009 tax years, the components of what is now defined as combined foreign oil and gas income included foreign oil and gas extraction income ("FOGEI"), typically higher taxed upstream income, and foreign oil related income ("FORI"), typically lower taxed downstream income. Both FOGEI and FORI were subject to separate limitations under section 907.[260] Amounts claimed as taxes paid on FOGEI of a U.S. corporation qualified as creditable taxes (if they otherwise so qualified), if they did not exceed the product of FOGEI multiplied by the highest marginal U.S. tax rate on corporations. A separate limitation was deemed to apply to FORI which theoretically applied in certain cases where the foreign law imposing such amount of tax is structured, or in fact operated, so that the amount of tax imposed with respect to FORI was generally "materially greater," over a "reasonable period of time," than the amount generally imposed on income that was neither FORI nor FOGEI.

1. Proposal to determine the deemed-paid foreign tax credit on a blended basis

<u>Description of Proposal</u>

The proposal would require a U.S. taxpayer to determine its deemed paid foreign tax credit on a consolidated basis by determining the aggregate foreign taxes and earnings and profits of all the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit (including lower tier subsidiaries described in section 902(b)). The deemed paid foreign tax credit for a taxable year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year.

<u>Effective date</u>.−The proposal would be effective for taxable years beginning after December 31, 2010.

<u>Analysis</u>

The proposal would limit opportunities for selective cross-crediting of foreign subsidiary taxes by establishing cross-crediting of all foreign subsidiary taxes within the same foreign tax credit basket as, in effect, a general rule under section 902. In other words, by determining the amount of deemed paid taxes on an aggregate or blended basis under section 902, the proposal would require that foreign taxes imposed at high rates be used to offset potential U.S. tax liability on lower-taxed foreign earnings, without regard to the timing or source of any particular distribution of foreign earnings.

Specifically, the proposal would revise the rules of section 902 so that a U.S. corporation would determine the amount of foreign taxes that it is deemed to have paid under section 902 with respect to dividends received from a foreign corporation (and, correspondingly, under

[260] Pub. L. No. 110-343, Sec. 402(a).

section 960 with respect to subpart F income inclusions) on an aggregate, rather than corporation-by-corporation, basis. Thus, a U.S. corporation would be required to aggregate its proportionate shares of the foreign taxes and the earnings and profits of all foreign subsidiaries with respect to which the U.S. corporation is eligible to claim a deemed paid foreign tax credit (including lower tier subsidiaries described in section 902(b)).[261] The amount of foreign taxes deemed paid by the U.S. corporation would be equal to the product of (i) the aggregate amount of such foreign taxes and (ii) a fraction, the numerator of which is the aggregate amount of such dividends and subpart F income inclusions (i.e., the amount of currently taxed income derived from the foreign subsidiaries) and the denominator of which is the sum of the U.S. corporation's proportionate shares of the total earnings and profits of each foreign subsidiary. This computation would be performed separately for each foreign tax credit limitation category.

Once the amount of foreign taxes that the U.S. corporation is deemed to have paid is determined for each limitation category under the modified rules of section 902, that amount would be added to the amount of foreign taxes in that category for which the U.S. corporation is entitled to claim a direct credit under section 901. The section 904 foreign tax credit limitation (i.e., the amount of pre-credit U.S. tax payable with respect to income in the relevant limitation category) would then be applied to the total amount of such foreign taxes, as under present law.

Under the proposal, therefore, the foreign taxes deemed paid with respect to dividends and subpart F income inclusions would reflect the weighted average of the foreign tax rates paid by each foreign subsidiary. Thus, a dividend paid to a U.S. parent by a subsidiary organized in a low-tax jurisdiction would typically carry deemed paid foreign taxes in excess of the foreign taxes actually paid to that low-tax jurisdiction with respect to the distributed earnings. In contrast, a dividend paid to a U.S. parent by a subsidiary organized in a high-tax jurisdiction would typically carry deemed paid foreign taxes in an amount that is less than the foreign taxes actually paid to that high-tax jurisdiction with respect to those earnings.

To illustrate this effect, consider a domestic corporation, Parent Co., that owns 100 percent of the shares of each of Alpha Co. and Bravo Co., CFCs organized in Alphaland and Bravonia, respectively. Alpha Co. has pre-tax earnings of $1,000 in the general limitation category, pays foreign taxes of $125 (at a 12.5 percent tax rate), and has net earnings after taxes of $875. Bravo Co. also has pre-tax earnings of $1,000 in the general category, but pays foreign taxes of $410 (at a 41 percent tax rate) and has net earnings after taxes of $590. The aggregate amount of net earnings and profits of Alpha Co. and Bravo Co. is $1,465 ($875 + $590),[262] and the aggregate amount of foreign taxes paid is $535 ($125 + $410).

If Alpha Co. distributes $500 to Parent Co. as a dividend, the amount of foreign taxes that Parent Co. would be deemed to have paid under the proposal with respect to the distributed

[261] Thus, the proposal would extend to foreign taxes paid by noncontrolled section 902 corporations (i.e., 10/50 corporations), as well as by CFCs.

[262] Undistributed earnings are reduced by the amount of foreign income taxes paid or accrued, whether or not those taxes are creditable. See Treas. Reg. sec. 1.902-1(a)(9)(iii) (post-1986 undistributed earnings are reduced for purposes of the analogous corporation-by-corporation computation under present law).

earnings is $183 (or $535 x ($500/$1,465)). Similarly, if Bravo Co. distributes $500 to Parent Co. as a dividend, the amount of foreign taxes that Parent Co. would be deemed to have paid with respect to the distributed earnings is also $183 ($535 x (500/1,465)). Absent other factors, Parent Co. would be indifferent as to whether the $500 is remitted from Alpha Co. or Bravo Co., leaving Parent Co. to decide the source of the dividend based on business needs, rather than U.S. tax considerations.[263]

Cross-crediting through selective repatriation

As described earlier, the present foreign tax credit limitation rules permit significant "cross-crediting" of foreign tax that is imposed at a rate higher than the applicable U.S. tax rate against residual U.S. tax on income in the same limitation category that is subject to foreign tax at a rate lower than the U.S. rate. Historically, the U.S. foreign tax credit rules have restricted cross-crediting to varying degrees. The per-country limitation that applied in various forms prior to 1976, and the nine-basket regime that applied from 1986 until 2004, represented fairly stringent, although conceptually different, limitations on cross-crediting. The reduction in the number of limitation categories to two (passive and general) by AJCA significantly increased the extent to which cross-crediting is feasible, between income of both different types and different sources.[264] As a consequence, planning to maximize the use of foreign tax credits has assumed increasing importance in determining whether and when to repatriate foreign earnings.

Under present law, foreign tax credit planning typically involves selective repatriation of particular pools of foreign earnings, e.g., timing the repatriation of high-taxed income to coincide with the inclusion of low-taxed income. For example, excess foreign taxes (i.e., foreign taxes in excess of the U.S. 35 percent corporate rate), such as those arising in connection with the receipt of dividends from a foreign subsidiary in a high-tax jurisdiction, may be used to offset U.S. tax on royalties received for the use of intangible property in a low-tax country. According to one study, almost two-thirds of all foreign-source royalties were sheltered by excess foreign tax credits in 2000, meaning that no residual U.S. tax was due.[265] In addition, as described further in section II.B, multinational corporations engage in a variety of techniques that utilize the entity classification rules to manipulate the source of foreign earnings, the time at which they are subject to U.S. tax or the amount of associated foreign tax.

The proposal would substantially curtail the benefits of selective repatriation strategies, by disassociating the amount of deemed paid foreign taxes under section 902 from the actual amount of foreign tax paid on distributed earnings. Under the proposal, earnings distributed by

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[263] The blended effective tax rate on Parent Co.'s share of the aggregate earnings of Alpha Co. and Bravo Co. is 26.8 percent (535/(1,000+1,000)). Parent Co.'s deemed paid foreign taxes of $183 on distributed earnings of $500 would reflect that blended rate, once the section 78 gross-up amount ($183) was taken into account, i.e., $183/($500 + $183) = 26.8 percent.

[264] The American Bar Association Task Force described the rules of present law as allowing "virtually unlimited cross-crediting, except with passive income." American Bar Association, Report of the Task Force on International Tax Reform, p. 775.

[265] Harry Grubert and Rosanne Altshuler, Corporate Taxes in the World Economy, p. 11.

a foreign subsidiary in any jurisdiction would carry with them foreign taxes deemed paid at the same average effective rate. In effect, the proposal would require universal cross-crediting of taxes paid by foreign subsidiaries, across both countries and income types (within each limitation category) and without regard to the timing of repatriation; taxpayers would no longer be able to cross-credit selectively, where doing so was to their advantage.

Viewed in this manner, the proposal represents a significant departure from traditional efforts to tailor limitation categories that are administrable yet sufficiently precise to approximate the results of an item-by-item limitation.[266] Instead, and perhaps in recognition of the inherent difficulty of that exercise, the proposal adopts a precisely opposite, aggregation approach in an effort to make taxpayers indifferent (from a foreign tax credit perspective) as to the source from which foreign subsidiary earnings are repatriated and the time at which foreign subsidiary taxes are eligible to be taken as a credit.

The proposal would not, however, eliminate opportunities for foreign tax credit planning. Because the proposal would apply only for determining deemed paid taxes creditable under section 902, incentives would exist for structural planning to distort the effective tax rate of income earned through subsidiaries. Such planning could be designed to remove high-taxed foreign earnings from the blending regime, e.g., by converting foreign subsidiaries located in high-tax jurisdictions into branches or partnerships, so that foreign taxes associated with those earnings would be considered directly paid taxes under section 901 rather than section 902. Alternatively, taxpayers could plan to remove low-taxed earnings from the blending regime, e.g., by placing low-taxed subsidiaries below the sixth-tier foreign corporations described in section 902(b)(2).

Under present law, sections 902 and 78 establish parity between the treatment of foreign taxes paid with respect to branch income and those paid with respect to income earned in foreign subsidiaries. Foreign source income earned through a foreign branch is fully includible by a U.S. corporation, without reduction for foreign taxes paid on that income, and the full pre-tax amount is reflected in the section 904 limitation fraction. The amount of foreign source income earned through a foreign subsidiary that can be distributed as a dividend for U.S. tax purposes will necessarily be an after-tax amount, i.e., earnings reduced by the amount of the foreign taxes paid by the subsidiary on those earnings.[267] Thus, the amount actually received by the U.S. corporation will be a net amount of earnings, after foreign taxes. Section 78 requires, however, that a U.S. corporation claiming a foreign tax credit under section 902 must include, as additional dividend income, an amount equal to the foreign taxes that it is deemed to have paid under section 902 (or section 960). This section 78 "gross-up" ensures that the full amount of the earnings on which the foreign taxes were paid is reflected in calculation of the section 904

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[266] The American Bar Association Task Force, for example, recently recommended reverting to a per-country foreign tax credit limitation on the grounds that, in most countries, the tax rate and tax base is the same throughout the country. American Bar Association, Report of the Task Force on International Tax Reform, p. 775. As an alternative, the Task Force suggested grouping together countries with similar tax bases or effective tax rates.

[267] The amount of the distribution is determined under foreign law, but the amount of the distribution that is a dividend is determined under U.S. law.

limitation. The result parallels the treatment of income earned through a branch, which is fully includible in income without reduction for foreign taxes (assuming that the taxpayer elects to claim a credit rather than a deduction for the foreign taxes paid).

Under the proposal, however, foreign taxes paid by a foreign branch would be fully available for credit, subject only to the general and passive category section 904 limitations, while foreign taxes paid by a foreign subsidiary would be creditable only to the extent of the average effective foreign tax rate (determined by taking into account all foreign subsidiaries). The section 78 gross-up mechanism provides parity in the computation of taxable income earned through a branch and through a subsidiary, but does not address this timing disparity. As a consequence, U.S. corporate taxpayers may have an incentive to earn high-taxed foreign source income through a branch, rather than a subsidiary. The result may be to encourage the conversion of existing subsidiaries into branch form, or the establishment of new branches rather than new subsidiaries in countries with relatively high foreign tax rates. To the extent that a U.S. corporation is able to place high-taxed foreign source income in branches, it could be expected that any foreign source income remaining in its foreign subsidiaries will be subject to a relatively lower foreign tax rate. Over time, the foreign tax associated with undistributed foreign subsidiary income could diminish, increasing the expected U.S. tax liability associated with repatriation of that income and thus the disincentive to repatriation. Such an effect should be considered in conjunction with the Administration's "Proposal to Defer Deduction of Expenses (Except R&E Expenses) Related to Deferred Income", discussed above, which is intended to encourage repatriation of foreign earnings.

An alternative approach that would retain parity between income earned through foreign branches and foreign subsidiaries would be to include both foreign taxes and foreign earnings of both branches and foreign subsidiaries in determining the amount of foreign taxes available for possible credit (i.e., before application of the section 904 limitation). This approach is reflected in H.R. 3970, the Tax Reduction and Reform Act of 2007, introduced on October 25, 2007 by House Ways and Means Committee Chairman Charles Rangel. H.R. 3970 would apply the blending approach in determining the amount of foreign taxes that are potentially creditable under both sections 901 and 902. The inclusion of section 901 for this purpose presents other technical and policy issues, however, such as the treatment of withholding taxes on distributions of previously deferred foreign earnings, and the treatment of deductible payments (such as interest or royalties) made to a U.S. corporation by a foreign subsidiary in a jurisdiction that does not impose withholding tax. The latter may allow taxpayers to claim credits for taxes paid by CFCs on a more accelerated basis than under current law.[268]

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[268] These issues are discussed in "Report on International Provisions of H.R. 3970 and Effects of Reduction in Corporate Tax Rates," New York State Bar Association Tax Section, December 24, 2008 (hereafter, NYSBA Tax Section Report on International Provisions of H.R. 3970).

Technical and administrative considerations

The proposal would require resolution of a number of additional technical and administrative questions, either by statute or by regulation.[269] Most importantly, it would be necessary to develop rules for allocating subsidiary earnings and foreign taxes proportionally among multiple shareholders (direct and indirect), including in situations where shareholders' proportionate interests change as a result of acquisitions, dispositions, dilutions, mergers and other corporate events. This would likely require the establishment of shareholder-level accounts to which the earnings and foreign taxes of a foreign subsidiary would be allocated annually, based on the shareholder's proportionate ownership of the subsidiary during the year. The rules would need to consider the treatment of the accounts upon a change in ownership of the shares.[270]

Another significant consideration is the manner in which the pools of foreign subsidiary earnings would be determined: whether on a consolidated basis, with elimination of the effects of intercompany transactions, or as the sum of separately-computed company results. Implicit in this question are technical questions such as: (1) the treatment of transactions between two foreign subsidiaries for purposes of determining the earnings of each that are includible in the section 902 aggregate earnings amount; (2) the treatment of deficits, including whether the earnings deficit of one foreign subsidiary should offset the positive earnings of other foreign subsidiaries; (3) ordering rules for determining the extent to which an E&P deficit in one limitation category should reduce positive E&P in another limitation category of the same entity or other entities; and (4) whether the amount and separate limitation character of dividends and subpart F inclusions should be determined by reference to the aggregate blended E&P pool or on a separate-entity basis.

Additional technical considerations include: (1) integration of the proposal with the rules of section 905(c) addressing foreign tax redeterminations; (2) currency translation rules for determining the amounts included in the blended pools of foreign taxes and foreign earnings, and for translating into dollars and computing exchange gain or loss on distributions from those blended pools; (3) treatment of earnings and taxes in entities below the sixth-tier that are not included in the section 902 qualified group;[271] (4) the interaction between the rules for determining the taxable distribution under sections 301 and 302, for which purpose E&P must be determined on an entity-by-entity basis, and the aggregate E&P pool approach mandated by this

[269] The NYSBA Tax Section Report on International Provisions of H.R. 3970 also addresses a number of these technical considerations.

[270] Under section 1248, gain recognized on a transfer of shares of a CFC by a U.S. 10-percent shareholder is generally treated as a dividend, to the extent of the accumulated earnings of the CFC attributable to those shares during the shareholder's holding period. Under section 902, as modified by the proposal, such a dividend would carry with it a proportional amount of the foreign taxes in the shareholder's account. Any earnings and foreign taxes remaining in the account, e.g., as a result of the application of the gain limitation to the amount treated as a dividend under section 1248, could be either added to the new shareholder's earnings and foreign tax accounts or eliminated.

[271] See sec. 902(b)(2)(B)(iii). Under present law, CFCs below the sixth tier of ownership (from the United States) are not considered part of the section 902 qualified group.

proposal for determining the available foreign tax credit; and (5) whether the available foreign tax credit (before application of the section 904 limitation) is determined on the basis of a single, carryforward calculation or under the approach taken in H.R. 3970, which provides for an annual calculation with respect to current earnings and a second calculation with respect to unrepatriated earnings.

Tax reporting requirements would also necessarily increase under the proposal. Under present law, annual information reporting relating to E&P and foreign taxes is required only with respect to CFCs. Under the proposal, however, every foreign subsidiary's E&P and foreign taxes would affect the current year section 902 credit of the U.S. parent corporation, regardless of the amount of actual or deemed distributions from that subsidiary. Thus, it will likely be necessary to provide for additional information reporting with respect to 10/50 companies so that the IRS can verify the amount of section 902 credits claimed on taxpayers' returns.

Moreover, although E&P and foreign tax information with respect to 10/50 companies is already required under present law in order to compute deemed- paid credits, apply the look-through rules to dividends paid by 10/50 companies and, in many cases, to apportion interest expense in calculating the foreign tax credit limitation,[272] this information can be difficult to obtain if U.S. shareholders do not control the company. Under existing Treasury regulations, a U.S. shareholder must track E&P and foreign tax information for a CFC or 10/50 company beginning only with the first taxable year in which the computation of E&P is significant for U.S. tax purposes with respect to its controlling domestic shareholder.[273] Under present law, this information often is not significant until the controlling domestic shareholder is required to include income in respect of the CFC or 10/50 company. Under the proposal, however, this information would likely be significant for all CFCs and 10/50 companies for every year.

Transition considerations

The proposal does not provide for a transition rule, with the result that all foreign taxes and all earnings of foreign subsidiaries, including amounts attributable to periods prior to the

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[272] The Tax Reform Act of 1986 (Pub. L. No. 99-514) created a separate foreign tax credit limitation category for dividends from 10/50 companies. As enacted, this limitation applied on a corporation-by-corporation basis. The Taxpayer Relief Act of 1997 (Pub. L. No. 105-34) added a new section 904(d)(4), which required that the foreign tax credit limitation applicable with respect to each 10/50 company be determined based on the underlying E&P from which the 10/50 company paid a dividend, for E&P accumulated in post-2002 taxable years. Any dividends paid during post-2002 years from E&P accumulated in pre-2003 years were, in general, assigned to a single 10/50 dividend basket, rather than to a separate basket for each 10/50 company as in the past. Section 904(d)(4) was then further modified by AJCA (Pub. L. No. 108-357) to extend look-through treatment to post-2002 dividends paid out of pre-2003 E&P.

[273] See Treas. Reg. sec. 1.964-1(c)(6), which generally provides that a foreign corporation that is a CFC or 10/50 company is not required to make an election to adopt a taxable year or method of accounting until the first taxable year in which the computation of its E&P is significant for U.S. tax purposes with respect to its controlling domestic shareholder(s). The regulation provides a list of events that are deemed significant for this purpose, including the shareholder's use of the tax book value method of interest expense apportionment and a distribution (either an actual dividend or a deemed dividend under subpart F) from the foreign corporation to its shareholders with respect to its stock.

enactment of the proposal, would be subject to the blending rule. This approach would be simpler than a phased-in effective date rule, because separate tracking of pre- and post-effective date earnings and taxes pools would not be required. However, complex rules would be required for merging earnings and taxes accounts of foreign subsidiaries that acquired U.S. shareholders and became subject to the pooling rules on different dates, or that presently maintained layered earnings and taxes accounts resulting from pre-effective date merger and acquisition activity.

An alternative approach, similar to that adopted with respect to the section 902 amendments made by the Tax Reform Act of 1986 (establishing the multi-year pooling rules), would be to establish separate pools of pre- and post-enactment date foreign taxes and earnings. This approach would require ongoing maintenance of separate pre- and post-effective date earnings and foreign tax accounts and, by implication, two sets of foreign tax credit rules. It would also require a dividend ordering rule for determining the amount of any dividend paid from pre-effective date earnings versus the amount paid from post-effective date earnings.[274]

Treaty considerations

It is conceivable that U.S. income tax treaty partners and commentators may argue that the proposal is inconsistent with the United States' obligations under the relief from double taxation provisions of its income tax treaties. Those provisions generally require the United States to relieve double taxation by allowing to its citizens and residents a credit against U.S. income tax liability for income tax paid or accrued directly by those citizens or residents to the other treaty countries. A typical U.S. tax treaty provision also requires the United States to allow to a U.S. corporation that owns at least 10 percent of the voting stock of a corporation resident in the other treaty country and that receives dividends from that other corporation a credit (an "indirect credit") against U.S. tax for the tax that the other corporation pays to the other treaty country with respect to the profits out of which the dividends are paid.[275]

As described earlier, in situations in which the U.S. corporation is a 10-percent-or-greater shareholder in two or more foreign corporations located in different countries with different effective tax rates, the amount of foreign taxes that a U.S. corporation would be deemed to have paid under the proposal with respect to distributed earnings of a foreign subsidiary may not correspond directly to the actual amount of taxes paid by the subsidiary on those earnings. Rather, the amount of taxes deemed to have been paid would reflect a weighted average of the effective tax rates paid by each of those subsidiaries. Thus, in the case of a foreign subsidiary located in a country with a relatively high tax rate, the amount of taxes deemed paid by the U.S. corporation could be lower than the amount actually paid by the subsidiary on the distributed earnings. Conversely, in the case of a foreign subsidiary located in a country with a relatively

[274] See e.g., Michael J. Graetz and Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Corporations," *National Tax Journal,* 54, p. 784, suggesting this approach in connection with transitioning to an exemption system and noting that precedent is found in the rules applicable to C corporations that elect subchapter S status and in the transition rules adopted in 1986 in connection with the modifications to the foreign tax credit limitation rules.

[275] U.S. Treasury Department, United States Model Income Tax Convention of November 15, 2006, Article 23 (Relief from Double Taxation). Most U.S. income tax treaties include essentially the same language.

low tax rate, the amount of taxes deemed paid by the U.S. corporation could be higher than the amount actually paid by the subsidiary on the distributed earnings. In either case, a question is whether the foreign tax credit allowed as a result of the provision is strictly consistent with a treaty's relief from double tax requirement that credit be allowed for "the" income tax paid to the treaty country in question. In particular, a treaty country whose income tax rate is relatively high[276] may argue that the disassociation of the deemed paid tax amount from the amount of tax actually paid or accrued by the subsidiary to that treaty country on the distributed earnings is a violation of the treaty.

Where potential technical arguments could allege the existence of a conflict between U.S. domestic law and U.S. treaties, there is precedent for providing an express treaty override in order to forestall litigation.[277] In the absence of an express treaty override, the legislation could be expected to take precedence over an income tax treaty based on the "last-in-time" principle if the proposal were not consistent with the treaty's relief from double taxation requirements.[278]

Treaties' relief from double taxation requirements prohibit the United States from amending the provisions of its internal law foreign tax credit rules only to the extent the amendments are inconsistent with the general principle of the treaty provisions,[279] which the Technical Explanation of the U.S. Model Income Tax Convention states is the "allowance of a

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[276] While less than half of the countries that are members of the Group of 20 (G-20) have effective corporate tax rates of 30% or more, all but three (Russia, Saudi Arabia and Turkey) have effective tax rates of 25% or more. See OECD Tax Database, Table II.1, available at http://www.oecd.org/document/60/0,3343,en_2649_34897_1942460_1_1_1_1,00.html (Table II.1) and KPMG Corporate and Indirect tax survey 2008, available at http://www.kpmg.com/Global/IssuesAndInsights/ArticlesAndPublications/Pages/Corporateindirecttaxsurvey2008.aspx. For updates to specific corporate tax rates by country, see the Deloitte *International Tax and Business Guides* at http://www.deloitte.com/dtt/section_node/0,1042,sid%253D11410,00.html. Only three of these countries (Argentina, Brazil, and Saudi Arabia) have not entered into income tax treaties with the United States. Moreover, each of the United States' largest trading partners that are not also members of the G-20 (Belgium, the Netherlands, Taiwan and Venezuela) has an effective corporate tax rate of 25% or more. U.S. Census Bureau, Foreign Trade Statistics, http://www.census.gov/foreign-trade/statistics/highlights/top/top0812yr.html (December, 2008). Of these, only Taiwan has not entered into an income tax treaty with the United States. In addition, Article 22 of the income tax treaty between the United States and China, which provides for relief from double taxation, does not impose any limitations with respect to future amendments to U.S. or Chinese law regarding foreign tax credits. For the list of current G20 members, see http://g20.org/about_what_is_g20.aspx.

[277] See e.g., Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647), Section 1012(aa)(2)(A). This provision expressly resolved several such conflicts that arose from the Tax Reform Act of 1986 (P.L. 99-514), including a treaty override provision with respect to the section 904(d) limitation categories. See also Joint Committee on Taxation, *Description of the Technical Corrections Act of 1987* (H.R. 2636 and S. 1350) (JCS 15-87), June 15, 1987, p. 320. The Joint Committee staff noted that prior legislation, such as the Revenue Act of 1962 (Pub. L. No. 87-834), had expressly provided an override of prior treaty obligations in order to forestall any possible litigation.

[278] Sec. 7852(d)(1).

[279] The credits required by Article 23 are allowed "[i]n accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle [of Article 23 (Relief from Double Taxation)])."

credit."[280] As a result, the proposal would not constitute a treaty override if the treaty partners of the United States agreed that it was consistent with the general principle of allowing a credit.[281]

The proposal may be viewed as consistent with the United States' treaty obligations because it does not deny a foreign tax credit for the full amount of foreign taxes paid on earnings distributed from higher-tax countries. Rather, in the case of foreign taxes paid at a relatively high rate (i.e., a rate higher than the weighted average rate paid by all of the U.S. corporation's subsidiaries), the effect of the proposal would be to defer the availability of the full credit until all earnings, in the aggregate, have been distributed to the U.S. corporation by its foreign subsidiaries. In other words, the proposal simply meters the inflow of deemed paid foreign taxes such that they correspond with the inflow of income from foreign subsidiaries on an aggregate basis. In this respect, the proposal is somewhat similar to the foreign tax credit limitation rules of section 904; those rules are expressly contemplated by U.S. income tax treaties. The purpose of these rules is to limit the extent to which foreign taxes may be credited in a particular year in order to ensure that U.S. tax on U.S. source income is not offset by direct and deemed paid credits, as well as to mitigate cross-crediting across different types of foreign source income. They do not deny a foreign tax credit to the extent that taxes in excess of the current year limitation can be used in a carryforward or carryback year.

On the other hand, the proposal would function differently from the section 904 limitation in the sense that section 904 restricts a taxpayer's ability to credit one country's tax against U.S. income tax on *other income* (i.e., income other than the income on which that tax was paid). In contrast, the proposal would limit a U.S. corporation's ability to credit foreign tax against the U.S. income tax imposed on the *same income* on which the foreign tax was paid, which some treaty partners may view as a conflict with the United States's treaty obligations.

The effect of the proposal on a particular U.S. corporation would vary depending on the locations of its foreign subsidiaries, their relative sizes and the extent to which the U.S. corporation chose to repatriate the subsidiaries' earnings.

Prior Action

No prior action.

[280] Article 23 (Relief from Double Taxation), paragraph 2.

[281] While the meaning attributed to treaty provisions by the Department of Treasury, which is charged with their negotiation, and (through the IRS) enforcement, is entitled to great weight, treaties are interpreted so as to give effect to the intent of both signatories. *Xerox Corp. v. U.S.,* 41 F.2d 647, 656 (Fed. Cir. 1994). Less deference to Treasury's contemporaneous interpretations is merited when the treaty partner disagrees on the meaning of the treaty. *National Westminster Bank PLC v. U.S.,* 512 F.3d 1347, 1358 (Fed. Cir. 2008), citing *Iceland Steamship Co. Eimskip v. U.S. Dep't of the Army*, 201 F.3d 451, 458 (D.C. Cir. 2000).

2. Proposal to modify the tax rules for dual-capacity taxpayers

Description of Proposal

In the case of a dual-capacity taxpayer, the proposal would treat a foreign levy that would otherwise qualify as an income tax or in lieu of tax as a creditable tax only if the foreign country generally imposes an income tax. An income tax would be considered generally imposed for this purpose only if the income tax applies to trade or business income from sources in that country, and only if the income tax has substantial application to non-dual-capacity taxpayers and to persons who are nationals or residents of that country. The proposal would replace the part of the present regulatory safe harbor that applies when a foreign country does not generally impose an income tax. The proposal generally would retain the rule of present law where the foreign country does generally impose an income tax. The proposal also would convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income. The proposal would, however, yield to existing U.S. treaty obligations that allow a credit for taxes paid or accrued on certain oil or gas income.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2010.

Analysis

The proposal would address the distinction between creditable taxes and non-creditable payments that are made in exchange for a specific economic benefit and would modify the rules provided under the present Treasury regulations in two respects. First, the proposal would deny a foreign tax credit for amounts paid by a dual-capacity taxpayer to any foreign country that does not have a generally applicable income tax. Thus, the proposal would eliminate the portion of the present-law regulatory safe harbor under which the portion of a foreign levy that does not exceed the applicable U.S. tax is treated as a creditable tax in this situation. It would also require that there be a generally applicable income tax when applying the facts and circumstances method.

Second, the proposal would modify the present regulatory criteria to provide that an income tax is "generally imposed" if it applies to trade or business income from sources in that country and that it has substantial application to non-dual-capacity taxpayers and to persons who are nationals or residents of that country. Therefore, the proposal would effectively eliminate the present regulatory rule as applicable to dual-capacity taxpayers under which foreign income taxes that are inapplicable to persons who are nationals or residents of the foreign country may nonetheless be considered generally imposed.

As discussed above, the original catalyst for rules that would govern the creditability of payments made by dual-capacity taxpayers was a concern that payments which purported to be income taxes imposed on U.S. oil companies by mineral-owning foreign governments were at least partially, in substance, royalties or some other business expense. Although the dual-capacity taxpayer regulations mitigate this concern, the present-law regulatory regime still permits a foreign levy to be treated as a creditable tax, despite there being no generally imposed income tax on the foreign country's residents, either using the facts and circumstances method, or under the safe-harbor, to the extent of the portion of the foreign levy that does not exceed the applicable U.S. tax. The regulations thus presume, in this circumstance, that the foreign levy represents a special type of income tax, even where the tax is imposed solely on dual-capacity taxpayers. The proposal would reverse that presumption by allowing a dual-capacity-taxpayer to treat all or part of a foreign levy as an income tax only where the country imposes a general income tax with substantial application to non-dual-capacity taxpayers and to nationals or residents of the country.

Although primarily applicable to oil and gas producers (and other companies engaged in mineral extraction businesses), the "dual-capacity" taxpayer provisions are broadly applicable to any taxpayer that is treated under the regulations as receiving a specific economic benefit from a foreign government. Thus, for example, a corporation engaged in a banking business that loans funds to a foreign government may meet the definition of a dual-capacity taxpayer and therefore be subject to the provisions in the Administration's proposal, with the result that if the foreign country has no generally imposed income tax, the taxes paid by the bank would not be creditable.[282]

The proposal does not clarify what would constitute "substantial application" to non-dual-capacity taxpayers and to persons who are nationals or residents of the foreign country. Presumably, Treasury would have the authority to issue guidance on when an income tax would be deemed to have substantial application. At one end of the spectrum, substantial application could require that the country impose a comprehensive income tax similar to that of the United States. At the other end of the spectrum, it could require that the tax only applies to substantially all residents or nationals of that country that are in the same industry as the dual-capacity taxpayer. It is likely that substantial application lies somewhere between these extremes.

The proposal also does not provide a definition of "resident," and it is not clear whether a controlled foreign corporation operating in a country and subject to tax in that country would be considered a resident, notwithstanding that its parent company has no direct operations in such country. Moreover it is not clear how joint ventures with both resident and non-resident investors would be treated under the proposal.

The proposal would treat dual-capacity taxpayers differently from non-dual-capacity taxpayers in a jurisdiction that does not impose an income tax on its residents or on resident-owned corporations but that imposes an income tax on all nonresident taxpayers and local corporations that are foreign owned. Under the proposal, such a tax would no longer be treated as generally applicable. Consequently, a dual-capacity taxpayer subject to the income tax would not be eligible for a foreign tax credit for that tax while a non-dual-capacity taxpayer subject to the same income tax would be eligible for a credit (subject to the application of sections 901 and 903). All else equal, this disparate treatment would tax the foreign country operations of a U.S. dual-capacity company more heavily than the foreign country operations of another U.S. firm

[282] Treas. Reg. sec. 1.901-2A(c)(2)(ii), Example 1. In this example, the taxes paid by the bank were creditable because the bank met its burden of proof under the facts and circumstances method.

simply because the dual-capacity company has a business arrangement (e.g., a royalty agreement) with the local government.

Proponents of the proposal argue that present law fails to achieve the appropriate allocation between a payment for specific economic benefit and a creditable tax in those cases where the foreign country imposes a levy on an item, but does not otherwise generally impose an income tax. Thus, they assert that the requirement that the foreign country generally impose an income tax ensures that the levy is not a payment for a specific economic benefit.

Opponents of the proposal argue that the potential for double taxation created under the proposal does not constitute sound tax policy. Instead, they contend that if the dual capacity taxpayer can establish that it is paying fair compensation to the foreign country for the economic benefit received from that country, amounts paid pursuant to the foreign levy on net income or a levy on excess profits should constitute a creditable tax, notwithstanding that the foreign country does not generally impose an income tax.

It is also asserted that the major U.S. based oil companies would be disadvantaged relative to foreign competitors in bidding for new projects as a result of the increased costs. This reduced competitiveness could, it is contended, impair energy security in the United States.

Also under the proposal, a separate foreign tax credit limitation category would apply to combined foreign oil and gas income, and the present-law special limitation for combined foreign oil and gas income under section 907 would be eliminated. Some have argued in the past that the original concerns that gave rise to the section 907 rules – royalties being disguised as foreign levies and the cross-crediting of taxes paid at high rates on foreign oil and gas related income against U.S. tax on other low-taxed income – have been sufficiently addressed by other provisions and that section 907 adds unnecessary complexity and should be repealed.[283] The disguised royalties issue, it is argued, was addressed by the dual-capacity taxpayer rules. As discussed above, however, the present law dual-capacity taxpayer rules permit certain foreign levies to be treated as creditable under a safe harbor even though the foreign country does not have a generally applicable income tax. If the proposed modifications to the dual-capacity taxpayer rules were enacted, these changes may render section 907 unnecessary in preventing crediting of disguised royalties. However, the cross-crediting of high taxes paid on extraction income against other income is a section 904 concern that is not addressed by changes to the amount of the foreign levy that qualifies under section 901. Furthermore, the recent change combining FOGEI and FORI into combined foreign oil and gas income allows for substantial cross-crediting of extraction taxes against U.S. tax on low-taxed downstream FORI income. By replacing section 907 with a separate section 904 limitation category for foreign oil and gas income, the proposal would restrict cross-crediting of oil and gas related taxes against other general category income as well as prevent the use of excess credits on other general category

[283] U.S. National Foreign Trade Council, Inc., *The NFTC Foreign Income Project: International Tax Policy for the 21st Century*, *2002 Tax Notes Today 66-57* (December 15, 2001); Statement by Gregory S. Nickerson and Fred Murray of National Foreign Trade Council, Inc. relating to National Foreign Trade Council Comments on Joint Committee on Taxation Study of Overall State of Federal Tax System and Recommendations for Simplification before the Committee on Finance United States Senate, 107th Congress, May 14, 2001.

income from offsetting U.S. tax on low-taxed FORI for taxpayers that do not have extraction income. At the same time, the proposal would simplify credit calculations because present law requires that the special section 907 limitation be applied first, followed by application of the section 904 limitation.

Prior Action

An identical proposal was included in the President's Fiscal Year 1998, 1999, 2000 and 2001 Budget Proposals. The proposal in the Fiscal Year 1998 Budget Proposal included an additional modification with respect to the treatment of foreign oil and gas income under subpart F of the Code which is not included in this proposal.

B. Tax Reduction Facilitated by Hybrid Entities

Introduction

The adoption in 1997 of the "check-the-box" regulations,[284] which provide taxpayers an elective method to determine the classification of most entities as either a corporation, partnership, or disregarded entity, has increased significantly the extent to which taxpayers can manage the repatriation of both earnings and foreign taxes to maximize the use of foreign tax credits and minimize U.S. tax liability. While those regulations have greatly simplified the entity classification process for both taxpayers and the IRS, that very simplicity has also made it possible for taxpayers to avoid or invoke selectively the limitations on deferral and the foreign tax credit. In particular, the regulations have facilitated the creation of "hybrid entities" that are treated as flow-through or disregarded entities for U.S. tax purposes but as corporations for foreign tax purposes, and "reverse hybrid entities" for which the opposite is true. The use of these hybrid and reverse hybrid entities is now central to numerous strategies designed to separate foreign tax credits from deferred foreign-source income, to create foreign tax credits with respect to income that is not taxable in the United States, or to avoid current inclusions under subpart F.

In general, the check-the-box regulations make classification of an entity (whether domestic or foreign) explicitly elective, subject to minimal restrictions, for nonpublicly traded unincorporated entities with two or more members. Certain entities are treated as "per se corporations" for which an election is not permitted. Generally, these are domestic entities formed under a State corporation statute, and certain foreign business entities listed in the regulations, which are generally corporations that are not closely held and the shares of which can be traded on a securities exchange.[285] An eligible entity with two or more members may elect, however, to be classified as a corporation or a partnership. If an eligible entity fails to make an election, default rules treat a domestic entity with multiple members as a partnership, and a foreign entity with multiple members as either a partnership, if at least one member does not have limited liability, or as a corporation if all members have limited liability.

The regulations also provide explicitly that a single-member unincorporated entity may elect either to be treated as a corporation or to be disregarded (treated as not separate from its owner). A disregarded entity (sometimes referred to as a "tax nothing") is treated in the same manner as a sole proprietorship, in the case of an entity owned by an individual, and in the same manner as a branch or division, in the case of an entity owned by a corporation or partnership. The default treatment for an eligible single-member domestic entity is as a disregarded entity. For an eligible single-member foreign entity, the default treatment is as a corporation, if the

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[284] Treas. Reg. sec. 301.7701-1, *et seq*.

[285] For domestic entities, the state corporation statute must describe the entity as a corporation, joint-stock company, or in similar terms. The regulations also treat insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a state, and organizations that are taxable as corporations under other Code provisions as per se corporations.

single owner has limited liability, and as a disregarded entity if the owner does not have limited liability.

The check-the-box regulations replaced prior regulations (the "Kintner regulations")[286] under which the classification of unincorporated entities for Federal tax purposes was determined on the basis of a multi-factor test.[287] The Kintner regulations set forth four characteristics indicative of status as a corporation that were to be used to distinguish between a corporation and a partnership: continuity of life, centralization of management, limited liability, and free transferability of interests.[288] If a business entity possessed three or more of these characteristics, then it was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership.[289] Thus, to achieve characterization as a partnership under this system, taxpayers needed to arrange the governing instruments of an entity in such a way as to eliminate two of these corporate characteristics. For example, a taxpayer desiring partnership classification for an entity might include transferability restrictions and dissolution provisions to eliminate the corporate characteristics of free transferability and continuity of life. Partnerships also needed to have at least two members, as the term suggests.[290]

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[286] T.D. 6503, 1960-2 C.B. 409. The Kintner regulations were a response to the decision in *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954). In *Kintner*, the court found that a group of physicians that had reorganized their partnership into an unincorporated "association" had conferred sufficient corporate characteristics on the unincorporated association for it to be treated as an association for Federal tax purposes, even though State law prohibited the formation of a corporation to engage in the practice of medicine. This outcome allowed the association to obtain certain pension-related tax benefits that were unavailable to the partnership.

[287] The Kintner regulations were generally consistent with the "resemblance test" set out by the Supreme Court in *Morrissey v. Commissioner*, 296 U.S. 344 (1935), under which the classification of an unincorporated entity depended on whether its organizational and legal characteristics more closely resembled those of a traditional corporation than those of other entities recognized by the Federal tax laws (partnerships, trusts, and estates). The principal characteristics of a corporation identified by the Court were associates, an objective to carry on a trade or business and divide the profits, continuity of life, centralized management, limited liability, and free transferability of interests. The Court did not identify whether any of these characteristics were controlling, although it stated that associates and a business objective were essential for corporate status. The Kintner regulations provided a similar, but more mechanical test under which an unincorporated entity was classified as an association only if it possessed more of the identified characteristics than it lacked. Consequently, the Kintner regulations generally made it more likely than under prior rules that an entity would be classified as a partnership rather than an association taxable as a corporation. In many cases, this result was favorable for taxpayers who were thus able to avoid becoming subject to two levels of tax (one at the corporate level and one at the individual shareholder level) and could deduct business losses on their individual tax returns. However, in particular cases, such as Kintner, taxpayers desired corporate tax treatment for their business entity.

[288] There were in fact six characteristics identified, although two of those characteristics were common to both corporations and partnerships—the presence of associates and an objective to carry on business and divide the gains therefrom—and thus did not provide any assistance in classifying a particular entity as either a corporation or partnership for tax purposes.

[289] Treas. Reg. sec. 301.7701-2, as in effect prior to 1997.

[290] In Rev. Rul. 73-254, 1973-1 C.B. 613, the IRS ruled that entity classification of a foreign unincorporated entity is determined by applying section 7701 and the regulations thereunder (including the Kintner regulations). However, the local law of the foreign jurisdiction is applied to determine the legal relationships of the

In adopting the check-the-box regulations, the IRS and Treasury explained that the Kintner regulations were based on historical differences between partnerships and corporations that effectively had ceased to exist, because many States had revised their laws to provide that partnerships and other unincorporated entities could possess characteristics traditionally associated with corporations.[291] A critical development in this regard was the advent and proliferation of limited liability companies ("LLCs") under State laws. Although LLCs were relatively unknown before 1988, by 2000 every state had enacted laws providing for LLCs. Although LLC laws varied from State to State, they were generally flexible and allowed business owners to create customized entities that possessed a critical common feature—limited liability for investors—as well as other corporate characteristics the owners found desirable. As a consequence, taxpayers could achieve partnership tax classification for a nonpublicly traded entity that in all meaningful respects was virtually indistinguishable from a corporation.

The check-the-box regulations were intended to relieve both taxpayers and the IRS from the need to expend considerable resources in determining the proper classification of unincorporated entities, when classification was effectively elective for well-advised taxpayers. The regulations extended elective classification to foreign, as well as domestic, entities on the basis that the complexities and resources devoted to classification of domestic unincorporated business entities were mirrored in the foreign context. Nevertheless, the IRS and Treasury Department recognized even prior to the adoption of the regulations that special considerations arise in the foreign context, including the concern that a purely elective approach might have a substantive effect on entity classification by increasing taxpayers' flexibility to achieve their desired classification of certain foreign entities, and the possibility that an elective system could expand the potential existing under the Kintner regulations for inconsistent, or hybrid, entity classification (i.e., a particular entity is treated as a taxable entity in one country but as a flow-through entity in another country).[292]

In fact, as noted above, it is now widely recognized that the ease with which hybrid entities can be created has increased significantly the extent to which taxpayers can manipulate the foreign tax credit limitation and the rules of subpart F. The President's budget includes three proposals intended to curtail the use of hybrid entities to separate foreign tax credits from the

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members of the entity among themselves and with the public at large, as well as the interests of the members of the organization in its assets. In 1988, the IRS ruled that all foreign entities are considered to be unincorporated entities for purposes of applying the Kintner regulations. Rev. Rul. 88-8, 1988-1 C.B. 403, *declared obsolete by* Rev. Rul. 98-37, 1998-2 C.B. 133. The IRS stated that it was inappropriate to classify an entity for Federal tax purposes based solely on the label attached to it by the foreign statute under which it is established. Instead, an inquiry into the legal relationships of the members of the entity as established under applicable local law is necessary. Thus, a foreign entity must have more corporate than noncorporate characteristics (as determined under the Kintner regulations) to be treated as a corporation for Federal tax purposes.

[291] See, e.g., Notice 95-14, 1995-1 C.B. 297.

[292] *Ibid.* The preambles to both the proposed and the final check-the-box regulations state that the IRS and Treasury Department will continue to monitor carefully the uses of partnerships in the international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of Code provisions and U.S. tax treaties. 61 Fed. Reg. 21,989 (May 13, 1996); T.D. 8697, 1997-1 C.B. 215.

income to which they relate and to avoid subpart F income inclusions (in one case, in connection with foreign tax minimization strategies, and in another case, in connection with cross-border reorganization transactions). These proposals are discussed below.

President's Budget Proposals

1. Proposal to reform foreign tax credit: Prevent splitting of foreign income and foreign taxes

Present Law

Under the so-called "technical taxpayer" rule of Treas. Reg. section 1.901-2(f)(1), the person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for the tax. This focus on legal liability applies even if another person, such as a withholding agent, actually remits the tax;[293] moreover, it applies even if another person bears the economic burden of the tax, for example through a gross-up clause.[294] It is generally understood that the purpose of this rule is to facilitate administration of the foreign tax credit, and to avoid potentially difficult inquiries as to the economic incidence of a foreign tax.[295]

Treas. Reg. section 1.901-2(f)(3) extends the technical taxpayer rule to situations in which more than one person is liable for a foreign income tax under the foreign law. That regulation provides that if foreign income tax is imposed on the combined income of two or more related persons (such as a corporation and one or more of its subsidiaries) and they are jointly and severally liable for the tax under foreign law, the foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of the tax, regardless of which person actually pays the tax. The regulation does not clearly address, however, certain consolidated tax regimes under which the members of a foreign consolidated group do not have in the U.S. sense the full equivalent of joint and several liability for the group's consolidated tax liability. Thus, for example, the application of the regulation is unclear with respect to the Luxembourg "fiscal unity" regime (the subject of the dispute in *Guardian Industries*, discussed below), under which the parent of a fiscal unity group files a consolidated return that combines the income and loss of the various group members and is liable to pay the entire tax liability of the group. To the extent that the regulation can be interpreted to treat the parent of such a group as the "technical taxpayer" with respect to the

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293 See *Norwest Corp. v. Commissioner*, 69 F.2d 1404 (8th Cir. 1995); *Continental Illinois Corp. v. Commissioner*, 988 F.2d 513 (7th Cir. 1993); *Nissho Iwai American Corp. v. Commissioner*, 89 T.C. 765 (1987); *Gleason Works v. Commissioner*, 58 T.C. 464 (1972).

294 Treas Reg. sec. 1.901-2(f)(2)(i); cf. *Continental Illinois Corp. v. Commissioner*, 988 F.2d at 516.

295 See Tax Section, New York State Bar Association, Report No. 1083, *Report on Regulation Section 1.901-2(f)(3) and the Allocation of Foreign Taxes Among Related Persons* (2005), *available at* 2005 Tax Notes Today 64-26.

entire amount of the group's tax liability, the regulation may facilitate the separation of creditable foreign income taxes from the income to which they relate.[296]

The availability of hybrid and reverse hybrid entities under the check-the-box regulations has allowed taxpayers to achieve essentially the same results for commonly controlled entities without reliance on foreign consolidation rules. For example, a foreign parent company with foreign subsidiaries that are reverse hybrid entities will be treated as solely liable for the foreign income tax payable by the subsidiaries (which may then be creditable by a U.S. shareholder under section 902), but will not be treated as earning the subsidiaries' income on which the taxes are imposed.[297] Hybrid entities can also be used in combination with foreign consolidation rules to generate foreign tax credits under section 901, without inclusion of the underlying income–the situation addressed in *Guardian Industries*.

Guardian Industries.–In 2007, the U.S. Court of Appeals for the Federal Circuit held that a U.S. company that wholly owned a foreign hybrid entity (a Luxembourg company treated as a disregarded entity for U.S. tax purposes, but as a corporation for Luxembourg tax purposes) was entitled to claim a direct foreign tax credit under section 901 for Luxembourg taxes paid by the hybrid entity on behalf of a consolidated group of companies of which it was the parent.[298] The other Luxembourg entities that were part of the consolidated group were operating companies treated as corporations for U.S. tax purposes. The income earned by those companies was not subpart F income, and the U.S. company consequently had no current income inclusions from those other group members. The Luxembourg taxes paid by the hybrid entity thus were available for credit against U.S. income tax imposed on other foreign source income derived by the U.S. company.

In challenging the U.S. company's foreign tax credit claim, the government argued that the Luxembourg operating entities were legally liable under Luxembourg law for the taxes on the income that they earned, even though the hybrid entity paid those taxes on their behalf.[299] Thus, the government argued that the hybrid entity was not entitled to the foreign tax credit, under the

[296] Other consolidation regimes that may present this question include the Australian "single entity" rule and the German consolidation rules. See *id.* at 16-19.

[297] See Rev. Ruls. 58-518, 1958-2 C.B. 381, and 72-179, 1972-1 C.B. 215. For further discussion of situations in which hybrid entities or hybrid securities are used to separate foreign taxes from the income to which they relate, see Tax Section, New York State Bar Association, Report No. 1083, *Report on Regulation Section 1.901-2(f)(3) and the Allocation of Foreign Taxes Among Related Persons* (2005), *available at* 2005 *Tax Notes Today* 64-26; Mary C. Bennett, "Whose Tax Is It Anyway? Foreign Tax Credits in a Check-the-Box World," *Taxes* 83, no. 3 (2005), p. 35.

[298] *Guardian Industries Corp. v. United States*, 477 F.3d 1368 (Fed. Cir. 2007).

[299] The particular issues presented by this case would not necessarily arise in foreign countries other than Luxembourg, as different foreign consolidation rules may not lead to the same separation of foreign tax and income.

"technical taxpayer" rule of the Treasury regulations.[300] The Federal Circuit examined Luxembourg law, however, and concluded that the hybrid entity bore sole liability for the tax.[301]

The government also argued that Treas. Reg. sec. 1.901-2(f)(1) creates a regime under which the party liable for the tax within the meaning of the regulation is the party that earns the income under the foreign country law; in this case, the government argued, the Luxembourg operating entities earned the income subject to the tax and thus were the entities liable for the tax. The court also rejected this argument on the basis that the regulation did not impose such a requirement. The court stated that if the Treasury Department had wanted to draft a regulation specifically calling for such a result, it could have done so.

Proposed section 901 regulations.–On August 4, 2006, the IRS and Treasury Department issued proposed regulations under section 901 intended to address situations, like the one at issue in *Guardian Industries*, in which a U.S. taxpayer seeks to claim direct foreign tax credits even though the underlying income is not currently recognized for U.S. tax purposes.[302]

The proposed regulations provide guidance on the availability of foreign tax credits in situations involving foreign consolidated groups, hybrid entities, and reverse hybrid entities.[303] The regulations retain the general principle that tax is considered paid by the person who has legal liability under foreign law for the tax. However, they purport to clarify application of the legal liability rule in situations in which foreign law imposes tax on the income of one person but requires another person to remit the tax. Specifically, the proposed regulations provide that foreign law is considered to impose legal liability for income tax on the person who is required to take such income into account for foreign tax purposes, even if another person has the sole obligation to remit the tax.

In addition, the proposed regulations provide detailed guidance regarding the treatment of taxes paid on the combined income of two or more persons. First, the proposed regulations provide that, in the case of a foreign consolidated-type regime, the foreign tax must be apportioned among all the members pro rata based on the relative amounts of net income of each member as computed under foreign law, regardless of whether members of the group are jointly and severally liable in the U.S. sense for the group's tax. The proposed regulations provide guidance in determining the relative amounts of net income.

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[300] Treas. Reg. sec. 1.901-2(f)(1).

[301] In the lower court, the government had argued in the alternative that the Luxembourg operating entities and the hybrid entity were jointly and severally liable for the taxes under Luxembourg law. This approach would effectively have precluded the U.S. company from claiming a foreign tax credit for the portion of the Luxembourg taxes attributable to income of the operating entities. The Court of Federal Claims rejected this argument, however, and the government did not make this alternative argument on appeal.

[302] 71 Fed. Reg. 44,240 (Aug. 4, 2006).

[303] The proposed regulations reserve on issues relating to hybrid instruments and payments, specifically on the question of who is considered to pay tax imposed on income attributable to amounts paid or accrued between related parties under a hybrid instrument or payments that are disregarded for U.S. tax purposes.

Second, the proposed regulations provide that a reverse hybrid is considered to have legal liability under foreign law for foreign taxes imposed on an owner of the reverse hybrid in respect of the owner's share of income of the reverse hybrid. The reverse hybrid's foreign tax liability is to be determined based on the portion of the owner's taxable income (as computed under foreign law) that is attributable to the owner's share of the income of the reverse hybrid.[304]

Third, the proposed regulations provide that a hybrid entity that is treated as a partnership for U.S. income tax purposes is legally liable under foreign law for foreign income tax imposed on the income of the entity, and that the owner of an entity that is disregarded for U.S. income tax purposes is considered to have legal liability for such tax.

The regulations are proposed to be effective for foreign taxes paid or accrued during taxable years beginning after the final regulations are published in the Federal Register.[305] The proposed regulations have not yet been finalized.

Description of Proposal

The proposal would adopt a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2010.

Analysis

The proposal does not provide a specific rule, but is essentially a statement that foreign tax credits are appropriate only in cases in which the foreign income to which they relate is currently subject to U.S. tax.[306] In general terms, the foreign tax credit regime is intended to

[304] The proposed regulations state that U.S. tax principles shall apply to determine the tax consequences if one person remits a tax that is the legal liability of another (as determined under the proposed regulations). Prop. Treas. Reg. sec. 1.901-2(f)(2)(v). The proposed regulations further state that when a corporation owns an interest in a reverse hybrid and pays foreign taxes on the income of the reverse hybrid, the corporation will generally be deemed to make a capital contribution to the reverse hybrid, with a deemed payment of the foreign taxes by the reverse hybrid.

[305] Notice 2007-95, 2007-2 C.B. 1091. Initially, the regulations were proposed to be effective for foreign taxes paid or accrued during taxable years beginning on or after January 1, 2007. However, once it became clear the regulations would not be finalized in 2007, the IRS and Treasury Department decided it was appropriate to modify the proposed effective date.

[306] As discussed under the analysis of the Administration's "Proposal to Reform Business Entity Classification Rules for Foreign Entities," a previous proposal by the staff of the Joint Committee on Taxation in 2005 would have limited to some extent the use of *Guardian*-type structures that relied upon the use of first-tier foreign disregarded entities. The Administration's proposal to reform business entity classification rules, however, would affect *Guardian*-type structures only by treating the first-tier foreign disregarded entity as regarded if such structures would be deemed to violate the "U.S. tax avoidance" exception within such proposal. Even then, however, the treatment of the first-tier foreign eligible entity as a regarded corporation would not alone hinder the ability for the taxpayer to separate the taxes from the underlying earnings and profits to which they relate. Joint

relieve U.S. taxpayers of double taxation that might otherwise result from the fact that the United States has a worldwide income tax system under which income earned in a foreign country may be taxed in both that country and in the United States. In addition, the foreign tax credit rules are generally designed to limit a taxpayer's ability to use foreign tax credits to offset U.S. tax on U.S. source income. The proposed matching rule may be viewed as a refinement of that general limitation. Nevertheless, "perfect" matching of income and foreign tax credits has never existed under the U.S. tax laws (due in part to practical limitations and to reasonable differences as to what would constitute perfect matching). Consequently, and in view of the general nature of the proposal, an initial consideration is the appropriate scope of a new, statutory matching rule.

One possibility is that the rule might codify the 2006 proposed regulations under section 901. In such a case, several issues related to the 2006 proposed regulations arise. The first is whether congressional action is necessary to adopt those rules and whether, instead, the IRS and Treasury Department could simply finalize the proposed regulations. One argument in favor of congressional action is a concern that the IRS and Treasury Department may lack the authority to make all of the changes necessary to finalize the proposed regulations in the desired form.[307] In particular, it may be asserted that the Code specifically provides that a taxpayer is entitled to a direct foreign tax credit in the amount of any income taxes paid during the taxable year to any foreign country.[308] The 2006 proposed regulations could be interpreted to be inconsistent with that legal liability rule because they may have the effect of denying a foreign tax credit in circumstances in which the person who has the sole obligation under foreign law to pay the tax (and in fact pays the tax) is different from the person who is required to take the related income into account. The IRS and Treasury Department may not promulgate regulations that are inconsistent with the plain language of the Code.[309] Moreover, the IRS and Treasury Department do not have specific regulatory authority under section 901, as they do in other areas of the

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Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-2-05), January 27, 2005.

[307] See, e.g., Howard J. Levine and Michael J. Miller, "Anti-Deferral and Anti-Tax Avoidance: Proposed Regulations "Clarifying" the Technical Taxpayer Rule Don't Pass the Giggle Test," *International Tax Journal* 33 (2007), p. 5; Margie Rollinson et al., "Foreign Tax Credit Proposed Regulations Substantially Revise the Technical Taxpayer Rule," *Journal of Taxation* 105 (2006), p. 367; Letter from Judy Scarabello, Vice President for Tax Policy, National Foreign Trade Council, Inc., to Harry J. Hicks III, International Tax Counsel, Department of the Treasury (November 4, 2005), available at 2005 *Tax Notes Today* 220-27.

[308] Section 901(a). More than 70 years ago, the Supreme Court stated, in a case involving the predecessor to section 901, that the U.S. tax laws "have never treated the stockholder for any purpose as paying the tax collected from the corporation. Nor have they treated as taxpayers those upon whom no legal duty to pay the tax is laid." *Biddle v. Commissioner*, 302 U.S. 573, 581 (1938). This case is generally considered the leading case articulating the rule as to who is the taxpayer for section 901 purposes.

[309] See, e.g., *National Muffler Dealers' Ass'n v. United States*, 440 U.S. 472 (1970) (stating that in determining whether a particular regulation is valid, the Supreme Court will look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose).

Code.[310] The Administration has previously requested such authority, and it has been included in two bills that passed the Senate, but Congress has yet to provide that authority.[311] People who believe the IRS and Treasury Department lack authority to make the changes set forth in the 2006 proposed regulations may also point to these proposals as an indication that the IRS and Treasury Department lack the necessary authority under present law. A potential response to this particular argument is that the prior Administration and legislative proposals simply enhanced the IRS and Treasury Department's existing regulatory authority by providing specific regulatory authority, which is afforded greater deference by the courts; in no way did these proposals suggest that the IRS and Treasury Department lacked authority to promulgate regulations in this area.

More generally, the IRS and Treasury Department arguably have sufficient authority to finalize the proposed regulations, even with modifications.[312] In this regard, it may be asserted that the Code grants broad, general regulatory authority to the Treasury Department to "prescribe all needful rules and regulations for the enforcement of [the U.S. tax laws]."[313] Moreover, the 2006 proposed regulations arguably are not inconsistent with the plain language of the Code and, in fact, implement the congressional mandate of section 901 in a reasonable manner.[314] The congressional mandate of section 901 is to mitigate the double taxation of income; however, when a U.S. taxpayer is able to claim a foreign tax credit currently while deferring indefinitely U.S. taxation of the related income, there is no double taxation to mitigate. Thus, the proposed regulations, which address exactly these types of situations, are an appropriate refinement of the regulations interpreting section 901.

A second issue with a proposal to codify the 2006 proposed regulations is how to best address situations in which withholding taxes are imposed on an amount received by one person on behalf of the beneficial owner of such amount ("nominee arrangements"). Nominee arrangements may arise in many circumstances, including when a broker holds stock in street name on behalf of a customer, securities lending arrangements, and sale-repurchase

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[310] The courts give greater deference to regulations promulgated under specific regulatory authority. See, e.g., *Rowan Cos. v. United States*, 452 U.S. 247 (1981).

[311] For additional information with respect to these proposals, see the prior action discussion immediately below.

[312] See, e.g., Letter from Susan P. Serota, Chair, Section of Taxation, American Bar Association , to Mark W. Everson, Commissioner, Internal Revenue Service (Mar. 22, 2007), *available at* 2007 Tax Notes Today 57-14 [hereinafter ABA Comment Letter]; Tax Section, New York State Bar Association, Report No. 1083, *Report on Regulation Section 1.901-2(f)(3) and the Allocation of Foreign Taxes Among Related Persons* (2005), available at 2005 *Tax Notes Today* 64-26.

[313] Sec. 7805(a).

[314] See, e.g., *National Muffler Dealers' Ass'n*, 440 U.S. 472 (stating that a regulation that implements a congressional mandate in a reasonable manner must be upheld).

transactions.[315] The proposed regulations recognize this potential issue and request comments on whether a special rule is necessary to address it, and, if so, how it should work.

As drafted, however, the 2006 proposed regulations do not include a special rule; instead, they provide that foreign law is considered to impose legal liability for any withholding tax (or other tax in lieu of income tax) on the person who is the owner of the base on which the tax is imposed for foreign tax purposes.[316] The consequence of this approach is that the 2006 proposed regulations would allocate to the nominee the foreign tax credit arising from the withholding tax when foreign law treats the nominee as the income earner, while the United States would treat the beneficial owner as the income earner and the appropriate party on whom to impose U.S. tax. Thus, the 2006 proposed regulations may, in certain circumstances, split foreign taxes from the related income in a way that could create double taxation or double nontaxation of income. With respect to the possibility for double nontaxation of income, such an outcome might result if the nominee is a U.S. taxpayer and the beneficial owner is a foreign person. Under certain circumstances, the U.S. nominee could be treated as the party eligible for the foreign tax credit but pass all or a portion of the actual cost of the foreign tax onto the foreign beneficial owner, who may be able eligible to claim a credit for the foreign tax or exemption of the related income under local law. In addition, the 2006 proposed regulations may place an additional burden on international financial transactions by placing the onus on the beneficial owner to establish, for purposes of claiming a foreign tax credit for U.S. purposes, whether foreign law treats a nominee as the owner of the income on which a withholding tax is imposed.

One response to these concerns may be to create a default rule for certain common nominee arrangements (such as a broker holding stock in street name for a customer) under which the beneficial owner is treated as having paid the withholding tax (without the need to demonstrate that foreign law treats the beneficial owner as the income earner). In addition, it may be appropriate to create a special rule to address other nominee arrangements in which a foreign country treats the nominee as the income earner while the United States treats the beneficial owner as the income earner. The objective of this rule would be to add additional flexibility to the 2006 proposed regulations that would allow for ease of administration and reduce the chances of creating inappropriate outcomes.

A third issue with codifying the 2006 proposed regulations is that in certain cases they would have the effect of permanently denying foreign tax credits to individuals (and certain domestic corporations) who currently are entitled to claim them, even when there is no separation of foreign tax and income (i.e., when the income is subject to tax in the same year that the foreign tax is paid).[317] Under present law, a U.S. individual who owns an interest in a reverse

[315] The 2006 proposed regulations include an example showing the application of the proposed regulations to a securities lending arrangement or sale-repurchase transaction. Prop. Treas. Reg. sec. 1.901-2(f)(6), example 3.

[316] Prop. Treas. Reg. sec. 1.901-2(f)(1)(ii).

[317] For example, suppose that Person A, a U.S. individual, owns a 20 percent interest in ForCo, a reverse hybrid entity located in country B. In a given tax year, ForCo earns $100 of income that flows through to the shareholders under country A law; the shareholders are legally liable for paying the country B tax, which is imposed at a 30 percent rate, on their pro rata share of that income. Thus, in that year, Person A pays $6 of country B tax on

hybrid entity (or a domestic corporation that owns less than ten percent of the reverse hybrid entity) may be entitled to claim a direct foreign tax credit for the foreign taxes he is required to pay under foreign law with respect to his share of the income of the reverse hybrid entity (whether or not any of that income is currently subject to tax in the United States); under the 2006 proposed regulations, the foreign taxes paid by the U.S. individual would be pushed down to the reverse hybrid entity where they would be permanently inaccessible to the individual (or domestic corporation), even if he received a distribution from the reverse hybrid entity that was fully taxable in the United States (whether in the same year that he paid the foreign taxes or in some subsequent year). This outcome results from the fact that individuals (and domestic corporations that are less than ten percent shareholders) are permitted to claim direct foreign tax credits (i.e., credits under section 901), but not indirect foreign tax credits (i.e., credits under section 902), and the 2006 proposed regulations effectively turn direct foreign tax credits into indirect foreign tax credits in the case of reverse hybrids.

On the other hand, it is arguably appropriate to deny the U.S. individual any foreign tax credit in this situation, even if there is no separation of foreign tax and income. Such a result is consistent with the general structure of the U.S. tax laws, which do not provide for corporate-shareholder integration (i.e., there may be two levels of tax on the same income, one at the corporate level and one at the shareholder level). Indirect foreign tax credits are made available to certain domestic corporations to mitigate the double corporate-level taxation of the income of domestic corporations operating abroad through foreign subsidiaries; the availability of indirect foreign tax credits to domestic corporations does nothing to alleviate the second level of U.S. tax that is imposed when the domestic corporation ultimately distributes the income of its foreign subsidiaries to its shareholders.

A fourth issue that might arise under a proposal to codify the 2006 proposed regulations is that the proposed regulations may create an opportunity for taxpayers to traffic in foreign tax credits. As stated above, the 2006 proposed regulations generally are designed so that in the case of a reverse hybrid entity, foreign taxes paid by the shareholders of the reverse hybrid entity are pushed down to the reverse hybrid entity, where they may be available as indirect foreign tax credits. However, the present law operation of the indirect foreign tax credit under section 902 makes such indirect foreign tax credits available on a pro rata basis as the related income of the foreign corporation is distributed as a dividend to a 10 percent or greater shareholder that is a

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his $20 share of ForCo's income. Finally, assume that at the end of the year, ForCo distributes all $100 of income to its shareholders on a pro rata basis, so that Person B receives $20, which is subject to tax in the United States at a 35 percent rate.

Under present law, Person A would have a $7 U.S. tax liability with respect to the $20 of income, although he would be able to claim $6 of foreign tax credits as a result of the $6 of taxes he paid to country B, leaving him with a $1 residual U.S. tax liability. Under the 2006 proposed regulations, Person A would have a $4.90 U.S. tax liability with respect to the $14 of income ($20 of income before foreign taxes, less the $6 of foreign taxes deemed paid by ForCo) distributed by ForCo, except that he would not be able to claim any foreign tax credits as a result of the $6 of taxes that he paid to country B. Thus, under the 2006 proposed regulations, Person A would pay total taxes of $10.90 ($6 to country B and $4.90 to the United States) instead of $7 ($6 to country B and $1 to the United States), even though his economic income from his investment in ForCo is unchanged.

domestic corporation. Thus, under the 2006 proposed regulations, a domestic corporation may be able to claim indirect foreign tax credits in cases in which another shareholder paid the foreign taxes and in which no foreign tax credit would otherwise be available for U.S. tax purposes.[318]

One possible response to this concern is to modify the rules of the 2006 proposed regulations to require the creation and maintenance of shareholder accounts at the reverse hybrid entity level for purposes of apportioning foreign taxes. With such accounts, one taxpayer would not be able to claim indirect foreign tax credits as a result of foreign taxes paid by another shareholder. While such accounts could be difficult for taxpayers and the IRS to administer,[319] the need to create and maintain such accounts may be limited as a practical matter; the requirement to create the accounts could deprive taxpayers of the principal benefits of the reverse hybrid structures and, if the structures do not exist, the accounts are not needed.

A final issue under a proposal that simply seeks to codify the 2006 proposed regulations is that the proposed regulations reserve on the treatment of hybrid instruments and disregarded payments.[320] A matching rule that is limited in scope to the types of situations addressed in the 2006 proposed regulations may ultimately have limited effectiveness in addressing situations in which foreign taxes are inappropriately separated from the related income, because hybrid

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[318] For example, suppose that U.S. Corp., a domestic corporation, owns a 50 percent interest in ForCo, a reverse hybrid entity located in country A, which imposes no income tax. B Corp., a country C corporation, owns the other 50 percent interest in ForCo. In a given tax year, ForCo earns $100 of income that flows through to the shareholders under country A law and country C law. Thus, B Corp. has $50 of income for country C tax purposes, which country C subjects to tax at a 30 percent rate (or $15 of tax liability). For U.S. tax purposes, ForCo is treated as a foreign corporation, and U.S. Corp. has no income and owes no U.S. tax.

Under the 2006 proposed regulations, ForCo has $100 of income (before foreign taxes) and is treated as having paid $15 in foreign taxes (the taxes that B Corp. paid to country C). If ForCo distributes the $85 of income ($100 less $15 of foreign taxes) pro rata to its two shareholders, then, for U.S. tax purposes, U.S. Corp. will have $50 of income ($42.50 plus $7.50 of section 78 gross up for the foreign taxes described below), which will be subject to tax at a 35 percent rate (or $17.50 of tax liability). However, U.S. Corp. will also be entitled to claim $7.50 of indirect foreign tax credits (50 percent of the $15 of foreign taxes ForCo is treated as having paid under the 2006 proposed regulations). Thus, U.S. Corp.'s residual U.S. tax liability on the $50 of income is $10 ($17.50 less $7.50).

In contrast, under present law, neither ForCo nor U.S. Corp. would be treated as having paid any foreign taxes. Thus, U.S. Corp.'s residual U.S. tax liability on the receipt of the $50 from ForCo would be $17.50.

[319] In addition, some people may assert that the IRS and Treasury Department may not have adequate regulatory authority to require the creation of such shareholder level accounts, even if adequate authority exists to finalize the proposed regulations as currently drafted.

[320] The IRS and Treasury Department requested comments regarding what rules should apply with respect to hybrid instruments and disregarded payments, with the possibility of incorporating those rules in the final regulations. To date, no comments have been submitted that suggest an optimal solution to the issue of hybrid instruments and disregarded payments. One comment did indicate, however, that the regulations, whenever finalized, should not adopt a general rule that treats all hybrid instruments and disregarded payments in the same manner. ABA Comment Letter, supra.

instruments may readily be used to create exactly such separations.[321] One possible response to this concern is to modify the 2006 proposed regulations to include an anti-abuse rule designed to limit the opportunities for taxpayers to separate inappropriately foreign taxes and income using hybrid instruments. However, given the myriad forms that transactions utilizing hybrid instruments might take and the potentially diverse reasons for undertaking such transactions, it may be difficult to effectively target all of the troublesome transactions.

If the proposal intends to take a different approach than the one in the 2006 proposed regulations, a couple of general observations may be made. On the one hand, a proposal with a narrow scope may be simpler, less burdensome, and easier to administer than a proposal with a broad scope. However, such a proposal may leave unaddressed a variety of situations in which foreign taxes get separated from the associated income, thus potentially undermining the matching objective. On the other hand, a proposal with a broad scope may capture most situations involving inappropriate separation of foreign taxes and income, but with an increased risk of sweeping in situations that are not generally considered to involve inappropriate separation of foreign taxes and income.

As an alternative means of addressing the inappropriate separation of foreign taxes and income with which this proposal is concerned, further consideration may be given to the Administration's proposal to require the determination of the foreign tax credit on a blended basis. If a blending proposal is adopted that applies to both direct and indirect foreign tax credits in a manner similar to H.R. 3970 (see the discussion under "Proposal to Determine the Foreign Tax Credit on a Blended Basis," above), and if it requires shareholder-level accounts, then it might obviate the need to adopt a separate matching proposal. A blending approach might, therefore, avoid several of the issues described above with respect to a separate matching proposal, although it might raise separate issues, such as those discussed in the analysis of the Administration's blending proposal. Such an approach, however, would not address permanent differences in the U.S. and foreign tax bases that are attributable to the income being assigned to different beneficial owners for U.S. and foreign tax purposes. A more traditional method for Congress to address issues of cross-crediting in cases in which the income is not in the U.S. tax base is by revising section 904. Potential modifications to section 904 might include creating a separate basket for dividends from reverse hybrids or distributions on hybrid instruments; per-country limitations; and more baskets designed to segregate high and low-taxed income, such as additional high-tax kickout rules.

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[321] A simple example in which a hybrid instrument may be used to separate foreign taxes from the related income involves U.S. Corp., a domestic corporation, that wholly owns CFC1, a country A corporation. CFC1, in turn, wholly owns CFC2, a country A corporation. CFC2 is engaged in an active business that generates $100 of income. CFC2 issues a hybrid instrument to CFC1. This instrument is treated as equity for U.S. tax purposes but as debt for foreign tax purposes. Under the terms of the hybrid instrument, CFC2 accrues (but does not pay currently) interest to CFC1 equal to $100. As a result, CFC2 has no income for country A tax purposes, while CFC1 has $100 of income, which is subject to country A tax at a 30 percent rate. From a U.S. tax perspective, CFC2 still has $100 of income (the accrued interest is ignored since the United States views the hybrid instrument as equity), while CFC1 has paid $30 of foreign taxes. Thus, there are $30 of indirect foreign tax credits that may be available to U.S. Corp. if it receives a distribution of even $1 of income from CFC1.

Other alternative approaches to limiting the inappropriate separation of foreign taxes and income include additional limitations on deferral and further limitations on the use of check-the-box rules. The Administration's proposal to limit the availability of the check-the-box rules with respect to disregarded entities is discussed below. An alternative proposal by the American Bar Association Task Force on International Tax Reform (also discussed below in connection with the Administration's check-the-box proposal) would generally preclude the classification of a foreign business entity for U.S. federal income tax purposes in a manner different from its classification for purposes of the tax laws of the country in which the entity is resident.[322] In addition to reducing planning opportunities under subpart F, this alternative (perhaps in combination with an increased number of foreign tax credit limitation categories) could mitigate both the problem of separation of foreign taxes from the associated income and the selective cross-crediting addressed by the Administration's proposal to determine the section 902 credit on a blended basis.

Prior Action

The President's fiscal year 2005, 2006, and 2007 budget proposals contained a proposal to enhance the regulatory authority of the Treasury Department to address transactions involving the inappropriate separation of foreign taxes from the related foreign income in cases in which taxes are imposed on any person in respect of income of an entity.

In 2006, the Senate passed a provision providing the Treasury Department with such enhanced regulatory authority.[323] In 2005, the Senate passed a provision providing the same enhanced regulatory authority.[324]

2. Proposal to reform business entity classification rules for foreign entities

Present Law

In Notice 98-11, the IRS and Treasury Department announced that they had become aware of the increased use of certain transactions that utilized "hybrid branches" to circumvent the purposes of subpart F.[325] The notice defined a hybrid branch as an entity with a single owner that is treated as a separate entity under the relevant tax laws of a foreign country and as a branch (i.e., disregarded entity) of a CFC that is its sole owner for U.S. tax purposes. In each of the transactions described in the notice, a taxpayer utilized a hybrid branch arrangement to make deductible interest payments that reduced the CFC's foreign tax liability, and created low-taxed interest income in another entity, without creating subpart F income.

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[322] American Bar Association, Report of the Task Force on International Reform, p. 669.

[323] H.R. 4297, 109th Cong. sec. 452 (2006); see H.R. Rep. No. 109-455, at 263-64 (2006).

[324] H.R. 4520, 108th Cong. sec. 661A (2004); see H.R. Rep. No. 108-755, at 783-84 (2005).

[325] Notice 98-11, 1998-1 C.B. 433, *withdrawn*, Notice 98-35, 1998-2 C.B. 34.

For example, the Notice described a transaction in which CFC1 owns all of the stock of CFC2, both of which are incorporated in Country A. CFC1 also has a branch, BR1, located in Country B. BR1 is a hybrid branch, classified as a separate legal entity under the laws of Country A and Country B, but as a disregarded entity for U.S. tax purposes. CFC2 earns only non-subpart F income and uses a substantial part of its assets in a trade or business in Country A. BR1 makes a transfer to CFC2 that both Country A and Country B recognize as a loan from BR1 to CFC2, and CFC2 pays interest to BR1. Country A allows CFC2 to deduct the interest for Country A tax purposes, and BR1 pays little or no tax on its interest income.

If BR1 is disregarded, then for U.S. tax purposes, the loan is considered made by CFC1 to CFC2, and the interest paid by CFC2 to CFC1. Although interest received by a CFC was generally subpart F income under section 954(c) (prior to the adoption of section 954(c)(6) on a temporary basis in 2006), the "same country" exception of section 954(c)(3) would apply to exclude the interest from subpart F income. Thus, because BR1 is disregarded, CFC1 is able to lower its foreign tax on deferred income, resulting in a significant tax incentive to invest abroad rather than in the United States.[326]

Notice 98-11 describes these transactions as inconsistent with one purpose of subpart F, to prevent CFCs (including those engaged in active business) from structuring transactions designed to manipulate the inconsistencies between foreign tax systems to generate inappropriately low- or non-taxed income on which U.S. tax might be permanently deferred. Notice 98-11 indicated that the IRS and Treasury Department would issue regulations to address such transactions, as well as certain partnership or trust arrangements raising similar issues.

Shortly after the publication of Notice 98-11, the IRS issued temporary and proposed regulations addressing the transactions described in the Notice.[327] Under those regulations, certain payments ("hybrid branch payments") between a CFC and its hybrid branch or between hybrid branches of the CFC were treated as giving rise to subpart F income. The regulations generally provided that nonsubpart F income of the CFC, in the amount of the hybrid branch payment, is recharacterized as subpart F income of the CFC if: (1) the hybrid branch payment reduces the foreign tax of the payor; (2) the hybrid branch payment would have been foreign personal holding company income (a category of subpart F income) if made between separate CFCs; and (3) there is a disparity between the effective tax rate on the payment in the hands of the payee and the effective tax rate that would have applied if the income had been taxed in the hands of the payor.

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[326] In the second transaction described in the Notice, CFC3 is incorporated in Country A. CFC3 has a branch, BR2, in Country B. CFC3 and BR2 are treated as separate legal entities under the tax laws of Country A and Country B, but BR2 is a disregarded entity for U.S. tax purposes. BR2 makes a transfer to CFC3 that the tax laws of both Country A and Country B recognize as a loan from BR2 to CFC3, and CFC3, which earns only non-subpart F income, pays interest to BR2. The interest is deductible by CFC3 for Country A tax purposes, and BR2 pays little or no tax on the interest income in Country B. Because BR2 is disregarded for U.S. tax purposes, neither the loan nor the interest payments are recognized for U.S. tax purposes and subpart F does not apply. If, however, BR2 were recognized as a separate CFC, the interest payments would be subpart F income under section 954(c) (prior to the temporary adoption of section 954(c)(6)).

[327] T.D. 8767, 1998-1 C.B. 875, *withdrawn*, T.D. 8827, 1999-2 C.B. 120.

The regulations also applied to other hybrid branch arrangements involving a partnership, including a CFC's proportionate share of any hybrid branch payment made between a partnership in which the CFC is a partner and a hybrid branch of the partnership or between hybrid branches of such a partnership. Under the regulations, if a partnership is treated as fiscally transparent by the CFC's taxing jurisdiction, the recharacterization rules are applied by treating the hybrid branch payment as if it had been made directly between the CFC and the hybrid branch, or as if the hybrid branches of the partnership were hybrid branches of the CFC, as applicable. If the partnership is treated as a separate entity by the CFC's taxing jurisdiction, the recharacterization rules are applied to treat the partnership as if it were a CFC.

The regulations also addressed the application of the same-country exception to the foreign personal holding company income rules under subpart F in the case of certain hybrid branch arrangements. Under the regulations, the same-country exception applied to payments by a CFC to a branch of a related CFC only if the payment would have qualified for the exception if the hybrid branch had been a separate CFC incorporated in the jurisdiction in which the payment is subject to tax (other than a withholding tax). The regulations provided additional rules regarding the application of the same-country exception in the case of certain hybrid arrangements involving a partnership.

The issuance of Notice 98-11 and the temporary and proposed regulations provoked great controversy among taxpayers and members of Congress. In its version of the Internal Revenue Service Restructuring and Reform Act of 1998, the Senate included provisions that would have precluded the immediate implementation of Notice 98-11, so that Congress could consider the international tax policy issues relating to the treatment of hybrid transactions under subpart F.[328] Prior to passage of the final version of that legislation, however, the IRS issued Notice 98-35,[329] which withdrew Notice 98-11, and announced its intention to withdraw the temporary and proposed regulations issued thereunder and reissue substantially similar proposed regulations to

[328] On April 22, 1998, the Senate Committee on Finance considered legislation to restructure and reform the IRS that had previously passed the House of Representatives. The version of the legislation reported out of Committee included a new provision stating that no temporary or final regulations with respect to Notice 98-11 may be implemented until at least six months after the date of enactment of the bill. S. Rep. No. 105-174 (1998). The Committee indicated the reason for this provision was its belief that the moratorium was necessary so as to allow Congress time to consider the important issues raised by the notice. In addition, the Committee included a separate provision stating that it is the sense of the Senate that the IRS and Treasury Department should withdraw Notice 98-11 and the regulations issued thereunder, and that the Congress, and not the IRS and Treasury Department, should determine the international tax policy issues relating to the treatment of hybrid transactions under subpart F. The Senate passed the bill with these provisions on May 5, 1998, H.R. 2676, sec. 3713(a) (as passed by the Senate on May 5, 1998), and the bill then went to a conference committee to resolve differences with the House-passed version of the legislation.

[329] 1998-2 C.B. 34.

be finalized no earlier than January 1, 2000.[330] As a result, the IRS Restructuring and Reform Act, as ultimately passed, did not include these provisions.[331]

In 1999, the IRS and Treasury Department issued new proposed regulations addressing certain transactions involving hybrid branches that were substantially the same as the withdrawn regulations.[332] Significantly, however, the regulations were proposed to be effective only for payments made in taxable years commencing at least five years after the date on which the regulations are finalized. The proposed regulations were withdrawn in 2003.[333]

In 2006, Congress added section 954(c)(6) to the Code on a temporary basis. Under the "look-through rule" of that provision, dividends, interest (including factoring income which is treated as equivalent to interest under section 954(c)(1)(E)), rents, and royalties, received by one CFC from a related CFC, are not treated as foreign personal holding company income (a category of subpart F income) to the extent attributable or properly allocable to income of the payor that is neither subpart F income nor effectively connected with a U.S. trade or business.[334] For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control for these purposes.[335] The look-through rule applies to taxable years of foreign corporations beginning after December 31, 2005, and ending before January 1, 2010, and to taxable years of United States shareholders with or within which such taxable years of such foreign corporations end. The purpose of the look-through rule, as stated in its legislative history, is to allow U.S. multinational companies to redeploy their active foreign earnings overseas with no additional U.S. tax burden. This is intended to make U.S. businesses and U.S. workers more competitive with businesses based in other countries, many of which grant a similar benefit to their companies.[336]

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[330] The proposed regulations were to be effective retroactively to payments made on or after June 19, 1998, subject to certain permanent and transition relief provisions for pre-existing arrangements.

[331] On June 24, 1998, the conference report was filed. H.R. Rep. No. 105-599 (1998). The report stated that the conference agreement did not include either of the Senate-passed provisions with respect to Notice 98-11 and the regulations thereunder. The conference report stated that the reason the provisions were not included was that the IRS and Treasury Department had already issued Notice 98-35. The bill, as agreed to in conference, passed both the House and the Senate and was signed by the President on July 22, 1998. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206.

[332] 64 Fed. Reg. 37,727 (July 13, 1999).

[333] Announcement 2003-78, 2003-2 C.B. 1172.

[334] The look-through rule, section 954(c)(6), was enacted by the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, sec. 103(b)(1) (2006).

[335] Sec. 954(d)(3).

[336] See H.R. Rep. No. 109-304, at 45 (2005).

Description of Proposal

The proposal provides that a foreign eligible entity may be treated as a disregarded entity only if the single owner of the eligible entity is created or organized in, or under the law of, the foreign country in, or under the law of, which the foreign eligible entity is created or organized. Therefore, a foreign eligible entity with a single owner that is created or organized in a country other than that of its single owner would be treated as a corporation for Federal tax purposes. Except in cases of U.S. tax avoidance, the proposal would generally not apply to a first-tier foreign eligible entity wholly owned by a U.S. person. The tax treatment of the conversion to a corporation of a foreign eligible entity treated as a disregarded entity would be consistent with current Treasury regulations and relevant tax principles.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2010.

Analysis

Under present law, the hybrid branch arrangements described in Notice 98-11 and the 1999 proposed regulations permit taxpayers to achieve results similar to those permitted by section 954(c)(6). Payments of interest, dividends, rent, and royalties between a disregarded entity and a CFC do not generate subpart F income, even if the disregarded entity is treated as a separate corporation under applicable foreign tax law and thus the CFC may be deducting the payment for foreign tax purposes. Prior to the enactment of section 954(c)(6), similar payments made between two CFCs located in different countries would generate subpart F income; under the look-through rule, however, they often do not, again even in cases in which the payments are deductible by the payor for foreign tax purposes. Both sets of rules permit taxpayers to move foreign earnings from one CFC to another CFC located in a different country, potentially reducing foreign tax liability without incurring U.S. tax–indeed, that is the stated purpose of the look-through rule.

Section 954(c)(6) expires for taxable years beginning after December 31, 2009.[337] The Administration has proposed extending section 954(c)(6) for one additional year (through 2010), but its subsequent expiration would then dovetail with this proposal's 2011 effective date. That is, under the Administration's proposals (and assuming no further extension of section 954(c)(6)), cross-border payments of the types contemplated by hybrid branch structures or by section 954(c)(6) could not be made in taxable years beginning after December 31, 2010, with the same favorable tax results that are achieved today.

By facilitating the reduction of foreign tax liability, both hybrid branch structures and the look-through rule can encourage indefinite deferral of U.S. tax on foreign income through continued foreign reinvestment of foreign earnings. Both may also affect the timing and utilization of foreign tax credits under some circumstances (or in conjunction with other

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[337] Taxpayers that desire greater certainty with respect to their ability to make such payments without adverse tax consequences have continued to use hybrid branch arrangements, notwithstanding the availability of section 954(c)(6), in view of its temporary status.

techniques), by facilitating the separation of relatively high-taxed and low-taxed foreign-source income and permitting a taxpayer to more effectively isolate and time the distribution of high-taxed income to maximize the taxpayer's ability to use the foreign tax credits under the section 904 limitation (while also minimizing the amount of low-taxed income that is repatriated to the United States). These techniques arguably may make the tax treatment of the foreign earnings of U.S. multinationals more comparable to that of an exemption system – the tax system applicable to many of their competitors – which some may view as beneficial. However, these techniques arguably may also make foreign reinvestment of foreign earnings significantly more attractive than repatriation and reinvestment of those earnings in the United States, thus exacerbating the investment distortion already inherent in the deferral regime that some may view as detrimental.

Hybrid branch arrangements are perhaps the first and best-known example of how a check-the-box election can be used to circumvent subpart F, but other similar uses for the election have been found. For example, the sale of stock of an operating company by a CFC generally would give rise to subpart F income, but if an election to disregard the company is in effect, then the transaction may be treated as a sale of operating assets, thus avoiding the creation of subpart F income.[338] As in the case of hybrid branch arrangements, a mere election, with no nontax economic effect, may transform what would have been subpart F income into an item exempt from subpart F.[339]

The proposal would address these techniques, while retaining the basic elective regime of the entity classification rules, by providing that single-member business entities organized under foreign law generally must be treated as corporations for Federal tax purposes. As a consequence, a wide range of transactions that are currently disregarded for Federal tax purposes would be "regarded," and the proposal (in conjunction with the expiration of section 954(c)(6)) would reduce opportunities for avoidance of subpart F and manipulation of the foreign tax credit limitation.[340]

The proposal includes, however, certain exceptions. First, the proposal would not apply in cases in which the single-member entity is organized in the same country as its owner. Consequently, it would appear to permit taxpayers to continue to use hybrid branches to achieve results similar to those of the "same-country" exception of section 954(c)(3), but in circumstances in which that exception might not otherwise apply. This exception appears to be intended to allow U.S. multinational enterprises to maintain foreign holding companies to

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338 See, e.g., *Dover Corp. v. Commissioner*, 122 T.C. 324 (2004). For a discussion of subpart F planning techniques using the check-the-box regulations, see, e.g., Philip R. West, *Re-Thinking Check-the-Box: Subpart F*, 83 Taxes 29 (2005).

339 Under section 412 of AJCA, certain sales of partnership interests by CFCs no longer give rise to subpart F income. Section 954(c)(4). AJCA did not extend a similar approach to the sale of stock by a CFC, which still gives rise to subpart F income.

340 While the Administration could make the proposed changes directly to the check-the-box regulations, the request for a legislative change may reflect the strong congressional interest that emerged in 1998 when the IRS and Treasury Department attempted to make regulatory changes addressing substantially the same concerns targeted by this proposal.

receive dividends from foreign subsidiaries free of foreign withholding tax, principally within the European Union. Second, the proposal would not generally apply to a first-tier foreign eligible entity wholly owned by a U.S. person, except in cases of U.S. tax avoidance. Third, the proposal would not apply to domestic eligible entities or multi-member foreign eligible entities.

Without additional guidance, these exceptions may permit taxpayers to engage in tax planning that could significantly undermine the intent of the proposal. To meet the exception for a second-tier foreign eligible entity with a single owner, the foreign eligible entity must be created or organized in, or under the law of, the foreign country in, or under the law of, which the foreign eligible entity is created or organized. This exception, however, does not require that the foreign eligible entity also be tax resident in the same country as the single owner. As a result, check-the-box planning similar to that under current law could continue in situations in which the foreign eligible entity is created or organized in the jurisdiction of its single owner but is subject to residence-based taxation in another country because it is managed and controlled or has its principal place of business in that other country.[341] Similarly, the proposal would not apply to domestic eligible entities such as single-member LLCs. Consequently, taxpayers may attempt to engage in check-the-box planning through a domestic LLC treated as tax resident in a foreign jurisdiction under a managed-and-controlled test or through a domestic LLC that is also organized under the laws of a foreign country.[342] Additionally, because the proposal applies only to single-member foreign eligible entities, in the absence of anti-abuse rules, a foreign eligible entity with a nominal second owner could be used to achieve similar results as under current law.

As noted above, the exception for a first-tier foreign eligible entity wholly owned by a U.S. person would not apply in cases of U.S. tax avoidance. In the context of this proposal, clarification may be desired as to what constitutes U.S. tax avoidance. While the use of a first-tier foreign disregarded entity presumably would not perpetuate a taxpayer's ability to shift income from high-taxed jurisdictions to low-taxed jurisdictions in a manner that avoids the application of subpart F, the use of a disregarded entity could perpetuate foreign tax base erosion through the use of disregarded indebtedness. To the extent that foreign base erosion is considered to be U.S. tax avoidance, clarification may still be needed as to whether the U.S. tax avoidance exception will apply to treat a disregarded foreign eligible entity as a corporation even if disregarded indebtedness is eliminated before the effective date of the proposal. Although the intended scope of the "tax avoidance" limitation is not clear, it also appears that the proposal may not address hybrid entity structures, such as those addressed in *Guardian Industries* designed to separate foreign taxes from the foreign income to which they relate.

Given the possibilities for avoidance of the proposal (albeit at potentially greater planning costs than under present law), a narrowing of the proposal's exceptions may warrant

[341] In contrast to the United States, which treats corporations as being U.S. tax resident only if they are incorporated within the United States, several foreign jurisdictions look to "management and control" for purposes of determining tax residence. For a discussion of planning possibilities facilitated by the exceptions to the proposal, Robert B. Stack, Danielle E. Rolfes, Joshua T. Brady, and John D. Bates, Recent International Tax Proposals Raise Technical Issues, *Tax Notes* (August 3, 2009), pp. 451-70.

[342] A business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity. Treas. Reg. sec. 301.7701-5.

consideration. One example would be to require lower-tier single-member domestic eligible entities and foreign eligible entities to be treated as corporations for U.S. tax purposes if they are subject to residence-based taxation in a country other than the one in which they are created or organized. Another possible rule would provide the Treasury Department authority to issue regulations to treat multi-member foreign eligible entities as corporations for U.S. tax purposes if a principal purpose of adding the additional members was to avoid the application of the proposal.[343]

In addition to granting regulatory authority to the Treasury Department, such an alternative proposal would apply more broadly to all single-member foreign entities. The proposal would not accommodate holding company structures; it would, however, prevent the use of *Guardian*-type structures, although without addressing explicitly the foreign tax credit matching issues presented by those and other structures involving hybrid entities and hybrid instruments. As described previously, the Administration appears to have chosen to address those foreign tax credit issues separately, by proposing the development of a matching rule.

The American Bar Association Task Force on International Tax Reform noted in 2006 that this type of alternative proposal would not (as the Administration's proposal also would not) affect the use of reverse hybrid partnership structures to separate income and credits and other techniques that use inconsistent classification with respect to local law pass-through entities, except possibly under regulatory anti-abuse rules.[344] The Task Force also pointed out that the alternative proposal (like the Administration's proposal) would preclude pass-through treatment even in a case in which a single member foreign entity would be taxed in the local country on a pass-through basis, such as in the case of a trust-like business entity with a single beneficial owner. Instead, the Task Force proposed to treat a foreign business entity (regardless of the number of members) generally as a corporation if it is subject to an entity-level income tax in its country of residence; if not, the entity would be treated as a pass-through.[345]

In support of its proposal, the Task Force observed that there is no clear justification for rules that facilitate inconsistent classification of foreign entities. Although the check-the-box regulations were intended to reduce the administrative costs associated with applying the Kintner regulations, the check-the-box regulations themselves impose substantial complexity and administrative burdens for both taxpayers and the government by virtue of the potential for inconsistent classifications. Moreover, the availability of elective classification, without regard

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[343] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-2-05), January 27, 2005, pp. 182-85, describes such a proposal under which the Treasury Department would be given explicit regulatory authority to classify as a corporation (i) a non-single-member foreign business entity in cases in which a partnership interest is issued to a person related to another member with a principal purpose of preventing the entity from being classified as a corporation under the rule for a single-member foreign entity and (ii) a domestic business entity that has a CFC as its sole member.

[344] American Bar Association, Report of the Task Force on International Tax Reform, p. 669.

[345] *Ibid.* Under certain circumstances, such as where pass-through entity accounting is not feasible, a foreign entity would be permitted to elect corporation classification (subject to agreement by its U.S. members to include in income currently their share of the foreign entity's earnings) or to elect classification as a domestic corporation.

to the tax treatment of a foreign entity in its jurisdiction of residence, merely fosters the use of intentionally inconsistent classification by taxpayers to achieve results not intended by the United States or the foreign jurisdiction, including potentially the avoidance of both foreign and U.S. tax.[346]

The scope of the Administration's proposal should be considered in this context. While the proposal would address a variety planning techniques that facilitate the avoidance of subpart F, it would leave untouched a significant range of other tax minimization strategies that also make use of inconsistent U.S. and foreign classifications. The proposal thus presents an opportunity to consider more generally the circumstances in which any inconsistency between the U.S. and foreign classifications of a business entity should be tolerated.

A concern has been raised that the Administration's proposal may be detrimental to some foreign disregarded entities' U.S. shareholders that are not eligible for deemed-paid foreign tax credits under section 902. The section 902 deemed-paid credit is allowed only to 10-percent subchapter C corporation shareholders. Consequently, U.S. individuals engaging in overseas activities either directly or through partnerships, limited liability companies, or S corporations, rather than through subchapter C corporations, are allowed a foreign tax credit for their shares of foreign taxes imposed on the income from those activities, if at all, only under the direct foreign tax credit rules of section 901. If foreign operations were conducted through a foreign branch, a direct foreign tax credit generally would be available to the U.S. individual owners. By contrast, if foreign operations were conducted through a foreign entity treated as separate from its U.S. individual owners, the individual U.S. owners would never be allowed a foreign tax credit. As a result, to ensure eligibility for the direct foreign tax credit, some U.S. taxpayers have elected disregarded entity status for wholly-owned foreign entities, including entities indirectly owned through other foreign entities. The proposal would not permit disregarded entity status for any foreign entity below the first-tier and thus would render U.S. non-C-corporation U.S. shareholders ineligible for foreign tax credits for their shares of the foreign taxes of that entity. Because the foreign taxes in this situation are entity-level taxes, arguably this result–the denial of direct foreign tax credits to the entity's indirect shareholders–is appropriate under the general distinction between direct and indirect foreign tax credits. Taxpayers seeking to avoid the result might restructure their foreign operations so that the operations were conducted through partnerships or branches, but this restructuring could entail tax and non-tax costs. To the extent that under present law U.S. shareholders in the situation just described are subject to current U.S. tax on their shares of the income of the foreign disregarded entities, a question is whether present law permits inappropriate results.

Finally, the effective date of the proposal and the absence of a transition rule may raise administrative and fairness considerations. The proposal would reverse a significant aspect of

[346] *Ibid.*, citing Professor Daniel Shaviro's observation that in a double non-taxation context, unilaterally denying the benefits of the unintended arbitrage works to the U.S. advantage in that it (i) increases efficiency and equity by reducing the incentive for tax-induced distortions in investment choice and (2) reduces the need to induce further economic distortion by requiring higher taxes on other activity. Daniel N. Shaviro, "More Revenues, Less Distortion? Responding to Cross-Border Tax Arbitrage" (New York University, Law and Economics Research Paper Series, Working Paper No. 04-013, 2004).

the check-the-box regulations on which taxpayers have been able to rely for more than 10 years. The delayed effective date should allow many taxpayers time to restructure arrangements that were established in reliance on the current regulations, but restructuring nonetheless may be costly. Moreover, in the absence of more tax-efficient restructuring, the deemed conversion of a disregarded entity to a corporation could entail substantial tax costs, including those by virtue of the application of section 367 to any deemed outbound transfer of assets,[347] the recognition of foreign currency gains or losses under section 987, the recognition of income under section 351(b), 357(c), or section 304 as a result of debt or other boot that springs into existence,[348] or by requiring the recapture of dual consolidated losses for which a domestic use election has been made.[349] These costs may warrant the consideration of additional transitional relief.

Prior Action

No prior action.

3. Proposal to prevent repatriation of earnings in certain cross-border reorganizations

Present Law

The transfer of assets by a transferor corporation to another corporation, controlled (immediately after the transfer) by the transferor or one or more of its shareholders, will qualify

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347 Subject to certain exceptions, section 367(a)(1) provides that if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a U.S. person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. In addition, section 367(d) provides that the transfer of intangible property by a U.S. person to a foreign corporation is treated as a sale of the property to the foreign corporation in exchange for annual payments that are contingent on productivity, use, or disposition of the intangible property.

348 Section 351(b) requires gain recognition in an otherwise tax-free section 351 transaction to the extent property other than stock is received by the transferor, but not in excess of the amount of money received or fair market value of such other property received. Section 357(c) generally requires recognition of gain to the extent that liabilities contributed to a corporation in a transaction to which section 351 or section 361 applies exceed the basis of the property transferred. Section 304(a)(1) generally provides that if one or more persons are in control of each of two corporations, and, in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control, then such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock.

349 Under section 1503(d), a "dual consolidated loss" (or DCL) means any net operating loss of a domestic corporation that is subject to an income tax of a foreign country on its income without regard to whether such income is from sources in or outside of such foreign country, or is subject to such a tax on a residence basis (a "dual resident corporation"). A DCL generally cannot be used to reduce the taxable income of any member of the corporation's affiliated group. Losses of a separate unit of a domestic corporation (a foreign branch or an interest in a hybrid entity owned by the corporation) are subject to this limitation in the same manner as if the unit were a wholly owned subsidiary of such corporation. An exemption is available under Treasury regulation section 1.1503(d)-6(d) in the case of DCLs for which a domestic use election (that is, an election to use the loss only for domestic, and not foreign, tax purposes) has been made; recapture is required, however, upon the occurrence of certain triggering events, including the conversion of a separate unit to a foreign corporation and the transfer of 50 percent or more of the assets of a separate unit within a twelve-month period. See Treas. Reg. sec. 1.1503(d)-6(e)(1).

as a tax-free reorganization under section 368(a)(1)(D) if certain requirements are met. These requirements generally are that (1) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor corporation followed by, in effect, a complete liquidation of the transferor corporation, or (2) the transfer is made by one corporation of a part of its assets consisting of an active trade or business meeting certain requirements to a controlled subsidiary corporation, followed by the distribution of the stock and securities of the controlled subsidiary in a divisive spin-off, split-off, or split-up which was not used principally as a device for the distribution of earnings and profits.

If, pursuant to an integrated plan, a parent corporation sells the stock of a subsidiary to another subsidiary and the acquired subsidiary liquidates into the acquiring subsidiary, the transaction is a tax-free reorganization.[350] This holds true, whether or not there is an actual issuance of stock, to the extent the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions.[351]

<u>Boot within gain limitation</u>

Under section 356(a)(1), if as part of that reorganization an exchanging shareholder receives, in exchange for its stock of the target corporation, both stock and property (such as cash) that cannot be received without the recognition of gain (so-called "boot"), the exchanging shareholder is required to recognize gain equal to the lesser of the gain realized in the exchange or the amount of boot received (commonly referred to as the "boot within gain" limitation). Further, under section 356(a)(2), if the exchange has the effect of the distribution of a dividend, then all or part of the gain recognized by the exchanging shareholder is treated as a dividend to the extent of the shareholder's ratable share of the corporation's earnings and profits ("E&P"). The remainder of the gain (if any) is treated as gain from the exchange of property.

The courts and the IRS have held that the principles developed in interpreting the rules relating to stock redemptions are applicable in determining whether boot received in a reorganization exchange or a section 355 exchange is treated as a dividend. In *Clark v. Commissioner*, the Supreme Court has explicitly applied the substantially disproportionate test of the stock redemption rules in the reorganization context by analyzing whether the distribution is substantially disproportionate with respect to the shareholder (i.e., the shareholder's ownership of voting stock and common stock declines by more than 20 percent as a result of the redemption and the shareholder owns less than 50 percent of the voting stock after the redemption).[352] This test was applied by treating the boot as being paid in redemption of stock hypothetically received by the transferor and applying the tests under section 302. Nevertheless, there is no explicit statutory coordination between the stock redemption rules and the rules relating to the treatment of boot received in a reorganization exchange or section 355 exchange.

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[350] Rev. Rul. 2004-83, 2004-2 C.B. 157.

[351] Temp. Treas. Reg. sec. 1.368-2T(l).

[352] *Clark v. Commissioner*, 489 U.S. 726 (1989).

As discussed above, boot will only be recast as a dividend to the extent of the exchanging shareholder's ratable share of the corporation's accumulated E&P. It is the position of the IRS under present law that, for purposes of determining the deemed dividend under section 356(a)(2), the E&P of the transferor and transferee corporation should both be taken into account.[353] Others, however, have taken the position based on prior case law that the E&P should be limited to that of the target transferor corporation.[354]

Section 304

In contrast to the treatment under section 356(a)(2), section 304 applies to certain transactions that involve a redemption through the use of related corporations. Specifically, if one or more persons are in control of each of two corporations, and in return for property, one of the corporations acquires stock in the other corporation from the person so in control, then such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock (i.e., the acquiring corporation). Such a distribution may be treated as dividend first to the extent of the E&P of the acquiring corporation and then to the extent of the E&P of the acquired corporation (i.e., the issuing corporation).[355]

Section 367

In general, to the extent that transactions include certain cross-border transfers, the provisions of Section 367 apply for the dual purposes of (i) preserving the U.S. ability to tax gains attributable to the accrued appreciation in assets that leave the U.S. tax system and (ii) requiring the inclusion of previously untaxed foreign earnings of certain foreign subsidiaries (hereinafter the "earnings repatriation purpose").[356] Thus, section 367(a)(1) provides that if, in connection with certain exchanges under subchapter C of the Code, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered a corporation.[357] By deeming the foreign corporation not to be a corporation, the provision precludes the transfer from qualifying as tax-free under subchapter C. The Secretary of the Treasury has broad regulatory authority under section 367(a)(2), (3) and (6) to provide that section 367(a)(1) will or will not apply to certain transfers described therein.

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[353] Rev. Rul. 70-240, 1970-1 C.B. 81; *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966).

[354] *American Mfg. Co. v. Commissioner,* 55 T.C. 204 (1970); *Atlas Tool Co. v. Commissioner*, 70 T.C. 86, 1970-1 C.B. 81 (1978).

[355] Sec. 304(b)(2).

[356] H.R. Rep. No. 94-658 (1975).

[357] The exchanges described under the general rule of section 367(a)(1) include: (1) complete liquidations of subsidiaries under section 332; (2) transfers to controlled corporations under section 351; (3) exchanges of stock and securities in certain reorganizations under section 354; (4) the distribution of stock and securities of a controlled corporation under section 355; (5) the receipt of additional consideration under section 356; and (6) the rules regarding the nonrecognition of gain or loss to corporations as well as the treatment of certain distributions under section 361.

Section 367(b) applies to certain exchanges in which there is no transfer of property described in section 367(a)(1).[358] Section 367(b)(1) provides that a foreign corporation shall be considered to be a corporation, except to the extent provided in regulations in order to prevent the avoidance of Federal income taxes. Section 367(b)(2) provides that the regulations prescribed pursuant to section 367(b)(1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing, among other things, the circumstances under which gain is recognized, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to basis of stock or securities.

In recent years, Treasury has focused on certain transaction structures that are inconsistent with section 367(a) and (b). Two recent examples include the transactions commonly referred to as "Killer B" transactions and transactions referred to as "Deadly D" transactions.[359]

"Killer B" Guidance

Notices 2006-85 and 2007-48 and temporary Treasury regulations subsequently issued under section 367(b)[360] apply to certain triangular reorganizations involving a parent (P) and subsidiary corporation (S), at least one of which is foreign. Pursuant to the reorganization, S acquires from P, in exchange for property, P stock that is then used by S to acquire the stock or assets of a target corporation (T) (which may be related or unrelated to P and S before the transaction) in a tax-free reorganization. Prior to the guidance, taxpayers took the position that no gain or loss was recognized on the exchange of P stock for property under section 1032 and the regulations thereunder, even if S acquired the P stock for cash or a note and had significant previously untaxed earnings and profits. In general, section 1032(a) provides that a corporation will not recognize any gain or loss to the extent it receives any money or other property in exchange for its own stock. To prevent the use of such transactions to inappropriately repatriate

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[358] Sec. 367(b)(1). Specifically, section 367(b) applies to an exchange described in section 332, 351, 354, 355, 356 or 361 in connection with which there is no transfer of property described in section 367(a)(1).

[359] The reference to "Killer B" and "Deadly D" transactions reflects the fact that the original transactions at which the guidance was aimed were reorganization transactions under sections 368(a)(1)(B) and 368(a)(1)(D), respectively. The guidance applies, however, to a broader range of transactions designed to qualify as tax free reorganizations. In addition to issuing guidance on these transactions, temporary regulations were also issued under Treas. Reg. sec. 1.956-1T(e)(6) to address a repatriation transaction where the domestic corporation makes an outbound transfer of its stock or obligations to a CFC in exchange for consideration consisting of CFC stock but primarily cash. Taxpayers had taken the position that the transfer did not trigger a gain or dividend inclusion under Section 1032(a) and that the CFC's ownership of the domestic corporations stock or obligations would not result in section 956 inclusions for the U.S. shareholders of the CFC since the CFC took a zero basis in the transferred stock or obligations pursuant to Section 362(a). The temporary regulation provides that, solely for purposes of Section 956, the basis of the stock or obligation in the hands of the CFC will be equal to its fair market value. As discussed in the preamble, this temporary regulation was issued under the authority of sections 956(e) and 367(b).

[360] Notice 2006-85, 2006-2 C.B. 677; Notice 2007-48, 2007-1 C.B. 1428; Treas. Reg. sec. 1.367(b)-14T. A "triangular reorganization" includes a forward triangular merger, a triangular C reorganization, a reverse triangular merger, or a triangular B reorganization under Treas. reg. sec. 1.358-6(b)(2)(i) through (iv), or a reorganization described in section 368(a)(1)(G) and (a)(2)(D).

previously untaxed earnings without an income inclusion, the regulations provide that the transfer of property by S to P in exchange for the P stock shall be treated as a transaction separate from, and occurring immediately before, the triangular reorganization. Therefore, P shall not be treated as receiving the property from S in exchange for the P stock. The separate distribution would be subject to section 301.[361]

<u>"Deadly D" guidance</u>

Notice 2008-10 and recently issued proposed regulations under section 367(a)(5)[362] address certain transactions designed to repatriate cash or other property from foreign subsidiaries without the recognition of gain or a dividend inclusion, in certain authorized reorganizations, by virtue of the application of the basis adjustment rule of section 367(a)(5).[363] The notice describes a fact pattern in which USP, a domestic corporation, wholly owns FA, a foreign corporation, and USP's basis in its FA stock is $100. USP also wholly owns UST, a domestic corporation, and USP's basis in its UST stock equals its fair market value of $100. UST owns property with zero tax basis such as self-created intangibles and fully depreciated tangible property. UST sells its property to FA in exchange for $100 cash and, in connection with the transaction, UST liquidates. FA then transfers all of the property acquired from UST to USN, a newly formed domestic corporation, in exchange for 100 percent of the USN stock.

In this and similar fact patterns, taxpayers took the position that the transfer of property by UST to FA was not subject to gain recognition under section 367(a) or (d), because the basis adjustment rule of 367(a)(5) allowed USP to reduce by $100 its basis in the FA stock that it held immediately prior to the transaction.[364] The result of this position was that USP was effectively able to repatriate FA's previously untaxed earnings and profits with little or no U.S. taxation. Notice 2008-10, however, provided that the basis adjustment rule of section 367(a)(5) could not be applied to the stock of FA held by USP immediately prior to the transaction, so that, under the facts within this notice, the transfer of property by UST to FA was subject to the gain recognition provisions of sections 367(a) and (d).

[361] In general, section 301(c) provides that any applicable distribution will first be treated as a dividend to the extent of earnings & profits, then as a reduction in the adjusted basis of such stock, and any excess will be treated as gain from the sale or exchange or property.

[362] Notice 2008-10, 2008-3 I.R.B. 277; Prop. Treas. Reg. sec. 1.367(a)-7.

[363] Sec. 367(a)(5) generally provides that a transfer of property by a U.S. transferor to a foreign acquiring corporation in a section 361 exchange will result in gain recognition to the transferor. It then, however, provides that, in lieu of such gain recognition, regulations will provide for certain basis adjustments if the U.S. transferor is controlled (within the meaning of section 368(c)) by five or fewer domestic corporations.

[364] In taking this position, taxpayers apparently relied upon the legislative history of section 367(a)(5), which provided that the regulations were expected to provide relief from the general rule only if the "U.S. corporate shareholders in the transferor agree to take a basis in the stock they receive in a foreign corporation that is a party to the reorganization equal to the lesser of (a) the U.S. corporate shareholder's' basis in such stock received pursuant to section 358, or (b) their proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation." S. Rep. No. 100-455, at 62 (1988).

The preamble to the proposed regulations issued under section 367(a)(5) announced that the IRS and Treasury Department were considering whether the gain limitation rule of Section 356(a)(1) should apply in an acquisitive asset reorganization involving a foreign acquiring corporation, considering that section 367(b) is intended to protect against U.S. tax avoidance upon the repatriation of previously untaxed foreign earnings. The preamble requested comments in this regard, including whether any guidance should apply only to cases in which section 356(a)(2) would otherwise apply to the shareholder's receipt of non-qualifying property (i.e., if the exchange has the effect of a distribution of a dividend).[365] Some comments have been received but to date no further action has been taken.

Description of Proposal

The proposal would repeal the boot-within-gain limitation of current law in the case of any reorganization in which the acquiring corporation is foreign and the shareholder's exchange has the effect of the distribution of a dividend, as determined under section 356(a)(2).

Effective date.–The proposal is effective for taxable years beginning after December 31, 2010.

Analysis

In cross-border reorganizations, the boot-within-gain limitation under section 356(a)(2) can permit U.S. shareholders to repatriate cash that is arguably attributable to previously untaxed earnings and profits of foreign subsidiaries, with minimal U.S. tax consequences. To the extent the exchanging shareholder's stock in the target corporation has little or no built-in gain at the time of the exchange, the shareholder will recognize minimal gain even if the exchange has the effect of the distribution of a dividend and/or a significant amount (or all) of the consideration received in the exchange is boot. This result applies even if the acquiring corporation has previously untaxed E&P equal to or greater than the amount of the boot.

The check-the-box regulations have enabled taxpayers to more easily avail themselves of this strategy. Making the check-the-box election converts what would otherwise have been a transfer taxable under section 304(a)(1) into a reorganization in which the taxable amount is limited under the boot-within-gain rule.

For example, assume that P, a U.S. domestic corporation, wholly owns CFC 1 and CFC 2. P's shares in CFC 1 have a tax basis of $400 and a FMV of $500. CFC 1 and CFC 2 each have previously untaxed E&P of $200 and $300, respectively. Assume CFC 2 purchases the shares of CFC 1 from P for $500 cash. If a check-the-box election is made to treat CFC 1 as a disregarded entity pursuant to the same plan in which CFC 1 is transferred to CFC 2, the transaction is treated as a cross-border reorganization to which the boot-within-gain rule applies to limit taxable gain to $100 ($500 FMV less $400 tax basis). If a check-the-box election were not made for CFC 1, or CFC 1 were not otherwise liquidated, section 304(a)(1) would apply to

[365] REG-209006-89, 73 Fed. Reg. 49,277 (Aug. 20, 2008) as corrected by REG-209006-89, 73 Fed. Reg. 56,535 (Sept. 29, 2008).

the transaction and the $500 in cash would be treated as a dividend to the extent of the previously untaxed E&P of CFC 2 ($300) and then CFC 1 ($200).

As illustrated above, in a transaction involving closely held participants, a taxpayer with nonpreviously taxed E&P in its CFCs may, at its option, prevent application of the section 304 requirement of full dividend inclusion to the extent of E&P, and instead invoke the boot-within-gain limitation under section 356(a)(2), by choosing to liquidate the target corporation as part of the transfer. Therefore, eliminating the application of the boot-within-gain limitation in the case of any reorganization in which there is a foreign acquirer and in which the exchange has the effect of distribution of a dividend under section 356(a)(2) is consistent with the principle that previously untaxed earnings and profits of a foreign subsidiary should be subject to U.S. tax upon repatriation. On the other hand, under present law, any previously untaxed earnings and profits not deemed distributed by virtue of the boot-within-gain limitation rule will be preserved for future taxation.

The limited comments provided to Treasury in response to its announcement in the preamble to the proposed regulations under section 367(a)(5) raise further questions regarding the interaction of section 356(a)(2) with section 367(b) and other provisions. One commentator suggested two alternative views for consideration but only in the context of outbound reorganizations.[366] The first is that, in certain cases, there may be no sufficiently compelling reason of international tax policy to require that the rules of section 356 be displaced by the section 367(b) rules in the context of an outbound asset reorganization. Considerations supporting this view include the fact that the treatment of any boot received in an outbound reorganization (at least in situations where there is an outbound transfer of United States property within the meaning of section 956(c) to a CFC) would need to be coordinated with the rules of section 956. In particular, to the extent that the outbound transfer of United States property would result in subsequent subpart F inclusions under section 951(a)(1)(B), the untaxed earnings of the acquiring CFC would remain subject to U.S. taxation and, accordingly, there may be no compelling need to recharacterize the boot received pursuant to an outbound reorganization as a dividend. The same commentator noted also that, in other situations in which a U.S. parent disposes of its shares of a target corporation (excluding transfers to which section 304 applies), the U.S parent would be entitled to reduce the amount of gain realized on the sale by its basis. The commentator suggested that it is not clear why the presence of an outbound reorganization should displace this concept in favor of taxation of the non-previously taxed earnings of a foreign acquiring corporation. If the closely held nature of the participants to these types of outbound transactions is a particular concern, that concern could be addressed through more traditional means (e.g., a finding that the transaction lacked a business purpose).

The second alternative suggested by the same commentator is that, consistent with the administrative guidance issued with respect to the "Killer B" and "Deadly D" transactions, section 367(b) principles should override section 356(a)(1) and require all boot received by a U.S. corporation in the context of an outbound asset reorganization to be subject to current U.S.

[366] New York State Bar Association Tax Section, Report on Proposed Regulations Issued under Code Sections 367, 1248 and 6038B, *2009 Tax Notes Today 17-18*, Jan. 28, 2009, Section IV.J.

federal income taxation without regard to the amount of gain realized by target shareholders. More specifically, all boot received in these types of reorganizations could be treated as a severable, pre-reorganization dividend from the foreign acquiring corporation.[367]

Another commentator suggested it would be inappropriate to issue guidance under section 367, because Congress has determined when gain shall be recognized and the amount of such gain constituting a dividend under section 356. This commentator also stated that any previously untaxed earnings and profits not deemed distributed by virtue of the boot-within-gain limitation rule will be preserved for future taxation, and any value attributable to the assets transferred will be maintained, suggesting that there has not been a constructive distribution.[368]

A general premise of the transaction discussed above is that there is a foreign acquiring/transferee corporation that is acquiring the shares of a target/transferor corporation (presumably foreign) from its U.S. parent in return for cash or other boot. By acquiring the other corporation from its U.S. parent, the foreign acquirer is able to repatriate cash with little or no U.S. taxation under the boot-within-gain limitation. Nonetheless, the proposal is intended to apply to any transaction under 356(a)(1) where there is a foreign acquiring/transferee corporation as opposed to just those transactions in which the selling shareholder is a U.S. taxpayer. As discussed within the proposal, this boot-within-gain limitation could equally apply to a transaction in which the selling shareholder is a controlled foreign corporation. In such a situation, cash would just be moving from one foreign corporation to another and not result in an actual repatriation of cash back to the United States such that there may be no intent to repatriate non-previously taxed earnings. While the proposal might be construed as overly broad in some circumstances, it can also be argued that it may be under-inclusive in that it would not capture certain transactions that may avoid U.S. withholding. In contrast with the Killer B guidance, the proposal does not address domestic-to-domestic reorganizations with a foreign shareholder where there may be the potential for withholding tax avoidance. Under such circumstances, the amount of boot recharacterized as a dividend and subject to withholding tax will continue to be limited under the boot-within-gain rule.

Some may question why boot received in such a transaction involving a foreign acquiring corporation should be differentiated from boot received in a similar transaction involving a domestic acquiring corporation. To that end, some have suggested that if the boot received by any exchanging shareholder in such a transaction with any corporation, whether domestic or foreign, has the effect of a distribution of a dividend, then the amount treated as a dividend should be consistent with all other rules for identifying and measuring dividends rather than being limited to the gain (if any) on the transaction.[369] An alternative approach would conform

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367 See, e.g., Treas. Reg. sec. 1.301-1(l) and *Bazley v. Commissioner*, 35 AFTR 1190 (67 S.Ct. 1489), 06/16/1947.

368 American Institute of Certified Public Accountants, "Comments on the Proposed Regulations on Transfers Subject to Section 367(a)(5) and Certain Cross-Border Asset Reorganizations and Nonrecognition Distributions of the Stock of Certain Foreign Corporations by Domestic Corporations," *2009 Tax Notes Today 100-19*, May 20, 2009, p. 11.

369 From a historical perspective, one of the explanations as to why Congress, in trying to prevent the bailout of corporate earnings, applied the gain limitation when the predecessor to section 356(a)(2) was enacted in

the rules relating to the treatment of "boot" received by a shareholder in a corporate reorganization involving corporations under common control or a restructuring of a single corporation (or in a section 355 transaction) to the rules relating to the redemption of stock such that the amount recharacterized as a dividend, if any, would not be limited to the gain on the transaction.[370]

While the proposal is clear in its intent to repeal the boot-within-gain limitation under the aforementioned circumstances, it does not specifically discuss the manner in which the boot will be taxed to the extent it is not subject to the boot-within-gain limitation. As discussed above, section 356(a)(2) requires treating the gain as a dividend to the extent of accumulated E&P with any additional gain being treated as gain from the exchange of property. Since the intent of the proposal is only to repeal the applicability of the boot-within-gain limitation rule and not the treatment of the transaction as one to which sections 354, 355 and 356 apply, one could conclude that section 356(a)(2) would still apply but would treat the entire amount of boot as a dividend to the extent of accumulated E&P. To the extent the boot received exceeds the accumulated E&P and there is any remaining gain, such gain would be treated as gain from the sale or exchange of property. To the extent there is any remaining boot over and above the gain, presumably it would be treated as a tax-free return of basis. Nonetheless, the intended treatment of this additional boot may require further clarification.

Another question that may require clarification is the source of the accumulated E&P from which the deemed dividend is generated under section 356(a)(2). As discussed above, conflicting positions exist under present law as to whether the accumulated E&P taken into account should be that of both the transferor and transferee corporation or, instead, be limited to only that of the transferor corporation. To the extent that the boot-within-gain limitation rule is repealed for such transactions, it will undoubtedly create more scenarios in which the boot will be for an amount that exceeds the E&P of either the transferor or transferee corporation on a stand-alone basis. Therefore, additional guidance may be necessary with respect to the source of any deemed dividend under section 356(a)(2). While one of the two approaches discussed above could be pursued, an alternative would be to adopt a rule similar to that which applies to boot received in an intercompany reorganizations within a consolidated group that would otherwise be covered under section 356(a)(2).[371] Such a rule would require that the boot be taken into account

1924 was that the predecessor to section 302 was not in the law at that time. As such, there was no precedent for treating dividend-like redemptions as 100-percent distributions (and hence possibly dividends). Therefore, Congress may have thought that the best it could do was to ensure that the gain was recharacterized as a dividend such that it was subject to the surtax applicable to dividends at that time. Jasper L. Cummings, Jr., Form vs. Substance in the Treatment of Taxable Corporate Distributions, *Taxes - The Magazine*, March 2007, p. 128 -131.

[370] Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendations of the staff of the Joint Committee on Taxation to Simplify the Federal Tax System*, pp. 267-68 (2001).

[371] Treas. Reg. sec. 1.1502-13(f).

immediately after the intercompany transaction which would be based on the combined E&P of acquiring entity and target entity.

Finally, it can be argued that, while the repeal of the boot-within-gain limitation when there is a foreign acquiring corporation will limit the ability of taxpayers to repatriate earnings with little or no tax, it may have other unintended consequences that may be used affirmatively by taxpayers for planning purposes. By way of example, section 304 was enacted to prevent what were deemed to be abusive transactions by taxpayers to convert what would otherwise be dividends into capital gain transactions. Today, taxpayers typically only trigger section 304 when they are affirmatively using it for foreign tax credit and cash repatriation planning purposes. Depending on the manner in which the repeal of the boot-within-gain limitation rule is implemented, it may be expected that similar tax planning opportunities will arise (e.g., if the E&P sourcing and ordering rules differ from that under section 304).

Prior Action

No prior action.

PART TWO: TAX COMPLIANCE AND ENFORCEMENT ISSUES WITH RESPECT TO OFFSHORE ACCOUNTS AND ENTITIES

The Administration's budget proposals include a number of proposals intended to combat under-reporting of income through the use of accounts and entities in offshore jurisdictions. In general, these proposals are designed to strengthen the information reporting and withholding systems that support U.S. taxation of income earned or held through offshore accounts and entities, and to aid the IRS's enforcement efforts through changes to certain statute of limitations and penalty rules. This part discusses those proposals and provides background on the withholding and information reporting requirements applicable to payments of U.S.-source portfolio investment income to foreign persons; the IRS Qualified Intermediary ("QI") program that plays a central role in the Administration's proposals; the self-reporting requirements applicable under present law with respect to interests in foreign trusts and foreign financial accounts; the effect of bank secrecy laws and practices on U.S tax compliance and enforcement efforts involving offshore accounts; and information exchange procedures under U.S. income tax treaties and tax information exchange agreements.

I. WITHHOLDING ON PAYMENTS TO FOREIGN PERSONS: BACKGROUND

Introduction

Under present law, foreign persons who receive payments of U.S.-source investment income are generally subject to U.S. withholding tax imposed at a 30-percent rate.[372] This withholding tax serves as the only mechanism for collection of tax in the case of payments made to foreign persons who are not otherwise required to file a U.S. income tax return. There are, however, a number of significant statutory exemptions from the 30-percent withholding tax (including for interest paid on bank deposits, portfolio interest and most capital gains), and income tax treaties typically provide additional withholding tax relief.

Distinguishing U.S. from foreign persons is, therefore, important in this context. The IRS has a variety of enforcement tools (including information reporting and backup withholding)[373] to enforce compliance by U.S. taxpayers. The IRS faces significant enforcement challenges, however, in confirming the status of an offshore payee as a bona fide non-U.S. investor. These challenges include resource constraints (and the resulting need to rely on compliance by both U.S. and foreign intermediaries), the difficulties inherent in determining beneficial ownership of income earned through intermediate vehicles (for example, trusts or partnerships), which typically are organized under foreign law and often do not have close analogies in U.S. trust or corporate law practice, and disclosure limitations imposed by foreign law.

If a U.S. person can arrange to receive investment income through means that permit the U.S. person to appear to be a foreign person, the U.S. investor may be able to evade U.S. income tax entirely. This problem is one of several identified in the ongoing investigation into the role played by UBS AG ("UBS"), based in Switzerland and one of the world's largest financial institutions, in facilitating tax evasion by U.S. clients and avoidance of U.S. reporting requirements.

This section provides an overview of the withholding tax rules applicable to payments to foreign persons, particularly as those rules apply to payments of portfolio investment income to customers of financial institutions. It then discusses briefly the enforcement challenges arising under those rules, both as a result of their substantive effect and as a matter of administration. Sections II and III discuss these enforcement challenges in more detail and describe the Administration's proposals to address them.

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[372] Foreign persons include, among others, nonresident alien individuals, foreign corporations, foreign partnerships, foreign trusts, and foreign estates. See Treas. Reg. sec. 1.1441-1(c)(2).

[373] U.S. persons may be subject in certain cases to a "backup withholding" tax with respect to payments of investment income. This backup withholding tax serves as a backstop to the regular information reporting and tax return filing requirements, and does not apply where the U.S. payee has provided an Internal Revenue Service Form W-9 to the payor or where the U.S. payee is a so-called "exempt recipient" (including a corporation, tax-exempt organization or governmental entity). See, generally, sections 3406 and 6041 through 6049 and the Treasury Regulations thereunder.

A. U.S. Tax Treatment of Payments to Foreign Investors

As is described in more detail in section I.C. below, payments of U.S.-source "fixed or determinable annual or periodical" ("FDAP") income, including interest, dividends, and similar types of investment income, that are made to foreign persons are subject to U.S. withholding tax at a 30-percent rate, unless the person otherwise required to withhold the tax (the "withholding agent") can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[374] The principal statutory exemptions from the 30-percent withholding tax apply to interest on bank deposits, portfolio interest, and capital gains. Since 1984, the United States has imposed no withholding tax on "portfolio interest" received by a nonresident individual or foreign corporation from sources within the United States.[375] Portfolio interest includes, generally, any interest (including original issue discount) other than interest received by a 10-percent shareholder,[376] certain contingent interest,[377] interest received by a CFC from a related person,[378] and interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[379]

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[374] See Treas. Reg. sec. 1.1441-1(b). For purposes of the withholding tax rules applicable to payments to nonresident alien individuals and foreign corporations, a withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).

[375] Secs. 871(h) and 881(c). Congress believed that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons might impair the ability of U.S. corporations to raise capital in the Eurobond market (i.e., the global market for U.S. dollar-denominated debt obligations). Congress also anticipated that repeal of the withholding tax on portfolio interest would allow the U.S. Treasury Department direct access to the Eurobond market. See Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84 (December 31, 1984), pp. 391-392.

[376] Sec. 871(h)(3). A 10-percent shareholder includes any person who owns 10 percent or more of the total combined voting power of all classes of stock of the corporation (in the case of a corporate obligor), or 10 percent or more of the capital or profits interest of the partnership (in the case of a partnership obligor). The attribution rules of section 318 apply for this purpose, with certain modifications.

[377] Sec. 871(h)(4). Contingent interest generally includes any interest if the amount of such interest is determined by reference to any receipts, sales or other cash flow of the debtor or a related person; any income or profits of the debtor or a related person; any change in value of any property of the debtor or a related person; or any dividend, partnership distributions, or similar payments made by the debtor or a related person, and any other type of contingent interest identified by Treasury regulation. Certain exceptions also apply.

[378] Sec. 881(c)(3)(C). A related person includes, among other things, an individual owning more than 50 percent of the stock of the corporation by value, a corporation that is a member of the same controlled group (defined using a 50-percent common ownership test), a partnership if the same persons own more than 50 percent in value of the stock of the corporation and more than 50 percent of the capital interests in the partnership, any United States shareholder (as defined in section 951(b) and generally including any U.S. person who owns 10 percent or more of the voting stock of the corporation), and certain persons related to such a United States shareholder.

[379] Sec. 881(c)(3)(A).

In the case of interest paid on a debt obligation that is in registered form,[380] the portfolio interest exemption is available only to the extent that the withholding agent has received a statement made by the beneficial owner of the obligation (or a securities clearing organization, bank or other financial institution that holds customers' securities in the ordinary course of its trade or business) that the beneficial owner is not a U.S. person.[381]

U.S. tax law also contemplates that U.S. issuers (other than the United States itself) may issue debt obligations in bearer form. Historically, in such cases, a holder would present a physical interest coupon for payment free of U.S. withholding tax, without provision of any certification of non-U.S. ownership. Now, however, so-called "bearer bonds" are typically held in "dematerialized" (or electronic) form, much like debt obligations that are issued in registered form; their "bearer" status arises solely from the fact that a holder may request a physical certificate with interest coupons from the issuer. As a practical matter, such requests for physical certificates are extremely rare. Nonetheless, the principal U.S. tax enforcement focus for bearer bonds rests on the historical premise that these bonds are actually held in physical form and relates to their mode of original distribution. More particularly, (i) the obligation must be offered and sold pursuant to arrangements that are reasonably designed to ensure that the obligation will be sold in connection with its original issuance only to a non-U.S. person, (ii) interest on the obligation must be payable only outside the United States, and (iii) the obligation must bear a legend to the effect that any U.S. person who holds the obligation will be subject to limitations under the U.S. income tax laws.[382]

Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. withholding tax (regardless of whether the recipient is a U.S. or foreign person).[383] In addition, interest on bank deposits, deposits with domestic savings and loan associations, and certain amounts held by insurance companies are not subject to the U.S. withholding tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.[384] Similarly, interest and OID on certain short-term obligations is also exempt from U.S.

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[380] An obligation is treated as in registered form if (i) it is registered as to both principal and interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder, (ii) the right to principal and stated interest on the obligation may be transferred only through a book entry system maintained by the issuer or its agent, or (iii) the obligation is registered as to both principal and interest with the issuer or its agent and may be transferred through both of the foregoing methods. Treas. Reg. sec. 5f.103-1(c).

[381] Secs. 871(h)(2)(B) and (5). This certification of non-U.S. ownership most commonly is made on an IRS Form W-8 discussed in detail in section I.C.

[382] Secs. 871(h)(2)(A) and 163(f)(2)(A).

[383] Treas. Reg. sec. 1.1441-1(b)(4)(iii).

[384] Treas. Reg. sec. 1.1441-1(b)(4)(ii).

withholding tax when paid to a foreign person.[385] Consequently, there is no information reporting with respect to payments of such amounts.[386]

Gains derived from the sale of property by a nonresident individual or foreign corporation similarly are exempt from U.S. tax, unless they are effectively connected with the conduct of a U.S. trade or business. Gains derived by a nonresident alien individual are subject to U.S. taxation only if the individual is present in the United States for 183 days or more during the taxable year.[387] Foreign corporations are subject to tax only with respect to certain gains on disposal of timber, coal, or domestic iron ore and certain gains from contingent payments made in connection with sales or exchanges of patents, copyrights, goodwill, trademarks and similar intangible property.[388] Most capital gains realized by foreign investors on the sale of portfolio investment securities thus are exempt from U.S. taxation.

Treasury regulations provide additional rules governing the treatment of notional principal contract payments and substitute dividend or interest payments made to foreign persons. Payments made pursuant to a notional principal contract (i.e., a derivative) are sourced in accordance with the residence of the recipient.[389] Accordingly, when such payments are made by a U.S. party to a nonresident counterparty, the payment is treated as foreign source and, as such, is generally not subject to U.S. taxation. This rule applies even if the payment is calculated in whole or part by reference, for example, to U.S.-source dividends paid on an underlying reference security. However, if the nonresident counterparty is engaged in a U.S. trade or business to which the payment is effectively connected, the payment is subject to regular U.S. net income taxation (and not withholding tax) in the same manner as if paid to a U.S. resident.[390]

On the other hand, substitute payments made in lieu of interest or dividend payments pursuant to a securities lending arrangement or similar transaction are treated by regulation as having the same source and character as the payments for which they substitute (a so-called

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[385] Secs. 871(g)(1)(B), 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

[386] Treas. Reg. secs. 1.1461-1(c)(2)(ii)(A), (B). However, Treasury regulations require a bank to report interest if the recipient is a resident of Canada and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049-4(b)(5), 1.6094-8. This reporting is required to comply with the obligations of the United States under the U.S.-Canada income tax treaty. T.D. 8664, 1996-1 C.B. 292. In 2001, the IRS and Treasury Department issued proposed regulations that would require annual reporting to the IRS of U.S. bank deposit interest paid to any foreign individual. 66 Fed. Reg. 3925 (Jan. 17, 2001). The 2001 proposed regulations were withdrawn in 2002 and replaced with proposed regulations that would require reporting with respect to payments made only to residents of certain specified countries (Australia, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, and the United Kingdom). 67 Fed. Reg. 50,386 (Aug. 2, 2002). The proposed regulations have not been finalized.

[387] Sec. 871(a)(2). In most cases, however, an individual satisfying this presence test will be treated as a U.S. resident under section 7701(b)(3), and thus will be subject to full residence-based U.S. income taxation.

[388] Secs. 881(a), 631(b) and (c).

[389] Treas. Reg. sec. 1.863-7(b)(1).

[390] Treas. Reg. sec. 1.863-7(b)(3).

"look-through" approach). As a result, substitute interest payments made to a nonresident with respect to interest paid on a debt obligation of a U.S. obligor may qualify for the portfolio interest exemption, to the extent that they meet the conditions otherwise applicable to actual interest payments on the obligation. Substitute dividends paid to a nonresident with respect to stock of a U.S. corporation are similarly treated as U.S.-source dividends and are subject to 30-percent nonresident withholding tax.[391] Substitute payments are also eligible for treaty benefits (described below) to the same extent and subject to the same conditions as the actual payments for which they substitute.

As the above summary suggests, many forms of income or gain from U.S. investments are simply not subject to U.S. withholding tax when earned by a non-U.S. investor. On the other hand, the Code does impose withholding tax on some important classes of U.S.-source income earned by non-U.S. investors. In particular, dividends paid by U.S. corporations (but, as described above, not dividend - equivalent payments made in respect of equity derivative contracts) to foreign investors are subject to U.S. withholding tax. So, too, are nonportfolio interest payments (e.g., interest paid by a U.S. subsidiary to a foreign parent company), and certain rent and royalty payments made in respect of property used in the United States (if not incurred in connection with the conduct of a trade or business in the United States).

Even in those cases where the Code imposes the general 30-percent withholding tax on the income or gain of a foreign investor, that tentative tax liability may be reduced or eliminated by a tax treaty between the United States and the country in which the investor is domiciled. Thus, most U.S. income tax treaties provide a zero rate of withholding tax on interest payments (other than certain interest the amount of which is determined by reference to any of certain income items or other amounts of the debtor or a related person), with the result that virtually all U.S.-source interest paid to residents of a treaty country is typically exempt from U.S. withholding tax. Most U.S. income tax treaties also reduce the rate of withholding on dividends to 15 percent (in the case of portfolio dividends) and to five percent (in the case of "direct investment" dividends paid to a 10 percent-or-greater shareholder).[392] For royalties, the U.S. withholding rate is typically reduced to five percent or to zero in certain cases. In each case, the reduced withholding rate is available only to a beneficial owner who qualifies as a resident of the treaty country within the meaning of the treaty and otherwise satisfies any applicable limitation on benefits provisions of the treaty.

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[391] Treas. Reg. secs. 1.861-2(a)(7) (substitute interest), and 1.861-3(a)(6) (substitute dividends).

[392] A number of recent U.S. income tax treaties completely eliminate withholding tax on dividends paid to an 80-percent or greater shareholder, including the present treaties with Australia, Belgium, Denmark, Finland, Germany, Iceland, Japan, Sweden and the United Kingdom.

B. Why Impose Withholding Taxes?

As a practical matter, withholding taxes are the only viable collection mechanism for taxing foreign investors with respect to U.S.-source portfolio income. This observation begs the question, however, of why the United States should seek to tax this income in the first place. Some commentators have described a longstanding global consensus in the general allocation of rights to tax cross-border income. Under this norm, in broad terms business income is taxed by the country in which it is derived (the source country) and passive or portfolio income is taxed by the country in which the recipient of the income resides (the residence country).[393] Unlike, for example, a corporation operating a business in a source country, a portfolio investor may have no ties to the source country other than the investor's passive holding of the investment. The source country therefore may have no clear economic claim to the income.

As described earlier, however, the Code does impose 30-percent withholding tax on U.S.-source dividends, rents, royalties, and other amounts derived by nonresidents. Notwithstanding the broad international tax framework of source-based taxation of business income and residence-based taxation of portfolio income, there are a few possible explanations for the persistence of these withholding taxes under domestic law. Two practical explanations are first, that source-based withholding taxes generate revenue[394] and, second, that the 30-percent statutory withholding rate is a tool that the U.S. Treasury Department can employ in negotiations over bilateral income tax treaties. On this second point, U.S. bilateral income tax treaties generally allow, as was described previously, reduced rates of U.S. withholding tax on dividends, rents, royalties, and non-portfolio interest derived by qualified residents of the other treaty countries in exchange for similar benefits for U.S. residents with investments in those countries.

A final explanation for the persistence of withholding taxes is the difficulty of enforcing residence-based taxation of foreign-source portfolio income.[395] This portfolio income may be

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[393] See, e.g., Reuven S. Avi-Yonah, "The Structure of International Taxation: A Proposal for Simplification," *Texas Law Review* 74 (1996), pp. 1301, 1305-08; Michael J. Graetz and Itai Grinberg, "Taxing International Portfolio Income," *Tax Law Review* 56 (Summer 2003), pp. 537, 540-41. Source countries typically retain the right to impose withholding taxes on portfolio income, and residence countries generally allow relief from their own income taxes for these withholding taxes, but withholding taxes are often reduced or eliminated under income tax treaties.

[394] For tax year 2005, foreign payees received $378.4 billion of U.S.-source income, as reported on Form 1042-S, and $333.2 billion (88 percent) of this income was exempt from withholding. (These figures do not include interest income paid by U.S. banking businesses to foreign depositors). A total of $6.7 billion in withholding tax was collected on the remaining $45.3 billion of U.S.-source income subject to withholding. This amount of withholding tax represented approximately two percent of the total amount of U.S.-source income reported on Form 1042-S. Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2009, p. 100.

[395] See, e.g., Reuven S. Avi-Yonah, "Memo to Congress: It's Time to Repeal the U.S. Portfolio Interest Exemption," *Tax Notes International*, December 7, 1998, p. 1817; Graetz and Grinberg, *supra,* note 394, p. 578. Graetz and Grinberg argue against source-based withholding taxes and contend that residence-based taxation of foreign portfolio income is possible through continued unilateral and multilateral enforcement and information exchange efforts. For a general discussion of the difficulties in collecting residence-based taxes given globalization and technological developments such as electronic commerce and money, see Vito Tanzi, "Globalization,

truly foreign source as, for example, when a Mexican resident owns shares of stock in U.S. companies, either directly or perhaps through an entity organized in a tax haven jurisdiction. Alternatively, the portfolio income may be foreign source in formal terms only as, for example, when a U.S. resident forms a foreign corporation or other entity for investing into the United States. In either case, the residence country (Mexico in the first example and the United States in the second example) may not be able to enforce residence-based taxation under its regular income tax rules. In this circumstance, tax collected at the source may be the only tax imposed on the income. The enforcement challenges presented when U.S. residents derive portfolio income through foreign entities or accounts are the subject of a number of the Administration's budget proposals.

Technological Developments, and the Work of Fiscal Termites," *Brooklyn Journal of International Law* 26 (2001), p. 1261.

C. Withholding Tax Administration: Self-Certification

To promote compliance with the individual income tax, the U.S. Federal tax rules include broad information reporting and withholding requirements. The withholding requirements applicable to payments of dividends, interest, capital gains, and other similar amounts rely on self-certification under which exemptions from or reductions in withholding tax are available only if recipients of those amounts certify their status to the payors of the amounts. Under this system of self-certification, U.S. individual investors receiving payments of amounts potentially subject to withholding generally are asked to certify to the financial institutions or other entities making the payments their taxpayer identification numbers and other identifying information on IRS Form W-9, "Request for Taxpayer Identification Number and Certification." Payors of these amounts are required to report the payments to the IRS and to the U.S. recipients of the income on IRS Form 1099.[396] Foreign investors receiving U.S.-source investment income are asked to certify to payors similar identifying information on IRS Form W-8, and payors of the income must report each year on IRS Form 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding," the total amount paid to each recipient and the amount of U.S. tax withheld.[397]

If U.S. investors fail to give payors of investment income the required identifying information on Form W-9, the payors generally are required to withhold tax from the payments at a 28-percent rate (in 2009) under the Code's "backup withholding" regime.[398] Likewise, under the withholding tax rules applicable to payments to foreign persons, if foreign investors fail to supply the requisite identifying information on Form W-8, any exemption from or any income-tax-treaty-based reduction in withholding tax is not available, and payors of U.S.-source amounts generally are required to withhold tax at a 30-percent rate.[399] Tax withheld from payments to a U.S. or foreign investor is credited against that investor's total U.S. income tax liability for the year.[400]

There are four types of Form W-8, three of which are designed to be filed by the beneficial owner of a payment of U.S.-source income: (1) the Form W-8BEN, which is filed by a beneficial owner of U.S.-source non-effectively-connected income, (2) the Form W-8ECI, which is filed by a beneficial owner of U.S.-source effectively-connected income,[401] and (3) the

[396] See, e.g., secs. 6042 (dividends), 6045 (gross proceeds), and 6049 (interest).

[397] Treas. Reg. sec. 1.1461-1(c).

[398] Sec. 3406.

[399] Secs. 1441 and 1442. Provision of the Form W-8, the four variants of which are described below, not only may entitle a foreign investor to a reduction in or exemption from the 30-percent withholding tax. It also establishes an exemption from the backup withholding and Form 1099 information reporting requirements for payments to U.S. investors. See Treas. Reg. sec. 1.1441-1(b)(5).

[400] Secs. 3406(h)(10), and 1462.

[401] The Form W-8ECI requires that the beneficial owner specify the items of income to which the form is intended to apply and certify that those amounts are effectively connected with the conduct of a trade or business in the United States and includible in the beneficial owner's gross income for the taxable year.

Form W-8EXP, which is filed by a beneficial owner of U.S.-source income that is an exempt organization or foreign government.[402] Each of these forms requires that the beneficial owner provide its name and address and certify that the beneficial owner is not a United States person. The Form W-8BEN also includes a certification of eligibility for treaty benefits (for completion where applicable). All certifications on Forms W-8 are made under penalties of perjury.

The United States imposes tax on the beneficial owner of income, not its formal recipient. For example, if a U.S. citizen owns securities that are held for him or her in "street" name at a brokerage firm, that U.S. citizen (and not the brokerage firm) is subject to tax on income from those securities. The distinction between nominal and beneficial ownership is important in determining liability for tax in the case of cross-border flows as well, but the complexity and opacity of some foreign law arrangements can make compliance more difficult.[403]

The fourth type of Form W-8 is the IRS Form W-8IMY, which is filed by a payee that receives a payment of U.S.-source income as an intermediary for the beneficial owner of that income. The intermediary's Form W-8IMY must be accompanied by a Form W-8BEN, W-8EXP, or W-8ECI, as applicable,[404] furnished by the beneficial owner, unless the intermediary is a "qualified intermediary," a "withholding foreign partnership" or a "withholding foreign trust." The rules applicable to qualified intermediaries are discussed in Section II below. A withholding foreign partnership or trust is a foreign partnership or trust that has entered into an agreement with the IRS to collect appropriate Forms W-8 from its partners or beneficiaries and act as a U.S. withholding agent with respect to those persons.[405]

[402] The Form W-8EXP requires that the beneficial owner certify as to its qualification as a foreign government, an international organization, a foreign central bank of issue or a foreign tax-exempt organization, in each case meeting certain requirements.

[403] A corporation (and not its shareholders) ordinarily is treated as the beneficial owner of the corporation's income; as a result, this problem technically is not one of withholding tax noncompliance as much as it is noncompliance with the rules governing U.S. owners of controlled foreign corporations or passive foreign investment companies. Similarly, a foreign complex trust ordinarily is treated as the beneficial owner of income that it receives, and a U.S. beneficiary or grantor is not subject to tax on that income unless and until he receives a distribution. However, as described by the Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, in its 2006 report, *Tax Haven Abuses: the Enablers, the Tools and Secrecy*, Senate Hearing 109-797, 109th Cong., 2d Sess. (August 1, 2006), arrangements such as "trust protectors" have been employed by U.S. taxpayers to achieve substantial control over assets held in offshore trusts. The UBS case, described later in this pamphlet, also involved the use of nominee and sham entities to conceal the assets and income of U.S. taxpayers.

[404] In limited cases, the intermediary may furnish other documentary evidence of the status of the beneficial owner, rather than a Form W-8.

[405] Rev. Proc. 2003-64, 2003-2 C.B. 306 (July 10, 2003), provides procedures for qualification as a withholding foreign partnership or withholding foreign trust and model withholding agreements.

II. WITHHOLDING TAX ENFORCEMENT PROBLEMS AND POSSIBLE SOLUTIONS: INCOME CATEGORIZATION

Although the existence of source-based withholding taxes can be explained as a response to the difficulty of enforcing residence-based taxation of portfolio income, the withholding tax itself is difficult to enforce. This section describes several reasons for that difficulty that arise from problems of income categorization, and discusses the Administration's proposals in this area.

A. Income Categorization

As was described previously, the U.S. 30-percent withholding tax is imposed on discrete categories of income — dividends, rents, royalties, and non-portfolio interest, for example. The withholding tax treatment of a particular item of income derived by a nonresident may vary based on how the income is categorized. Particularly with the growth of financial derivatives, taxpayers have exploited problems of characterization.[406]

Perhaps the best-known example of structuring to avoid withholding tax is the use of instruments known as "swaps" to replicate actual ownership of stock while avoiding the withholding tax that would be imposed on dividends paid on the stock. A nonresident seeking returns from the U.S. equity markets could purchase stock in U.S. companies. Dividends paid on this stock generally would be considered U.S.-source and therefore would be subject to withholding tax at a 30-percent (or reduced treaty) rate.[407] Instead of actually owning the stock, however, the non-U.S. investor could create synthetic ownership by holding an equity derivative contract.

For example, under a typical "total return swap," the investor would enter into an agreement with a counterparty under which returns to each party would be based on the returns generated by a notional investment in a specified dollar amount of stock. The investor would agree for a specified period to pay to the counterparty (a) interest calculated at a market rate (such as the London Interbank Offered Rate (LIBOR)) on the notional amount of stock and (b) any depreciation in the value of the stock, and the counterparty would agree for the specified period to pay the investor (c) any dividends paid on the stock and (d) any appreciation in the value of the stock.[408] This swap would be economically equivalent to a transaction in which the foreign investor actually purchased the stock from the counterparty, using funds borrowed from the counterparty, and at the end of the period sold the stock back to the counterparty and repaid the borrowing.

[406] At the end of December 2008, the notional amount of over-the-counter derivatives (that is, the value of the financial assets underlying the derivatives) outstanding worldwide was $592.0 trillion. Bank for International Settlements, Monetary and Economic Department, "OTC Derivatives Market Activity in the Second Half of 2008," (May 2009), p. 1.

[407] Secs. 861(a)(2)(A), 871(a)(1)(A), and 881(a)(1).

[408] Amounts owed by each party under a total return swap typically are netted so that only one party makes an actual payment.

Although the equity swap just described has identical economic characteristics to a leveraged purchase of stock (except that the equity swap party has credit exposure to its swap counterparty), the tax treatment of the foreign investor would be different. Because the source of income from an equity swap (in tax terms, a notional principal contract) is (as described previously) determined by reference to the residence of the recipient of the income, amounts representing dividends in this example would be foreign source and therefore would not be subject to U.S. withholding tax.[409]

There may be non-tax reasons why foreign investors enter into equity swaps on U.S. stock rather than holding the underlying stock. For instance, U.S. securities law regulations forbid extending credit above certain levels for the purchase of stock, but these rules do not apply to swap transactions that replicate leveraged purchases.[410] Nonetheless, certain arrangements have been viewed as abusive from a tax perspective. For example, a foreign investor might (1) sell stock it owns to a U.S. counterparty shortly before a dividend is paid, (2) simultaneously enter into a total return swap on the stock with the counterparty, (3) terminate the swap agreement and (4) repurchase the stock from the counterparty shortly after the dividend is paid.[411] The IRS has sought data from large U.S. financial institutions to determine whether U.S. withholding tax should have been paid on certain swap transactions that those institutions facilitated.[412] Notwithstanding possible IRS successes in individual cases, the volume of swap transactions remains large. Financial engineering has made it difficult to collect withholding tax on cross-border dividend payments.

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[409] Treas. Reg. sec. 1.863-7(b)(1). For a fuller discussion of sourcing and other tax issues related to derivatives transactions, see Joint Committee on Taxation, *Present Law and Analysis Relating to the Tax Treatment of Derivatives* (JCX-21-08), March 4, 2008. For a presentation of various hypothetical equity and interest rate swaps and stock lending transactions and a discussion of whether and when imposition of withholding tax might be appropriate, see David P. Hariton, "Equity Derivatives, Inbound Capital, and Outbound Withholding Tax," *Tax Lawyer* 60 (Winter 2007), 313. As a policy matter, Hariton argues that the withholding tax on U.S.-source dividends should be eliminated.

[410] See Hariton, *supra*, note 409, at pp. 324-25.

[411] For an extensive discussion of swap transactions entered into by U.S. financial institutions, offshore hedge funds, and other taxpayers, see United States Senate, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends*, Staff Report, September 11, 2008 (hereafter the *PSI Dividends Report*).

[412] Anita Raghavan, "IRS Probes Tax Goal of Derivatives," *Wall Street Journal*, July 19, 2007, C1; Anita Raghavan, "Happy Returns: How Lehman Sold Plan to Sidestep Tax Man − Hedge Funds Use Swaps to Avoid Dividend Hit; IRS Seeks Information," *Wall Street Journal*, September 17, 2007, A1.

B. Proposal to Prevent the Avoidance of Dividend Withholding Taxes

<u>Present Law Relating to Treatment of Dividend Equivalent Payments</u>

As described previously, the source of notional principal contract income generally is determined by reference to the residence of the recipient of the income.[413] Consequently, as indicated above, a foreign person's income related to a notional principal contract that references stock of a U.S. company, including any amount attributable to, or calculated by reference to, dividends paid on the stock, generally is foreign source and is therefore not subject to U.S. withholding tax.

In contrast, a substitute dividend payment made to the transferor of stock in a securities lending transaction or a sale-repurchase transaction is sourced in the same manner as actual dividends paid on the transferred stock.[414] Accordingly, because dividends paid with respect to the stock of a U.S. company are generally U.S. source, if a foreign person lends stock of a U.S. company to another person (or sells the stock to the other person and later repurchases the stock) and receives substitute dividend payments from that other person, the substitute dividend payments are U.S. source and are generally subject to U.S. withholding tax.[415] In 1997, the Treasury and IRS issued Notice 97-66 to address concerns that the sourcing rule just described (and the accompanying character rule) could cause the total U.S. withholding tax imposed in a series of securities lending or sale-repurchase transactions to be excessive.[416] In that Notice, the Treasury and IRS also stated that they intended to propose new regulations to provide detailed guidance on how substitute dividend payments made by one foreign person to another foreign person were to be treated. To date, no regulations have been proposed.

<u>Description of Proposal</u>

Under the proposal, income that foreign persons derive from equity swaps that reference U.S. equities is treated as U.S. source to the extent the income is attributable to or calculated by reference to dividends paid by a domestic corporation.

The proposal provides an exception to this U.S.-source rule for equity swaps with certain characteristics. To qualify for the exception from re-sourcing, an equity swap: (1) must not have terms that require the foreign person to post more than 20 percent of the value of the underlying

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[413] Treas. Reg. sec. 1.863-7(b)(1).

[414] Treas. Reg. sec. 1.861-3(a)(6). This regulation defines a substitute dividend payment as a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction.

[415] For purposes of the imposition of the 30-percent withholding tax, substitute dividend payments (and substitute interest payments) received by a foreign person under a securities lending or sale-repurchase transaction have the same character as dividend (and interest) income received in respect of the transferred security. Treas. Reg. secs. 1.871-7(b)(2), 1.881-2(b)(2).

[416] Notice 97-66, 1997-2 C.B. 328 (December 1, 1997).

stock as collateral; (2) must not have terms that include any provision addressing the hedging position of the counterparty to the transaction; (3) must have as an underlying instrument stock that is publicly traded and must have a notional amount that represents less than five percent of the total public float of the referenced class of stock and less than 20 percent of the 30-day average daily trading volume; (4) must not reference underlying stock that the foreign person has sold to the counterparty at the inception of the contract or that the foreign person will buy from the counterparty at the termination of the contract; (5) must reference underlying stock that has objectively observable prices that are used to measure the parties' entitlements and obligations under the swap; and (6) must have a term of at least 90 days.

The proposal also announces that the Treasury Department intends to revoke Notice 97-66 (described above) and to issue guidance that restricts the avoidance of U.S. withholding tax through the use of securities lending transactions and that minimizes excessive withholding.

Analysis

Background

A simple example illustrates the economic equivalence of making a leveraged purchase of stock of a U.S. company and entering into a swap transaction that references that stock. As described previously, in a typical total return swap, U.S. Bank agrees to make 10 payments to Cayman Hedge Co. on December 31 of each of the next 10 years in an amount equal to the sum of: (1) the appreciation, if any, in value of 100 shares of American Inc. stock during the year, and (2) dividends paid on 100 shares of American Inc. stock during the year. Likewise, Cayman Hedge Co. agrees to make 10 identically timed payments to U.S. Bank on December 31 of each of the next 10 years in an amount equal to the sum of: (1) the depreciation, if any, in value of 100 shares of American Inc. stock during the year, and (2) a fixed or floating rate of interest multiplied by the value of 100 shares of American Inc. stock at the beginning of the year. Because the amounts required each year from Cayman Hedge Co. and U.S. Bank are due on the same day in that year, the parties agree that all amounts are netted, and only one party makes a net payment to the other.

As indicated above, the equity swap just described puts Cayman Hedge Co. in the same economic position (disregarding possible credit risks) as it would have been in if it had bought American Inc. stock at the inception of the swap contract and borrowed the purchase price from U.S. Bank. Cayman Hedge Co. incurs the same costs (expressed as the interest on a "notional" principal amount), receives the same current returns (dividend-equivalent amounts), and is subject to the same market opportunities and risks (appreciation or depreciation in the value of the stock).[417]

[417] This example of a leveraged purchase of stock assumes that the foreign investor has borrowed the entire amount of the purchase price of the stock. In fact, as noted previously, margin requirements may prevent a fully leveraged purchase of stock. Foreign persons seeking a fully leveraged investment in U.S. stock therefore may enter into an equity swap on that stock to achieve the effect of that leverage.

In spite of the general economic equivalence in the example above of a leveraged purchase of stock of a U.S. company and the holding of an equity swap on that stock, the U.S. tax consequences to the foreign investor differ. In the former case, a leveraged purchase of stock, dividend payments on the stock are subject to U.S. withholding tax at a 30-percent rate (or at a lower rate under a U.S. income tax treaty). In the latter case, an equity swap, payments on the swap generally are not subject to U.S. tax.

Many hedge funds and other unregulated collective investment vehicles are organized as partnerships or corporations resident in the Cayman Islands or other zero-tax jurisdictions. Because the United States has no income tax treaties with zero-tax jurisdictions, dividends on U.S. stock paid to entities in these jurisdictions would be subject to 30-percent withholding tax. Consequently, hedge funds and other sophisticated institutional investors (as well as other foreign persons) often invest in U.S. equities synthetically. By investing synthetically through equity swaps, these foreign persons are able to receive dividend-equivalent payments on the swaps free of any U.S. withholding tax.

Foreign investors have entered into equity swap transaction with characteristics suggesting that in substance the investors owned the stock that the swaps referenced.[418] The counterparty to a foreign investor's equity swap often is a U.S. derivatives dealer (U.S. Bank in the example above) that may hedge its obligation under the swap by buying the stock that the swap references.[419] In some cases, foreign investors have sold U.S. stock to U.S. dealers shortly before dividend payment dates, have entered into equity swaps over those dividend dates, and have repurchased the stock from the U.S. dealers after the dividend payments. The proposal is intended to restrict the avoidance of U.S. withholding tax in these and other circumstances in which a foreign person's entering into an equity swap on U.S. stock is substantially the same as the investor's direct ownership of the stock.

<u>Scope of proposal</u>

The proposal generally ends the present-law exclusion from U.S. withholding tax for notional principal contract income of foreign persons to the extent the income references dividends paid by a domestic corporation. Presumptively, therefore, the proposal treats the holding of an equity swap that references U.S. stock as broadly equivalent to the direct

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418 See Anita Raghavan, "Happy Returns: How Lehman Sold Plan To Sidestep Tax Man ─ Hedge Funds Use Swaps To Avoid Dividend Hit; IRS Seeks Information," *Wall Street Journal*, Sept. 17, 2007, A1. The IRS has been investigating U.S. financial firms' equity swap related activities. See Anita Raghavan, "IRS Probes Tax Goal of Derivatives," *Wall Street Journal*, July 19, 2007, C1. For a discussion of several large financial firms' activities related to equity swaps and securities lending transactions, see the *PSI Dividends Report*.

419 Since the equity swap economically is a direct surrogate for the underlying stock (but for the right to vote the stock), the dealer that hedges in this manner buys exactly as many shares of the underlying stock as the swap references. For this reason, equity swaps and similar total return swaps are sometimes described as "Delta 1" contracts. From a dealer's perspective, this line of business sometimes also is referred to as "equity finance," to signify that the dealer is not taking significant market risks with respect to the swaps it writes or the hedges (physical stocks) it buys, but rather earns the preponderance of its profits from the business from the difference between the dealer's actual funding costs for its hedge, on the one hand, and the implicit funding rate it charges the equity swap counterparty (in the form of the fixed or floating notional interest rate embedded in the swap).

ownership of that stock. An equity swap avoids this presumptive characterization if it meets certain criteria intended to ensure that the foreign swap party has not entered into the swap solely to avoid U.S. dividend withholding tax. Because the proposal potentially repeals a tax exclusion for income from a wide variety of transactions, policy questions about the proposal relate to its scope.

One question is whether the criteria for avoiding the proposal are based on a coherent view of what constitutes a purely tax-motivated swap. Taken as a whole, the criteria – whether a swap has a short term; whether a sale and repurchase of underlying stock occur around the swap; whether the swap requires substantial collateral (and therefore achieves no more leverage than could be achieved by a purchase of stock on margin); whether price and hedging terms suggest some relationship between the U.S. counterparty's actions related to the swap and the foreign investor's entitlements under the swap – ask whether, when a foreign investor and a U.S. counterparty have entered into a swap on a U.S. company's stock, the arrangement appears to be no different from the foreign investor's actual ownership of the stock (through an agency relationship with the U.S. counterparty). In particular, a short term swap – especially one with a term just around a dividend date and in which the foreign investor owns the underlying stock before and after the term – would seem a clear example of a transaction entered into simply to replicate actual stock ownership while avoiding dividend withholding tax. Precedents exist in present law for denying tax benefits related to short-term transactions: there are minimum holding period requirements for allowance of a foreign tax credit for withholding tax on a dividend with respect to stock of a corporation or for withholding tax on an item of income or gain with respect to property (such as a royalty payment for a license to use intellectual property).[420]

A second question is whether leverage should be relevant in distinguishing among different swap transactions. In the equity swap described in the simple example above, Cayman Hedge Co. may make rather than receive net payments because the amount of notional interest owed under the swap may be greater than the amount of required dividend-equivalent payments (and the stock underlying the swap may not appreciate by more than that excess or may decline in price). The proposal is unclear about whether imposition of withholding tax on a foreign person's income under a swap contract subject to the proposal would be determined based on the person's gross income from the contract or on the person's net income from the contract. Under the most natural reading of the proposal, no U.S. withholding tax would be owed if the foreign investor in the swap received no net payments: the proposal re-sources only "income earned" by foreign persons, and if a foreign person receives no net payment, the foreign person has not earned any income. Alternatively, the proposal's reference to "income" could be interpreted to mean gross income, which is the basis on which nonresident withholding tax normally is imposed.

By its terms, the proposal always applies to swaps that last for less than 90 days; relatively little notional interest may accrue under such short-term swaps, in comparison to the amount of any dividend equivalent payment. A swap with a term of at least 90 days may avoid

420 Secs. 901(k) and 901(l).

the proposal if it satisfies the proposal's other safe-harbor criteria. However, to the extent that a foreign investor in an equity swap referencing U.S. stock may incur a reduced U.S. withholding tax under the proposal because the investor's interest-based payments under the swap offset the investor's dividend-based receipts, the U.S. tax consequences of holding that swap are more favorable than the tax consequences of an actual leveraged purchase of the stock. If instead of entering into the equity swap, the foreign investor purchased the referenced stock with borrowed funds, the investor would be subject to U.S. withholding tax on dividends received on the stock and, unless the investor were otherwise engaged in a U.S. trade or business, would not be entitled to a deduction in the United States for its interest costs on the borrowing. By permitting interest-based payments under a swap to be netted against dividend-based payments in determining whether U.S. withholding tax is imposed (and the amount of any such tax), the proposal – unlike present law rules that do not allow foreign portfolio investors interest deductions for their borrowing costs – credits the foreign investor for its notional interest costs under the equity swap and thereby does not completely eliminate the U.S. tax preference for entering into an equity swap over making a leveraged purchase of stock even though the two transactions are economically identical.[421] A question is whether allowing this preference is appropriate in any circumstance.[422]

A practical answer to that question is that it may be administratively difficult to equate completely the U.S. tax treatment of an equity swap with the U.S. tax treatment of a leveraged purchase of stock. Because typical equity swaps provide for netting of all dividend-based and interest-based amounts (as well as appreciation-based and depreciation-based amounts) under the swaps, a proposal that did not give credit for interest-based amounts and instead imposed U.S. withholding tax on the gross amount of any dividend-based amount could create liability for withholding tax in circumstances in which foreign investors made rather than received payments and U.S. persons (the counterparties in the swaps) received rather than made payments. In those circumstances, foreign investors would be subject to U.S. withholding tax in respect of swap transactions even though the investors had no cash proceeds from the transactions. By contrast, if a foreign investor made a leveraged purchase of dividend-paying stock, the foreign investor would receive dividend payments on which withholding tax could be imposed. By similarly creating a U.S. withholding tax obligation only when a foreign swap holder receives a dividend-based payment, the proposal may be interpreted as providing a rule that the IRS can easily administer and with which taxpayers can readily comply. Instead imposing U.S. withholding tax

[421] A short-term swap (one with a term of less than 90 days) around a dividend date cannot qualify for the exception from the proposal.

[422] It could be argued that foreign investors should be allowed an interest deduction when they borrow to purchase stock of U.S. companies. The decision to buy stock of a U.S. company is, however, separate from the decision about how to finance that purchase. Even if the investment and financing decisions were not distinct, tracing a purchase of an investment to a borrowing has proved difficult in other contexts. See, e.g., section 265 (denying a deduction for interest on debt incurred to purchase tax-exempt debt). The deduction and income rules for foreign investors in U.S. real estate take a different approach. Nonresident individuals and foreign corporations with rental income from U.S. real property or gains from the sale of U.S. real property may elect to treat the income and gains as effectively connected with the conduct of a U.S. trade or business. Secs. 871(d) and 882(d). A consequence of this election is that expenses related to U.S. real property investments – such as interest on debt incurred to buy the real property – may be used to offset income from the property.

in the absence of an outbound payment from the United States would be a departure from general U.S. withholding tax principles.[423]

Although the proposal does not fully align the U.S. tax consequences of a foreign investor's holding of a swap on stock of a U.S. company with the U.S. tax consequences of a foreign investor's leveraged purchase of that stock, the proposal roughly equates the U.S. tax treatment of foreign and domestic investors in U.S. company stock. A U.S. person who buys stock with borrowed funds is subject to U.S. tax on dividend income derived in respect of the stock but may offset that income with a deduction for interest paid on the borrowing (subject to applicable limitations). As described previously, the proposal allows a similar offset for foreign investors in equity swaps because it taxes dividend-based receipts only to the extent they exceed interest-based payments. More broadly, however, under both present law and the proposal, foreign and domestic investors in stock of U.S. companies are taxed very differently. Domestic investors generally are subject to a 15-percent tax rate on dividend income. Foreign investors not otherwise engaged in a U.S. trade or business, by contrast, are generally subject to 30-percent U.S. withholding tax (or withholding tax at a reduced treaty rate) on dividends. Domestic investors are subject to tax, generally at a 15-percent rate, on gains from the sale of stock, while foreign investors generally are not liable for tax in the United States on capital gains. Likewise, the proposal does not tax the capital gain component of a foreign investor's return from holding an equity swap; it taxes only dividend-based payments. Because of these differences, it is not clear that equating the treatment of domestic and foreign investors is or should be a policy basis for the proposal.

A related question of scope is how broad an effect the proposal will have on the equity swaps market and the market for other cross-border financial instruments. In response to the proposal, foreign investors may enter into swaps only if it is likely the swaps would not result in net payments from the United States that would be subject to U.S. withholding tax. Alternatively, foreign investors may enter into only those swaps that satisfy all the criteria required for being excluded from the re-sourcing rule. To the extent those criteria accurately distinguish between swaps based on whether the swaps are pure substitutes for actual stock ownership, it is possible that the proposal would stop foreign investors from entering into purely tax-motivated swap transactions. Because, however, the proposal's criteria for exclusion from the re-sourcing rule do not necessarily reflect the terms of equity swap transactions that have been common in the market, the proposal may impose new compliance burdens on taxpayers seeking to satisfy the proposal's safe harbor criteria.

A potential problem with the proposal is the availability of other financial instruments to which the proposal does not apply. This problem of substitutability is fundamental to any proposal that addresses the treatment of a defined category of financial transactions. For instance, the proposal does not apply to prepaid forward contracts. The purchaser of a prepaid forward contract that references stock of a corporation pays a sum at the initiation of the contract

[423] But see, for example, the withholding tax rules for payments to U.S. and foreign partnerships. Treas. Reg. sec. 1.1441-5 and section 1446 and the accompanying regulations. See also, Treas. Reg. sec. 1.1441-2(b)(3), providing that withholding is required with respect to original issue discount at the time that a payment is made on the debt obligation or the obligation is sold or exchanged.

and is promised returns during the term of the contract based on dividend payments on the stock and appreciation in the price of the stock over that term. Under present law, taxpayers have taken the position that no U.S. tax is owed until the contract matures or is sold.[424] In response to the proposal, foreign investors seeking returns based on U.S. stock may enter into prepaid forward contracts on the stock rather than entering into swap transactions.

Withholding tax policy generally

A broader policy question underlying the proposal is whether the United States should impose any withholding tax on U.S.-source dividend income of nonresidents. As described previously, some commentators have suggested the withholding tax on U.S.-source dividends should be abolished.[425] To the extent it is appropriate to impose withholding tax on outbound payments of U.S.-source income, the most appropriate circumstance for withholding might be when there are payments made of deductible amounts such as interest or royalties. But the United States for several decades has not imposed withholding tax on portfolio interest, and the withholding tax on royalties is often eliminated under income tax treaties. Moreover, nonresidents' capital gains from the sale of stock of U.S. companies are generally not subject to U.S. tax. Given the U.S. tax treatment of portfolio interest, royalties, and capital gains, the treatment of dividends − non-deductible payments that attract U.S. withholding tax − appears anomalous. As described earlier, however, there are various reasons why the United States might impose withholding taxes, including on dividends.

Notice 97-66

The proposal generally aligns the source rule for income in respect of equity swaps with the source rules for substitute dividend and interest payments. Those source rules, however, raise concerns about imposition of excessive withholding tax in situations involving multiple related securities lending or sale-repurchase transactions. Notice 97-66, which was published in response to those concerns, may have unintentionally created the opposite problem: there is evidence that some taxpayers have taken the position that Notice 97-66 sanctions the elimination of withholding tax in certain situations.[426] To the extent any new guidance that the Treasury Department proposes appropriately addresses problems of both avoidance of U.S. withholding tax and imposition of excessive U.S. withholding tax, the guidance should be an improvement over existing guidance.

[424] For a discussion of the tax treatment of and policy issues related to prepaid forward contracts, see Joint Committee on Taxation, *Present Law and Analysis Relating to the Tax Treatment of Derivatives* (JCX-21-08), March 4, 2008, pp. 6-9, 26-34.

[425] See, e.g., Hariton, *supra*, note 409; Gregory May, "Flying on Instruments: Synthetic Investments and Withholding Tax Avoidance," *Tax Notes*, December 9, 1996, p. 1225.

[426] See *PSI Dividends Report*, pp. 18-20, 22-23, 40, 47, 52.

Prior Action

A provision similar to the equity swaps proposal is included in Senate and House bills introduced in 2009 by Sen. Levin and Rep. Doggett.[427]

[427] S. 506, 111th Cong., 1st Sess. (March 2, 2009), section 108; H.R. 1265, 111th Cong., 1st Sess. (March 3, 2009), sec. 108.

C. Proposal to Repeal 80/20 Company Rules

Present Law

The source of interest and dividend income generally is determined by reference to the country of residence of the payor.[428] Thus, an interest or dividend payment from a U.S. corporation to a foreign person generally is treated as U.S.-source income and is subject to the 30-percent gross-basis U.S. withholding tax.[429] However, if a U.S. corporation satisfies an 80-percent active foreign business income requirement (the "80/20 test"), all or a portion of any interest or dividends paid by that corporation (a so-called "80/20 company") is exempt from U.S. withholding tax. Interest paid by an 80/20 company is treated as foreign-source income and, therefore, exempt from the 30-percent withholding tax if paid to unrelated parties.[430] When an 80/20 company pays interest to a related party, the re-sourcing rule applies only to the percentage of the interest equal to the percentage of the company's total gross income during the three-year testing period, described below, that is from foreign sources (a so-called "look-through" approach).[431] Unlike interest, dividends paid by an 80/20 company remain U.S. source (for example, for foreign tax credit limitation purposes). Instead, a percentage of dividends paid by an 80/20 company to a foreign shareholder is exempt from the 30-percent gross-basis U.S. withholding tax. As with related-party interest, the percentage equals the percentage of the 80/20 company's total gross income during the testing period that is foreign source.[432]

In general, a U.S. corporation meets the 80/20 test if at least 80 percent of the gross income of the corporation during the testing period is derived from foreign sources and is attributable to the active conduct of a trade or business in a foreign country (or a U.S. possession) by the corporation or a 50-percent owned subsidiary of that corporation. The testing period generally is the three-year period preceding the year in which the interest or dividend is paid.[433]

Description of Proposal

The proposal would repeal the 80/20 company provisions.

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[428] Secs. 861(a)(1), (2), 862(a)(1), (2).

[429] Secs. 871(a)(1)(A), 881(a)(1), 1441(b), 1442(a).

[430] Sec. 861(a)(1)(A).

[431] Sec. 861(c)(2).

[432] Sec. 871(i).

[433] Sec. 861(c)(1). The income of a subsidiary is attributed to the tested company only to the extent that the tested company actually receives income from the subsidiary in the form of dividends. *Conference Report to the 1986 Tax Reform Act,* Pub. L. No. 99-514, Vol II, 602. See also Rev. Rul. 73-63, 1973-1 C.B. 336 and P.L.R. 6905161160A (May 16, 1969).

Effective date.−The proposal is effective for taxable years beginning after December 31, 2010.

Analysis

The present law withholding tax exemption for dividends paid by an 80/20 company is intended to relieve double taxation of foreign-source earnings without changing the sourcing rule that permits imposition of U.S. withholding tax. It has been observed that, by originally enacting the 80/20 company rules, Congress "displayed its unwillingness to treat as income from sources within the United States, interest paid out of gross income realized in large measure from sources without the United States, no matter what the residence of the obligor.[434] Nonetheless, the 80/20 company rules have, at times, permitted the reduction of U.S. tax in an unintended manner. First, taxpayers have utilized the 80/20 company provisions to increase their foreign tax credit limitation through a strategy intended to generate low-taxed foreign source income. Second, taxpayers have taken advantage of the mechanical nature of the 80/20 company tests so as to avoid U.S. withholding tax on payments of income generated from U.S. domestic operating activities.

Anecdotal evidence suggests that taxpayers have utilized the 80/20 company rules in transactions intended to increase their foreign tax credit limitation. For example, a CFC wholly owned by a U.S. parent corporation may make a loan to an 80/20 company that is a member of the U.S. corporation's consolidated group. The 80/20 company holds only assets that produce income in the general limitation foreign tax credit basket and all of the income earned by the 80/20 company, in fact, is foreign source general limitation income. The U.S. parent corporation generally would be subject to current U.S. tax under subpart F on the interest income received by the CFC,[435] but the related 80/20 company generally would be allowed an offsetting deduction (in consolidation) for its interest expense.[436] Nonetheless, for purposes of determining the U.S. group's foreign tax credit limitation under section 904, the subpart F interest income would be treated entirely as foreign source income received from the 80/20 company (assuming the 80/20 company had only foreign-source income), but the interest expense would be apportioned to foreign sources only to the extent of the ratio of foreign assets to worldwide assets of the U.S. affiliated group.[437] Assuming that the U.S. affiliated group had material domestic assets for purposes of apportioning interest expense, this transaction could generate significant foreign tax credit limitation.

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[434] Richard Dailey, "The Concept of the Source of Income," *Tax Law Review* 15 (1959), p. 426.

[435] Sec. 954(c)(1)(A).

[436] Although the loan by the controlled foreign corporation to the 80/20 company generally would constitute an investment in U.S. property under section 956, this treatment may not trigger current U.S. tax if the controlled foreign corporation has no current or accumulated earnings and profits in excess of the interest income from the loan.

[437] Temp. Treas. Reg. sec. 1.861-9T.

The 80/20 company rules have also, at times, permitted avoidance of withholding tax in a manner that is inconsistent with the intent of the rules.[438] As described previously, the testing period for qualification as an 80/20 company is the three-year period preceding the year in which a dividend is paid. Once a U.S. company has satisfied the three-year active business requirement to qualify as an 80/20 company, the company can pay dividends (or interest not eligible for the portfolio interest exemption) in the subsequent year free of U.S. withholding tax even if the company does not meet the 80/20 test in that year (because, for example, all of its income in that year is U.S. source) and even if the distribution includes other U.S. source earnings (for example, those of a U.S. subsidiary) that were not taken into account in applying the 80/20 test.

Assume that a U.S. holding company (owned by a foreign shareholder) owns a foreign subsidiary and a U.S. operating subsidiary. For the years 2006, 2007 and 2008, the U.S. holding company receives foreign-source dividends from its foreign subsidiary but no dividends from its U.S. subsidiary (although the U.S. subsidiary earns significant U.S.-source operating profits annually); these dividends are the holding company's only income. Under present law, the U.S. holding company satisfies the 80/20 test for the year 2009 (because 100 percent of its income during the testing period is foreign source). If in 2009 the U.S. subsidiary paid the U.S. holding company a dividend representing several years of accumulated U.S.-source earnings, and the U.S. holding company then distributed those earnings as a dividend to its foreign shareholder, that dividend would generally be exempt from U.S. withholding tax even though it represented the U.S.-source earnings of the U.S. subsidiary.

The proposal would prevent taxpayers claiming the foreign tax credit benefits sought in the transactions just described by repealing the 80/20 company rules. The proposal reflects a judgment that the policy goal of relieving double taxation of foreign source income is not sufficient to warrant tailoring the 80/20 rules to mitigate tax avoidance planning. Indeed, it is not clear that significant numbers of foreign investors currently choose to invest in foreign assets through a U.S. holding company. Moreover, an increasing number of U.S. income tax treaties now provide a zero-percent rate of withholding on interest and on dividends paid to a foreign parent corporation; these treaty provisions obviate the need for the 80/20 company rules where they apply and, arguably, the continued presence of the 80/20 company rules may impede to some degree the negotiation of those zero-rate provisions. For example, each of these treaties includes limitation-on-benefits provisions designed to restrict the availability of the zero-percent rate of withholding to legitimate residents of the treaty country.[439] The 80/20 company rules

[438] See, e.g., Field Service Advice 199926011, where the Internal Revenue Service determined that a domestic holding company which technically qualified as an 80/20 company was not exempt from the collection of withholding tax under section 1442 on dividend distributions to its foreign parent. The withholding tax exemption was disallowed under section 269(a) as the corporate acquisitions that gave rise to the domestic holding company structure were principally motivated by the avoidance of federal income tax.

[439] Testimony of Treasury International Tax Counsel, John Harrington, before the Senate Committee on Foreign Relations and Pending Income Tax Agreements, (July 2007).

may, nonetheless, permit foreign investors to obtain the same result in situations in which those limitation-on-benefits provisions apply.[440]

On the other hand, there are some circumstances in which the 80/20 company provisions may facilitate the structuring of cross-border business transactions in a manner that accommodates legitimate non-tax considerations without incurring a U.S. tax penalty. For example, the provisions may assist U.S. multinational corporations to obtain financing for foreign acquisitions by facilitating the use of a U.S. acquisition company to acquire a foreign target. To the extent that borrowing by the U.S. acquisition company is serviced from dividends paid by the foreign target, the interest payments may be eligible for foreign source treatment, and thus an exemption from U.S. withholding tax, under the 80/20 regime. The withholding tax exemption may assist the U.S. acquiror in attracting the broadest group of potential lenders, including offshore funds or foreign banks that might not qualify for the portfolio interest exemption if the interest payments were treated as U.S. source.[441] However, while it may be more difficult for some taxpayers to arrange, a similar result can be achieved (even when a U.S. income tax treaty with a zero percent withholding tax rate is not available) by obtaining acquisition financing through a foreign acquisition company in a jurisdiction with no withholding tax.

Conceivably, a more targeted legislative approach could preserve the intended benefits while limiting opportunities for manipulation of the 80/20 company rules. For example, the President's Budget Proposals of 2000 included a proposal that would have applied the 80/20 income test on a group-wide basis with respect to at least 50-percent owned subsidiaries. As this would have required that at least 80 percent of the income from all 50-percent owned subsidiaries be U.S.-source income for any member of a group to qualify under the 80/20 regime, this, presumably would have significantly limited the ability for taxpayers to take advantage of either the withholding tax minimization strategy or the foreign source income generation strategy discussed above. The President's Budget Proposals of 2001 included a proposal that would have limited annually the amount of interest and dividends otherwise exempt from U.S. withholding tax under the 80/20 regime to the foreign active business income received by the U.S. corporation during the three-year testing period, reduced by the amount of distributions in prior tax years to which the 80/20 company rules applied. This approach would have prevented the distribution of U.S operating earnings without withholding tax.

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[440] See, e.g., Hardy and Colan, "Peculiarities of 80/20 Company Taxation," *PLI/Tax* 846 (March 12, 2008), p. 953 (commenting on utility of 80/20 company rules in view of limitations on availability of zero-rate dividend withholding provisions in treaties).

[441] Portfolio interest generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (1) on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) that is not received by a 10-percent shareholder (sec. 871(h)). This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person (sec. 881(c)(3)). Moreover, this exception is not available for certain contingent interest payments (sec. 871(h)(4)).

The 80/20 company rules are arbitrary and complex. Incorporating additional restrictions may make the rules more complicated. A question is whether the policy goal of those rules – relieving possible double taxation of foreign-source earnings in situations in which U.S. income tax treaties do not provide full relief – justifies restricting rather than eliminating the rules.

Prior Action

Although proposals to limit the scope of the 80/20 regime were included in the President's Fiscal Year 2000 and 2001 Budget Proposals, no prior legislative action has been taken.

III. WITHHOLDING TAX ENFORCEMENT PROBLEMS AND POSSIBLE SOLUTIONS: SELF-CERTIFICATION

A. Introduction

A second enforcement difficulty originates in the basic framework of the U.S. withholding tax rules. Those rules rely on certifications by recipients of income potentially subject to withholding and by withholding agents. As described previously, recipients of income potentially subject to withholding must certify their status so that the payors of the income can determine to what extent withholding is required. Recipients must, for example, certify whether they are U.S. or foreign persons and, if they are foreign, whether they are eligible for reduced rates of withholding tax allowed by a tax treaty. Withholding agents must certify that they have withheld the proper amount of tax, often with respect to very large volumes of payment flows. Proper withholding, in turn, requires the withholding agent to determine whether a payee has U.S. or foreign status (generally relying on the certification by the recipient); certain other characteristics of the payee, such as whether the payee is an individual or corporation, and whether a payee is the beneficial owner[442] of the income or is an intermediary receiving a payment on behalf of the owner; whether the payment can be reliably associated with proper documentation; and whether, in the absence of documentation, certain presumptions require full, reduced, or zero withholding or instead require backup withholding.[443]

Problems with withholding can result from errors related to any aspect of this self-certification process. Moreover, the self-certification system can be difficult for the IRS to audit. Applicable Treasury regulations generally do not impose an "audit" or affirmative diligence requirement on domestic withholding agents to determine the validity of a Form W-8,[444] and as a practical matter U.S. withholding agents cannot verify the accuracy of every Form W-8 they receive. As a consequence, U.S. investors may be able to portray themselves successfully as foreign persons, thereby escaping U.S. income taxation.

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[442] The beneficial owner of income is, generally, the person who is required under U.S. tax principles to include the income in gross income on a tax return. A person is not a beneficial owner of income if that person is receiving the income as a nominee, agent, or a custodian, or if the person is a conduit whose participation in a transaction is disregarded. Foreign partnerships, foreign simple trusts, and foreign grantor trusts are not the beneficial owners of income paid to the partnership or trust. The beneficial owner of income paid to a foreign estate is the estate itself. See Treas. Reg. sec. 1.1441-1(c)(6) and the Instructions to IRS Form 1042-S.

[443] Backup withholding is required under section 3406 for reportable payments made to certain payees, including individuals. Payments that may be subject to backup withholding include interest, dividends, rents, royalties, commissions, non-employee compensation, and other payments including broker proceeds. Backup withholding generally applies only to payments made to U.S. persons who have failed to provide the payor with a valid IRS Form W-9, "Request for Taxpayer Identification Number and Certification;" however, it may also apply to certain payments made to persons in the absence of valid documentation of foreign status. Backup withholding does not apply to payments made to exempt recipients, including tax-exempt organizations, corporations, and certain other entities.

[444] See e.g., Treas. Reg. section 1.1441-1(b)(2)(vii)(A) (providing that a withholding agent generally can rely on IRS Form W-8 or similar documentation if, before the payment, the agent holds the documentation, can reliably determine how much of the payment relates to the documentation, and has no actual knowledge or reason to know that any of the information, certifications, or statements in or associated with the documentation are incorrect).

In a December 2007 report to the Senate Finance Committee, the Government Accountability Office ("GAO") found a number of potential problems with the self-certification process.[445] Withholding agents may not know the identity of beneficial owners of income when income is paid through foreign intermediaries. In particular, withholding agents may not be able to identify U.S. owners who ultimately control foreign corporations or trusts.[446] Consequently, these U.S. persons may improperly benefit from treaty-based reductions of withholding tax or exemptions from withholding tax altogether (because, for instance, the income in question is interest on a bank account or a bond). The problem of U.S. owners hiding behind foreign entities or accounts is central to the UBS case discussed III.D. of this pamphlet and has been the focus of various efforts to address noncompliance with information reporting and withholding rules.

Relatedly, according to the GAO significant amounts of income have flowed to undisclosed recipients and undisclosed jurisdictions, and withholding taxes on these income flows have been imposed, in the aggregate, at rates significantly below 30 percent.[447] Because beneficial ownership and residence information typically is the basis for reduced withholding tax rates, these reduced rates, according to GAO, suggest some amount of noncompliance. This noncompliance can be expected to have included evasion of U.S. tax by U.S. persons who have derived portfolio income through foreign intermediaries.

Potential changes to the information reporting and withholding rules to address problems arising from the self-certification nature of the rules range from modest to sweeping. In its 2007 report the GAO recommended, among other steps, that the IRS improve its enforcement efforts by making better use of data that it already collects. In particular, the GAO suggested that the IRS determine the extent to which (1) income paid by withholding agents flows through foreign intermediaries that may be providing the IRS with unreliable documentation, and (2) reductions in withholding taxes collected from funds flowing to undisclosed jurisdictions and undisclosed recipients were proper.[448]

The IRS's qualified intermediary ("QI") program has been the major initiative undertaken by the IRS to deal with the compliance issues presented by self-certification for payments made through foreign intermediaries. Under this program, the IRS contracts with

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[445] Government Accountability Office, *Report to the Committee on Finance, U.S. Senate, Tax Compliance: Qualified Intermediary Program Provides Some Assurance that Taxes on Foreign Investors Are Withheld and Reported, but Can Be Improved* (GAO-08-99), December 2007 (hereafter "GAO Report").

[446] As previously noted, a corporation (and not its shareholders) ordinarily is treated as the beneficial owner of the corporation's income. Similarly, a foreign complex trust ordinarily is treated as the beneficial owner of income that it receives, and a U.S. beneficiary or grantor is not subject to tax on that income unless and until he receives a distribution.

[447] The GAO Report states that the IRS did not have information to explain why withholding rates were low in relation to this income, but that the low rates could in part be explained by the use of pooled reporting by QIs (for example, recipients from two countries with the same treaty rates for the same type of income would be included together in a pool and the QI would not be required to report each jurisdiction separately).

[448] GAO Report, pp. 15-16, 21.

foreign financial institutions to enforce U.S. withholding and reporting rules. The QI program is discussed in detail below.

B. The Qualified Intermediary Program: In General

Treasury regulations establishing the Qualified Intermediary ("QI") program became effective on January 1, 2001.[449] The QI regulations implement a strategy of reliance on certain foreign intermediaries (QIs) to enforce compliance with U.S. tax information reporting requirements, in an attempt to balance the needs of tax administration with the need to minimize burdens on the financial markets. These foreign intermediaries agree to assume responsibility for obtaining documentation from their customers and to substantiate the status of their customers as the beneficial owners of U.S.-source income. In turn, the IRS agrees to permit the QIs to certify on behalf of their foreign customers, without revealing to the IRS or to U.S. withholding agents the identity of those foreign customers. Moreover, the IRS agrees to rely on third-party private auditors to audit the compliance of the QIs with the QI program. This condition was viewed as a practical necessity if foreign banks were to agree to participate in the QI program, because the banks feared that their non-U.S. customer base would not agree to allow a foreign taxing authority (the IRS) direct access (through an IRS audit) to customer account information.

At the time the QI program was adopted, the IRS explained its scope and purpose as follows in Announcement 2000-48:

> The QI system is a significant step forward for both taxpayers and the IRS. It does, however, represent a paradigm shift to greater self-regulation. Treasury and the IRS believe that it is appropriate to allow the greatest self-regulation under circumstances in which Treasury and the IRS have the greatest confidence that such self-regulation will be effective. In pursuit of that objective, Treasury and the IRS considered allowing QI status only for businesses operating in jurisdictions with which the United States has a bilateral tax treaty or tax information exchange agreement. In response to taxpayer comments, however, that approach was not adopted. Taxpayers requested that the QI system have the broadest scope possible, so that financial institutions can potentially act as qualified intermediaries in all jurisdictions in which they do business. In an attempt to balance these competing concerns, Treasury and the IRS intend to permit financial institutions to act as qualified intermediaries in accordance with the provisions of this announcement [and the model QI Agreement].[450]

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[449] Treas. Reg. sec. 1.1441-1(e)(5). In April 1996, the IRS published proposed regulations under sections 1441 and 1442 addressing certain U.S.-source income paid to foreign persons. 61 Fed. Reg. 17,614 (April 22, 1996). Final regulations were issued in 1997, but their effective date was twice delayed, and they became effective only as of January 1, 2001. T.D. 8734 (October 6, 1997). The regulations specific to QIs have subsequently been amended. See T.D. 8804 (Dec. 30, 1998) (delaying effective date and providing additional transition rules); T.D. 8856 (Dec. 30, 1999) (delaying effective date); and T.D. 8881 (May 16, 2000) (providing for withholding rate pools for QIs and changing model QI agreement regulations to conform with Rev. Proc. 2000-12, which includes a provision requiring a QI to disinvest in cases in which a non-exempt U.S. customer does not waive local bank secrecy laws).

[450] Announcement 2000-48, 2000-1 C.B. 1243.

The Announcement explained that, as part of this "paradigm shift," the IRS's cross-border withholding tax compliance effort would be built on reliance on local country "know-your-customer" rules:

> Treasury and the IRS believe it is appropriate to permit the self-regulation envisioned by the QI system only under circumstances in which Treasury and the IRS have confidence that such self-regulation may be effective. Because Treasury and the IRS regard know-your-customer (KYC) rules as a vital component of adequate self-regulation, the IRS generally will not extend the QI system to any country that does not have KYC rules or has unacceptable KYC rules. The IRS will, however, permit a branch of a financial institution (but not a separate juridical entity affiliated with the financial institution) located in such a country to act as a qualified intermediary if the branch is part of an entity organized in a country that has acceptable KYC rules and the entity agrees to apply its home country KYC rules to the branch. As is the case with any violations of the QI agreement by the branch, failure to obtain adequate documentation will cause the entity to be in default of its agreement and may cause the agreement to be terminated.[451]

Before the issuance of the current withholding tax regulations and the QI program, withholding agents were subject to complex rules depending on the type of income and source of income of the payment. Inconsistent rules for determining whether a payee was a U.S. or foreign person applied to different types of income, and IRS guidance was sometimes unclear. The IRS and Treasury determined that, due to the substantial growth in cross-border flows and the desire to continue a net withholding system (rather than moving to a full withholding system with refundability), it was necessary to standardize and coordinate the procedures imposed on withholding agents for verifying U.S. or foreign status for Form 1099 reporting, compliance with backup withholding rules, and administration of the withholding provisions applicable to foreign persons. Additionally, Treasury was under a congressional mandate to consider options for replacing the address/self-certification method of administering income tax treaty benefits.[452]

In developing the QI program, Treasury and the IRS gave particular attention to the problems raised under prior practice by payments made through foreign intermediaries. (As previously noted, payments made through an intermediary are treated as payments made directly to the beneficial owner for whom the intermediary is collecting the payments.) Prior Treasury regulations required different documentation depending on the type of payment, whether the intermediary remitted through a U.S. office, or whether the payee had a foreign address. In cases in which withholding certificates were required, the beneficial owner certification was required to be passed up through a chain of intermediaries to the U.S. withholding agent. As a practical matter, however, there was no realistic way for a U.S. withholding agent to know whether the beneficial owner of a payment was a U.S. or foreign person, or whether such a foreign person

[451] *Ibid.* After December 31, 2006, however, branches located in countries without approved know-your-customer rules are no longer permitted to operate as QIs. See Notice 2006-35, 2006-14 I.R.B. 708.

[452] See Pub. L. No. 97-248, Tax Equity and Fiscal Responsibility Act of 1982, sec. 342.

was entitled to treaty benefits.[453] This was particularly the case for financial institutions that served as U.S. custodians for foreign financial institutions, holding large volumes of U.S. securities in omnibus accounts for the benefit of customers of the foreign institutions. Compliance with the prior Treasury regulations was difficult or impossible in these cases, exposing U.S. custodians to a substantial risk of withholding tax liability that eventually exceeded their profits from the custodial business.[454] In an effort to reduce their exposure, those institutions, together with other U.S. withholding agents, worked closely with the IRS and Treasury to develop the QI regime.[455]

A QI is defined as a foreign financial institution or a foreign clearing organization, other than a U.S. branch or U.S. office of such institution or organization, which has entered into a withholding and reporting agreement (a "QI agreement") with the IRS.[456] In exchange for entering into a QI agreement, the QI is able to shield the identities of its customers from the IRS and other intermediaries (for example, other financial institutions in the chain of payment that may be business competitors of the QI) in certain circumstances and is subject to reduced information reporting duties compared to those that would be imposed in the absence of the agreement. This ability to shield customer information is limited, however, with respect to U.S. persons, because the QI is required to furnish Forms 1099 to its U.S. customers if it has assumed primary withholding responsibility for these accounts, or to provide Forms W-9 to the withholding agent in cases in which the QI has not assumed such responsibility.

A foreign financial institution that becomes a QI is not required to forward beneficial ownership information with respect to its customers to a U.S. financial institution or other withholding agent of U.S.-source investment-type income to establish their eligibility for an exemption from, or reduced rate of, U.S. withholding tax.[457] Instead, the QI is permitted to establish for itself the eligibility of its customers for an exemption or reduced rate, based on information as to residence obtained under the "know-your-customer" rules to which the QI is subject in its home jurisdiction as approved by the IRS or as specified in the QI agreement. The

[453] Written Testimony of Stephen E. Shay, Hearing on Issues Involving Banking Secrecy Practices And Wealthy American Taxpayers, House Committee on Ways and Means, Subcommittee on Select Revenue Measures, 111th Congress, 1st Session, March 31, 2009. (hereafter "Shay Testimony"), p. 8.

[454] *Ibid.,* p. 8 ("It was an open secret that U.S. withholding agents were treating foreign banks as though they were the beneficial owners of omnibus accounts that they held for customers and that the withholding agents were failing to withhold tax contrary to regulations.").

[455] *Ibid.,* p. 8; see also Stephen E. Shay, J. Clifton Fleming, and Robert J. Peroni, "The David Tillinghast Lecture, 'What's Source Got to Do With It?' Source Rules and U.S. International Taxation," 56 *Tax Law Review* 81, p. 124 n. 160.

[456] The definition also includes: a foreign branch or office of a U.S. financial institution or U.S. clearing organization; a foreign corporation for purposes of presenting income tax treaty claims on behalf of its shareholders; and any other person acceptable to the Internal Revenue Service. Treas. Reg. sec. 1.1441-1(e)(5)(ii).

[457] U.S. withholding agents are allowed to rely on a QI's Form W-8IMY without any underlying beneficial owner documentation. By contrast, nonqualified intermediaries are required both to provide a Form W-8IMY to a U.S. withholding agent and to forward with that document Form W-8s or W-9s for each beneficial owner.

QI certifies as to eligibility on behalf of its customers, and provides withholding rate pool information to the U.S. withholding agent as to the portion of each payment that qualifies for an exemption or reduced rate of withholding. As described below, a QI may also assume responsibility for both nonresident withholding and, in the case of U.S. customers, backup withholding.

The IRS has published a model QI agreement (described in more detail below) that financial institutions wishing to become QIs are generally expected to sign.[458] A prospective QI must submit an application to the IRS providing certain specified information, and any additional information and documentation requested by the IRS. The application must establish to the IRS's satisfaction that the applicant has adequate resources and procedures to comply with the terms of the QI agreement.

Before entering into a QI agreement that provides for the use of documentary evidence obtained under a country's know-your-customer rules, the IRS must receive (1) that country's know-your-customer practices and procedures for opening accounts and (2) responses to 18 related items. If the IRS has already received this information, a particular prospective QI need not submit it again. The IRS has received such information and has approved know-your-customer rules in 59 countries.

The IRS does not require that an institution applying to become a QI provide information regarding bank secrecy or other laws that could apply in a foreign jurisdiction to restrict disclosure of the institution's customers to the IRS or otherwise affect the IRS's ability to enforce the terms of the QI agreement. Instead, Announcement 2000-48 stated that the IRS expected to apply more rigorous oversight to financial institutions or their branches in jurisdictions that are tax havens or bank secrecy jurisdictions and that show an unwillingness to cooperate with the United States to reform their practices relating to transparency and the provision of tax information. In addition, the Announcement indicated that QIs should not assume that, merely because they have an agreement covering a business in a particular jurisdiction, such jurisdiction would not later be identified as a specified tax haven or secrecy jurisdiction. However, Announcement 2000-48 indicated that any enhanced audit requirements or stricter enforcement standards would be imposed only on agreements entered into or renewed after identification of the jurisdiction as a specified tax haven or secrecy jurisdiction.

Announcement 2000-48 further stated that the IRS expected that it would agree to renew a QI agreement or, in the case of new agreements that become effective on or after January 1, 2004, enter a new agreement for QIs in a particular country only if the IRS received a certification from the Treasury Department that the country had effective rules and/or procedures for providing tax information to the United States for both civil tax administration and criminal tax enforcement purposes (including, for example, under an income tax treaty or a tax

[458] Rev. Proc. 2000-12, 2000-1 C.B. 387, supplemented by Announcement 2000-50, 2000-1 C.B. 998, and modified by Rev. Proc. 2003-64, 2003-2 C.B. 306, and Rev. Proc. 2005-77, 2005-2 C.B. 1176. The QI agreement applies only to foreign financial institutions, foreign clearing organizations, and foreign branches or offices of U.S. financial institutions or U.S. clearing organizations. However, the principles of the QI agreement may be used to conclude agreements with other persons defined as QIs.

information exchange agreement), or had taken significant steps towards achieving such effective provision of information.

C. The Model Qualified Intermediary Agreement

A foreign financial institution or other eligible person becomes a QI by entering into an agreement with the IRS, based on a published model. Under the agreement, the financial institution acts as a QI only for accounts that the financial institution has designated as QI accounts. A QI is not required to act as a QI for all of its accounts; however, if a QI designates an account as one for which it will act as a QI, it must act as a QI for all payments made to that account.

The model QI agreement describes in detail the QI's withholding and reporting obligations. Certain key aspects of the model agreement are described below.[459]

<u>Withholding and reporting responsibilities</u>

As a technical matter, all QIs are withholding agents for purposes of the nonresident withholding and reporting rules, and payors (who are required to withhold and report) for purposes of the backup withholding and Form 1099 information reporting rules. However, under the QI agreement, a QI may choose not to assume *primary* responsibility for nonresident withholding. In that case, the QI is not required to withhold on payments made to non-U.S. customers, or to report those payments on Form 1042-S; instead, the QI must provide a U.S. withholding agent with a Form W-8IMY that certifies as to the status of its (unnamed) non-U.S. account holders. Similarly, a QI may choose not to assume *primary* responsibility for Form 1099 reporting and backup withholding. In that case, the QI is not required to backup withhold on payments made to U.S. customers or to file Forms 1099; instead, the QI must provide a U.S. payor with a Form W-9 for each of its U.S. non-exempt recipient account holders (i.e., account holders that are U.S. persons not generally exempt from Form 1099 reporting and backup withholding).[460] A QI may elect to assume primary nonresident withholding and reporting responsibility, primary backup withholding and Form 1099 reporting responsibility, or both.[461] A QI that assumes such responsibility is subject to all of the related obligations imposed by the

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[459] Additional detail can be found in Joint Committee on Taxation, *Selected Issues Relating to Tax Compliance With Respect to Offshore Accounts and Entities* (JCX-65-08), July 23, 2008.

[460] Regardless of whether a QI assumes primary Form 1099 reporting and backup withholding responsibility, the QI is responsible for Form 1099 reporting and backup withholding on certain reportable payments that are not reportable amounts. See Rev. Proc. 2000-12, 2001-1 Cumulative Bulletin 387, sec. 2.43 (defining reportable amount), sec. 2.44 (defining reportable payment), sec. 3.05, and sec. 8.04. The reporting responsibility differs depending on whether the QI is a U.S. payor or a non-U.S. payor. Examples of payments for which the QI assumes primary Form 1099 reporting and backup withholding responsibility include certain broker proceeds from the sale of certain assets owned by a U.S. non-exempt recipient and payments of certain foreign source income to a U.S. non-exempt recipient if such income is paid in the United States or to an account maintained in the United States.

[461] A QI is not required to assume primary withholding responsibility and/or primary backup withholding and Form 1099 reporting responsibility for all accounts it has with a withholding agent, rather it can choose to assume primary responsibility for some, and not for others. To the extent that a QI assumes primary responsibility for an account, it must do so for all payments made by the withholding agent to that account. See Rev. Proc. 2000-12, 2001-1 Cumulative Bulletin 387, sec. 3.

Code on U.S. withholding agents or payors. The QI must also provide the U.S. withholding agent (or U.S. payor) certain additional information about the withholding rates to enable the withholding agent to appropriately withhold and report on payments made through the QI. These rates can be supplied with respect to withholding rate pools that aggregate payments of a single type of income (e.g., interest or dividends) that is subject to a single rate of withholding.

In general, a QI is not required to disclose, either to a withholding agent or to the IRS, the identity of an account holder that is a foreign person or a U.S. person that is an exempt recipient (such as a corporation).[462] As noted above, a QI that has not assumed primary Form 1099 reporting and backup withholding responsibility must provide a withholding agent with a Form W-9 obtained from each U.S. non-exempt recipient account holder (for example, an individual). If a U.S. non-exempt recipient has not provided a Form W-9, the QI must disclose the name, address, and taxpayer identification number (if available) to the withholding agent (and the withholding agent must apply backup withholding). However, no such disclosure is necessary if the QI is, under local law, prohibited from making the disclosure and the QI has followed certain procedural requirements (including providing for backup withholding, as described further below).

Documentation of account holders

QIs agree to use best efforts to obtain documentation regarding the status of their account holders in accordance with the terms of their QI agreement.[463] A QI must apply certain presumption rules[464] unless a payment can be reliably associated with valid documentation from the account holder. The QI agrees to adhere to the know-your-customer rules set forth in the QI agreement with respect to the account holder from whom the evidence is obtained.

A QI may treat an account holder as a foreign beneficial owner of an amount if the account holder provides a valid Form W-8 (other than a Form W-8IMY) or valid documentary evidence that supports the account holder's status as a foreign person.[465] With such documentation, a QI generally may treat an account holder as entitled to a reduced rate of

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[462] This absence of a requirement to disclose a U.S. exempt recipient is consistent with the fact that exempt recipients are excluded from the scope of the general rules governing backup withholding and information reporting.

[463] See Rev. Proc. 2000-12, 2001-1 Cumulative Bulletin 387, sec. 5.

[464] The QI agreement contains its own presumption rules. See Rev. Proc. 2000-12, 2001-1 Cumulative Bulletin 387, sec. 5.13(C). An amount subject to withholding that is paid outside the United States to an account maintained outside the United States is presumed made to an undocumented foreign account holder (i.e. subject to 30% withholding). Payments of U.S. source deposit interest and certain other U.S. source interest and original issue discount paid outside of the United States to an offshore account is presumed made to an undocumented U.S. non-exempt account holder (i.e., subject to backup withholding). For payments of foreign source income, broker proceeds and certain other amounts, the QI can assume such payments are made to an exempt recipient if the amounts are paid outside the United States to an account maintained outside the United States.

[465] Documentary evidence is any documentation obtained under know-your-customer rules per the QI agreement; evidence sufficient to establish a reduced rate of withholding under Treas. Reg. sec. 1.1441-6; evidence sufficient to establish status for purposes of chapter 61 under Treas. Reg. 1.6049-5(c). See Rev. Proc. 2000-12, 2001-1 Cumulative Bulletin 387, sec. 2.12.

withholding if all the requirements for the reduced rate are met and the documentation supports entitlement to a reduced rate. A QI may not reduce the rate of withholding if the QI knows that the account holder is not the beneficial owner of a payment to the account.

If a foreign account holder is the beneficial owner of a payment, then a QI may shield the account holder's identity from U.S. custodians and the IRS. If a foreign account holder is not the beneficial owner of a payment (for example, because the account holder is a nominee), the account holder must provide the QI with a Form W-8IMY for itself along with specific information about each beneficial owner to which the payment relates. A QI that receives this information may shield the account holder's identity from a U.S. custodian, but not from the IRS.[466]

In general, if an account holder is a U.S. person, the account holder must provide the QI with a Form W-9 or appropriate documentary evidence that supports the account holder's status as a U.S. person. However, if a QI does not have sufficient documentation to determine whether an account holder is a U.S. or foreign person, the QI must apply certain presumption rules detailed in the QI agreement. These presumption rules may not be used to grant a reduced rate of nonresident withholding; instead they merely determine whether a payment should be subject to full nonresident withholding (at a 30 percent-rate), subject to backup withholding (at a 28 percent-rate), or treated as exempt from backup withholding.

In general, under these presumptions, U.S.-source investment income that is paid outside the United States to an offshore account is presumed to be paid to an undocumented foreign account holder. A QI must treat such a payment as subject to withholding at a 30-percent rate and report the payment to an unknown account holder on Form 1042-S.[467] However, U.S.-source deposit interest and interest or original issue discount on short-term obligations that is paid outside the United States to an offshore account is presumed made to an undocumented U.S. non-exempt recipient account holder and thus is subject to backup withholding at a 28-percent rate.[468] Importantly, both foreign-source income and broker proceeds are presumed to be paid to a U.S. exempt recipient (and thus are exempt from both nonresident and backup withholding) when such amounts are paid outside the United States to an offshore account.

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[466] This rule restricts one of the principal benefits of the QI regime, nondisclosure of account holders, to financial institutions that have assumed the documentation and other obligations associated with QI status.

[467] As described previously, Form 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding," is the IRS form on which a withholding agent reports a foreign person's U.S.-source income that is subject to reporting to the foreign person and to the IRS.

[468] These amounts are statutorily exempt from nonresident withholding when paid to non-U.S. persons.

Information return requirements

A QI must file an IRS Form 1042 by March 15 of the year following any calendar year in which the QI acts as a QI.[469] A QI is not required to file Forms 1042-S for amounts paid to each separate account holder, but instead files a separate Form 1042-S for each type of reporting pool.[470] Account holder identities generally need not be reported on the forms, with certain exceptions.[471] The Form 1042 must also include an attachment setting forth the aggregate amounts of reportable payments paid to U.S. non-exempt recipient account holders, and the number of such account holders, whose identity is prohibited by foreign law (including by contract) from disclosure.[472]

A QI has certain specified Form 1099[473] filing requirements including: (1) filing an aggregate Form 1099 for each particular type of reportable amount paid to U.S. non-exempt recipient account holders whose identities are prohibited by law from being disclosed; (2) filing an aggregate Form 1099 for reportable payments other than reportable amounts[474] paid to U.S. non-exempt recipient account holders whose identities are prohibited by law from being disclosed; (3) filing separate Forms 1099 for reportable amounts paid to U.S. non-exempt recipient account holders for whom the QI has not provided a Form W-9 or identifying information to a withholding agent; (4) filing separate Forms 1099 for reportable payments other than reportable amounts paid to U.S. non-exempt recipient account holders; (5) filing separate Forms 1099 for reportable amounts paid to U.S. non-exempt recipient accounts holders for which the QI has assumed primary Form 1099 reporting and backup withholding responsibility; and (5) filing separate Forms 1099 for reportable payments to an account holder that is a U.S.

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[469] Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," is the IRS form on which a withholding agent reports a summary of the total U.S. source income paid and withholding tax withheld on foreign persons for the year.

[470] A reporting pool consists of income that falls within a particular withholding rate and within a particular income code, exemption code, and recipient code as determined on Form 1042-S.

[471] A QI must file separate Forms 1042-S for amounts paid to certain types of account holders, including: (1) other QIs which receive amounts subject to foreign withholding; (2) each foreign account holder of a nonqualified intermediary or other flow-through entity to the extent that the QI can reliably associate such amounts with valid documentation; and (3) unknown recipients of amounts subject to withholding paid through a nonqualified intermediary or other flow-through entity to the extent the QI cannot reliably associate such amounts with valid documentation.

[472] For undisclosed accounts, QIs must separately report each type of reportable payment (determined by reference to the types of income reported on Forms 1099) and the number of undisclosed account holders receiving such payments.

[473] If the QI is required to file Forms 1099, it must file the appropriate form for the type of income paid (*e.g.*, Form 1099-DIV for dividends, Form 1099-INT for interest, Form 1099-B for broker proceeds).

[474] The term reportable amount generally includes those amounts that would be reported on Form 1042-S if the amount were paid to a foreign account holder. The term reportable payment generally refers to amounts subject to backup withholding, but it has a different meaning depending upon the status of the QI as a U.S. or non-U.S. payor.

person if the QI has applied backup withholding and the amount was not otherwise reported on a Form 1099.

Foreign law prohibition of disclosure

The QI agreement includes procedures to address situations in which foreign law (including by contract) prohibits the QI from disclosing the identities of U.S. non-exempt recipients (such as individuals). Separate procedures are provided for accounts established with a QI before January 1, 2001, and for accounts established on or after January 1, 2001.

Established before January 1, 2001

For accounts established before January 1, 2001, if the QI knows that the account holder is a U.S. non-exempt recipient, the QI must (1) request from the account holder the authority to disclose its name, address, taxpayer identification number (if available), and reportable payments; (2) request from the account holder the authority to sell any assets that generate, or could generate, reportable payments; or (3) request that the account holder disclose itself by mandating the QI to provide a Form W-9 completed by the account holder. The QI must make these requests at least two times during each calendar year and in a manner consistent with the QI's normal communications with the account holder (or at the time and in the manner that the QI is authorized to communicate with the account holder). Until the QI receives a waiver on all prohibitions against disclosure, authorization to sell all assets that generate, or could generate, reportable payments, or a mandate from the account holder to provide a Form W-9, the QI must backup withhold on all reportable payments paid to the account holder and report those payments on Form 1099 or, in certain cases, provide another withholding agent with all of the information required for that withholding agent to backup withhold and report the payments on Form 1099.

Established on or after January 1, 2001

For any account established by a U.S. non-exempt recipient on or after January 1, 2001, the QI must (1) request from the account holder the authority to disclose its name, address, taxpayer identification number (if available), and reportable payments; (2) request from the account holder, before opening the account, the authority to exclude from the account holder's account any assets that generate, or could generate, reportable payments; or (3) request that the account holder disclose itself by mandating the QI to transfer a Form W-9 completed by the account holder.

If a QI is authorized to disclose the account holder's name, address, taxpayer identification number, and reportable amounts, it must obtain a valid Form W-9 from the account holder, and, to the extent the QI does not have primary Form 1099 and backup withholding responsibility, provide the Form W-9 to the appropriate withholding agent promptly after obtaining the form. If a Form W-9 is not obtained, the QI must provide the account holder's name, address, and taxpayer identification number (if available) to the withholding agents from whom the QI receives reportable amounts on behalf of the account holder, together with the withholding rate applicable to the account holder. If a QI is not authorized to disclose an account holder's name, address, taxpayer identification number (if available), and reportable amounts, but is authorized to exclude from the account holder's account any assets that generate, or could generate, reportable payments, the QI must follow procedures designed to ensure that it will not hold any assets that generate, or could generate, reportable payments in the account holder's account.[475]

External audit procedures

The IRS generally will not audit a QI with respect to withholding and reporting obligations covered by a QI agreement if an approved external auditor conducts an audit of the QI. An external audit must be performed on the second and fifth full calendar years in which the QI agreement is in effect. In general, the IRS must receive the external auditor's report by June 30 of the year following the year being audited.

Certain requirements for the external audit are provided in the QI agreement. In general, however, the QI must permit the external auditor to have access to all relevant records of the QI, including information regarding specific account holders. In addition, the QI must permit the IRS to communicate directly with the external auditor, review the audit procedures followed by the external auditor, and examine the external auditor's work papers and reports.

In addition to the external audit requirements set forth in the QI agreement, the IRS has issued further guidance (the "QI audit guidance") for an external auditor engaged by a QI to verify the QI's compliance with the QI agreement.[476] An external auditor must conduct its audit in accordance with the procedures described in the QI agreement. However, the QI audit guidance is intended to assist the external auditor in understanding and applying those procedures. The QI audit guidance does not amend, modify, or interpret the QI agreement.

Term of a QI agreement

A QI agreement expires on December 31 of the fifth full calendar year after the year in which the QI agreement first takes effect, although it may be renewed. Either the IRS or the QI may terminate the QI agreement before its expiration by delivering a notice of termination to the other party. However, the IRS will not terminate a QI agreement unless there is a significant change in circumstances or an event of default occurs, and the IRS determines that the change in circumstance or event of default warrants termination. If an event of default occurs, a QI is given an opportunity to cure it within a specified time.

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[475] Under both of these procedures, a U.S. non-exempt recipient may effectively avoid disclosure and backup withholding simply by investing in assets that generate solely non-reportable payments such as foreign source income (such as bonds issued by a foreign government) paid outside of the United States. See further discussion in section III.D. below.

[476] Rev. Proc. 2002-55, 2002-2 C.B. 435.

D. Strengths and Weaknesses of the Present Qualified Intermediary Program

Since the adoption of the QI regime in 2001, more than 7,000 QI agreements have been signed. As of July 2008, there were 5,660 active QI agreements involving financial institutions in 60 countries.[477] The QI program provides a significant benefit to foreign financial institutions—in particular, the ability to obtain a reduced rate or exemption from U.S. withholding tax for their non-U.S. customers without disclosing the identities of those customers to the IRS or competing financial institutions. At the same time, however, the contractual nature of the QI program provides the IRS with an important mechanism to enforce compliance with U.S. reporting and withholding rules. For example, a foreign financial institution that is a QI is contractually required to disclose the identity of its U.S. customers to the IRS, report the payment of certain amounts to those customers and, in some circumstances, apply backup withholding. These contractual requirements extend beyond the scope of the reporting and withholding that would otherwise be required under applicable Treasury regulations. Moreover, the fact that so many of the world's major financial institutions have entered into QI agreements may place a nonqualified intermediary financial institution at a competitive disadvantage and creates a significant incentive for existing QIs to maintain their QI status. The IRS's ability to terminate a QI agreement in the event of noncompliance, thereby placing a financial institution at such a disadvantage, is a powerful tool for enforcing compliance and ensuring cooperation by a QI when instances of noncompliance are discovered.

On the other hand, as evidenced by the recent investigation and settlement with UBS, there are weaknesses in the QI program as presently implemented. For example, a U.S. non-exempt recipient investing through a QI may effectively avoid disclosure and backup withholding by investing in assets that generate solely foreign source income (such as bonds issued by a foreign government). Under present law, foreign source income generally is not subject to Form 1099 reporting and backup withholding or to U.S. nonresident withholding tax.[478] Thus, this feature of the QI agreement is arguably consistent with the present law framework for withholding and information reporting. Moreover, a U.S. investor seeking to avoid disclosure can hold foreign assets through an account with a foreign financial institution that is not a QI and, similarly, escape information reporting and backup withholding.

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[477] See Written Testimony of Douglas H. Shulman, Commissioner, Internal Revenue Service, Hearing on Tax Haven Banks and U.S. Tax Compliance Before the Permanent Subcommittee on Investigations, Senate Committee on Homeland Security and Governmental Affairs, 110th Congress, 2nd Session, July 17, 2008 (hereafter "Shulman 2008 Testimony"). The difference between signed agreements and active agreements is due to mergers, acquisitions, and terminations. As of July 2008, the IRS had issued 600 default letters and had terminated 100 QI agreements.

[478] Non-U.S. investments can generate amounts subject to information reporting if they are not considered paid outside the U.S. under Treas. Reg. sec. 1.6049-5(e). Payments are not considered paid outside the U.S. if the customer has transmitted instructions to an agent, branch, or office of the institution from inside the U.S. by mail, phone, electronic transmission, or otherwise, unless the transmission from the U.S. has taken place in isolated and infrequent circumstances.

The UBS investigation is described briefly below, followed by a description of certain modifications to the QI program as recommended in a report issued by the Permanent Subcommittee on Investigations ("PSI")[479] and modifications presently under consideration by the IRS to address problems identified in the UBS and other enforcement proceedings.

<u>The UBS case</u>

UBS, based in Switzerland and one of the world's largest financial institutions entered into a QI agreement with the IRS, effective January 1, 2001. According to the 2008 PSI Report, many of UBS's U.S. clients refused to be identified, to have taxes withheld, or to sell their U.S. assets as required under the QI agreement. To retain these customers, UBS bankers assisted the customers in concealing their ownership of the assets held in offshore accounts by helping to create nominee and sham entities. These entities were set up in various jurisdictions, including Switzerland, Liechtenstein, Panama, the British Virgin Islands, and Hong Kong. The UBS bankers and their U.S. customers then claimed that the offshore accounts were owned by these nominee and sham entities and were not subject to the reporting requirements imposed by the QI agreement.

On February 18, 2009, the United States District Court for the Southern District of Florida accepted a deferred prosecution agreement between the United States and UBS.[480] Pursuant to this agreement, UBS acknowledged that, beginning in 2000 and continuing through 2007, it participated in a scheme to defraud the United States and the IRS by actively facilitating the creation of accounts in the names of offshore companies and allowing U.S. taxpayers to conceal their ownership of, or beneficial interest in, the accounts in an effort to evade U.S. tax reporting and payment requirements.

On February 19, 2009, the government filed a petition with the United States District Court for the Southern District of Florida to enforce a previously issued John Doe summons.[481] In this petition, the government requested that the court issue an order requiring UBS to disclose to the IRS the identities of the bank's U.S. customers with undeclared Swiss accounts. The lawsuit alleged that there may be as many as 52,000 undeclared accounts with approximately $14.8 billion in assets as of the mid-2000s. UBS stated that its ability to comply with the summons was restricted by Swiss law; in particular, Swiss law prohibited UBS from producing information located in Switzerland. UBS took the position that it could produce only

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[479] U.S. Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, "Tax Haven Banks and U.S. Tax Compliance Staff Report, Released in Conjunction with the Permanent Subcommittee on Investigations July 17, 2008 Hearing" (hereafter, the *2008 PSI Tax Haven Report*).

[480] See *United States v. UBS AG*, 09-60033-CR-COHN (S.D. Fl.). As part of the agreement, UBS agreed to pay $780 million in fines, penalties, interest and restitution. To the extent UBS meets this, and all other, obligations under the deferred prosecution agreement, the government will recommend dismissal of the charge. For a repository of documents related to the case, see http://www.ubs.com/1/e/index/crossborder/home.html.

[481] On July 1, 2008, a Federal district court in Florida granted the IRS permission to issue a John Doe summons to UBS seeking the names of as many as 20,000 U.S. citizens who were UBS customers for which reporting or withholding obligations may not have been met.

information located in the United States.[482] UBS also expressed concern that further enforcement of the summons would be in violation of the original QI agreement and the information exchange provisions of the income tax treaty between Switzerland and the United States. In particular, the QI agreement entered into between UBS and the IRS in 2001 expressly recognized that UBS would open and maintain accounts covered by Swiss financial privacy laws for U.S. clients who chose not to provide a Form W-9, as long as those accounts held no U.S. securities.

On August 19, 2009 the United States and Swiss governments signed an agreement under which (1) the IRS has subsequently submitted a separate request under the United States-Switzerland income tax treaty for information regarding approximately 4,450 accounts of certain U.S. customers of UBS, and (2) the Swiss government has agreed to process the request and to direct UBS to turn over information on those U.S. customers.[483] Additionally, judicial enforcement of the John Doe summons will be dismissed. The agreement requires the Swiss government to establish a task force to expedite its decisions as to disclosure under the treaty request. The Swiss Federal Tax Administration is required to render final decisions on 500 accounts within 90 days after the IRS submitted the treaty request and is required to render final decisions on the remaining accounts within 360 days after the treaty request. The Swiss government has also agreed to review and process additional requests for information for other banks where an equivalent pattern of facts and circumstances exist. An annex to the agreement that sets forth the criteria for which U.S. accounts are subject to the agreement will be disclosed not earlier than 90 days after the agreement was signed.

Under voluntary disclosure procedures announced on March 26, 2009, individual taxpayers with unreported offshore accounts and entities can avoid criminal prosecution in return for making a voluntary disclosure by September 23, 2009.[484] In general, the guidance provides that taxpayers who make voluntary disclosures will be required to make all delinquent filings (e.g., FBAR and other information returns), pay back-taxes and interest for six years, and an accuracy or delinquency penalty for all six years. Additionally, such taxpayers will be required to pay a penalty equal to 20 percent of the highest asset value in any unreported account at any

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[482] Written Testimony of Mark Branson, Chief Financial Officer of UBS AG, Hearing on Tax Haven Banks and U.S. Tax Compliance − Obtaining the Names of U.S Clients with Swiss Accounts Before the Permanent Subcommittee on Investigations, Senate Committee On Homeland Security and Governmental Affairs, 111th Congress, 1st Session, March 4, 2009. The Swiss banking authority with the permission of the Swiss government allowed UBS to agree to transfer approximately 250 names of United States resident account holders for which there was a reasonable suspicion of conduct constituting what Swiss law considers fraudulent acts to the Justice Department as part of the deferred prosecution agreement. See Lee Sheppard, "Don't Ask, Don't Tell, Part III: UBS's Sweet Deal," *Tax Notes*, March 2, 2009, p. 1050.

[483] See Agreement Between the United States and the Swiss Confederation on the Request for Information from the Internal Revenue Service of the United States of America Regarding UBS AG, a Corporation Established Under the Laws of the Swiss Confederation (Aug. 19, 2009). See also, "USA Requests Administrative Assistance in UBS Case," Federal Authorities of the Swiss Confederation, press release, available at http://www.admin.ch/aktuell/00089/index.html?lang=en&msg-id=28799 (last accessed September 8, 2009).

[484] For a question-and-answer discussion of the voluntary disclosure procedures, see http://www.irs.gov/newsroom/article/0,,id=210027,00.html (last accessed September 8, 2009).

time during the six-year period. The penalty amount may be reduced to five percent if the taxpayer did not open the account, there was no account activity while the taxpayer controlled the account, and all taxes have been paid on the account.[485] The penalty provisions of the voluntary disclosure procedure are discussed further in Section IV.B.

2008 PSI Tax Haven Report

The 2008 PSI Tax Haven Report includes several recommendations for strengthening the QI program, based primarily on its investigation of the UBS matter and a similar investigation of the Liechtenstein Global Trust Group ("LGT"). First, the report recommends that QIs should be required to file Forms 1099 for all U.S. persons who are clients (whether or not the client has U.S. securities or receives U.S.-source income) and for all accounts beneficially owned by U.S. persons, even if the accounts are held in the name of a foreign corporation, trust, foundation, or other entity.

The report also recommends that the IRS close what the report describes as a gap in the QI program by expressly requiring QIs to apply to their QI reporting obligations all information obtained through their know-your-customer procedures to identify the beneficial owners of accounts. As part of the PSI investigation, an LGT compliance officer stated that the rules of the QI program are distinct from the know-your-customer rules that apply for due diligence purposes under the internal laws of the country in which the QI is located, although a QI must apply such know-your-customer rules as a prerequisite for entering into the QI program. As a result, the 2008 PSI Report concludes, some QIs, including UBS and LGT, have apparently taken the position that information the QI acquires about a particular customer as a result of satisfying the QI's requirements under applicable know-your-customer rules does not necessarily affect the determination of that customer's status for purposes of the QI program. Thus, for example, the report states that such a QI may take the position that it can rely on a certification of non-U.S. status (technically a Form W-8BEN) proffered by a foreign nominee owner (e.g., a Liechtenstein foundation) to establish that the nominee in fact is the beneficial owner of an account for withholding and reporting purposes under the QI program, even if the QI knows, as a result of satisfying the applicable know-your-customer rules, that a U.S. person is the actual beneficial owner of the account.

The better reading of the model QI agreement is that the gap identified by the 2008 PSI Report does not in fact exist, although admittedly the model QI agreement might be revised to make the point more explicitly. Very simply, a QI is a "withholding agent" for all U.S. tax purposes. The QI agreement expands the obligations of withholding agents under the relevant Treasury regulations,[486] but does not override them. Under the regulations (and, indeed, under the model QI agreement itself[487]), a withholding agent may not accept a certification of non-U.S.

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[485] For news coverage of the initial voluntary disclosure announcement, see Kristen A. Parillo and Jeremiah Coder, "IRS Reduces Penalties on Voluntarily Disclosed Offshore Accounts," *Tax Notes*, (March 30, 2009), p. 1561.

[486] Principally Treas. Reg. secs. 1.1441-1 and 1.1441-7.

[487] See section 5.10 of the model QI agreement, as set forth in Rev. Proc. 2000-12, 2000-1 C.B. 387.

status (a Form W-8BEN) if the withholding agent has actual knowledge that the beneficial owner of the relevant income (the taxpayer) is a U.S. person. There is no obvious basis for concluding that information obtained through know-your-customer rules is irrelevant for this purpose. Moreover, the relevant Treasury regulations also provide that a withholding agent effectively must compare a Form W-8BEN that it receives with other account information in its possession, and reject the Form W-8BEN if it is inconsistent with that information.[488]

As a result, a straightforward reading of the model QI agreement, in the context of the Treasury regulations under which the QI program exists, is that a foreign QI cannot accept a Form W-8BEN certification of non-U.S. status where it has actual knowledge (whether obtained through know-your-customer rules or otherwise) that the beneficial owner of the income in question is a U.S. person or where the certification is inconsistent with other account information. The gap, to the extent one exists, is with the consistent treatment of foreign corporations, in particular, as entities separate from their owners for both know-your-customer and withholding tax purposes, but this is a different (and larger) issue.

The 2008 PSI Tax Haven Report also recommends that the IRS broaden QI audits to require external auditors to report evidence of fraudulent or illegal activity.[489] The report also recommends that the Treasury Department penalize banks located in tax haven jurisdictions that impede U.S. tax enforcement or fail to disclose accounts held directly or indirectly by U.S. clients by terminating their QI status. The report further recommends that Congress amend the Patriot Act to allow the Treasury Department to bar such banks from doing business with U.S. financial institutions.

<u>Potential modifications under IRS consideration</u>

During 2008, the IRS announced a series of potential modifications to the QI program to address certain of the issues raised by the 2008 PSI Report and the UBS investigation. These modifications are described further below. The modifications do not, however, purport to address compliance and enforcement issues relating to bank secrecy laws.

[488] Treas. Reg. sec. 1.1441-7(b)(4).

[489] A similar recommendation was made in the GAO report discussed in section III.A. above. The report generally found that the QI program provides some assurance that tax on U.S.-source income sent offshore is properly withheld and reported. However, the report offered four recommendations for the IRS to further improve the QI program. In addition to recommending that external auditors report fraud or illegal acts, the report recommended that the IRS: (1) measure U.S. withholding agents' reliance on self-certified documentation and use that data in its compliance efforts; (2) determine why some funds are reported to unknown jurisdictions and to unidentified recipients and take appropriate steps to recover withholding taxes that should have been paid and to better ensure that U.S. taxes are withheld; and (3) require electronic filing of forms in QI agreements whenever possible.

Announcement 2008-98

On October 14, 2008, the IRS released Announcement 2008-98, which describes proposed amendments to the QI agreement and to the QI audit guidance.[490] The announcement contains three proposed changes, which are proposed to be effective for calendar years beginning after December 31, 2009. The first proposed change relates to internal controls. It requires a QI to ensure that specific employees are responsible for oversight of the QI's performance under the QI agreement, and that those employees take steps to prevent, deter, detect, and correct failures in performance. In addition, the QI agreement will be amended to require a QI to notify the IRS whenever the QI becomes aware of a material failure of internal controls relating to its performance under the QI agreement, any employee allegations of such failures, or any investigation by regulatory authorities of such failures. The IRS does not anticipate automatically terminating a QI agreement as a result of any such notice; instead, the IRS expects prompt notification to allow the IRS and the QI to work together to remedy such failures.

The second proposed change relates to additional fact finding during the basic fact finding phase (phase 1) of a QI audit to enable the IRS to evaluate risk. The QI audit guidance will be amended to add an audit procedure testing certain accounts for characteristics that suggest that a U.S. person has authority over the account. Such information will allow the IRS in the follow up fact finding phase (phase 2) of the audit process to evaluate the risk of any failure of controls and, if necessary, to request that the external auditor perform additional audit procedures.

Furthermore, the QI audit guidance will be amended to add additional procedures for fact gathering by the external auditor relating to the IRS's evaluation of the risk of a material failure of internal controls. These procedures will include, for instance, identifying the persons charged with oversight of performance under the QI agreement and the authority given them to prevent, deter, detect, and correct such failures on the part of other operational personnel. The external auditor will be required to report any facts and circumstances observed in the course of its audit that reasonably relate to the evaluation by the IRS of the risk of a material failure of internal controls.

The third proposed change relates to oversight and review of the QI audit. The QI audit guidance will be amended to require a QI's external auditor to associate a U.S. auditor with the audit and to require the U.S. auditor to accept joint responsibility for the performance of the procedures under the QI audit guidance. It is intended that joining a U.S. auditor to the QI audit will assure appropriate application of U.S. withholding rules and enhance accuracy and accountability in the audit process.

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[490] 2008-44 Internal Revenue Bulletin 1087.

E. Administration's Proposal to Require Greater Reporting by Qualified Intermediaries Regarding U.S. Account Holders

Description of Proposal

Under the proposal, no foreign financial institution would qualify as a QI unless it identified all of its account holders that were U.S. persons. A QI would be required to report all reportable payments (for this purpose, treating the QI as a U.S. payor) received on behalf of all U.S. account holders. Thus, a QI would file Forms 1099 with respect to payments to those U.S. account holders as though the QI were a U.S. financial institution. The Treasury Department would be authorized to issue regulations to implement the purposes of this proposal, including authority to require that for any financial institution to be a QI, commonly-controlled foreign financial institutions must meet certain reporting obligations with respect to account holders or that a financial institution may be a QI only if all commonly-controlled financial institutions are also QIs, and including authority to provide that for any financial institution to be a QI it must collect information indicating the beneficial owners of foreign entity account holders and specifically report if a U.S. person is a beneficial owner. The proposal would also clarify that under section 6103 the IRS may publish the list of QIs.

Effective date.−The proposal would be effective beginning after December 31 of the year of enactment.

Analysis

Overview

The proposal is designed to address an acknowledged weakness of the existing QI program — the fact that a QI is required to report to the IRS only with respect to certain U.S. source income received by U.S. account holders who are not otherwise exempt from information reporting and backup withholding.[491] Under the existing requirements, a U.S. person may avoid information reporting and backup withholding by establishing an account with a QI to hold assets that produce only foreign source income. IRS Commissioner Shulman, the GAO, PSI, and others have observed that the failure to require information reporting on foreign source income can facilitate tax evasion by U.S. persons.[492]

Under the proposal, a QI would be required to identify all of its account holders that are U.S. persons. A QI would also be required to report all reportable payments (for this purpose,

[491] Under present law, a QI that is a U.S. payor under Treas. Reg. sec. 1.6049-5(c)(5) (i.e. a U.S. branch of a foreign financial institution or a foreign financial institution owned by a U.S. person) must report on other reportable payments as well, including reporting certain foreign source income and broker proceeds paid to U.S. non-exempt recipients.

[492] See e.g., Shay Testimony, p. 27, and Written Testimony of Douglas H. Shulman, Commissioner, Internal Revenue Service, Hearing on Issues Involving Banking Secrecy Practices And Wealthy American Taxpayers, House Committee on Ways and Means, Subcommittee on Select Revenue Measures, 111th Congress, 1st Session, March 31, 2009.

treating the QI as a U.S. payor) received on behalf of all U.S. account holders. Thus, a QI would file Forms 1099 with respect to payments to those U.S. account holders as though the QI were a U.S. financial institution. "Reportable payments" for these purposes includes payments of foreign source income.[493]

The proposal would not, in and of itself, preclude a U.S. person from evading U.S. tax by opening an offshore account with a foreign financial institution that is *not* a QI and, thus, is not required to perform information reporting. A foreign financial institution that has no U.S. connection clearly falls outside the jurisdiction of the U.S. tax laws and cannot be required to comply with U.S. reporting requirements. As discussed further below, however, certain other proposals by the Administration are designed to address this jurisdictional gap. In particular, several other proposals are designed to encourage foreign financial institutions to become QIs (and thereby subject themselves to U.S. information reporting requirements) by requiring withholding of tax on payments made through nonqualified intermediaries. Other proposals are designed to obtain information on cross-border transfers of assets by U.S. persons to (and from) foreign financial institutions that are not QIs, so that the IRS can identify cases of potential tax evasion. Together, these proposals represent a coordinated strategy to strengthen the QI program, bring foreign financial institutions more directly into the U.S. information reporting and withholding tax system, and thus reduce instances of tax evasion by U.S. (as well as foreign) investors.

Compliance and administrative considerations

It may be difficult and costly, however, for QIs to comply with all of the information reporting requirements that apply to U.S. financial institutions. Most QIs would need to undertake significant modifications to their existing computer systems in order to capture the additional information required and prepare the information returns. In addition, the existing information reporting requirements require in many instances a sophisticated knowledge of U.S. tax rules, for example with regard to the classification of financial instruments, the computation of original issue discount and (for securities acquired on or after January 1, 2011) the determination of tax basis. Applying these rules with respect to complex financial instruments that are issued by foreign persons may be particularly difficult, in view of the absence of reporting or disclosure by the issuer on U.S. tax characteristics.[494]

[493] Section 3406(b).

[494] For example, a U.S. issuer of a debt instrument with original issue discount is required to report the amount of the OID to the IRS on Form 8281 for inclusion in Publication 1212. This information can then be used by U.S. financial institutions to prepare Forms 1099-OID with respect to OID inclusions on the debt instrument. Comparable information will not be available in most cases for OID instruments issued by foreign issuers. In addition, U.S. securities laws require that an issuer of securities in the U.S. public markets provide general disclosure in the offering document with regard to the U.S. income tax consequences of ownership of the security; offering documentation for securities sold in foreign markets would not normally include that disclosure. It is important to note, however, that U.S. financial institutions are currently complying with full Form 1099 reporting on foreign securities held by U.S. persons. Compliance expertise is available in the market and could be retained by foreign financial institutions to administer U.S. tax obligations.

These considerations have implications for both the schedule on which the new requirements are implemented and the substance of those rules. As proposed, the new requirements would be effective beginning after December 31 of the year of enactment. Experience with the initial implementation of the QI program suggests, however, that a longer transition period will be needed for the IRS and Treasury to issue guidance under the new legislation and for QIs to modify their reporting and collection systems accordingly.[495] While the length of the period needed will depend upon the scope of the legislation ultimately enacted, experience would suggest that a delay of at least one or two years in the effective date would be prudent.

Concerns have also been expressed by international financial institutions that the exportation of the U.S. information reporting requirements − even with a reasonable transition period − will impose too great an administrative burden on QIs and will result in many QIs leaving the system.[496] Many foreign financial institutions do not have the technical expertise needed to ensure compliance with the U.S. withholding and reporting requirements, in particular with regard to foreign securities. In addition, institutions with relatively few U.S. customers, or relatively few customers who invest in U.S. securities, may find that the costs of compliance with the full range of U.S. reporting rules outweigh the benefits they derive from QI status.

On the other hand, the fact that QI status affords foreign financial institutions a number of significant benefits (such as the ability to certify as to residence status and treaty eligibility on behalf of non-U.S. customers and to use pooled reporting) arguably justifies the imposition of enhanced reporting by those institutions. Moreover, enhanced reporting requirements clearly are needed to preclude the use of QIs by U.S. persons for tax evasion. These issues of cost and complexity may suggest, however, that a more limited set of reporting requirements be adopted for QIs. At a minimum, the rules should be designed to ensure that a QI reports all of the payments that it makes to a U.S. account holder, whether those represent U.S. or foreign source income. With respect to foreign source amounts, however, a simplified reporting regime could be considered under which, for example, amounts not clearly identifiable as interest, dividends or sales proceeds could be reported on a cash flow basis. This could be coupled with enhanced reporting of account information to the IRS, such as opening and closing balances for the year and the amounts and dates of withdrawals or contributions (i.e., information similar to that normally provided by financial institutions on annual statements to their customers). Such information provided on other than a U.S. tax basis would not readily lend itself to automated matching with return information, and may be somewhat more difficult for the IRS to use in an audit. However, it would provide the IRS with valuable information regarding foreign account

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[495] As described earlier, the IRS proposed regulations for the QI program in April of 1996 and finalized those regulations in 1997. Their effective date was twice delayed, however, and they became effective only as of January 1, 2001. See T.D. 8734 (Oct. 6, 1997); T.D. 8804 (December 30, 1998) (delaying effective date and providing additional transition rules); T.D. 8856 (December 30, 1999) (delaying effective date); and T.D. 8881 (May 16, 2000). More recently, and in response to similar systems development concerns, Congress provided a transition period of more than two years for implementation of the basis reporting rules, which were enacted on October 3, 2008 with a delayed effective date of January 1, 2011.

[496] See Louise Armistead, "British Banks Revolt Against Obama Tax Plan," *Telegraph.co.uk* (May 24, 2009).

balances and payment flows. This information would assist the IRS in identifying taxpayers who have failed to report foreign accounts or to include income from a foreign account, and would provide the IRS with information on foreign accounts that is currently difficult to obtain in a timely manner. Additionally, a simpler reporting regime could have the benefit of retaining more (and in particular, smaller) foreign financial institutions in the QI system and minimizing disincentives for other institutions to become QIs.

Coordination with other jurisdictions

As discussed in Section VI below, the United States is one of many jurisdictions seeking ways to reduce offshore tax evasion and ensure compliance with domestic tax laws. These efforts are garnering attention and support even among jurisdictions traditionally labeled as tax havens. However, multi-jurisdictional solutions will take a long time to develop and implement, given that such solutions require cooperation between governments and changes to the domestic law of each jurisdiction. The Administration's unilateral proposals could serve as a model for developing further multilateral programs and could serve as an interim solution to some of the current problems faced in enforcing U.S. tax law. On the other hand, unilateral implementation comes at significant cost to financial institutions that might also be tasked with implementing similar reporting programs for other jurisdictions. A broad-based multilateral solution would reduce the incremental cost of reporting.

The United States has come under increasing pressure to eliminate policies that provide foreign persons with the ability to shelter income. For example, as discussed in section I above, the United States does not tax bank deposit interest earned by non-U.S. persons and generally does not collect information on such income. It is therefore possible for a nonresident alien to shelter income from his home jurisdiction by maintaining a U.S bank account. The Administration's proposals may impose a heavier burden on foreign financial institutions than currently exists for some U.S. financial institutions in regard to foreign customers. However, a multilateral approach would involve financial institutions from many jurisdictions, including those in the United States.

Disclosure of QI status

The IRS does not currently publish a list of financial institutions that have entered into QI agreements. The financial institution's QI agreement with the United States is taxpayer return information subject to non-disclosure protection under section 6103. However, both the existing withholding and reporting rules related to foreign persons, and many of the Administration's proposals in regard to offshore compliance, require U.S. withholding agents to distinguish between foreign financial institutions that are QIs and those that are not. In addition, making this distinction will be increasingly important for foreign investors if proposals to require U.S. withholding on payments made to nonqualified intermediaries (discussed further below) are adopted. To ensure that QIs and nonqualified intermediaries can be properly identified by payors and investors, the proposal would clarify that the IRS may publish the list of QIs, notwithstanding confidentiality protections provided for taxpayer return information.

Extension of QI obligations to commonly-controlled financial institutions

The proposal would authorize the Secretary to require that, for a foreign financial institution to become a QI, commonly-controlled financial institutions must meet certain reporting obligations with respect to account holders. These obligations might include, for example, a requirement that nonqualified intermediary affiliates of a QI must identify all U.S. account holders and perform some type of information reporting with respect to payments to those account holders. This proposal would help to ensure that financial institutions that wish to take advantage of the benefits of the QI regime cannot simultaneously assist U.S. customers to avoid U.S. tax reporting by opening accounts in nonqualified intermediary affiliates — a problem revealed by the UBS investigation. Arguably, such a requirement should be imposed by statute in order to ensure that it is uniformly applicable. There may be circumstances, however, in which the costs of performing this reporting would represent an undue burden, for example, if a nonqualified intermediary affiliate has a very small number of U.S. customers. Delegating authority to Treasury to implement the requirement would permit Treasury to identify appropriate circumstances for limited exceptions.

Alternatively, Treasury would have authority under the proposal to require that, for a foreign financial institution to become a QI, all commonly-controlled foreign financial institutions must also be QIs. Such a requirement would prevent a financial institution from splitting or grouping account holders in nonqualified intermediary affiliates in such a way as to enable tax avoidance. However, it could also significantly increase the cost of being a QI. At present, a financial institution can choose which of its affiliates or branches will become QIs, based on factors such as the number of customers holding U.S. securities or the number of U.S. account holders.

A requirement that branches or affiliates of a QI with little to no U.S.-related business also become full QIs could impose substantial costs in terms of systems modifications and the development of technical expertise. Moreover, a QI may have affiliates located in countries whose know-your-customer rules have not been approved by the IRS for application in the QI program (in which case the affiliates may need to learn and apply another set of customer identification rules). Consideration should be given, therefore, to delegating the authority to apply a uniformity requirement only on a case-by-case basis, or in appropriate circumstances. In other words, while the wording of the proposal appears to contemplate regulatory authority for the adoption of a general rule, an alternative approach may be to limit that authority to application of the requirement only where the IRS has determined that uniformity is necessary to ensure compliance with the QI rules, whether by virtue of the circumstances of a particular financial institution or in particular fact patterns where opportunities for evasion might arise.

Beneficial ownership reporting

The proposal would also provide Treasury with the authority to require that, for any financial institution to be a QI, it must collect information indicating the beneficial owners of the foreign entity account holders and specifically report if a U.S. person is a beneficial owner.

As an initial matter, it is important to note that the fact that a U.S. person is the owner of a foreign entity does not mean that the U.S. person is necessarily required to include as taxable income any portion of the income earned by such entity. The partners of a foreign partnership, or the grantors or beneficiaries of certain flow-through trusts, are generally treated as the beneficial owners of income earned by the partnership or trust. However, U.S. income tax principles generally treat corporations, certain trusts, estates and foundations as the beneficial owners of income legally received by the entity, unless the income is received in the entity's capacity as a nominee, agent, or custodian for another person. The U.S. withholding regulations and the QI rules follow these principles by treating a foreign corporation (or other non-flow-through entity) as the beneficial owner of the income it derives,[497] and generally do not require withholding agents to identify the owner(s) of the corporation when determining the tax status of the corporation.[498] Instead, withholding agents generally may rely on the foreign entity's self-certification regarding its qualifications for exemptions or reduced withholding rates,[499] unless the withholding agent knows or has reason to know that the certification is incorrect.[500]

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[497] Treas. Reg. sec. 1.1441-1(c)(6). Beneficial owner is defined for withholding tax purposes as the person that is the owner of the income for U.S. tax purposes. Treas. Reg. sec. 1.1441-1(c)(6)(ii)(B). The beneficiaries of foreign simple or grantor trusts are generally considered to be the beneficial owners of income paid to such trust. Treas. Reg. sec. 1.1441-1(c)(6)(ii)(C). A foreign estate or foreign complex trust is treated for these purposes as the beneficial owner of income paid to such trust or estate. Treas. Reg. sec. 1.1441-1(c)(6)(ii)(D).

[498] Withholding agents often do have to determine ownership of flow-through entities as payments made to foreign partnerships and foreign simple or grantor trusts may be treated as payments made to the partners or beneficiaries or owners of the trust. See Treas. Reg. sec. 1.1441-5(c) (regarding foreign partnerships) and Treas. Reg. sec. 1.1441-5(e) (regarding foreign trusts and estates). A foreign partnership can enter into an agreement with the IRS and be treated as a withholding foreign partnership (essentially act as a QI with respect to its partners). See Treas. Reg. sec. 1.1441-5(c)(2).

[499] Generally, the determination by a withholding agent as to a person's status (i.e. as a U.S. or foreign person) and the person's relevant characteristics (i.e. as beneficial owner or intermediary, individual, corporation, or flow through entity) is made on the basis of withholding certificates or documentary evidence provided to the withholding agent by the payee. See Treas. Reg. sec. 1.1441-1(c)(6)(b)(2). For certain types of payments (i.e. certain dividends and interest generally from actively traded or registered investments), a withholding agent may rely on documentary evidence to establish the payee's eligibility for reduced treaty rates. For individuals, withholding agents can rely on documentation that includes the individual's name, address, and photograph, is an official document issued by an authorized governmental body, and is no more than three years old. Treas. Reg. sec. 1.1441-6(c)(4)(i). For persons other than individuals, withholding agents can rely on documentation that includes the name of the entity and the address of its principal office in the treaty country and that is an official document issued by an authorized governmental body. Treas. Reg. sec. 1.1441-6(c)(4)(ii). Additionally, the non-individual payee must provide a statement that it meets one or more of the conditions set forth in the limitation on benefits article of the relevant treaty and a statement that income is properly treated as derived by it as a resident of the applicable treaty jurisdiction. Treas. Reg. sec. 1.1441-6(c)(5). Additional requirements on the withholding agent include procedures to obtain, review, and maintain the evidence in accordance with established procedures. See Treas. Reg. sec. 1.6049-5(c)(1).

[500] See Treas. Reg. sec. 1.1441-1(b)(2)(vii). This would include knowledge the financial institution obtained through customer due diligence performed in compliance with know-your-customer due diligence requirements. A withholding agent has reason to know that the information is unreliable when the withholding agent's knowledge of relevant facts or of statements contained in the withholding certificate or other documentary evidence is such that a reasonably prudent person in the position of the withholding agent would question the claims made. Treas. Reg. sec. 1.1441-7(b)(2).

If the withholding agent is a financial institution, the reason to know standard is limited under certain circumstances. Treas. Reg. sec. 1.1441-7(b)(3). For direct account holder payees that receive certain types of

If Treasury were to exercise its authority under this proposal to require QIs to collect and report to the IRS on the U.S. ownership of foreign entity account holders, the information would substantially assist the IRS in identifying the use of sham entities to hide income beneficially owned by U.S. persons, in circumstances such as those identified in the UBS and LGT investigations. This information could be used by the IRS to identify U.S. persons who fail to report income when it is earned, for example in U.S. business operations. Such persons may attempt to avoid detection of this unreported income by hiding the resulting assets in an offshore entity. Under the proposal, if the funds are held in a financial institution that is a QI, the identity of the owner would be disclosed to the IRS, which could then use such information to identify and substantiate income that has not been reported on the tax return. In addition, the information would assist the IRS in identifying U.S. persons who fail to report income inclusions under subpart F or the passive foreign investment company rules with respect to income earned through offshore entities.

At the same time, a requirement to collect beneficial ownership information could represent a substantially new and difficult responsibility for many QIs and other U.S. withholding agents. Most financial institutions are required to comply with anti-money laundering laws which require adherence to certain know-your-customer due diligence rules and procedures. In general, however, anti-money laundering laws impose risk-based requirements for financial institutions to confirm the identity of their customers. Within the anti-money laundering framework, a financial institution develops customer identification and due diligence programs based on the financial institution's risk profile.[501] The financial institution is expected to conduct risk assessments and develop controls designed to mediate or reduce the effect of identified risks associated with its operations. This can include an assessment of its business line risk (i.e., the inherent risk posed by the customer base, the products or services offered, the types of transactions, and the geographic footprint of the institution) and its customer risk (i.e., types of customers, types of accounts, customer segments). Customer identification and due diligence should enable a financial institution to verify the identity of a customer and assess the risks associated with that customer. This risk-based approach results in wide disparity in the implementation of know-your-customer rules not only from country to country, but also from institution to institution within a country and even from branch to branch within a given institution.

For account holders other than individuals, there are generally no prescriptive anti-money laundering rules that dictate how or when a financial institution is required to determine the ultimate owners of such accounts. Even in countries, such as many in the European Union,

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income, the financial institution withholding agent has reason to know that a withholding certificate is unreliable where: 1) the withholding certificate is incomplete, 2) the withholding certificate contains information inconsistent with the account holder's claim, 3) the withholding agent has other account information that is inconsistent with the account holder's claim, or 4) the withholding certificate lacks information necessary to establish entitlement to a reduced rate of withholding. Treas. Reg. sec. 1.1441-7(b)(4).

[501] For a detailed discussion of U.S. anti-money laundering laws, see Protiviti Inc., *Guide to U.S. Anti-Money Laundering Requirements*, (2008, 3rd Edition), available at http://www.protiviti.com/en-US/Insights/Resource-Guides/Pages/Guide-to-US-AML-Requirements.aspx.

where know-your-customer rules require some identification of ultimate ownership of accounts owned by non-individuals, there are minimum ownership threshold levels for obtaining such information and generally no obligation for periodic review of such information. The existing United States know-your-customer rules do not include a general requirement for financial institutions to obtain information on the ultimate owners of domestic or foreign entity account holders, although it is required in certain limited situations. The European Union's know-your-customer rules normally require identification of some level of beneficial ownership, but not to the extent required under the proposal.

Building upon any relevant information-gathering requirements that already apply to financial institutions would significantly reduce the cost of implementation. The unevenness of those requirements, however, presents a significant question as to whether existing know-your-customer rules, developed for non-tax purposes, will provide sufficient information for tax compliance and enforcement purposes, or whether additional tax-specific rules will be required. The areas in which tax-specific rules may be needed fall into three general categories:

1. Ownership threshold. Even the most comprehensive know-your-customer rules do not require the identification of every owner of an entity; instead, these rules typically apply some percentage threshold of ownership (such as 25 percent or 10 percent), or a standard of control, below which identification is not required. Thus, it will be necessary to consider what, if any, threshold should apply for tax purposes.

2. Frequency of review. Although anti-money laundering laws require on-going monitoring of accounts, in general a financial institution is only required to verify know-your-customer information at the time of the account opening, when relevant information related to the account changes (such as a new signatory), or upon the occurrence of certain other events that may indicate suspicious activity. In contrast, the IRS Form W-8BEN must be renewed every three years, and existing Treasury regulations governing the more limited circumstances under which a U.S. withholding agent or payor may rely on documentary evidence in place of a Form W-8BEN for offshore accounts require renewal of that evidence every three years in some circumstances.[502]

3. Due diligence requirements. Standards will need to be provided for the extent to which financial institutions are required to undertake independent investigation of ownership information or instead may rely on documentation (including self-certifications) provided by customers. There is significant inconsistency in the information that is available to financial institutions and other withholding agents for independent verification of ultimate ownership.[503]

[502] Treas. Reg. sec. 1.6049-5(c)(4).

[503] For example, most States in the United States do not require companies to report ultimate ownership either at the time of the initial formation of the company or in periodic filings by the company. On the other end of the spectrum are the Crown Dependencies which generally require disclosure and periodic updates of company

In addition, it would be desirable to coordinate implementation of beneficial ownership rules to the extent possible with implementation of the ownership identification requirements contemplated in other jurisdictions.[504] Implementation of a program to identify and verify ultimate ownership in the international context could be effective when combined with treaty and information exchange agreements that provide for the sharing of such information. The OECD suggests three methods or data points for collection of ultimate ownership information.[505] The first is to require up-front disclosure to local authorities when a corporation is established and would impose an obligation to update such information when changes occur. This would put the obligation to collect and keep such information on the relevant local authorities and could impose the obligation to report such information on the entity itself, on the ultimate owner, or on corporate service providers.[506] Another option is to require corporate service providers (such as trust companies, registered agents, lawyers, and others) to obtain, verify and retain records that they establish or administer, or for which they provide fiduciary services.[507] The final option is an investigative system in which authorities obtain ultimate ownership information where illicit activity is suspected, when such information is required for other regulatory functions, or when the information is requested by other domestic or international authorities.[508]

Prior Action

No prior action.

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ownership. See Government Accountability Office, *Company Formations, Minimal Ownership Information Is Collected and Available*, GAO-06-376 (April 2006).

[504] For example the United States and other non-EU jurisdictions could adopt rules consistent with the European Union's Third Anti-Money Laundering Directive, 2005/60/EC, which generally requires identification of any natural persons who own than 25 percent of a legal entity account holder.

[505] See Organisation for Economic Co-operation and Development Steering Group on Corporate Governance, *Options for Obtaining Beneficial Ownership and Control Information* (September 2002).

[506] This could be difficult to implement in the United States, as individual States currently have the ability to set the requirements for formation and on-going certification of legal entities.

[507] This is similar to the corporate procedures currently in place in many small financial-service oriented jurisdictions, such as Guernsey, Isle of Man, and others.

[508] This system is only viable where the jurisdiction has adequate resources and compulsory power to collect such information.

F. Administration's Proposals to Require Withholding on Payments of Fixed or Determinable Annual or Periodical Income and Gross Proceeds Made Through Nonqualified Intermediaries

Description of Proposal

Under the first proposal, any withholding agent making a payment of fixed or determinable annual or periodical ("FDAP") income to a nonqualified intermediary would be required to treat the payment as made to an unknown foreign person (and therefore to withhold tax at a rate of 30 percent).[509] The Treasury Department would receive regulatory authority to provide exceptions, including exceptions for payments collected by nonqualified intermediaries for foreign government, central bank, foreign pension fund, and foreign insurance company payees, and other similar investors, and for payments that the Treasury concludes present a low risk of tax evasion. The rules would be designed so as not to disrupt ordinary and customary market transactions. Foreign persons that are subject to over-withholding as a result of this proposal would be permitted to apply for a refund of any excess tax withheld.

Under the second proposal, a withholding agent would be required to withhold tax at a rate of 20 percent on gross proceeds from the sale of any security of a type that would be reported to a U.S. non-exempt payee, when paid by the withholding agent to a nonqualified intermediary that is located in a jurisdiction with which the United States does not have a comprehensive income tax treaty that includes a satisfactory exchange of information program. The Treasury Department would receive regulatory authority to provide exceptions, including exceptions for payments collected by nonqualified intermediaries for foreign government, central bank, foreign pension fund, and foreign insurance company payees, and other similar investors; payments to nonqualified intermediaries located in jurisdictions with which the United States has a tax information exchange agreement; and payments that Treasury concludes present a low risk of tax evasion. The rules would be designed so as not to disrupt ordinary and customary market transactions. Nonqualified intermediaries would be eligible to claim a refund on behalf of their direct account holders for any taxable year in which they identified all of their direct account holders that are U.S. persons and reported all reportable payments received on behalf of U.S. account holders. Foreign persons that are subject to withholding tax in excess of their income tax liability as a result of this proposal, and on whose behalf a refund claim is not made by a nonqualified intermediary, would be permitted to apply for a refund of any tax withheld.

Effective date.–Each proposal would be effective for payments made after December 31 of the year of enactment.

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[509] Although the proposal presumes that the payee is a foreign person, it also presumes that there is no documentation (i.e. the person is unknown). Certain exceptions and reduced treaty rates are only available where documentation is provided. For example, to qualify for the portfolio interest exception, registered obligations require a statement that the beneficial owner of the obligation is not a U.S. person. Sec. 871(h)(2)(B)(ii). It appears that under the proposal, even if the nonqualified intermediary or withholding agent has applicable documentation, the payment will be treated as made without such documentation and thus will be subject to 30-percent withholding.

Analysis

Overview

A foreign financial institution that has no U.S. connection falls outside the jurisdiction of the U.S. tax laws and cannot be required to comply with U.S. reporting requirements. These two proposals are designed to address this jurisdictional gap by encouraging foreign financial institutions to become QIs (and thereby subject themselves to U.S. information reporting requirements) by requiring withholding of tax on payments made through nonqualified intermediaries.

Foreign financial institutions benefit significantly from participation in the QI program by virtue of the fact that they can avoid disclosure of their foreign customer base to U.S. withholding agents and other financial intermediaries (who are potential business competitors) in the chain of payment. However, not all foreign financial institutions participate in the QI program now. This could be for various reasons. A financial institution would be unlikely to participate if it has limited or no investment in U.S. securities, or if the cost of complying with the QI program requirements outweighs the benefits of participation by the financial institution. The proposal's imposition of withholding tax, and the resulting inconvenience and cost to customers who wish to invest in U.S. securities, may be enough to tip the scales in favor of QI participation.

The Administration has proposed to expand significantly the reporting and information gathering requirements associated with QI status. These additional requirements may be quite costly for a financial institution to implement. As a result, it is possible that some financial institutions that are presently QIs would choose to terminate that status. Additionally the new requirements could cause some financial institutions that may be considering QI status to decide against becoming QIs. Moreover, it is possible that the implementation of new, more comprehensive reporting requirements by QIs could cause some U.S. taxpayers wishing to evade tax to move their investments from QIs to nonqualified intermediaries in order to avoid having their identification or information on foreign source income reported to the IRS under this new reporting regime. Foreign investors may also choose to do business with nonqualified intermediaries in order to avoid more intrusive customer due diligence procedures (such as disclosure of beneficial ownership of foreign entities) or any perceived additional exposure to U.S. tax authorities.

The Administration's proposals with regard to nonqualified intermediaries would provide strong counter-incentives, both for financial institutions to become (or remain) QIs and for both U.S. and foreign investors to maintain accounts with QIs rather than nonqualified intermediaries. The proposals would represent, however, a significant departure from the traditional "relief-at-source" approach of present U.S. law. As a result, they raise issues with respect to the efficient operation of the U.S. capital markets, and the ability of the IRS to administer withholding and refund procedures on the scale contemplated by the proposals. These issues are discussed further below. It should be noted, also, that a foreign bank with no connection to the United States other than a customer base can continue under the proposals to provide foreign source investments to U.S. customers without the additional burden imposed by the proposals. The Administration's additional proposals requiring self and third party reporting of bank transfers (discussed below) are meant to discourage, and to assist the IRS in discovering, such arrangements.

Financial markets

Disincentives for investment.−The imposition of a 30-percent withholding tax on any and all FDAP payments made through nonqualified intermediaries could discourage some investment in U.S. securities. Of particular concern in this regard is whether foreign investment in U.S. Treasury securities would be affected. The proposal, however, gives Treasury regulatory authority to provide exceptions from mandatory withholding, and specifically states that the rules would be designed so as not to disrupt ordinary and customary market transactions. Treasury could use this authority to craft rules and exceptions to provide for as little disruption in the markets as possible. For example, most foreign-held U.S. Treasury securities would fit a listed exception from the imposition of withholding tax (i.e., that amounts paid through nonqualified intermediaries are for the benefit of foreign governments, central banks, foreign pension funds, foreign insurance companies and similar investments).[510] Additionally, nearly half of the value of U.S. securities held by foreign investors as of June 30, 2008 was held by investors in countries with know-your-customer rules already on the IRS approved list for QI status, suggesting that a substantial volume of that investment may already be held through QIs and that any investments presently held through nonqualified intermediaries in those countries could be shifted to accounts with QIs in order to avoid incurring the withholding tax.[511]

Tax gross-ups.−Typically, debt obligations issued by U.S. debtors to foreign investors include gross-up provisions requiring the issuers to compensate holders for any U.S. withholding tax imposed under a change in law by "grossing up" payments of interest to cover the withholding tax. Imposing U.S. withholding tax on interest payments made through nonqualified intermediaries could trigger these gross-up provisions in existing debt instruments, even where a refund of the withholding tax may be available to the investor. Most issuers have the right to redeem (generally at par) in situations where gross-up provisions are triggered due to a change in law. However, the proposal could have significant market implications in tight credit markets and in markets where debt is trading at a premium. Given these existing contractual arrangements, transition or grandfather rules for currently outstanding debt should be considered.

Bearer bonds.−The proposals do not specifically address the treatment of debt instruments issued in bearer form. If such bonds are held through nonqualified intermediaries,

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[510] For example, in June 2009 $2,295 billion of the $3,382 billion U.S. Treasury securities held by foreign holders were held as foreign official holdings. U.S. Treasury and Federal Reserve Board, *Major Foreign Holders of Treasury Securities*, (August 17, 2009). Available at http://www.treas.gov/tic/mfh.txt.

[511] See U.S. Treasury, Federal Reserve Bank of New York, and Board of Governors of the Federal Reserve System, *Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2008*, (April 2009), Table 5, p.8 (available at http://www.treas.gov/tic/shla2008r.pdf). The report lists China and some of the Middle East oil-exporters that are not on the IRS list of countries with approved know-your-customer rules. Investors in listed know-your-customer approved countries account for 46.5 percent of the total value of U.S. securities held by foreign investors.

presumably interest paid on the bonds would trigger 30-percent withholding tax, and the sale of the bonds would trigger 20 percent withholding tax if sold through a nonqualified intermediary in a jurisdiction without an adequate information exchange program. However, given the nature of these instruments, it would be difficult or impossible for holders of bearer bonds to obtain refunds of excess withholding tax given that there is no documentation available to verify the ownership of the instrument and the payment of the related tax. Additionally, bearer-form debt obligations typically would also include gross-up provisions with the same consequences as discussed above.

Commercial paper and bank deposits.–Both U.S. source original issue discount paid with respect to debt obligations having a term of 183 days or less (i.e., commercial paper)[512] and U.S. source interest paid with respect to bank deposits[513] are generally exempt from the 30 percent withholding tax, without regard to whether the withholding agent has received a statement that the beneficial owner of the income is not a United States person. The proposal does not specifically address the treatment of these items, suggesting that both are intended to fall within its scope. In light of the fact that substantial international markets have developed for both U.S. commercial paper and U.S. bank deposits in the context of an absence of withholding and documentation requirements, consideration should be given to whether special rules or exceptions – whether transitional or permanent – would be needed with respect to these items in order to avoid significant market disruptions.

Additional considerations relating to gross proceeds

U.S. law and U.S. tax treaties generally treat gains as taxable only in the country of the taxpayer's residence, unless the gains are connected with a trade or business or are gains related to real property. The proposal does not change the sourcing or taxation of gains earned by foreign persons and paid through nonqualified intermediaries, but it would impose withholding tax on the gross proceeds from certain sales of securities. As a consequence, however, the proposal can be expected to result in substantial over-withholding. Implementation of an efficient refund procedure (see below) may mitigate the effects of over-withholding to some degree; in many cases, however, the amount of tax withheld may substantially exceed the gain (if any) realized by the investor on the transaction, so that any delay in receiving the full amount of sale proceeds could have a punitive effect. The proposal may, therefore, create an incentive for foreign investors to conduct U.S. securities sales transactions through financial institutions that are not U.S. withholding agents (i.e., a foreign broker sells the security directly in an overseas

[512] Secs. 871(g)(1)(B)(i) and 881(f). This rule reflects the practical difficulty of collecting such a statement with respect to very short-term obligations. In the case of commercial paper issued in bearer form, the exemption generally applies without regard to the foreign targeting requirements of section 163(f)(2)(B), in recognition that satisfaction of those requirements may be practically difficult for a very short-term obligation. However, special requirements apply under Treas. Reg. sec. 1.6049-5(b)(10) for purposes of the application of information reporting and backup withholding with respect to commercial paper in both registered and bearer form.

[513] Secs. 871(i)(2)(A) and 881(d).

market, which does not trigger gross proceeds withholding because it does not involve a U.S. withholding agent).[514]

This proposal is narrower than the proposal on FDAP income in that withholding tax is not imposed on payments of gross proceeds made through nonqualified intermediaries located in jurisdictions where the United States has a comprehensive income tax treaty that includes a satisfactory exchange of information program. Additionally, Treasury is given authority to except payments that are made through nonqualified intermediaries in jurisdictions with which the United States has a Tax Information Exchange Agreement ("TIEA"). By limiting imposition of withholding tax only to nonqualified intermediaires in jurisdictions without adequate information exchange agreements, the proposal targets only payments that are made to persons in situations where the IRS does not have access to information through either a treaty, TIEA or QI agreement. In addition to ensuring collection of tax in these situations and providing an incentive for financial institutions to enter the QI program, the proposal provides an incentive for non-treaty jurisdictions to enter into treaties or TIEAs with the United States.

It is not entirely clear, however, what is meant by the proposal's reference to a "satisfactory" exchange of information program. Presumably, this will require more than merely an agreement to exchange information.[515] Treasury will need to articulate some standards for evaluation of these programs and identify which ones meet those standards. Relevant factors may include the extent to which the agreements are in compliance with existing U.S. and international standards, or the availability of automatic information exchange and the responsiveness of the treaty partner to requests for information.

Refund claims

These withholding proposals move away from the current relief-at-source withholding system in the direction of a full withholding-refunding system for many payments made through nonqualified intermediaries. While this provides more assurance that U.S. tax is collected, it also involves additional compliance costs, not only for investors and nonqualified intermediaries that are subject to over withholding, but also to the IRS, which must administer refund claims. Currently, QIs may file refund claims on behalf of direct account holders. The gross proceeds proposal would also allow nonqualified intermediaries that have met certain requirements to file refund claims on behalf of direct account holders. At a minimum, the implementation of these proposals should take into account the amount of time that will be necessary for the IRS to establish efficient refund procedures, to provide guidance on the documentation that will be required for claiming a refund, and to set up additional facilities for processing refund claims.

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[514] Although the gross proceeds would not be subject to withholding tax, holding the security through a nonqualified intermediary would subject any FDAP payments related to the security to withholding under the proposal.

[515] As discussed further in section VI below, unless the treaty or TIEA provides for an automatic exchange of information, the IRS generally has access to information only if it knows the identity of the U.S. person. Thus the mere presence of an exchange agreement does not ensure the IRS has adequate information for administering the U.S. tax laws where U.S. persons hold securities through foreign financial intermediaries.

Administrative and transitional considerations

If the proposals are successful in expanding the QI network, the IRS will need sufficient time and resources to evaluate the know-your-customer rules for financial institutions in countries without current approval and to draft and implement new QI agreements that include the new reporting and withholding requirements. Transition rules should also address the existing QI agreements and the timing for application of the new rules to existing QIs.

Prior Action

No prior action.

G. Administration's Proposal of Negative Presumption Regarding Withholding on Fixed or Determinable Annual or Periodical Payments to Certain Foreign Entities

Description of Proposal

Under the proposal, any withholding agent making a payment of FDAP income to a foreign entity would be required to treat the payment as a payment made to an unknown person (and therefore subject to 30-percent gross-basis withholding tax), unless the foreign entity provides documentation of the entity's beneficial owners. Exceptions would be provided for payments made to publicly traded companies and their subsidiaries, foreign governments, and pension funds. In addition, the Treasury Department would receive regulatory authority to provide additional exceptions for payments to entities engaged in the active conduct of a trade or business in their country of residence, charities, widely-held investment vehicles, entities that enter into an agreement with the IRS to collect documentation for all owners and report all U.S. non-exempt owners to the IRS, and for any other payment that the Treasury Department concludes presents a low risk of tax evasion.

Effective date.−The proposal would be effective for payments made after December 31 of the year of enactment.

Analysis

The proposal limits the ability of U.S. persons to evade U.S. tax through the use of a foreign entity, as it requires the foreign entity either to provide documentation of its ultimate owners or to receive payments net of withholding tax. Similarly, for foreign persons, the imposition of the highest rate of withholding tax where beneficial owners are not disclosed should eliminate most opportunities for foreign persons to claim treaty benefits inappropriately through use of a foreign entity, as a withholding rate reduction would be available only where the withholding agent has access to beneficial owner information and can verify eligibility for a lower (treaty) rate.

It is not entirely clear, however, whether the proposal would permit a foreign entity that is subject to the full 30-percent withholding to later obtain a refund of all or some portion of the tax withheld by presenting the required ownership documentation to the IRS. For example, a foreign entity may be entitled to a reduced rate of withholding on U.S. source dividend payments under an income tax treaty by virtue of being resident in the treaty country and satisfying the treaty's limitation on benefits requirements. If the entity provides sufficient ownership documentation to the withholding agent to establish entitlement to treaty benefits but cannot provide full ownership documentation in accordance with the proposal, the withholding agent will be required to withhold at the full 30-percent rate. If the foreign entity cannot then present appropriate ownership documentation to the IRS and obtain a refund of the excess tax withheld, the proposal may be viewed as imposing additional conditions on obtaining a reduced treaty rate that are not merely procedural and are arguably inconsistent with the agreement reflected in the treaty.

The proposal attempts to minimize some of the reporting burden by providing exceptions for payments made to publicly traded companies and their subsidiaries, foreign governments, and pension funds. However, financial institutions have argued that it is difficult to develop and implement systems that separate and account for similar transactions in a different manner, depending upon the status of the payee, and that it can be difficult to identify which entities fit within the exceptions, particularly as the proposal provides the Secretary with authority to exempt other, as yet undefined payments. The proposal also presents essentially the same considerations with regard to standards for identification of ultimate ownership as are discussed in connection with the proposal to modify the reporting requirements applicable to QIs (who are U.S. withholding agents, and would be subject to this proposal).

Prior Action

No prior action.

IV. ENFORCEMENT CHALLENGES: CROSS-BORDER ASSET TRANSFERS BY U.S. PERSONS

A. Background

The suite of proposals intended to combat underreporting of offshore financial interests by U.S. persons are part of an overall effort to increase the access by U.S. tax authorities to information related to such offshore financial interests. This includes providing incentives for foreign financial intermediaries to enter the QI program and to strengthen the withholding and reporting requirements that apply to QIs, as discussed in the preceding section. The QI proposals do not, however, address the movement to and reporting of assets in offshore accounts that are not held through QIs. Therefore, in addition to proposals to strengthen the QI program itself, the Administration has made several proposals that link the reporting of foreign financial interests to the filing of one's income tax return and impose a variety of adverse consequences for failure to meet the new reporting obligations. The measures target both U.S. taxpayers seeking to reduce or avoid taxes through use of such accounts and third-parties who facilitate the transfer of funds to such accounts. Changes to the self-reporting requirements applicable to U.S. persons and the reporting requirements imposed on financial institutions and other third parties are discussed in this section.

The proposals as a whole are based on the presumption that increasing the number of QI institutions can reduce tax evasion, and that participation in the QI program should be encouraged. At best, however, an increase in QI participation is only a partial solution, as many foreign financial institutions can be expected to choose not to participate for a variety of legitimate reasons. Policy makers thus may wish to consider other, more direct steps that may curb tax evasion through the use of offshore vehicles, including bridging the gap between enforcement of the Bank Secrecy Act, found in the United States Code at Title 31, and the Internal Revenue Code, in Title 26. Policy makers also may wish to consider targeted penalties to accompany the proposals, and measures that enable the United States to leverage its network of international agreements to exchange information with other nations and thereby achieve greater transparency with respect to foreign financial accounts held by U.S. persons, even if the institution in question is not a QI. In this regard, duplicative and potentially burdensome reporting requirements may prove counterproductive, in that they will burden the compliant without discouraging those prepared to commit tax evasion.

Before discussion of the proposals, a general discussion of the means by which the United States may currently obtain access to offshore financial information of its citizens or residents, without resort to judicial or compulsory administrative process, is in order. The degrees of protection afforded financial information range from the relative transparency in the United States to the traditional opacity of jurisdictions such as Switzerland, Liechtenstein or the Cayman Islands. The term "bank secrecy" generally refers to a legal standard, whether judicial or statutory in origin, which prevents governmental access to the financial information necessary to ascertain beneficial ownership and enforce tax, securities and financial regulations. The limitations may apply only to certain entities operating within the jurisdiction or may apply only to the sharing of information with a foreign jurisdiction,[516] and are often reinforced by civil or criminal penalties.

The difficulties in piercing the "bank secrecy" of tax haven jurisdictions can be traced to the centuries-long tradition against expecting one jurisdiction to assist another jurisdiction with collection of its taxes. This doctrine, known as the "Revenue Rule," is rooted in common law and sovereign immunity. It is often referred to as the Lord Mansfield Rule.[517] Although its vitality and scope have been questioned, most recently in *Pasquatino v. United States*,[518] the doctrine remains a cornerstone of all common law jurisdictions, as well as many others. One way it can be abrogated, or is sometimes abrogated, is by state-to-state negotiations, in the form of multilateral or bilateral international agreements or treaties.

In the United States, rights to financial privacy, both in tax matters and other financial information, are generally governed by statute and protect one from public dissemination of information. The government's need to have access to financial information to assist it in detecting and preventing money-laundering led to enactment of the Bank Records and Foreign Transactions Act, now known as the Bank Secrecy Act of 1970,[519] which requires U.S. financial institutions to maintain records and submit reports on certain cash or cash equivalent transactions. Since enactment of the Privacy Act of 1974, federal statute has established controls over how federal agencies gather, maintain and use personal information, including financial information.[520] The Right to Financial Privacy Act of 1978 ensures that the government will not have access to information without service of a valid subpoena, consent of an account holder or as provided in the Code.[521] Specific prohibitions on the disclosure of tax return information were enacted in 1976.[522]

The United States generally has three options for accessing information notwithstanding the bank secrecy laws of other jurisdictions: information reported by the account holder (self-reporting); third-party information reporting; and information obtained from other jurisdictions through an exchange of information under a bilateral agreement. The first two methods are discussed herein. The third is described below in section VI.

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[516] OECD, *Tax Co-operation: Towards a Level Playing Field, 2008 Assessment by the Global Forum on Taxation,* tabulates the numerous permutations by which information that is available to the host jurisdiction may or may not be shared with a requesting state.

[517] In *Holman v. Johnson*, 98 The English Reporter 1120 (King's Bench 1775), cited in *AG of Canada v. R.J. Reynolds Tobacco Holdings, Inc.,* 268 F.3d 103, *cert. denied,* 537 U.S. 1000 (2002), Lord Mansfield stated, "For no country ever takes notice of the revenue laws of another."

[518] 544 U.S. 349; 125 S. Ct. 1766; 161 L. Ed. 2d 619 (2005).

[519] 31 U.S.C. Secs. 5311-5314e, 5316-5332e; 12 U.S.C. secs. 1829b and 1951-1959e.

[520] Privacy Act of 1974, 5 U.S.C. sec. 552a.

[521] 12 U.S.C. 3402.

[522] Sec. 6103.

1. Accessing information through self-reporting

Under present law, a series of self-reporting requirements apply to U.S. persons who engage in foreign activities directly or indirectly through a foreign business entity. To the extent the U.S. person is engaging in foreign activity directly, and such activity necessitates the opening of a foreign bank account, the U.S. person will be required to make an annual filing of a Report of Foreign Bank and Financial Accounts, Treasury Department Form TD F 90-22.1, ("FBAR") to the extent the value of all assets within all such accounts in which the person has an interest is in excess of $10,000 at any time during the year.

To the extent that the U.S. person is instead engaging in such foreign activities indirectly through a foreign business entity, certain other self-reporting requirements may apply. Upon the formation, acquisition or ongoing ownership of certain foreign corporations, U.S. persons that are officers, directors, or shareholders must file a Form 5471, "Information Return of U.S. Persons with Respect to Certain Foreign Corporations,"[523] identifying the foreign corporation, amount of stock held, the principal business and functional currency of the corporation. Similar information with respect to interests in a controlled foreign partnership is required to be reported on Form 8865, "Return of U.S. Persons With Respect to Certain Foreign Partnerships," and a Form 8858, "Information Return of U.S. Persons With Respect To Foreign Disregarded Entities" must be filed with respect to a foreign disregarded entity.[524]

As part of the initial formation of a foreign business entity, the foreign business entity is often capitalized with cash as well as other assets and liabilities. If the foreign entity receiving such contributions is a foreign corporation, the U.S. person capitalizing the entity will be required to file a Form 926, "Return by a U.S. Transferor of Property to a Foreign Corporation."[525] Additionally, if the foreign business entity opens a foreign bank account, an FBAR filing requirement may apply for certain U.S. persons.

<u>Self-reporting on foreign financial accounts</u>

Self-reporting by U.S. persons who transfer assets to, and hold interests in, foreign bank accounts or foreign trusts is principally governed by Title 31 of the United States Code (the "Bank Secrecy Act"). Since its enactment, in one of the first efforts to address law enforcement problems posed by the growing use of offshore accounts, the Bank Secrecy Act has expanded beyond its original focus on large currency transactions, while retaining its broad purpose of obtaining reports with "a high degree of usefulness in criminal, tax, or regulatory investigations

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[523] Secs. 6038 and 6046.

[524] The Form 8858 is used to satisfy reporting requirements of sections 6011, 6012, 6031, and 6038, and related regulations.

[525] Sec. 6038B. The filing of Form 926 may also be required upon future contributions to the foreign corporation.

or proceedings."[526] The statute was explicitly intended to provide enforcement tools necessary "to cope with the problems created by the so-called secrecy jurisdictions."[527]

As the reporting regime has expanded,[528] it has imposed reporting obligations on both financial institutions and the account holders. With respect to the latter, the obligation to report with respect to their foreign accounts is set forth in regulations promulgated pursuant to broad regulatory authority granted to the Secretary.[529] The statute specifies only that the rules "shall contain the following information in the way and to the extent the Secretary prescribes" including the identity and address of participants in a transaction or relationship, the legal capacity in which a participant is acting, the identity of real parties in interest, and a description of the transaction. A citizen, resident, or person doing business in the United States is required to keep records and file reports, as specified by the Secretary of the Treasury, when that person enters into a transaction or maintains a relationship (e.g., an account) with a foreign financial entity.[530]

The FBAR must be filed by June 30 of the year following the year in which the $10,000 threshold is met.[531] The form is filed by mailing to the Department of the Treasury at the IRS Detroit Computing Center. Failure to file the FBAR is subject to both criminal[532] and civil penalties.[533] Since 2004, the civil sanctions have included a penalty of up to $10,000 for failures that are not willful, and a penalty of the greater of $100,000 or 50 percent of the balance in the account for willful failures. Although the form is received and processed by the IRS, it is neither part of the income tax return that the individual files with the IRS nor filed in the same office as

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[526] 31 U.S.C. 5311.

[527] H.R. Rep. No. 975, 91st Cong., 2d Sess. 19 (1970).

[528] E.g., Title III of the US PATRIOT Act, Pub. L. No. 107-56 (October 26, 2001), Sections 351 through 366, amended the Bank Secrecy Act as part of a sweeping series of reforms directed at international financing of terrorism.

[529] 31 USC 5314(a) provides: Considering the need to avoid impeding or controlling the export or import of monetary instruments and the need to avoid burdening unreasonably a person making a transaction with a foreign financial agency, the Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency. See the Instructions to Treasury Department Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts."

[530] 31 U.S.C. sec. 5314.

[531] 31 C.F.R. sec. 103.27(c).

[532] 31 U.S.C. sec. 5322 provides that failure to file is punishable by a fine up to $250,000 and imprisonment for five years, which may double if the violation occurs in conjunction with certain other violations.

[533] 31 U.S.C. sec. 5321(a)(5).

the return. As a result, it is not considered "return information," and its distribution to other law enforcement agencies is not limited by the nondisclosure rules of the Internal Revenue Code.[534]

Although the obligation arises under title 31, most individual taxpayers subject to the reporting requirements are alerted to the existence of the requirements when preparing annual Federal income tax returns by a question regarding foreign bank accounts that is contained in Part III of Schedule B of IRS Form 1040, "Foreign Accounts and Trusts." The exact wording of the question on the 2008 Form 1040, Schedule B is: "At any time during 2008, did you have an interest in or signature or a other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-2 for exceptions and filing requirements for Form TD F 90-22.1." The instructions on page B-2 to which the form refers identify certain types of accounts that are not subject to the requirement to disclose, including accounts that at no time in the year had a value in excess of $10,000. The form instructs individuals who answer "yes" in response to the question to identify the foreign country or countries in which such accounts are located.[535] The response to this question does not discharge one's obligations under Title 31 and constitutes "return information" as that term is defined in section 6103, and is protected from routine disclosure to those charged with enforcing Title 31.

The FBAR requires disclosure of any account in which the filer has a financial interest or as to which the filer has signature authority (in which case the filer must identify the owner of the account). The Treasury Department and the IRS clarified the requirements with respect to U.S. persons holding an interest in a foreign bank account by means of revising the form and its accompanying instructions in October 2008. Specifically, the form updated terminology to clarify how the filing requirement applies to new types of financial transactions and to use sufficiently broad language to avoid lending credence to arguments that transactions intended to be covered fall outside the literal language of the instructions. In August 2009, the IRS requested public comments to help determine the scope and nature of future additional guidance.[536]

As revised, the definition of "financial interest" in the instructions specifically includes an account held by a corporation in which a U.S. person owned, directly or indirectly, more than 50 percent of the value "or the voting power" of the corporation.[537] Similarly, the definition of a

[534] Section 6103 bars disclosure of return information, unless permitted by one of its numerous exceptions.

[535] 31 C.F.R. sec. 103.24.

[536] Notice 2009-62, 2009-35 I.R.B. (August 7, 2009) specifically requested comments concerning when a person having only signature authority or having an interest in a commingled fund should be relieved of filing an FBAR; the circumstances under which the FBAR filing exceptions for officers and employees of banks and some publicly traded domestic corporations should be expanded; when an interest in a foreign entity should be subject to FBAR reporting; and whether the passive asset and passive income thresholds are appropriate and should apply conjunctively.

[537] The revised instructions state, "A financial interest in a bank, securities, or other financial account in a foreign country means an interest described in one of the following three paragraphs: 1. A United States person has a financial interest in each account for which such person is the owner of record or has legal title, whether the account is maintained for his or her own benefit or for the benefit of others including non–United States persons. 2.

financial interest is clarified to include a partnership in which the U.S. person owns an interest, "either directly or indirectly," in more than 50 percent of the profits "or capital of the partnership." The revised instructions also address special allocations by partnerships that allocate more than 50 percent of the income from the account to a partner who has a 50 percent or less interest in the partnership (by profits or capital). Finally, the definition of "financial interest" was expanded to include any beneficial interest in an account for which the owner of record or holder of legal title is a trust, or a person acting on behalf of a trust, that was established by a U.S. person and for which a trust protector, usually a foreign person, has been appointed. A trust protector is a third party who is responsible for monitoring the trustee's activities and can replace the trustee under certain specified conditions. A trust protector has sometimes been used to prevent the U.S. person from appearing to have signature or other authority, as presently defined for FBAR reporting purposes.

Other clarifications to the instructions include the definition of "financial account," which now specifies that credit, debit or prepaid cards are examples of financial accounts[538] for which a report may be required and "signature or other authority," which now makes clear that such authority may be indirectly exercised without need for a written instruction.[539] The instructions also provide that the duty to file a report may apply to foreign individuals who do business in the

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A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is: (a) a person acting as an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person; (b) a corporation in which the United States person owns directly or indirectly more than 50 percent of the total value of shares of stock or more than 50 percent of the voting power for all shares of stock; (c) a partnership in which the United States person owns an interest in more than 50 percent of the profits (distributive share of income, taking into account any special allocation agreement) or more than 50 percent of the capital of the partnership; or (d) a trust in which the United States person either has a present beneficial interest, either directly or indirectly, in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income. 3. A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is a trust, or a person acting on behalf of a trust, that was established by such United States person and for which a trust protector has been appointed. A trust protector is a person who is responsible for monitoring the activities of a trustee, with the authority to influence the decisions of the trustee or to replace, or recommend the replacement of, the trustee. Correspondent or "nostro" accounts (international interbank transfer accounts) maintained by banks that are used solely for the purpose of bank-to-bank settlement need not be reported on this form, but are subject to other Bank Secrecy Act filing requirements. This exception is intended to encompass those accounts utilized for bank-to-bank settlement purposes only."

[538] See Chief Counsel Advice 200603026 (January 20, 2006) for a discussion of the whether payment card accounts constitute financial accounts.

[539] According to the instructions to the FBAR, a person has "signature authority" over an account "if such person can control the disposition of money or other property in it by delivery of a document containing his or her signature (or his or her signature and that of one or more other persons) to the bank or other person with whom the account is maintained."

"Other authority" exists in a person "who can exercise comparable power over an account by communication to the bank or other person with whom the account is maintained, either directly or through an agent, nominee, attorney, or in some other capacity on behalf of the US person, either orally or by some other means."

United States.[540] Other information required to be reported is explained in greater detail, including the need to identify all foreign persons with an interest in the account, to provide foreign identification numbers for those persons, and to disclose the highest value held by the account at any point in the year. The filing responsibilities of corporate employees with signature authority but no financial interest were also clarified. Such individuals would have a responsibility to disclose the signature authority, but are exempted if they receive a statement from the corporate chief financial officer, or in the case of an employee of a subsidiary, from the parent's CFO, in which the CFO certifies that the account that would have been reported on the individual filing will be reported on the corporate filing. Finally, the instructions now specify that any amended or delinquent filing should be identified as such, and accompanied by an explanatory statement.

FBAR enforcement responsibility

As part of its broad revision of international financial transaction record and reporting requirements enacted by the USA PATRIOT Act, Congress directed the Secretary of the Treasury to study and report on means to enhance the enforcement of existing legislation and propose additional measures needed.[541] In April 2002, the Secretary submitted the first of three reports.[542] In his report, the Secretary estimated that the compliance rate with respect to FBAR filing requirements might have been less than 20 percent based on the available information.[543] At that time, responsibility for civil penalty enforcement of FBAR rested with the Financial Crimes and Enforcement Network ("FinCEN"), an agency of the Department of the Treasury, although the Secretary had delegated authority to investigate FBAR compliance to the IRS

[540] Although the revised instructions track the language of the statute in stating that a person in or doing business in the United States is within its purview, and thus arguably merely clarify what has long been required, the IRS announced that pending publication of guidance on the scope of the statute, people could rely on the earlier, unrevised instructions to determine whether they are required to file a FBAR. Announcement 2009-51 (June 5, 2009). Subsequently, the IRS announced that persons with only signature authority over a foreign financial account as well as signatories or owners of a financial interest in a foreign commingled fund have until June 30, 2010 to file an FBAR for the 2008 and earlier calendar years with respect to those accounts. Notice 2009-62 (August 7, 2009).

[541] Pub. L. No. 107-56 (October 26, 2001), sec. 361(b).

[542] Secretary of the Treasury, "A Report to Congress in Accordance with § 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)" (April 26, 2002).

[543] Although FBAR filings increased by almost 52 percent from 1991 to 2001 (116,600 FBAR filings in 1991 and 177,151 FBAR filings in 2001), there may have been as many as one million U.S. taxpayers in 2002 who had signature authority or control over a foreign bank account and were required to file FBARs. In a subsequent report, the Secretary acknowledged that any approximation of the compliance rate is difficult due to the difficulty in determining whether the amounts held in the offshore accounts exceed the $10,000 threshold. Secretary of the Treasury, "A Report to Congress in Accordance with sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)" (April 8, 2005).

Criminal Investigation Division.[544] As a result, if a taxpayer refused to pay the penalty, FinCEN could refer penalties that were delinquent for a period of 180 days to the Financial Management Service, which is responsible for such non-tax collections,[545] or refer the matter to the Department of Justice, which instituted an action against the taxpayer in which the liability and the amount of the penalty were litigated. The Secretary's report to Congress considered the disparity of resources between FinCEN and IRS to be a significant problem in achieving compliance and proposed that the IRS be authorized to administer the civil penalties. By the time of its report to Congress the following year, April 24, 2003, the Secretary had redelegated civil enforcement authority to the IRS.[546] This report explained that the end of the bifurcation of enforcement authority was desirable because the FBAR was directed more toward tax evasion than the enforcement interests at the core of FinCEN's mission.[547]

The delegated authority includes the authority to determine and enforce civil penalties.[548] As a result, the IRS can "create interpretive education outreach materials for the FBAR, revise the form and instructions, examine individuals and other entities, and assess civil penalties for violations."[549] Because one cannot delegate authority one does not have, the only means of collecting the civil penalties remains limited. The extensive collection and enforcement powers available to enforce the tax laws are not within scope of the FinCEN authority under Title 31.

As part of its new role in administering the civil penalties, the IRS undertook education outreach, in order to remind foreign account holders of the reporting requirements. The outreach included the distribution of a one-page document, "Do You Have a Foreign Bank Account?" in 2008 (Pub. 4261) that alerts account holders of their potential filing requirements and how to determine their reporting responsibilities. That publication is available on the IRS website, is provided to tax practitioners, brokers and banks, and is now available in Spanish, Korean and Chinese as well as English.

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[544] Treas. Directive 15-14 (12/1/92), in which the Secretary delegated to the IRS authority to investigation violations of the Bank Secrecy Act. If Criminal Investigation Division declined to pursue a possible criminal case, it would refer the matter to FinCEN for civil enforcement.

[545] 31 U.S.C. sec. 3711(g).

[546] 31 C.F.R. sec. 103.56(g). Memorandum of Agreement and Delegation of Authority for Enforcement of FBAR Requirements (April 2, 2003); News Release, Internal Revenue Service, IR-2003-48 (April 10, 2003). Consequently, the IRS now processes the FBARs.

[547] Secretary of the Treasury, *A Report to Congress in Accordance with sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)* (April 24, 2003).

[548] A penalty may be assessed before the end of the six-year period beginning on the date of the transaction with respect to which the penalty is assessed. 31 U.S.C. sec. 5321(b)(1). A civil action for collection may be commenced within two years of the later of the date of assessment and the date a judgment becomes final in any a related criminal action. 31 U.S.C. sec. 5321(b)(2).

[549] Secretary of the Treasury, *A Report to Congress in Accordance with sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)* (April 8, 2005).

The number of FBAR filings has increased in recent years, as attention to offshore accounts has increased. During calendar year 2008, the Treasury received 349,667 FBAR filings for the 2007 reporting period.[550] The number of U.S. persons with an interest in foreign bank accounts is substantial and appears to have grown significantly in recent years.[551]

2. Accessing information through third-party reporting

Tax related third-party reporting requirements under present law focus on reporting of payments of income or gross proceeds (as discussed above) and, in general, do not target the movement of assets. U.S. financial institutions are required to maintain records of certain offshore transfers[552] and to file reports related to certain transactions,[553] but these reporting and record keeping requirements are primarily targeted at preventing money laundering and terrorist financing.[554] FinCEN is generally responsible for enforcement of these laws. FinCEN receives over 15,000,000 reports each year from more than 200,000 financial institutions and money services businesses.[555]

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[550] <www.irs.gov/compliance/enforcement/article/0,,id=113003,00.html>, as of June 15, 2009.

[551] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, at 378; *see also,* Statement of Eileen J. O'Connor, Assistant Attorney General, Tax Division, Before the Committee on Finance, United States Senate, Concerning "Corporate and Partnership Enforcement Issues" (June 13, 2006).

[552] 31 CFR sec. 103.33 requires financial institutions to retain, for five years, a record of transfers of more than $10,000 to or from any person, account or place outside the United States.

[553] Suspicious Activity Reports (SARs) are required under 31 CFR sec. 103.18 for certain transactions aggregating at least $5,000 where the bank knows, suspects, or has reason to suspect certain illegal activity. Currency Transaction Reports (CTRs) are required under 31 CFR sec. 103.22 any deposit, withdrawal, or other payment involving currency of more than $10,000.

[554] The reporting and record keeping requirements are primarily found in the Bank Secrecy Act of 1970 and in the USA PATRIOT Act. Although primarily targeted at money laundering and terrorist financing, one of the purposes of the Bank Secrecy Act is to maintain a paper trail so as to enable law enforcement to pursue investigations of tax violations. See 31 USC sec. 5311.

[555] U.S. Department of the Treasury, Financial Crimes Enforcement Network, *Feasibility of a Cross-Border Electronic Funds Transfer Reporting System under the Bank Secrecy Act,* (October 2006).

B. Administration's Proposals to Require Self-Reporting by Individuals with an Interest in Offshore Bank Accounts and Offshore Trusts

1. Proposal to require reporting of certain transfers of money or property to foreign financial accounts

Present Law

U.S. persons currently have limited obligations to report or disclose to the IRS cross-border transfers of property, whether as a separate report or with the tax return. As explained in the background discussion above, there are reporting requirements under Title 31 that are enforced with a network of civil and criminal penalties. In addition, there are required information returns reflecting ownership of, as well as transfers to, foreign entities.[556]

Description of Proposal

A U.S. individual would be required to report, on the individual's income tax return, any transfer of money or property made to, or receipt of money or property from, any foreign bank, brokerage, or other financial account by the individual, or by any entity of which the individual owns, actually or constructively, more than 50 percent of the ownership interest. Transfers to accounts held at qualified intermediaries ("QIs") and receipts from accounts held by U.S. persons at qualified intermediaries would not be required to be reported. In addition, individuals would be exempt from the reporting requirement if the cumulative amount or value of transfers and the cumulative amount or value of receipts that would otherwise be reportable on the individual's income tax return for a given year were each less than $10,000. The Treasury Department would receive regulatory authority to issue rules to prevent abuse of the reporting exemptions and to provide exceptions to the reporting requirement, such as an exception for arm's length payments in the ordinary course of business for services or tangible property.

Effective date.−The proposal would be effective for transfers made after December 31 of the year of enactment.

Analysis

The proposal presumably includes an exception for transfers to QIs on the grounds that those institutions will be subject to the enhanced reporting requirements detailed in the proposals described in Section III. For individuals who have accounts with non-QIs, the proposal seeks to capture information at the only point where the U.S. may have jurisdiction, i.e., the transfer of funds to or from the United States.

To determine whether or not the reports contemplated by this proposal are required, an individual would have to know whether or not the institution with which he or she holds an account is a QI. The exception from reporting for transfers to a QI could have the effect of promoting participation in the QI program. Investors who know of the reporting requirements

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556 See, for example, sections 6038, 6038B.

presumably will prefer to invest with a QI, in order to avoid reporting, and, collectively, they will exert market pressure on institutions to participate.

If, however, the institutions in a particular jurisdiction were to conclude that the benefits of QI status were insufficient to warrant the compliance costs, or if the local jurisdiction were unable to satisfy the know-your-customer rules that are a predicate to QI approval, there may be no option for the U.S. person other than investment with a non-QI. In addition, the Information Reporting Program Advisory Committee ("IRPAC") has observed that there are many non-U.S. persons who act in agency capacities throughout various business sectors who are not currently eligible for QI status. Their participation in negotiating royalty arrangements relating to copyrights, patents and other intangible use agreements is common commercial practice in some jurisdictions and in some cases may be legally required.[557]

2. Proposal to require disclosure of FBAR accounts to be filed with tax return

Present Law

Other than the questions included on Schedule B of the income tax return concerning the ownership or signature authority over a foreign financial account, there is no requirement to disclose the information includible on FBAR on one's income tax return. In general, the information about FBAR reports is available to the IRS and other law enforcement agencies. In contrast, information on income tax returns, including the responses to the questions on Schedule B, is not readily available to those charged with administering FBAR compliance, despite the fact that Federal income tax returns and return information may be the best source of information needed by the agency.

The nondisclosure constraints on IRS personnel who examine income tax liability generally preclude them from sharing return information with any other IRS personnel, or Treasury officials except for tax administration purposes.[558] Tax administration is defined as "the administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws or related statutes . . ." and does not necessarily include administration of Title 31.[559] The non-tax law enforcement purposes of Title 31 preclude determining that it is per se a "related statute" for purposes of finding a tax administrative purpose for a disclosure. As a result, those charged with investigating and enforcing the civil penalties under Title 31 are not routinely permitted access to return information that would support or shed light on the existence of an FBAR violation. Instead, a determination in writing that the FBAR violation occurred in conjunction with an Internal Revenue Code violation is required to support a finding that the statutes are "related statutes" for purposes of authorizing

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[557] Jon Lakritz, Chairperson, 2009 IRPAC, "Letter to Commissioner, IRS," *Tax Analysts* Doc 2009-15205 (June 25, 2009).

[558] Sec. 6103(h)(1). In essence, section 6103(h)(1) authorizes access to information to an employee of the Service when that employee establishes a "need to know" in order to perform a tax administration function.

[559] Sec. 6103(b)(4).

the disclosure. The effect of that determination is to subsume the FBAR information under the scope of "return information" and the protection of the Internal Revenue Code.[560]

Description of Proposal

Individual taxpayers required to file an FBAR would be required to disclose certain information on their income tax returns. The information would be disclosed on a schedule that would be considered part of the individual's income tax return. The schedule would be consistent with the information disclosure obligations of the FBAR itself, and would require the taxpayer to provide information such as the account number, financial institution, and maximum value during the year. The disclosures would be required when the income tax return is due, even if Title 31 does not require the FBAR to be filed until a later date.

The tax return disclosure would not replace or mitigate the individual's obligation to separately file an FBAR with the Treasury Department as required under Title 31. The penalties imposed under Title 31 for failing to file an FBAR would continue to apply to a failure to file an FBAR as required under Title 31. Failure to disclose the foreign accounts with the income tax return would not be subject to the Title 31 penalties, although it could give rise to penalties and other consequences imposed under the Code, including extension of the statute of limitations.

Effective date.−The proposal would be effective for taxable years beginning after December 31 of the year of enactment.

Analysis

Overview

The proposal would make foreign account information directly available to the IRS without the need to coordinate with another agency to obtain it. As taxpayers would already be required to collect and report the requisite information as part of filing a complete Federal income tax return, the proposal may improve FBAR compliance generally by increasing the awareness of the FBAR reporting requirements and the perceived risk of failing to disclose the required information. To the extent that the IRS has encountered difficulties in obtaining FBAR information in the past, this proposal would provide information comparable to that included on the FBAR. It would not provide information about whether a taxpayer had complied with FBAR.

The proposal would not assist in enforcement of FBAR administration or collection of the related penalties, nor would it provide a new penalty for failure to comply with the new requirement. Existing Code provisions provide penalties of $50 per return for certain failures with respect to information returns.[561] The lack of an additional assessable penalty for failure to disclose on one's income tax return (without regard to any substantive error in the reported tax

[560] Internal Revenue Manual paragraphs 4.26.14.2 and 4.26.14.2.1.

[561] See e.g., secs. 6721 and 6723.

liability), together with the failure to provide any proposals that would enhance the ability to assess and collect the existing regime of penalties under Title 31, could reduce the likelihood that compliance with the new regime will be greater than compliance with the current Title 31 requirements.

As discussed above, present law regarding confidentiality and disclosure of returns and return information embodies confidentiality as a core principle, and reflects a balancing of a taxpayer's right to privacy, the institutional concerns that disclosure may undermine voluntary compliance, the belief that the government should not disclose information that taxpayers are required by law to provide, and concerns regarding possible misuse of the information against the law enforcement needs of a variety of Federal and State agencies who seek access to Federal returns and return information in order to monitor compliance with both tax and nontax laws. With respect to these present law requirements, the proposal does not address what has been identified by some observers as a significant impediment to enforcement of the existing FBAR reporting regime and its related penalties, the barriers to sharing return information with IRS employees investigating FBAR violations. Both H.R. 1265 and S. 506 would provide that Title 31 is a related statute for purposes of determining whether proposed sharing of return information by the IRS is sufficiently linked to tax administration to permit the disclosure under the authority of section 6103, with the result that return information would be available to use to develop a failure to file FBAR reports.[562] The breadth of this provision has caused concerns that information critical to the non-tax aspects of Bank Secrecy and the PATRIOT Act will become less readily available to agencies charged with enforcement of those aspects, because such agencies would have to approach the IRS to gain access to such information.[563]

<u>Duplicative and overlapping reporting requirements</u>

The proposed system of reporting is explicitly duplicative. Although there are numerous instances in which more than one party has an obligation to report with respect to a particular transaction or taxable event, the rationale for such redundant reporting generally is rooted in the observation that compliance by one party is improved when there is a possibility that another party under a similar duty to report will in fact do so.[564] The overlapping information reporting obligations in turn improve the likelihood that the party whose tax liability may be affected by the transaction will comply with the substantive provisions governing the tax consequences of the transaction.[565] In contrast, the proposal requires that the same person file more or less

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[562] Section 205 of both H.R. 1265 and S. 506, "The Stop Tax Haven Abuse Act," provides that "Paragraph (4) of section 6103(b) (relating to tax administration) is amended by adding at the end the following new sentence:

For purposes of clause (i), section 5314 of title 31, United States Code, and sections 5321 and 5322 of such title (as such sections pertain to such section 5314), shall be considered to be an internal revenue law.".

[563] Lee A. Sheppard, FBAR Filing for Hedge Funds, *Tax Notes* (August 10, 2009), p. 509.

[564] Statement of Michael Brostek, Director, Tax Issues Strategic Issues, to the Committee on the Budget, House of Representatives, "Tax Compliance: Multiple Approaches are Needed to Reduce the Tax Gap," GAO-07-488T (February 16, 2007).

[565] For example, the reportable transaction regime of secs. 6011, 6111 and 6112 imposes discrete disclosure obligations on both material advisers and their clients.

identical information in two different forms with respect to the same event, and further, that they be filed with the same agency. In this respect, the duplication is similar to that required with respect to large currency transactions.[566] The differences between the instant proposal and the legislation enacted to address currency transactions are significant. The latter included a provision that explicitly permitted disclosure of return information obtained as a result of those reports to be shared with any Federal agency upon request, even for purposes not related to tax administration.[567] It also explicitly addressed the penalties that would apply in the instance of noncompliance, even if the noncompliance did not result in understating tax liability.

Administrative and taxpayer burdens

In determining whether the proposals strike an appropriate balance between the government need for information and the burden of providing such information, it is helpful to consider whether the proposals reach the intended targets. In the Secretary's first report to Congress under section 361 of the PATRIOT ACT,[568] he explained that individuals who failed to comply with FBAR generally were in one of three categories: (1) those taxpayers who lack requisite knowledge or understanding of the filing requirements; (2) taxpayers whose failure to file is part of a conscious effort to conceal income or some kind of criminal activity; and (3) those who structure transactions, usually with advice from lawyers or accountants, in a manner intended to circumvent the filing requirements. For the first group, the improved instructions to the forms and a possible due diligence requirement on return preparers could help to alleviate much of the lack of knowledge and confusion. For those in the second category, "achiev[ing] deterrence . . . will require a series of highly publicized criminal actions against intentional violators in order to raise the cost of being an FBAR scofflaw." The third type of "scofflaw" described by the Secretary seeks to maintain a veneer of respectability by maintaining plausible deniability as to his noncompliance. The difficulty of sustaining that veneer increases as the reporting requirements become more precise and the penalty for noncompliance rises. The proposals, if enacted with appropriate modifications to avoid unnecessary administrative burden, may bring the first group into fuller compliance, and may also reach the third group. The second category of non-reporter presents a more intractable problem, but making it easier for the IRS to impose a penalty may alter the cost/benefit analysis on the margin for this category.

Among the higher risk taxpayers (i.e., those in the second and third category above) are high-net worth individuals, whose ability to exploit international structures to minimize tax has a significant influence on the overall perception of the integrity of a tax system.[569] As such, they may fairly be viewed as appropriate targets of the enhanced reporting requirements. A study by

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[566] Sec. 6050I.

[567] Sec. 6103(l)(15).

[568] Secretary of the Treasury, *A Report to Congress in Accordance with § 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)*, (April 26, 2002).

[569] OECD Forum on Tax Administration, *Paris Communique from Fifth Meeting of OECD FTA*, Paris, May 28-29, 2009.

the GAO, reviewing taxpayers who participated in a settlement initiative, found that even among those who complied with income tax reporting requirements, more than half had not complied with FBAR.[570] In addition, the costs that higher risk taxpayers would incur in complying with the requirements may be appropriate.

The proposal as currently formulated may unintentionally reach large classes of taxpayers who pose relatively little risk of tax evasion. These groups include first or second generation immigrants who send money to their families in their country of origin; beneficiaries of employee plans of multinational companies; and U.S. expatriates working overseas as employees of foreign entities and having signature authority in that capacity but no financial interest. The latter individuals currently have an FBAR obligation, but under the Administration proposals would now have to include such reporting with their individual income tax returns, potentially creating a high volume of information of limited use to tax authorities. The other individuals would not likely have an FBAR obligation currently.

Additional or alternative proposals to support FBAR reporting

Because the types of noncompliance that are encompassed by the concept of "offshore noncompliance" are varied, the approaches needed to attack the problem are also varied, and overreliance on the QI regime may be misplaced.

Some have proposed a "due diligence" requirement for return preparers to establish compliance with FBAR. Although the efficacy of such a provision has been questioned,[571] such a proposal could improve compliance among less knowledgeable taxpayers if the steps required of the preparer were sufficiently specific.[572] It could be similar in structure to the "due diligence" duty on income tax return preparers in section 6695(g) of present law, relating to the earned income credit.[573] The steps required of a preparer to ascertain whether the client is required to file an FBAR or Form 3520 could include a requirement that the preparer explain to the client the reporting requirements pursuant to the FBAR and Form 3520, the meaning of the various terms (such as "financial interest" and "signature authority") that are used in determining whether the forms are required to be filed, and the applicable penalties, civil and criminal, if the client negligently or willfully fails to file the forms when required to do so. In addition, the

[570] Michael Brostek, General Accounting Office, testimony before the Senate Finance Committee, *Tax Compliance: Offshore Financial Activity Creates Enforcement Issues for IRS*, GAO-09-478T, (March 17, 2009).

[571] Martin Sullivan, "Economic Analysis: Proposals to Fight Offshore Tax Evasion, Part 2," *Tax Notes* (April 27, 2009), p. 371.

[572] Joint Committee on Taxation, *Additional Options to Improve Tax Compliance*, August 3, 2006, (released by Senate Finance Committee on October 19, 2006, and available on the Senate Finance Committee website at http://finance.senate.gov/press/Gpress/2005/prg101906.pdf) (hereafter, Joint Committee on Taxation, *Additional Options to Improve Tax Compliance*).

[573] In 1997, Congress enacted section 6695(g), which imposes a due diligence requirement on income tax return preparers with respect to the earned income credit. Under that section, the preparer is subject to a $100 penalty for each failure if the preparer fails to comply with the due diligence requirements imposed by the Secretary by regulations with respect to determining the eligibility and the amount of the earned income credit.

statute could require that the return preparer document the client's responses and retain the documentation for possible use in any audit with respect to the client's income tax return for the year. It may be appropriate to consider a minimum income threshold to ensure that the proposal penalty is appropriately targeted. The amount of the preparer's penalty for failure to follow the due diligence rules should be specified in the statute at a level sufficiently high to be meaningful.

In addition to a longer limitations period and increased accuracy related penalties,[574] other possible measures include denial of any abatement of interest[575] on tax deficiencies related to the offshore accounts or interests, or a denial of otherwise available deductions for expenses related to maintaining the offshore account and reporting on foreign holders of US accounts.[576] Some commentators have proposed that any efforts to enhance withholding agent duties and increase participation in the QI program be accompanied by 'carrots' such as promises of economic assistance to the jurisdiction that enacts domestic legislation supportive of greater transparency.[577] Legislation that would position the U.S. to make better use of any automatic exchange of information available under its bilateral and multilateral agreements also merits consideration, because the information gathered may allow the United States to rely less upon information that otherwise may only be available if taxpayers are complying with self-reporting requirements.

In addition, commentators have noted the need to ensure that any information obtained through any of these measures is usable.[578] Toward that end, e-filing could be required of withholding agents, whether or not QIs. At present, FBARs cannot be filed electronically. Measures that would require modernization to permit e-filing of those forms merit consideration. Additionally, compliance with international standards for use of identification numbers could enhance the usefulness of information provided through cross-border reporting.

Finally, legislation to refute the perception that the United States itself permits states to operate as tax havens could be helpful to engender foreign cooperation in this area, including the U.S. role in spearheading the adoption of global anti-money laundering standards. In 2006, reports critical of the U.S. norms governing maintenance of information on corporate formation and ownership were published. In two reports prepared for the Permanent Subcommittee on Investigations in the U.S. Senate Committee on Homeland Security and Governmental Affairs,

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574 See discussion in section V.C., *infra*.

575 Sec. 6404.

576 Cynthia Blum, "Sharing Bank Deposit Information With Other Countries: Should Tax Compliance or Privacy Claims Prevail?" 6 *Florida Tax Review* 579 (2004).

577 Timothy V. Addison, "Shooting Blanks: The War on Tax Havens," *Indiana Journal of Global Legal Studies* 16 (Summer 2009), p. 703.

578 General Accounting Office, *Tax Compliance: Qualified Intermediary Program Provides Some Assurance that Taxes on Foreign Investors Are Withheld and Reported, but Can Be Improved* GAO-08-99 (December 2007); Steven Shay, Testimony to the Ways & Means Committee, March 31, 2009.

the problem was delineated by the GAO.[579] More or less contemporaneously, the Financial Action Task Force on Money Laundering ("FATF") reported that the United States did not itself require the collection of information on beneficial ownership that FATF recommended.[580] In particular, the States of Nevada, Wyoming and Delaware have been the subject of considerable commentary, in particular due to use of entities formed in those states to facilitate VAT fraud.[581] In the past, the perceived hypocrisy of OECD member countries was used effectively to enable smaller countries to deflect earlier efforts to bring transparency to offshore structures.[582] Recently, legislation has been proposed that would establish a minimum standard for corporate transparency by conditioning certain funding for States on enactment of acceptable information gathering as to ownership and management of structures formed under State law.[583] Requiring States to collect this information would help the Federal government to better respond to information requests from foreign governments conducting their own tax evasion and anti-money laundering investigations of their citizens and residents suspected of engaging in illegal activities through U.S. corporations and limited liability companies.

Prior Action

No prior action.

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[579] General Accounting Office, *COMPANY FORMATIONS: Minimal Ownership Information Is Collected and Available,* a report to the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate GAO-06-376 (April 2006); General Accounting Office*, Suspicious Banking Activities: Possible Money Laundering by US Corporations Formed for Russian Entities*, GAO-01-120 (October 31, 2006).

[580] Financial Action Task Force, IMF, *Summary of the Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism United States of America at* pp. 10-11 (June 23, 2006).

[581] K. Steven Burgess, Director of Examinations, Small Business/Self-Employed Division, IRS, Testimony before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate (November 14, 2006). He stated that Wyoming and Nevada were the only states to permit bearer ownership of corporate shares, and further stated that the use of such companies to evade VAT has been a source of numerous requests for exchange of information by US treaty partners. Since that hearing, both Nevada and Wyoming have outlawed bearer shares. See also, Unger and Ferweda, "Regulating Money Laundering and Tax Havens: The Role of Blacklisting" *Tjalling C. Koopman's Research Institute*, Utrecht School of Economics, Universiteit Utrecht, Discussion Paper Series nr. 08-12, in which the authors detail structures permitted under the law of various OECD member countries, including limited liability corporations authorized in the US, and compares them to entities that lead other jurisdictions to be included on various blacklists. But see, Table C.3, "Bearer Securities" in the OECD, "*Tax Cooperation: Towards a Level Playing Field" 2008 Assessment by the Global Forum on Taxation."* (OECD, Paris, 2008).

[582] See*,* J.C. Sharman, Havens in a Storm: The Struggle for Global Tax Regulation*, Cornell University Press* (2006).

[583] S. 569, "Incorporation Transparency and Law Enforcement Assistance Act,"111th Congress, 1st Sess., (March 11, 2009). In general, this legislation would require States to implement an incorporation system requiring that each applicant to form a corporation or limited liability company provide the State with certain information about the beneficial owners of the corporation or limited liability company during the formation process as well as maintain and periodically update such information.

C. Administration's Proposals on Third-Party Information Reporting

Present Law

Despite the presence of the self-reporting requirements described earlier with respect to U.S. persons engaging in foreign activities, present law generally does not require third-party information reporting to the IRS with regard to the transfer of money or property to, or receipt of money or property from, a foreign bank, brokerage, or other financial account on behalf of a U.S. person, or with regard to the establishment of a foreign bank, brokerage, or other financial account on behalf of a U.S. person. Present law also generally does not require withholding agents to ascertain the ownership of foreign payees that may be entities with respect to which U.S. persons have a U.S. reporting or income tax obligation.

1. Proposal to require third-party information reporting regarding the transfer of assets to foreign financial accounts and the establishment of foreign financial accounts

Description of Proposal

Any U.S. financial intermediary and any qualified intermediary that transfers money or property with a value of more than $10,000 to a foreign bank, brokerage, or other financial account on behalf of a U.S. person (or on behalf of any entity of which a U.S. person owns, actually or constructively, more than 50 percent of the ownership interest) would be required to file an information return regarding such transfer. Any U.S. financial intermediary and any qualified intermediary that receives a transfer of money or property with a value of more than $10,000 from a foreign bank, brokerage, or other financial account on behalf of a U.S. person (or on behalf of any entity of which a U.S. person owns, actually or constructively, more than 50 percent of the ownership interest) would be required to file an information return regarding such transfer. Any U.S. financial intermediary and any qualified intermediary that opens a foreign bank, brokerage, or other financial account on behalf of a U.S. person (or on behalf of any entity of which a U.S. person owns, actually or constructively, more than 50 percent of the ownership interest) would be required to file an information return with the IRS regarding such account, including reporting any amounts of money or property transferred by the financial intermediary to such account.

Exceptions to the reporting requirement would be provided for 1) accounts opened and amounts transferred to, from, or on behalf of, publicly traded companies and their subsidiaries, 2) accounts opened at and transfers made to qualified intermediaries on behalf of a U.S. person (or on behalf of any entity of which a U.S. person owns, actually or constructively, more than 50 percent of the ownership interest) or 3) transfers received by or on behalf of a U.S. person (or on behalf of any entity of which a U.S. person owns, actually or constructively, more than 50 percent of the ownership interest) from accounts held by a U.S. person at a qualified intermediary. The Treasury Department would receive regulatory authority to provide additional exceptions to the reporting requirement, to require that certain additional information be reported, and to permit U.S. financial intermediaries and qualified intermediaries to report additional transfers of money or property to a foreign bank, brokerage, or other financial account on behalf of a U.S. person (or on behalf of an entity of which the U.S. person owns, actually or constructively, more than 50 percent of the ownership interest).

Effective date.–The proposal applies to amounts transferred and accounts opened beginning after December 31 of the year of enactment.

Analysis

The current reporting regime for offshore financial accounts relies primarily on self-reporting with respect to foreign financial accounts, but the Administration is concerned that U.S. persons are failing to comply with these self-reporting requirements. The Administration believes that this proposal, which establishes a third-party reporting requirement with respect to transfers to foreign financial accounts, receipts from such accounts, and the establishment of such accounts would lead to greater disclosure of foreign financial accounts, and consequently would discourage the evasion of U.S. taxation. Since this proposal focuses on transfers made to, or received from, a foreign financial account at a financial institution that is not a qualified intermediary on behalf of a U.S. person, it is intended to give the IRS a line of sight into certain transactions that may not otherwise be captured by the Administration's proposals. In general, if the IRS were to receive an information return relating to transfers to or from a foreign financial account by a U.S. taxpayer, the IRS should be able to match that information return with an FBAR form filed by the taxpayer.

While one may agree in principle that the problem of tax evasion by U.S. individuals through the use of foreign financial accounts is serious, and that conceptually some form of third-party information reporting to the IRS may deter such evasion, one may question whether this specific provision, which requires third-party reporting on certain transfers to and receipts from a foreign financial account, is an effective and efficient approach to tackling this problem.

By way of background, FinCEN is the agency within the Treasury Department responsible for patrolling the nation's financial system. Its primary purpose is to fight money laundering and terrorist financing. At the request of Congress, FinCEN studied and issued a feasibility report in 2007 discussing the building of a cross-border information reporting system that would store and report information on cross-border wire transfers.[584] The information received by this system would be provided by U.S. financial institutions that send wire transfer instructions to or receive wire transfer instructions from non-U.S. financial institutions. It could then be used by various law enforcement agencies such as the Secret Service, the Drug Enforcement Administration, the Federal Bureau of Investigation, and other U.S. intelligence agencies. The feasibility study reported that although the construction of such a system was feasible, it would cost approximately $32.6 million and take over three years to implement. To date, implementation of this reporting system has not been pursued.

Proponents of third-party information reporting of certain offshore transfers such as the Administration's proposal believe that such a system or similar system, if developed, could be used for tax information reporting purposes. The expectation is that the IRS would be able to look at the overall flow of funds out of the United States and see to what extent they are being

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[584] Financial Crimes Enforcement Network, *Feasibility of a Cross-Border Electronic Funds Transfer Reporting System under the Bank Secrecy Act*, (Jan. 27, 2009), http://www.fincen.gov/news_room/rp/files/cross_border.html.

directly sent to tax havens. It could then identify and investigate anomalies such as disproportionate funds to one country or institution, or irregular and one-time transfers. Additionally, the IRS could link new cross-border fund transfer information with tax return information to identify suspicious activity. Moreover, this information could be used for matching purposes to determine whether an FBAR has been filed.[585]

Various differences exist between the FinCEN proposal as contemplated and the Administration's proposal. First, the FinCEN proposal would apply to any transfer in or out of the United States whether or not the recipient is a QI. The Administration's proposal, however, would only apply to transfers involving non-QIs. Second, the FinCEN proposal only applies to certain wire transfers, whereas this proposal applies to cross-border transfers whether or not by wire transfer. Additionally, the FinCEN proposal did not contemplate the need for obtaining taxpayer identification numbers for the relevant parties involved in the transfer. Such information would be necessary for reporting to be useful for tax administration purposes. These differences would need to be bridged if a single system were to be used for tax and non-tax purposes.

Representatives of the financial services sector, however, have suggested that this proposal will do nothing more than generate a massive volume of information reports that capture routine, legitimate business transactions of U.S. persons making payments to, or receiving payments from, offshore accounts as payment for goods and services including the reporting of information on transactions relating to income already being reported by U.S. businesses as well as payments for goods and services to foreign persons who are not subject to U.S. taxes.

They have also asserted that the reporting requirements under the Administration's proposal would be even more challenging to meet than the one studied by FinCEN. In general, the proposal studied by FinCEN would have required the identification of all wire transfers to or from a foreign financial account. This proposal, however, would require the more complex task of identifying a defined subject of a larger universe of cross-border transactions, storing and collating information from those transactions, and reporting the results, along with additional information, to the IRS.

Proponents of this and other recent proposals of a similar nature have argued that some of the information to meet the third-party information reporting requirements of this proposal should already be available as a result of the anti-money laundering requirements that financial institutions already must meet. However, others believe that the inherent limitation to this approach is that the type of information that must be gathered as part of a firm's tax reporting system should be as automated as possible, whereas the information gathering as part of anti-money laundering efforts requires a significant amount of manual processes.

To the extent that such a third-party information reporting requirement on transfers was enacted, it has been argued that these requirements will take several years to implement such that

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[585] Martin Sullivan, "Economic Analysis: Proposals to Fight Offshore Tax Evasion, Part 2," *Tax Notes* (April 27, 2009), p. 371.

the proposed effective date (i.e., effective for amounts transferred and accounts opened beginning after December 31 of the year of enactment) may be ambitious.

Prior Action

No prior action.

2. Proposal to require third-party information reporting regarding the establishment of offshore entities

Description of Proposal

Any U.S. person, or any qualified intermediary, that forms or acquires a foreign entity on behalf of a U.S. individual (or on behalf of any entity of which the individual owns, actually or constructively, more than 50 percent of the ownership interest) would be required to file an information return with the IRS regarding the foreign entity that is formed or acquired. The Treasury Department would receive regulatory authority to determine the information to be reported and to provide exceptions to the reporting requirement. In addition, the Treasury Department would receive regulatory authority to require, as necessary, withholding agents to collect additional information to determine whether a U.S. person is the beneficial owner of a foreign entity and specifically report if a U.S. person is a beneficial owner.

Effective date.–The proposal would be effective for entities formed or acquired after December 31 of the year of enactment.

Analysis

As present law generally only requires self-reporting by U.S. taxpayers upon the formation or acquisition of a foreign business entity, the IRS cannot readily ascertain whether U.S. individuals are complying with their ongoing reporting obligations in regard to income derived by foreign business entities that they control. Under the proposal, U.S. persons and QIs would be required to file an information return with respect to a foreign entity formed or acquired on behalf of certain U.S. individuals. The Administration believes that requiring this third-party reporting, and providing for additional information collection by withholding agents, would supplement the reporting requirements of current law and help the IRS to enforce U.S. tax law and reduce tax evasion through the use of foreign entities. For those entities acquired on behalf of U.S. individuals that are formed or acquired by U.S. persons or any QI, it is reasonable to conclude that the proposal should have its desired effect as the IRS would receive an information return from the U.S. person or QI in the year the entity was formed or acquired. As this information return can then be matched up with the requisite information return (i.e., Form 5471, 8865, or 8858) as filed by the U.S. individual, the proposal will allow the IRS to better ascertain whether U.S. individuals are complying with their reporting obligations.

The proposal, however, may have a limited effect in practice. As discussed above, the third party information reporting requirement must be met by U.S. taxpayers and QIs that either form or acquire a foreign entity on behalf of a U.S. individual (or on behalf of any entity of which the individual owns, actually or constructively, more than 50 percent of the ownership interest). Presumably, the group of U.S. persons being covered in the proposal would be U.S.

law firms (or other U.S. service providers), and the QIs being referred to are foreign financial institutions. While both U.S. law firms and foreign financial institutions in the QI program represent groups upon which the U.S. feasibly could impose such a requirement, in practice these two groups may not be the parties directly responsible for the formation or acquisition of a foreign entity on behalf of a U.S. individual. Rather, the U.S. law firm or QI might arrange for the U.S. individual to directly engage a foreign law firm in the desired country of incorporation of the foreign entity. The activities of this foreign law firm with respect to formation or acquisition of such a foreign entity would not be covered by the proposal.

The proposal could be modified to apply to any U.S. service provider or foreign financial institution in the QI program that has a significant level of involvement in a transaction that involves the formation or acquisition of the foreign entity on behalf of a U.S. individual. With such a modification, a U.S. service provider or foreign financial institution engaged by a U.S. individual to advise on the transaction involving the formation or acquisition of the foreign entity would be required to complete the third-party information reporting even if a foreign party, outside the scope of the proposal, performed the actual entity formation or acquisition. Nonetheless, U.S. individuals wanting to avoid such third-party information reporting could do so by directly engaging a foreign service provider to form or acquire the foreign entity on their behalf. This foreign provider may not have any legal relationship with the U.S. law firm or QI. As a result, such a modification to the proposal might only increase information reporting with respect to taxpayers that are already complying with the existing self-reporting requirements.

Prior Action

No prior action.

V. CROSS-BORDER ENFORCEMENT ACTIONS

A. Overview

Because the United States taxes its citizens and residents on their worldwide income, U.S. tax administrators frequently need foreign-based financial information to verify the accuracy of reporting by U.S. taxpayers. Obtaining that information requires a balancing of the U.S. interest in tax enforcement with the interests of the other state in maintaining confidentiality. In *Société Internationale v. Rogers*,[586] the Supreme Court articulated a basic rule of comity, holding unanimously that a U.S. district court could not ignore the interests of the foreign state in determining whether it would compel production of foreign based documents. Since then, courts balancing these conflicting U.S. and foreign interests[587] have tended to give greater weight to the U.S. interests in cases involving money laundering or drug dealing than in cases involving tax compliance. In *United States v. Bank of Nova Scotia,* the court enforced a grand jury subpoena served in the United States for records maintained in the Cayman Islands, despite claims that the bank secrecy laws of that jurisdiction would not permit production.[588] In that case, the records were sought in connection with prosecution of money laundering and possible drug dealing.

By contrast, in cases in which the only U.S. law enforcement interest was tax compliance, results have been mixed. Although the Ninth Circuit Court of Appeals enforced a grand jury subpoena for Swiss business records in a tax fraud case,[589] the Seventh Circuit Court of Appeals refused to enforce IRS administrative summons for Greek bank records in a tax case in which disclosure of the records could have subjected bank employees to the risk of substantial criminal penalties under Greek law.[590]

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[586] 357 U.S. 197 (1958).

[587] The balancing test is summarized in the *Restatement (Third) of the Foreign Relations Law of the United States* as follows: (a) A court or agency in the United States, when authorized by statute or rule of court, may order a person subject to its jurisdiction to produce documents, objects, or other information relevant to an action or investigation, even if the information or the person in possession of the information is outside the United States; (b) failure to comply with an order to produce information may subject the person to whom the order is directed to sanctions, including finding of contempt, dismissal of a claim or defense, or default judgment, or may lead to a determination that the facts to which the order was addressed are as asserted by the opposing party; and (c) in deciding whether to issue an order directing production of information located abroad, and in framing such an order, a court or agency in the United States should take into account the importance to the investigation or litigation of the documents or other information requested; the degree of specificity of the request; whether the information originated in the United States; the availability of alternative means of securing the information; and the extent to which noncompliance with the request would undermine important interests of the United States, or compliance with the request would undermine important interests of the state where the information is located. *Restatement (Third) of the Foreign Relations Law of the United States*, sec. 441(1) (1987).

[588] 691 F.2d 1384 (11th Cir.1982).

[589] *United States v. Vetco*, 691 F.2d 1281 (9th Cir. 1981).

[590] *United States v. First National Bank of Chicago*, 699 F. 2d 341 (7th Cir. 1983).

The remainder of this section describes the various enforcement measures available to the IRS under present law to assist it in obtaining offshore information when the information has not been provided via information reporting and is not available through an exchange of information program with a foreign jurisdiction.

B. Unilateral Measures to Facilitate Production of Foreign-Based Documents

In response to the difficulties in compelling production of information across-borders, a variety of statutory measures have been enacted to require greater voluntary disclosure, at the risk of incurring penalties or adverse findings. These measures include specific authority for the Tax Court to order foreign entities invoking its jurisdiction to provide all relevant information[591] and a statutory exclusionary rule affecting admissibility of foreign-based documents not been earlier in administrative or judicial proceedings.[592] Each is a valuable tool, but is limited to the situation in which an offshore transaction has been identified and selected for examination; they do not assist in identifying an offshore transaction. In the latter situation, the IRS can make use of its authority to issue so-called "John Doe" summonses, although recent experience has shown that enforcement of these summonses can be particularly difficult when the information sought is located in jurisdictions with restrictive bank secrecy laws.[593]

1. Section 7456(b)

Any party who initiates proceedings in the U.S. Tax Court may be subject to an order compelling production of offshore materials that are subject to that party's control. The term control is not limited to legal control. If the party establishes to the Court's satisfaction that it is unable to produce the materials in court, it may be ordered to make the documents available for inspection wherever situated. Although the Tax Court has attempted to rely on this provision to order production of materials, despite local law prohibitions against disclosure, it has met with limited success. The orders requiring production have been used to enforce government requests for documents as well as interrogatories,[594] and may require that the party appear personally at hearings or proceedings. The sanctions for failure to comply may include entry of a default judgment, striking pleadings, or adverse findings as to the issues to which the documents relate.

2. Section 982 exclusionary rules

In 1984, Congress enacted section 982, which limits the evidentiary value of foreign-based information by barring its admissibility in a civil proceeding if it was not timely produced to the IRS in response to a formal request for foreign-based documents. The provision permits a defense of reasonable cause for nonproduction, but specifically precludes a defense that foreign

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[591] Sec. 7465(b).

[592] Sec. 982.

[593] The discussion of measures available to assist gathering foreign-based information is limited to measures intended to encourage production of information during the examination phase of a controversy, prior to litigation, and does not encompass measures such as requests that a court issue letters rogatory or issuance of a request under the Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters, 23 U.S.T. 2555; T.I.A.S. 7444, (entered into force for the United States on October 7, 1972).

[594] *Gerling International Insurance Co. v. Commissioner,* 839 F.2d 131 (3d Cir. 1988); *Hong Kong Shanghai Banking Corporation v. Commissioner*, 85 T.C. 701 (1985).

law prohibits disclosure of such information.[595] The exclusionary rule has been upheld,[596] and is useful in prompting compliance with requests for information that are otherwise difficult to enforce. Nevertheless, the exclusion is of value only in denying a taxpayer's ability to use the information in defense of its own position. The exclusion does not compel a taxpayer to produce information in its possession that would be adverse to its position or that would help the IRS develop and support an issue identified in an examination.

3. John Doe summonses

The IRS has broad statutory authority to require production of information in the course of an examination.[597] A request for information in the form of an administrative summons is enforceable if the IRS establishes its good faith, as evidenced by the four factors enunciated by the Supreme Court in *United States v. Powell*.[598] The *Powell* factors require that the information (1) is sought for a legitimate law enforcement purpose, (2) is of a type that will shed light on the subject of the examination, (3) is not already in the possession of the IRS, and (4) that the IRS has complied with all applicable statutory requirements, such as service of process. Subsequent to *United States v. Powell*, the legitimacy of using an administrative summons in furtherance of an investigation into criminal violations was validated in *United States v. LaSalle National Bank*,[599] in which the Supreme Court determined that the dual civil and criminal purpose was legitimate, so long as there had not yet been a commitment to refer the case for prosecution.

The use of this summons authority to obtain information from third parties is subject to greater procedural safeguards,[600] but otherwise the same good faith elements are analyzed to determine whether the summons should be enforced. When the existence of a possibly noncompliant taxpayer is known but not his identity, as in the case of holders of offshore bank accounts or investors in particular abusive transactions, the IRS is able to issue a summons to learn the identity of the taxpayer, but must first meet greater statutory requirements, to guard against fishing expeditions.

An effort to learn the identity of unnamed "John Does" requires that the United States seek judicial review in an *ex parte* proceeding prior to issuance of the summons. In its application and supporting documents,[601] the United States must establish that the information sought pertains to an ascertainable group of persons, that there is a reasonable basis to believe

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[595] Sec. 982(b)(2).

[596] *Flying Tigers Oil Co. v. Commissioner*, 92 T.C. 1261 (1989).

[597] Sec. 7602.

[598] *United States v. Powell*, 379 U.S. 48 (1964).

[599] 437 U.S. 298 (1978); codified in sec. 7609(c).

[600] Sec. 7609.

[601] Sec. 7609(h)(2) provides that the determination will be made *ex parte,* solely on the pleadings.

that taxes have been avoided, and that the information is not otherwise available.[602] The reviewing court does not determine whether the summons will ultimately be enforceable. Once a court has determined that the predicate for issuance of a summons is met, the summons is served, and the summoned party served may challenge enforcement of the summons, based on the *Powell* factors. It is not entitled to judicial review of the *ex parte* ruling that permitted issuance of the summons.[603]

If a taxpayer whose liability is the subject of the summons either initiates or intervenes in a proceeding to challenge the enforcement of the summons, the limitations period for the tax year under investigation is suspended during the pendency of the proceeding.[604] The taxpayer whose identity is at issue in a John Doe summons would not initiate or intervene in a proceeding, and may not know of the proceeding. Nevertheless, enforcement of a John Doe summons is likely to be subject to time-consuming challenges, possibly warranting an extension of the limitations period. Thus, under current law, the limitations period for the tax year under investigation is suspended beginning six months after the service of a John Doe summons and ends with the final resolution of the response to the summons.[605]

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[602] Sec. 7609(f).

[603] *United States v. Samuels, Kramer & Co., and First Western Government Securities, Inc.*, 712 F.2d 1342 (9th Cir. 1983), which affirmed a lower court determination that the issuance of the John Doe summons was not subject to review, but reversed and remanded to permit a limited evidentiary hearing on whether the *Powell* standard was met.

[604] Sec. 7609(e)(1).

[605] Sec. 7609(e)(2).

C. Administration's Proposals Relating to Cross-Border Enforcement Actions

1. Proposals to establish negative presumptions in connection with certain failures to file FBARs for foreign accounts

Present Law

In a suit to collect an FBAR penalty, the government bears the burden of proof, including the need to establish a prima facie case that a penalty is owed. In contrast, a determination by the IRS that additional tax or a penalty is due is afforded a presumption of correctness[606] that the taxpayer must overcome to discharge his burden of proof in a civil proceeding against the IRS. Other than cases involving fraud, transferee liability, foundation management, or certain affirmative defenses, such as statute of limitations exceptions or collateral estoppel,[607] the taxpayer has the burden of proof. In the U.S. Tax Court, that burden is prescribed by rules of procedure[608] and is generally satisfied if the taxpayer prevails as to the item or adjustment that was the subject of the statutory notice on which the case is premised. In the context of a refund suit, the taxpayer must establish the correct tax liability for the taxable year.[609]

Since 1998, the Code has specified that the burden of proof may shift to the IRS if a qualified taxpayer produces credible evidence to rebut the IRS determination, has fully cooperated with the examination and controversy process, and has met any particular substantiation requirements of the Code.[610] "Credible evidence" is a "quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness)."[611] In addition, in cases in which the IRS has reconstructed a taxpayer's income from unrelated statistical data, the IRS bears the burden as to those items of income.

Description of Proposal

The Administration's budget includes two proposals to establish negative presumptions in connection with certain failures to file FBARs for foreign accounts.

Under the first proposal, a rebuttable evidentiary presumption would be applicable in a civil administrative or judicial proceeding providing that any foreign bank, brokerage, or other financial account in which a citizen or resident of the United States, or a person in and doing

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[606] *United States v. Janis*, 428 U.S. 433, 441 (1976).

[607] Secs. 7453, 7454; T.C. Rule 39.

[608] T.C. Rule 142.

[609] *Helvering v. Taylor,* 293 U.S. 507, 513 (1935).

[610] Sec. 7491.

[611] H.R. Conf. Rep. No. 105-599, at 240-41 (1998), 1998-3 C.B. 747, 994-95; see also *Griffin v. Commissioner*, 315 F.3d 1017 (8th Cir. 2003); *Okerlund v. United States,* 53 Fed. Cl. 341, 355 (2002).

business in the United States, has a financial interest in or signature or other authority over the account contains enough funds to require that an FBAR be filed. An exception would apply for accounts held through a QI. The Treasury Department would receive regulatory authority to provide additional exceptions. The rebuttable evidentiary presumption would not apply in criminal proceedings.

Under the second proposal, a rebuttable evidentiary presumption would be applicable in a civil administrative or judicial proceeding providing that failure to file an FBAR with respect to any foreign bank, brokerage, or other financial account held with a non-QI is willful if the account has a balance of greater than $200,000 at any point during the calendar year. The evidentiary presumption would not apply to accounts in which the person has signature or other authority by virtue of being an officer or employee of a corporation, but otherwise has no more than a de minimis financial interest in that corporation. The Treasury Department would receive regulatory authority to provide additional exceptions to the evidentiary presumption. The evidentiary presumptions would not apply in criminal proceedings.

Effective date.−Both proposals would be effective for FBARs due to be filed beginning after the date of enactment.

Analysis

The Administration expects the imposition of rebuttable evidentiary presumptions to encourage voluntary disclosure of foreign account information and assist the IRS in its FBAR enforcement efforts. In recent testimony before the Oversight Subcommittee of the Ways and Means Committee, Commissioner Shulman explained that the assumption underlying the proposals is that financial institutions that are not QIs can facilitate tax evasion, so that the burden of proof should be shifted to those institutions and their account holders.[612] He also noted with approval that other legislative proposals had as a key component such burden-shifting measures.[613] The Administration expects that these presumptions will facilitate assertion of the penalties and that threat of the penalties will, in turn, prompt noncompliant U.S. persons to disclose their offshore accounts, notwithstanding their failure to do so in the past.

The proposed presumptions will likely facilitate administration of the penalties. Both evidentiary presumptions are predicated on the fact that, without cooperation of the account holder or the financial institution (through its participation in the QI program), the government effectively has little or no access to foreign-based financial records, rendering the present law FBAR-related penalties difficult to enforce. In explaining its rationale for these proposals, the Administration noted its concern that the civil penalties for failure to file an FBAR are difficult

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[612] Douglas H. Shulman, June 4, 2009, Written Testimony before the House Ways and Means Subcommittee on Oversight, Filing Season and FY2010 Budget Request.

[613] See H.R. 1265 and S. 506, "The Stop Tax Haven Abuse Act," which would create presumptions of control and existence of reporting requirements that could be rebutted only by "clear and convincing" evidence, authenticated in open court. The presumptions would apply if the foreign financial interests are held in an "offshore secrecy jurisdiction," identified either in statute or regulation. The application of the presumption in those pending bills is determined without regard to the status of the financial institution holding the funds as a QI or non-QI.

to apply in cases in which the IRS is aware of the existence of unreported foreign financial accounts but cannot obtain documentation from the foreign financial institution to determine whether the accounts contain more than $10,000. Furthermore, although QIs must perform certain information reporting with respect to U.S. account holders, foreign intermediaries that are not QIs provide no such information reporting, limiting the ability of the IRS to discover unreported accounts and to enforce compliance with respect to those accounts. Thus, the proposed evidentiary presumption that an account has at least $10,000 ensures that the threat of a penalty for failure to file is realistic in any case in which the government is already in receipt of information sufficient to link a specific account or financial interest with a taxpayer. If information exists to establish a balance of at least $200,000, the rarely used penalty for willful failure to file[614] also would pose a realistic threat.

Under the proposal, in order to challenge the penalties and overcome the proposed negative presumptions in a suit for a refund, the taxpayer would bear a heightened burden of proof.[615] In a suit by the government to collect an FBAR penalty, the government is assigned the burden of proof, but can rely on the appropriate presumption to establish at least part of its case in chief, thus shifting to the account holder the burden of producing sufficient information to overcome the presumption.

On their face, the proposals are sufficiently broad to apply in any civil proceeding in which an interest in a foreign account or entity is relevant. To the extent that disclosure of the accounts is required on an income tax return, the presumption could assist the IRS in determining the appropriate accuracy-related penalties with respect to that return, by providing a basis for findings as to a pattern of nondisclosure or culpability. The presumption could thus be used to support an adverse inference that, in turn, would support a tax or penalty determination under the Code. If these presumptions are enacted in conjunction with the other administrative proposals requiring disclosure of FBAR information on an income tax return or doubling of accuracy-related penalties as discussed above, these presumptions could be relied upon to establish the failure to file that would trigger the doubling of the accuracy-related additions to tax or the extension of the limitations period for assessment.

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[614] In *Ratzlaf v. United States*, 510 U.S. 135, 138 (1994), the Supreme Court held that "willfulness" required both knowledge of the reporting requirement and a specific intent to disobey the law, a difficult standard to meet. The Court overturned a conviction of a person who structured currency transactions after being informed of bank reporting requirements because that knowledge and subsequent action did not themselves establish intent. That analysis was thought to apply to other Bank Secrecy Act violations and may have influenced the willingness of the IRS to refer cases for civil penalties if criminal prosecution was not available. From 1993 until 2002, only 12 civil penalty cases were referred to FinCEN by the IRS, resulting in assessment of only two penalties. See Secretary of the Treasury, *A Report to Congress in Accordance with sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)* (April 26, 2002).

[615] In footnote 2 of *United States v. Dollar Bank Money Market Account*, 980 F.2d 233 (3d Cir. 1992), dealing with a violation of the anti-structuring provisions of section 5324 of Title 31, the court stated that "in a civil penalty or criminal case under 31 U.S.C. §§ 5321-5322 (1988), the government has the burden [of proof regarding *mens rea*]."

The type of evidence that would be necessary to rebut this presumption is not discussed in the Administration's explanation of the proposal. Because the negative presumptions are expected to be relevant to Internal Revenue Code actions as well as Title 31 enforcement, one can anticipate that the jurisprudence surrounding the historical presumption of correctness that is afforded an IRS determination in a statutory notice of deficiency[616] will be adapted in some form to these presumptions. As applied to a statutory notice of deficiency, the presumption of correctness generally prevents a court from inquiring as to the basis of the IRS determination. It has also been called "Goliath-like"[617] and held to be inapplicable when applied to "naked" assessments, that is, assessments for which the IRS had not identified sufficient predicate evidence. In such cases, the determination was arbitrary. The description of the proposals also does not specify the requisite level of predicate evidence needed by the government to permit it to rely on the proposed negative presumptions as to the amount in an undisclosed foreign financial account and the willfulness of the failure to disclose the account. For the sake of administrability, any statute incorporating these presumptions should clearly state the requisite threshold.

In *Weimerskirch v. Commissioner*,[618] the court held that the IRS determination that a taxpayer had income from the sales of heroin was "arbitrary" when it was unsupported by any document or witness that would place the taxpayer in the alleged income-producing activity or establish the receipt of the income, such as a bank deposits analysis or net worth determination. At least one other Circuit followed that reasoning, again in the context of illegal activities that produced the income.[619] To some extent these chinks in presumed correctness developed simultaneously with the increased ability of the IRS to match third-party information reports with income tax returns and identify possible understatements and underreporting. The two trends collided in the early 1990s in a case involving a painting contractor, *Portillo v. Commissioner*.[620] On the basis of a Form 1099 filed by a contractor for whom the taxpayer admittedly worked, the IRS determined that the proceeds from that contractor were underreported. The Tax Court sustained the deficiency. On appeal to the Fifth Circuit, the case was reversed, and the mere Form 1099 was held not to be an adequate basis for determining that the amount reported on that form constituted income to the taxpayer. Subsequently, the result of *Portillo* was partially codified in the IRS Reform and Restructuring Act of 1998,[621] with the enactment of section 7491.

Prior Action

No prior action.

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[616] Sec. 6212(a).

[617] *Portillo v. United States,* 932 F.2d 1128 (5th Cir. 1991).

[618] 596 F.2d 358 (9th Cir 1979).

[619] *Anastasato v. United States*, 794 F.2d 884 (3d Cir. 1986).

[620] 932 F.2d 1128 (5th Cir. 1991).

[621] Pub. L. No. 105-206, sec. 3001(a).

2. Proposal to extend statute of limitations for certain reportable cross-border transactions and foreign entities

Present law

The general rule under section 6501 provides a three-year period in which assessment of tax may be made.[622] Although there are numerous exceptions to the general rule, including an open-ended period for non-filing or cases of civil tax fraud and a six-year period for a substantial omission of income, only one exception specifically targets the difficulty of collecting cross-border information or identifying such a transaction–section 6501(c)(8). That exception provides that a limitation period will not expire any sooner than three years after certain information is provided to the IRS. The returns in question are generally due with the income tax return; if a timely and complete return is filed, with all required reports, the normal three-year period begins to run. If the information reports do not accompany the return, the period will not begin to run until the information required by such reports is provided to the IRS.

Other existing exceptions that may apply, based on procedural difficulties in obtaining information, are those that suspend the limitations period after a summons is served, either beginning six months after service, in the case of John Doe summonses,[623] or when a proceeding to quash a summons is initiated by a taxpayer named in a summons to a third-party record-keeper. Judicial enforcement proceedings begun by the government do not themselves trigger a suspension of the statute generally, except in the instance of "designated summonses" that currently apply only to large corporate taxpayers and are seldom used.[624]

Description of Proposal

The proposal would extend the period during which the statute of limitations provided by section 6501(c)(8) does not expire to six years after the taxpayer furnishes the information required to be reported. The information returns with respect to which section 6501(c)(8) applies would be broadened to include the information returns filed by qualifying electing funds pursuant to regulations under section 1295(b), the proposed tax return disclosure of FBAR information, and the information returns proposed to be required of U.S. individuals with respect to certain transfers of money or property to and receipts from certain foreign bank, brokerage, or other financial accounts. The extended statute of limitations provided by section 6501(c)(8) would also apply in the case of failure to furnish information or maintain records as required by section 6038A(a). The section 6501(c)(8) exception to the general statute of limitations would

[622] Congress has regarded it as "ill-advised, to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest. Hence, a statute of limitation is an almost indispensible element of fairness as well as of practical administration of an income tax policy." *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 300 (1946).

[623] Sec. 7609(e)(2).

[624] Sec. 6503(j).

be made applicable to the entire income tax return. The Treasury Department would receive regulatory authority to provide exceptions to these rules.

Effective date.−The proposal would be effective for returns due to be filed after the date of enactment.

Analysis

Many of the exceptions to the general three-year statute of limitations are premised on the theory that the statute of limitations should not run when the taxpayer has not disclosed facts that allow the IRS to make an accurate assessment. That rationale underlies the current exception in section 6501(c)(8). The aspect of the proposal to add additional reports to those already identified in that section is consistent with that rationale.

In contrast, the aspect of the proposal to extend the statutory period to six years arguably departs from that rationale, because the new limitations period would apply to any return reflecting certain cross-border transactions, even those that were adequately disclosed on schedules submitted timely with all required information.[625] To justify that change, one must assume that there are inherent difficulties in identifying and developing issues even when all requested information is made available. In a report issued in 2007,[626] the GAO proposed that the limitations period be extended when cross-border transactions are implicated, based on its research demonstrating that an average 500 additional days are needed to complete an examination of a return involving such transactions. In that report, however, the GAO explained that the need for additional time was almost entirely due to the difficulties the IRS encounters in gathering foreign-based information. Even if a taxpayer discloses the nature of an account, the IRS still needs additional time to audit such account, especially if any sort of treaty request is needed. To the extent that the information is provided with a timely filed return, one cannot assume that the additional time would be needed. Thus, the findings of the GAO report do not necessarily support an expansion of the general limitations period to six years for all taxpayers who engage in cross-border transactions. One possible solution would be to extend the statute for six years if (i) the bank account is located at a non-QI, or (ii) the bank is located in a country that does not have automatic information exchange with the United States.

Other more limited revisions to the limitations period may better achieve the underlying intent of the proposal. One possibility is to expand the circumstances in which a six-year statute of limitations applies under section 6501(e) by lowering the threshold for a substantial omission of income, from 25 percent to a lower percentage of income, if the understatement is related to an offshore account or transaction. This change would represent a valuable backstop to the

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[625] In this respect, the proposal is similar to section 104 of H.R. 1265 and S. 506, "The Stop Tax Haven Abuse Act," which would explicitly provide a six year limitations period for any return filed for a year in which the taxpayer held an interest in an entity or account in an offshore secrecy jurisdiction. The Administration proposal does not use the concept of "offshore secrecy jurisdiction" to determine the applicability of the longer limitations period and applies without regard to the foreign jurisdiction involved.

[626] Government Accountability Office, *Tax Administration: Additional Time Needed to Complete Offshore Tax Evasion Examinations*, GAO-07-237 (March 30, 2007).

otherwise applicable limitations periods for examination of returns of U.S. persons. However, to assist the IRS in planning whether to devote resources to an issue, it would be necessary to set the income threshold low enough that its applicability could be determined sufficiently early in the examination process. More importantly, the question of what constitutes adequate disclosure sufficient for a taxpayer to avoid the longer limitations period could present opportunities for extensive litigation.[627] Finally, this proposal is not needed to assist with enforcement of withholding taxes; in a withholding tax controversy, one of the existing exceptions generally applies because either the relevant amounts were not disclosed on Form 1042, or the appropriate return was not filed.

Another option is to provide a new exception that would balance the IRS's need for assistance in obtaining foreign-based documents or testimony against taxpayers' need for greater certainty with regard to examination procedures. This alternative basis for suspension of the general limitations periods could be added to section 6503 and modeled after the current "designated summons" authority in section 6503(j). The elements of such a suspension could include all of the following:

- The return selected for audit includes a cross-border transaction;
- Informal requests for documents were made to the taxpayer or a third party, and either no response or incomplete responses were received, without reasonable cause;[628]
- A formal request for documents that notifies the taxpayer of the intent to rely upon the suspension of the limitations period is served while the statute is otherwise open, unless information is produced in response to that request within some reasonable time before expiration of the statute;
- The suspension would continue while the request is pending, or its enforceability is in litigation, and for some specified period after a response is obtained; and,
- A U.S. "deemed" agent for service of a summons must be designated if the entity under examination is foreign and has refused to identify an agent for acceptance of service of process.

In addition, amendments to the operation of the limitations period in the context of summons enforcement proceedings may be warranted. For example, section 7609(e)(2) could be amended to provide for the suspension of a limitations period effective upon issuance of a summons with respect to the taxpayer whose liability is the subject of the summons and whose identity is unknown, rather than requiring a six month period to elapse before any suspension. If

[627] For a discussion of the importance of the six-year limitations period in the context of abusive transactions and international structuring, see Hale E. Sheppard, "Only Time Will Tell: The Growing Importance of the Statute of Limitations in an Era of Sophisticated International Tax Structuring," *Brooklyn Journal of International Law* 30 (2005), p. 453.

[628] For this purpose, reasonable cause would not include arguments that foreign secrecy or blocking statutes do not permit production of the requested information.

a taxpayer whose liability is the subject of the summons either initiates or intervenes in a proceeding to challenge the enforcement of the summons, the limitations period for the tax year under investigation is suspended during the pendency of the proceeding.[629] The taxpayer whose identity is at issue in a John Doe summons would not initiate or intervene in a proceeding, and may not know of the proceeding. Nevertheless, enforcement of a John Doe summons is likely to be subject to time-consuming challenges warranting an extension of the limitations period. Under current law, the limitations period for the tax years under investigation is not suspended until a date six months after the service of the summons and ends with the final resolution of the response to the summons.[630]

The UBS investigation[631] illustrates the time-consuming nature of gathering information in contested cases, and the attendant dangers of expiration of the limitations periods before the information sought is produced. It also establishes that suspension of the limitations period based only on the existence of a pending judicial proceeding would not be satisfactory in light of the extensive negotiations when an institution in a foreign jurisdiction is involved. Once a court has found that there is a likelihood of tax noncompliance and authorized the issuance of a summons, it is difficult to justify the requirement that an additional six months elapse before the limitations period is suspended with respect to the anonymous taxpayers whose liabilities are the subject of the examination. As long as the statute retains the requirement that the summoned party promptly notify the clients or taxpayers whose limitations period is suspended as a result of the summons, any disadvantage to those taxpayers whose limitations period would otherwise elapse in that six month period is outweighed by the improved ability to ensure that there is adequate time to examine the summoned material when it is produced.

Prior Action

No prior action.

3. Proposal to enhance penalties for failure to disclose foreign financial interest

Present Law

FBAR penalties

Penalties may apply if the FBAR is not timely filed or the information supplied is inaccurate or incomplete. These penalties are imposed under Title 31 of the United States Code, rather than the Internal Revenue Code, and may be both civil and criminal. Since its initial

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[629] Sec. 7609(e)(1).

[630] Sec. 7609(e)(2).

[631] On July 1, 2008, a Federal district court in Florida granted the IRS permission to issue a John Doe summons to UBS seeking the names of as many as 20,000 U.S. citizens who were UBS customers for which reporting or withholding obligations may not have been met, Case No. 08-21864-MC-LENARD/GARBER. The summons was served on July 21, 2008. A petition to enforce that summons was filed on February 21, 2009. See *United States v. UBS AG*, Civil No. 09-20423 (S.D. Fla.). On August 19, 2009, the United States and UBS announced that UBS had agreed to provide information on over 4,000 U.S. persons with accounts at UBS.

enactment, a willful failure to comply with the reporting requirement has been subject to a civil penalty. In 2004, the available penalties were expanded to include a reduced penalty for non-willful failure to file.[632] The individual who willfully fails to file an FBAR may be subject to penalties under Title 31 equal to the greater of $100,000 or 50 percent of the amount in the account at the time of the violation.[633] A non-willful but negligent failure to file is subject to a penalty of $10,000 for each negligent violation.[634] The penalty may be waived if there is both reasonable cause for the failure to report and all income from the transaction was properly reported. In addition, serious violations are subject to criminal prosecution, resulting in both monetary penalties and imprisonment. The civil and criminal sanctions are not mutually exclusive.

Accuracy-related penalties

An accuracy-related penalty under section 6662 applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 (or, in the case of corporations, by the lesser of (a) 10 percent of the correct tax (or $10,000 if greater) or (b) $10 million), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[635] Except in the case of tax shelters,[636] the amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. The Treasury Secretary may prescribe a list of positions that the Secretary believes do not meet the requirements for substantial authority under this provision.

The section 6662 penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[637] The relevant regulations provide that reasonable cause exists in cases in which the taxpayer "reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts

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[632] American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 821(b), 118 Stat. 1418. This provision is codified in 31 U.S.C. sec. 5321(a)(5).

[633] 31 U.S.C. sec. 5321(a)(5)(C).

[634] 31 U.S.C. sec. 5321(a)(5)(B)(i), (ii).

[635] Sec. 6662. In the case of gross valuation misstatements, the penalty is doubled. Sec. 6662(h).

[636] A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Sec. 6662(d)(2)(C).

[637] Sec. 6664(c).

and authorities . . . and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[638]

A separate accuracy-related penalty under section 6662A applies to "listed transactions" and to other "reportable transactions" with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction"). The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.[639] An exception to the penalty is available if the taxpayer satisfies a strengthened reasonable cause and good faith exception premised on adequate disclosure of the relevant facts affecting the tax treatment, existence of substantial authority for the claimed tax treatment, and a reasonable belief that the claimed tax treatment was more likely than not the proper treatment. If the taxpayer did not adequately disclose the transaction, no reasonable cause exception is available (i.e., a strict-liability penalty generally applies), and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.[640]

Description of Proposal

The Administration's budget includes two proposals to enforce the new self-reporting requirements discussed in section IV, above.

Under the first proposal, failure to report a covered transfer would result in the imposition of a penalty equal to the lesser of $10,000 per reportable transfer or 10 percent of the cumulative amount or value of the unreported covered transfers. No penalty would be imposed for a failure to report due to reasonable cause.

Under the second proposal, the 20-percent accuracy-related penalty imposed on (i) substantial understatements of income tax, (ii) understatements resulting from negligence or disregard of rules or regulations, or (iii) a reportable transaction understatement, would be doubled to 40 percent when the understatement arises from a transaction involving a foreign account that the taxpayer failed to disclose properly under the proposed requirement that taxpayers disclose FBAR-related information on their income tax returns. In addition, in the case of a reportable transaction understatement, the reasonable cause exception would not be available with respect to this increased penalty.

Effective date.−The proposals would be effective for taxable years beginning after December 31 of the year of enactment.

[638] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); see also Treas. Reg. sec. 1.6664-4(c).

[639] Sec. 6662A(a).

[640] Sec. 6662A(c).

Analysis

Penalty for nondisclosure of covered transfers

The proposed penalty for failure to comply with the new reporting requirement on covered transfers to, or receipts from, non-QIs is similar to the civil FBAR penalties applicable to non-willful failures to file in that it would be capped at $10,000. However, the proposed penalty differs in that it permits a lesser fine equal to 10 percent of the unreported transfer if such amount would be less than $10,000. To the extent that enacting a penalty similar to the FBAR penalties is appropriate, the use of an amount different from the applicable amounts under Title 31 is difficult to rationalize.

Nevertheless, the relatively modest amount of the new penalty proposed is less susceptible to the chief criticism applied to the FBAR penalty, i.e., that it is often disproportionate to the offense in the case of a non-filer who appropriately reported all income related to the account for which an FBAR filing was required. In that case, the penalty can pose a significant disincentive to a person who mistakenly fails to file and subsequently wishes to take remedial action. To the extent that a taxpayer's failure to file was willful, it is doubtful that the taxpayer will undertake remedial action without some assurance of leniency.

In recognition of these disincentives, the IRS waived the civil FBAR penalties in the Offshore Voluntary Compliance Initiative ("OVCI") earlier this decade.[641] In January 2003, the IRS announced the OVCI to encourage the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through credit card or other financial arrangements similar to those targeted by an IRS enforcement program known as the Offshore Credit Card Program. Under the OVCI, the IRS waived the civil fraud penalty and certain penalties relating to failure to file information and other returns, including the FBAR,[642] but taxpayers remained liable for back taxes, interest, and certain accuracy-related and delinquency penalties.[643] The IRS reported that, as of July 31, 2003, it had received OVCI applications from 1,299 taxpayers who paid over $75 million in taxes and identified over 400 offshore promoters of abusive credit card or other financial arrangements.[644] Then IRS Commissioner Mark Everson discussed the limited success of the OVCI initiative at a PSI hearing on August 1, 2006. In his testimony, he stated "In reality, we did not have a good idea of the potential universe of individuals covered by this initiative. As a result, the incentive for taxpayers to come forward

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[641] Rev. Proc. 2003-11, sec. 2.02.

[642] News Release, Internal Revenue Service, IR-2003-48 (April 10, 2003). Taxpayers wishing to participate in the OVCI program were required to apply before April 15, 2003.

[643] Rev. Proc. 2003-11, 2003-1 C.B. 311; News Release, Internal Revenue Service, IR-2003-5 (Jan. 14, 2003); General Accounting Office, *Testimony of Michael Brostek Before the Committee on Finance, U.S. Senate: Taxpayer Information: Data Sharing and Analysis May Enhance Tax Compliance and Improve Immigration Eligibility Decisions*, GAO-04-972T (Nov. 19, 2003).

[644] News Release, Internal Revenue Service, IR-2003-95 (July 31, 2003).

and take advantage of this initiative was diminished due to the fact that we did not have the ability to identify immediately and begin examinations for all non-participating individuals."[645]

The IRS also proposed to waive those penalties in significant part under the terms of the 2009 voluntary compliance initiative announced by the Commissioner on March 26, 2009.[646] Under the terms of the guidance issued to field agents, no FBAR penalty would be imposed on any delinquent FBAR filer who was otherwise in compliance with the tax laws. For those who were not in compliance with the tax laws but voluntarily disclose and submit delinquent FBARs and other information returns by September 23, 2009, the IRS will assess an "offshore penalty" in lieu of the otherwise applicable FBAR penalties. The offshore penalty will equal 20 percent of the aggregate balances at their highest point in any of the six years covered by the voluntary disclosure.

No new penalty is proposed for failure to comply with the new requirement (discussed in section IV above) that certain information required on an FBAR filing be disclosed on the income tax return. Instead, failure to comply with that proposal could result in doubling any applicable accuracy-related penalties of section 6662; however, those penalties could be disproportionately harsh when applicable, and at the same time insufficiently targeted to ensure compliance with the proposal.

Accuracy-related penalties

The proposal to double otherwise applicable accuracy-related penalties in the case of certain offshore transactions reflects the heightened concern about use of foreign accounts to evade tax. In the past, when confronted with specific pockets of noncompliance or abusive transactions, Congress has enacted penalties that vary in amount based on the nature or severity of the offense or the perceived culpability of the taxpayer. For example, the current accuracy-related penalty for a substantial valuation misstatement may be doubled if the magnitude of the misstatement is sufficient.[647] The reportable transaction understatement penalty is increased if the reportable transaction was not disclosed as required under section 6011.[648] Under the proposal, a penalty may be doubled if "the understatement *arises from* a transaction *involving* a foreign account that the taxpayer failed to disclose properly" on their income tax returns (emphasis added).

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[645] Written Testimony of Commissioner of Internal Revenue Mark Everson Before Senate Committee on Homeland Security and Governmental Affairs' Permanent Subcommittee on Investigations Hearing on Offshore Abuses: The Enablers, The Tools and Offshore Secrecy, 109th Cong., 2d Sess., August 1, 2006.

[646] See Kristen A. Parillo and Jeremiah Coder, "IRS Reduces Penalties on Voluntarily Disclosed Offshore Accounts," *Tax Notes Today* 57-02 (March 27, 2009), reporting the statement from IRS Commissioner Doug Shulman on offshore income and the release of several internal memoranda outlining the settlement conditions for those who voluntarily disclose.

[647] Sec. 6662(e), (h).

[648] Sec. 6662A(c).

The language of the proposal is reminiscent of the nexus required under section 6662 between an underpayment and the substantial valuation misstatement, but not identical. Under section 6662, doubling of the penalty requires that an underpayment be attributable to the misstatement to sustain a penalty. Whether an underpayment is attributable to a valuation misstatement has proven to be a controversial issue since the concept was introduced in section 6659, the predecessor to section 6662. That provision was found to be inapplicable in the case of a tax shelter investor in *Todd v. Commissioner*.[649] In that case, the court concluded that the underpayment was attributable to a failure to place the subject property in service, not to the claimed valuation, which was clearly overstated. In subsequent cases, taxpayers adopted the strategy of admitting an error other than valuation to avoid the penalty. Despite subsequent clarification by the Tax Court, *Todd v. Commissioner* and its reasoning has continued to thwart congressional intent of the penalties.[650]

Under the proposal, both the link between the transaction and the foreign account and the connection between the transaction and the understatement of tax must be considered. Of the two, the nature of the requisite link between the understatement and the transaction may prove difficult to define. It may be that the language of the proposal was chosen to signal an intention to avoid use of the "attributable to" standard, thus permitting the government to double penalties more readily when a relaxed standard is met.

Prior Action

No prior action.

4. Proposal to improve the foreign trust reporting penalty

Present Law

Section 6048 requires certain persons to report information to the IRS with respect to foreign trusts. A grantor or other person transferring assets to a foreign trust must report the transfer and the identity of the trust and of each trustee and beneficiary of the trust. A U.S. person that receives a distribution from the trust must report the distribution. A U.S. owner of any portion of a foreign trust is responsible for ensuring that the trust files an information return for the year. In the case of transfers to, or distributions from, a foreign trust, reporting is accomplished by filing Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. A foreign trust with a U.S. owner files a Form 3520-A, Annual Information Return of Foreign Trust with a U.S. Owner.

[649] 89 T.C. 912 (1987), *aff'd*, 862 F.2d 540 (5th Cir. 1988).

[650] For example, the Court of Federal Claims recently held that a partnership that conceded all underlying adjustments could not be held liable for the 40-percent penalty under section 6662 because the underpayment was attributable to the concession, not to the valuation misstatement. *Alpha I, LP, v. United States*, Tax Analysts Doc. 2009-5883 (Ct. Fed. Claims March 16, 2009).

The Code imposes a penalty on any person responsible for filing Form 3520 or Form 3520-A if the applicable form is not filed timely or it is incomplete or incorrect.[651] In the case of persons required to file Form 3520, the penalty is equal to 35 percent of the "gross reportable amount." In the case of a U.S. owner of a foreign trust, the penalty is equal to five percent of the "gross reportable amount." In general, the gross reportable amount is the gross value of property transferred to the trust, the gross value of the portion of the trust's assets at the close of the year that is treated as owned by a U.S. person, or the gross amount of distributions received from the trust. In the case of any failure to report that continues for more than 90 days after the IRS mails notice of such failure, an additional penalty of $10,000 applies for each 30-day period (or fraction thereof) during which the failure continues. The total penalties with respect to any failure may not exceed the gross reportable amount.

Description of Proposal

The penalty provision would be amended to impose an initial penalty of the greater of $10,000 or 35 percent of the gross reportable amount (if the gross reportable amount is known). The additional $10,000 penalty for continued failure to report would remain unchanged. Thus, even if the gross reportable amount is not known, the IRS may impose a $10,000 penalty on a person who fails to report timely or correctly as required, and may impose a $10,000 penalty for each 30-day period (or fraction thereof) that the failure to report continues. If the person subsequently provides enough information for the IRS to determine the gross reportable amount, the total penalties would be capped at that amount and any excess penalty already paid would be refunded. Accordingly, a person can stop the compounding of penalties by cooperating with the IRS so that it can determine the gross reportable amount.

Effective date.–The proposal is effective for information reports required to be filed after December 31 of the year of enactment.

Analysis

Reporting requirements assist taxpayers in complying with the U.S. tax laws and the IRS in determining whether taxpayers' returns are correct and complete. Penalties for failure to comply with reporting requirements create an incentive to comply by increasing the expected costs of noncompliance.

There is substantial evidence of noncompliance with the foreign trust reporting requirements, including by U.S individuals who are concealing income or possibly engaged in some criminal activity. In addition, there is evidence that transactions are structured in a manner to avoid the reporting requirements.[652]

[651] Sec. 6677.

[652] Joint Committee on Taxation, *Additional Options to Improve Tax Compliance*, August 3, 2006, p. 26; see also Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, *Tax Haven Abuses: The Enablers, the Tools and Secrecy*, August 1, 2006 (providing a detailed description of several strategies utilizing foreign trusts and other offshore entities in tax havens to avoid U.S. tax).

A third party may provide the IRS with information that certain persons are not complying with the foreign trust reporting requirements. In such cases, although the IRS may be aware of noncompliance by a particular person, the IRS may not have sufficient information to determine the gross reportable amount and calculate the appropriate penalties. This lack of information makes imposition of the penalties problematic and impedes the ability of the IRS to enforce the reporting requirements and related trust provisions.[653] By ensuring that the IRS can assess penalties, notwithstanding a gap in its available information, the proposal will assist the IRS in its enforcement of the reporting requirements and related foreign trust provisions.

More generally, by increasing the expected cost of failing to comply with the foreign trust reporting requirements, the proposal can be expected to increase compliance by those persons who are required to report, but who choose not to based on the belief that detection is unlikely. The proposal is not expected to affect the behavior of those who successfully structure a transaction to avoid the reporting requirements. In addition, the proposal may not affect the behavior of certain persons, such as those engaging in criminal activity.[654]

Prior Action

A similar proposal was included in the President's fiscal year 2009 budget proposal.

[653] Sec. 7491(c) (providing that the Secretary has the burden of production in any court proceeding with respect to the liability of any individual for any penalty).

[654] Joint Committee on Taxation, *Additional Options to Improve Tax Compliance*, p. 27.

VI. INTERNATIONAL AGREEMENTS

A. Overview

In general, the Administration's budget proposals related to offshore tax compliance rely on unilateral measures.[655] There has, however, been extensive bilateral and multilateral cooperation in addressing issues of cross-border tax compliance and financial regulatory reform. A broad international consensus has coalesced around the issue of bank transparency for tax purposes and strengthened in recent months. In the current global financial crisis, greater attention to all means of restoring integrity and stability to financial institutions has led to greater efforts to reconcile the conflicts between jurisdictions, particularly between jurisdictions with strict bank secrecy and those seeking information to enforce their own tax laws. In addition to purely domestic measures such as the Administration's budget proposals, the United States is one of many jurisdictions seeking new ways to ensure an adequate network of bilateral treaties and exploring multilateral programs to complement those domestic efforts. In the following section, we summarize some of the efforts underway that are leading to greater transparency. In subsection B below, we describe generally how the United States developed a bilateral exchange of information program and how it administers that program. In subsection C below, we describe a range of multilateral efforts that led to today's consensus. These efforts include a variety of international forums in which the United States participates, as well initiatives undertaken by the European Union.

[655] There is one prominent exception to the unilateral nature of the proposals. The proposal to require withholding from payments of gross proceeds to non-QIs does not apply to payments made to a non-QI located in a jurisdiction with which the United States has a comprehensive income tax treaty that includes a satisfactory exchange of information program.

B. Accessing Information Through Exchange of Information Under a Bilateral Agreement

An alternative means of obtaining documents maintained in a foreign jurisdiction is through agreements between the states, usually in the context of an income tax treaty or a tax information exchange agreement ("TIEA"). The information exchange procedures available to the United States under its network of international agreements are described below.[656]

Tax treaties establish the scope of information that can be exchanged between the treaty partners. Exchange of information provisions first appeared in the late 1930s,[657] and are included in almost all[658] current double tax conventions to which the United States is a party. Beginning in the 1980s, the United States began entering into specific TIEAs. Presently, the United States is a party to more than 60 income tax conventions, more than 20 TIEAs, and more than 50 Mutual Legal Assistance Treaties ("MLATs"), and is in negotiations for several additional agreements. In addition, the United States is a member of the Convention on Mutual Administrative Assistance in Tax Matters, which includes provisions on the exchange of tax information.[659]

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[656] As of September 1, 2009, the United States has TIEAs in force with the following countries: Antigua & Barbuda; Aruba; Bahamas; Barbardos; Bermuda; British Virgin Islands; Cayman Islands; Costa Rica; Dominica; Dominican Republic; Grenada; Guernsey; Guyana; Honduras; Isle of Man; Jamaica; Jersey; Marshall Islands; Mexico; Netherlands Antilles; Peru; St. Lucia; Trinidad & Tobago. The IRS has concluded that two of these agreements, those with the Cayman Islands and the British Virgin Islands, have certain limitations that cause them not to be described in section 274(h)(6)(C)(i). Rev. Rul. 2007-28, 2007-18 I.R.B. 1039. Section 274(h) restricts the deduction for expenses allocable to conventions and similar meetings held outside the North American area, and section 274(h)(6) defines the North American area to include certain Caribbean countries that, among other things, have TIEAs with the United States that satisfy the requirements of section 274(h)(6)(C)(i). The IRS also has concluded that the TIEA with St. Lucia is not in effect for purposes of section 274(h)(6)(C)(i) because the government of St. Lucia has not enacted legislation to implement the agreement.

[657] The United States' first double tax convention was entered into in 1932 with France; it did not contain an exchange of information provision. Article XV of the U.S.-Sweden Double Tax Convention, signed on March 23, 1939, included the United States' first the exchange of information provision. This event was followed shortly by a second double tax convention with France, signed on July 25, 1939, which provided for the exchange of information in Article 26.

[658] The 1973 income tax treaty between the Union of Soviet Socialist Republics and the United States does not have an exchange of information provision. It still applies to the countries of Armenia, Azerbaijan, Belarus, Georgia, Kirgizstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan.

[659] This multilateral treaty entered into force in 1995. Members include Azerbaijan, Belgium, Denmark, Finland, France, Iceland, Italy, the Netherlands, Norway, Poland, Sweden, Ukraine and the United Kingdom. Canada and Germany have signed, but not ratified, this agreement. Although the United States is a member, it included the following reservations with its instrument of ratification deposited February 13, 1991:

> The United States will not provide any form of assistance in relation to the taxes of other parties described in subparagraphs b.i or b.iv of paragraph 1 of Article 2 of the Convention (taxes imposed by or on behalf of possessions, political subdivisions, or local authorities)(as permitted by paragraph 1.a of Article 30 of the Convention); The United States will not provide assistance in the recovery of any tax claim, or in the recovery of an administrative fine, for any tax, pursuant to Articles 11 through 16 of the Convention (as permitted by

In 2006, the U.S. Treasury Department adopted the current version of the U.S. Model Income Tax Convention (the "U.S. Model").[660] Article 26 of the U.S. Model establishes the obligation of each state to obtain and provide information to the other and provides assurances that information exchanged will be treated as secret in accordance with the same disclosure restraints as information obtained under the laws of the requesting state. Its provisions effectively override domestic bank secrecy laws and also require that information provided may be required to be in a form appropriate for use in a judicial forum. Article 26 does not require a state generally to: (a) carry out administrative measures that are at variance with the laws or administrative practices of either state; (b) supply information not obtainable under the laws or administrative practice of either state; or, (c) disclose trade secrets or other information in cases in which the disclosure of such information would be contrary to public policy. When information is requested by one state, the requested state is obligated to obtain the requested information as if the tax in question were the tax of the requested state, even if the requested state has no direct tax interest in the case to which the request relates.

In contrast to the bilateral double tax conventions, TIEAs are executive agreements entered into by Treasury without the advice and consent of the Senate and are limited in scope to the mutual exchange of information.[661] These agreements often are entered into with countries that impose little or no income tax. While the OECD adopted a model TIEA in 2002, the U.S. Treasury Department has not adopted a model TIEA but only has developed a working draft that remains under continuous review and revision and is not publicly available. The United States has entered into TIEAs with countries in the Caribbean and elsewhere.

The goals of the U.S. tax information exchange program are (a) assuring the accurate assessment and collection of taxes, (b) preventing fiscal fraud and tax evasion, and (c)

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paragraph 1.b of Article 30 of the Convention); and The United States will not provide assistance in the service of documents for any tax, pursuant to Article 17 of the Convention (as permitted by paragraph 1.d of Article 30 of the Convention); this reservation does not apply to the service of documents by mail, pursuant to paragraph 3 of Article 17 of the Convention.

[660] U.S. Department of the Treasury, *U.S. Model Income Tax Convention of November 15, 2006*, *available at* http://www.treasury.gov/offices/tax-policy/library/model006.pdf., updated an earlier model treaty published September 20, 1996. The Technical Explanation of the 1996t draft included a brief history of its provenance, explaining that it was drawn from a number of sources, including the U.S. Treasury Department's draft Model Income Tax Convention published on June 16, 1981, and withdrawn as an official U.S. Model on July 17, 1992, the Model Double Taxation Convention on Income and Capital, and its Commentaries, published by the OECD, as updated in 1995 (the "OECD Model"), existing U.S. income tax treaties, recent U.S. negotiating experience, current U.S. tax laws and policies and comments received from tax practitioners and other interested parties. U.S. Department of the Treasury, *U.S. Model Income Tax Convention: Technical Explanation* (September 20, 1996), *available at* 96 *Tax Notes Today* 186-7.

[661] Section 274(h)(6)(C); see also *Barquero vs. United States*, 18 F.3d 1311, 1314-15 (5th Cir. 1994); Congressional Research Service, *Treaties and Other International Agreements: the Role of the United States Senate, A Study Prepared for the Committee on Foreign Relations, United States Senate*, *Library of Congress* (January, 2001), S. Prt. 106-71.

developing improved information sources for tax matters in general.[662] With respect to the United States, taxes covered generally are limited to national taxes, such that state and local taxes are not covered. The objective of a TIEA is to promote international cooperation in tax matters (civil and criminal) through exchange of information. A State must have adequate process for obtaining information; if the State is required to enact measures providing such process, then the entry into force of the TIEA may be delayed until such requirements have been met.[663] The requirements of the TIEA often require a State to override its domestic laws and practices pertaining to disclosure of information regarding taxes.

To administer its obligations under the network of bilateral treaties, the Secretary of the Treasury has delegated the role of U.S. Competent Authority for the treaties to the Deputy Commissioner, International, IRS. The Competent Authority is responsible for resolving disputes with the other contracting state about the scope or interpretation of the treaty. With respect to exchange of information articles, the Competent Authority determines whether the agency should present a request for information to a treaty partner as well as how to respond to any requests that it receives from the treaty partner. All information exchanged flows through the offices of the Competent Authorities,[664] and is safeguarded by the domestic laws of each state as well as the secrecy clause in the exchange of information article. In the United States, the information received from a treaty partner is within the scope of "Tax convention information"[665] and, if it is taxpayer-specific, is also treated as "return information"[666] for purposes of protecting it from disclosure. Nonspecific information received from a partner is also protected from publication if its disclosure would harm tax administration, as determined by the Competent Authority in consultation with his counterpart.[667] Since the entry into force of the first treaty to include an exchange of information article, the United States has exchanged information with its partners in a variety of ways.[668] The principal types of information

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[662] Treasury Department News Release R-2780 (July 24, 1984), reprinted in Richard A. Gordon and Bruce Zagaris, *International Exchange of Tax Information: Recent Developments* (1985).

[663] For example, the Liechtenstein TIEA provides that it is not effective until each state has notified the other that it has completed the necessary internal procedures required for entry into force (Article 15), including any changes or additions to domestic laws necessary to give effect to the agreement, and that such changes or additions to domestic law must be enacted by December 31, 2009 (Article 13). No list of the changes that must be made to the Liechtenstein laws for this purpose was published, but it is likely that Liechtenstein bank secrecy laws must be changed to give effect to the TIEA.

[664] In the United States, the requests are initially received by Tax Attaches, or, in the case of France or Canada, the Exchange of Information Team program analysts in Washington. I.R.M. par. 4.60.1.1(6)(b).

[665] Sec. 6105(c)(1).

[666] Sec. 6103(a)(2)

[667] Sec. 6105.

[668] In calendar year 2007, the United States made 1,429,499 disclosures of information to foreign countries under the exchange of information program. *See,* Joint Committee on Taxation, *Disclosure Report for Public Inspection Pursuant to Internal Revenue Code Section 6103(p)(3)(C) for Calendar Year 2007* (JCX-47-08), June 3, 2008, p. 3.

exchanges are generally referred to as routine, spontaneous,[669] or specific exchanges.[670] In addition, there are industry-wide exchanges with certain treaty partners, and simultaneous examinations or criminal investigations with other partners.

A "routine exchange of information" is one in which the contracting states have agreed that a category of information will be shared with one another on an ongoing basis, without the need for a specific request because it is of a type that is consistently relevant to the tax administration of the receiving jurisdiction. Information that is automatically shared under this authority may include information that is not taxpayer specific, such as news about changes in domestic tax legislation, or it may comprise voluminous taxpayer filings, such as magnetic disks containing the information from Forms 1042-S, relating to U.S.-source fixed or determinable income paid to persons claiming to be residents of the receiving treaty country. The type of information, when it will be provided and how frequently, are typically determined by the respective Competent Authorities after consultation. The information will then be automatically provided. OECD has developed standards for the electronic format of such exchanges, to enhance their utility to tax administration.[671]

The international steps taken to standardize the information exchanged and improve its usefulness are a positive development, but there remain numerous shortcomings, both practical and legal, in the routine exchange of information. Chief among them is the lack of taxpayer identification numbers ("TINs") in the information provided under the exchange, despite the recommendation of the OECD that member states provide such information.[672] Ideally, the information received by the IRS should either include a TIN or be subject to a process referred to as "TIN perfection" to enable the IRS to correlate account data in the information received with a

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[669] A "spontaneous exchange of information" occurs when one contracting state is in possession of an item of information that it determines may be of interest to the other contracting state for the tax administration of that other state. In such an instance, the first state will spontaneously provide the information to the treaty partner. In the United States, such information would typically be identified by a revenue agent or other employee, who would forward the information to the U.S. Competent Authority to decide whether the information should be forwarded to the foreign jurisdiction. Information spontaneously provided by a treaty partner to the United States is generally reviewed by the Exchange of Information program analyst or Tax Attache who first receives it, who then forwards it to an appropriate field office for further action and follows up to determine the outcome of the exchange.

[670] A "specific exchange" is a formal request by one contracting state for information that is relevant to an ongoing investigation of a particular tax matter. These cases are generally taxpayer specific. Those familiar with the case prepare a request that explains the background of the tax case and the need for the information. That request is forwarded to the Competent Authority, who determines whether to issue the request. If he determines that it is an appropriate use of the treaty authority, he forwards it to his counterpart. When a contracting state receives a specific request for information, it is obligated to use its powers to obtain the information to the same extent that it would do so if it were a domestic case, even if the information obtained could not be used in a domestic case.

[671] See OECD, Committee on Fiscal Affairs, *Manual on the Implementation of Exchange of Information Provisions for Tax Purposes*, Module 3(January 23, 2006) ("OECD Exchange Manual").

[672] OECD Exchange Manual refers to a recommendation dating to 1997, "Recommendation on the use of Tax Identification Numbers in an International Context" C(97)29/FINAL (1997).

valid TIN in its taxpayer databases.[673] Such an undertaking is time-consuming and costly. Other practical hurdles that limit its value are the lack of timeliness of its production, the fact that the data may not readily conform to U.S. taxable periods, the need to translate the language of the documents and the currencies, and its voluminous nature.[674] An adequate cost/benefit study of various means of strategically using the information is needed.

Despite the likelihood that the information exchanged would readily establish whether a U.S. person with a foreign financial account had complied with FBAR, it cannot easily be used for that purpose. The practical limitations described above are exacerbated by the legal barriers to use of the information, under the treaty as well as under domestic statutes. The treaty information may only be used for a purpose consistent with the treaty. The FBAR penalties arise under Title 31 of the United States Code and are not generally within the scope of the taxes covered by the tax treaties.[675] As a result, the treaty may prevent sharing the information with those who investigate FBAR compliance. Even if the FBAR penalties are within the scope of the treaty, domestic legislation could prevent use of the information. If foreign account information received under the treaty can be associated with a specific taxpayer's income tax accounts, it becomes tax return information, subject to the provisions of section 6103.[676] Under section 6103, the information may be disclosed for "tax administration" purposes, as determined on a case-by-case basis. However, both the OECD Convention on Mutual Assistance in Tax Matters (in Article 4) and the OECD Model Convention (in Article 26) allow for the use of information obtained under a treaty for nontax matters, such as FBAR violations, money laundering, and corruption, if the country supplying the information consents to such use. The U.S. TIEA with Liechtenstein and the proposed treaty with Malta (signed in 2008, but not yet ratified) include provisions that allow the use of information exchanged for other purposes if the country providing the information consents to such other use and the provisions of an MLAT between the two countries allows for the exchange.

The treaty partners may also work together to gain expertise about specific industries and to facilitate sharing of information when there is a common interest in the information. In those instances, they may arrange a meeting of agents or officials familiar with a particular industry or economic sector to share experiences, know-how, investigative techniques, and observations about trends in that industry. These discussions do not generally address the cases of specific taxpayers. Both the industry-wide meetings and the simultaneous examinations occur under the

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[673] Letter from Commissioner, IRS to Chairman, Senate Finance Committee (June 12, 2006), 2006 *Tax Notes Today* 115-17.

[674] *Ibid.*

[675] Article 26 of the U.S. Model provides that "The exchange of information is not restricted by paragraph 1 of Article 1 (General Scope) or Article 2 (Taxes Covered)." In any treaty including that provision, an FBAR penalty could be the predicate for exchange of information if it is considered to be related to tax administration. However, that language is not in all treaties currently in force, and its absence suggests that the permitted exchanges would be limited to the taxes covered in such treaties.

[676] Article 26, paragraph 2, of the U.S. Model provides that information exchanged will be treated as secret in accordance with the same disclosure restraints as information obtained under the laws of the requesting State.

auspices of the exchange of information program; they are not in lieu of formal exchanges. They establish a process by which extensive exchanges of information can occur, with the assistance of an Exchange of Information analyst or Tax Attache.

Several of the treaties also provide that treaty partners will provide administrative assistance under a mutual assistance article in the tax treaties. The United States has specifically agreed to provide mutual assistance in collection of the taxes to five treaty partners: France, Canada, Sweden, Denmark, and the Netherlands. The United States does so under its Mutual Assistance Collection Program ("MCAP").[677] It also provides assistance in criminal tax matters via the MLATs. Unlike the tax treaties, MLATs designate the Department of Justice as the "Central Authority" having the role of administering the treaty on behalf of the United States.[678]

As part of its obligations under its treaties, the United States has successfully defended its efforts to honor its treaty obligations against a variety of challenges. These challenges have included suits seeking to obtain publication of information received under treaty exchanges, objections to enforcement of administrative summonses and finally, an attempt to claim that the disclosure to another tax administrator was negligent. The United States successfully protected the secrecy of certain information in internal memoranda, including the identity of the treaty partner that had communicated with the IRS.[679] The need to safeguard the secrecy of the information to protect the working relationship of the treaty partners was sufficient reason to sustain the government position that documents from meetings of Competent Authorities are entitled to treaty protection.[680]

The IRS does not require that an institution applying to become a QI provide information regarding bank secrecy or other laws that could apply in a foreign jurisdiction to restrict disclosure of the institution's customers to the IRS or otherwise affect the IRS's ability to enforce the terms of the QI agreement. Instead, Announcement 2000-48 stated that the IRS expected to apply more rigorous oversight to financial institutions or their branches in jurisdictions that are tax havens or bank secrecy jurisdictions and show an unwillingness to cooperate with the United States to reform their practices relating to transparency and the provision of tax information. In addition, the Announcement indicated that QIs should not assume that, merely because they have an agreement covering a business in a particular jurisdiction, such jurisdiction would not later be identified as a specified tax haven or secrecy jurisdiction. However, Announcement 2000-48 indicated that any enhanced audit requirements or stricter enforcement standards would be imposed only on agreements entered into or renewed after identification of the jurisdiction as a specified tax haven or secrecy jurisdiction.

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[677] See I.R.M. Pars. 11.3.25.5 and 11.3.25.6.

[678] See I.R.M. Pars. 11.3.28.3.2.

[679] *Tax Analysts v. Internal Revenue Service*, 152 F. Supp. 2d 1, 9 (D.D.C. 2001), *rev'd in part on other grounds*, 1 2002 WL 1300028 (D.C. Cir. 2002). Congress enacted section 6105, which explicitly provides that information obtained under a treaty and not taxpayer-specific is nevertheless protected information.

[680] *Tax Analysts v. Internal Revenue Service*, 217 F. Supp. 2d 23 (D.D.C. 2002).

Announcement 2000-48 further stated that the IRS expected that it would agree to renew a QI agreement or, in the case of new agreements that become effective on or after January 1, 2004, enter a new agreement for QIs in a particular country only if the IRS receives a certification from the Treasury Department that the country has effective rules and/or procedures for providing tax information to the United States for both civil tax administration and criminal tax enforcement purposes (including, for example, under an income tax treaty or a tax information exchange agreement), or has taken significant steps towards achieving such effective provision of information. The actions taken by the Treasury Department and IRS in connection with the execution of a TIEA with Liechtenstein, and which are described further below, are consistent with this approach.

C. **Attempts to Develop a Multilateral Solution**

At the conclusion of the June 2009 G8 Meeting, the Finance Ministers issued a statement expressing support for efforts to improve tax information exchange and transparency:

> We welcome progress in negotiations of agreements on the exchange of information for tax purposes. We urge further progress in the implementation of the OECD standards and the involvement of the widest possible number of jurisdictions, including developing countries. It is also essential to develop an effective peer-review mechanism to assess compliance with the same standards. This could be delivered by an expanded Global Forum. We also look forward to an update on progress on the G20 agreement to tackle tax havens at the next OECD Ministerial meeting.[681]

To the extent that there is less than near universal acceptance of any emerging norms on the desirability of greater exchange of information, countries that are implementing international standards on exchange of information are understandably concerned that capital for investment will flow to noncompliant jurisdictions. The development of international norms in recent years owes a great deal to the work done on transparency and exchange of information by the OECD Global Forum on Transparency and Exchange of Information (the "Global Forum"), begun in 1996. In response to criticism that the OECD did not adequately address the interests of developing or emerging economies,[682] the United Nations has also taken a more active role in this process in recent years through a new organization to address international tax cooperation, which is discussed below.

OECD standards

The OECD lists the following key principles as its standards for transparency and effective exchange of information:

- Existence of mechanisms for exchange of information upon request;
- Exchange of information for purposes of domestic tax law in both criminal and civil matters;
- No restrictions of information exchange caused by application of dual criminality principle or domestic tax interest requirement;
- Respect for safeguards and limitations;
- Strict confidentiality rules for information exchanged; and

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[681] Statement of G8 Finance Ministers, Lecce, Italy, 13 June, 2009.

[682] David Spencer, "The UN: A Forum for Global Tax Issues? (Part 1)," *Journal of International Taxation* 17 (2006), p. 42, describes how the 1998 OECD strategy against harmful tax competition, which included naming havens and threatening sanctions if agreement to OECD standards was not forthcoming, had the effect of galvanizing cooperation among the havens acting in their mutual self-interests.

- Availability of reliable information (in particular bank, ownership, identity and accounting information) and powers to obtain and provide such information in response to a specific request.[683]

OECD Model Tax Convention on Income and Capital

The information exchange provisions in the current OECD Model Tax Convention on Income and Capital (the "OECD Model")[684] generally correspond to the first five paragraphs of Article 26 of the U.S. Model.[685] At the time the OECD Model was approved, several member countries expressly reserved with respect to paragraph 5 of Article 26 (prohibiting a requested State from declining to supply information because that information is held by a bank, other financial institution, nominee, or person acting in an agency or fiduciary capacity, or because it relates to ownership interests in a person). These members were Austria, Switzerland, Luxembourg, and Belgium, all of which have bank secrecy laws. Notably, each of these countries has recently withdrawn its reservation and announced its intention to adopt OECD standards for the exchange of tax information and transparency.[686]

OECD Model TIEA

In 2002, the OECD released its Agreement on Exchange of Information on Tax Matters (the "OECD Model TIEA"), together with commentary (the "Commentary"). The OECD Model TIEA was developed by the OECD Global Forum Working Group on Effective Exchange of Information, which consisted of representatives from OECD Member countries as well as delegates from Aruba, Bermuda, Bahrain, Cayman Islands, Cyprus, Isle of Man, Malta, Mauritius, the Netherlands Antilles, San Marino, and the Seychelles.[687] It represents the standard of the effective exchange of information for purposes of the OECD's initiative on harmful tax practices,[688] but does not seek to prescribe the precise format for achieving this standard.[689]

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[683] OECD, *Tax Cooperation: Towards a Level Playing Field, 2008 Assessment by the Global Forum on Taxation,* p. 8.

[684] OECD Model Tax Convention on Income and Capital revised and approved on July 17, 2008.

[685] Paragraph 1 of the OECD Model provides, however, for the exchange of information imposed on behalf of each respective state, or "of their political subdivisions or local authorities." In contrast, the U.S. Model is silent with respect to taxes imposed by political subdivisions and local authorities and the technical explanation specifically states that the Article 26 applies with respect to "taxes of every kind applied at the national level." The OECD Model does not incorporate paragraphs 6 through 9 (described below) of the U.S. Model.

[686] Randall Jackson, Kristen A. Parillo, and David D. Stewart, "Tax Havens Agree to OECD Standards," *Tax Notes Int'l* (March 23, 2009), p. 1027.

[687] OECD Model TIEA, Introduction, paragraph 2.

[688] OECD Model TIEA, Introduction, paragraph 3.

[689] OECD Model TIEA, Introduction, paragraph 6.

The OECD Model TIEA provides only for exchange upon specific request.[690] In addition, it abrogates the principle of dual criminality,[691] often relied upon by uncooperative jurisdictions to avoid exchanges, by providing that information requested with respect to a criminal matter must be exchanged without regard to whether the conduct under investigation would constitute a crime under the laws of the requested State.[692] It further prohibits banks, other financial institutions, and any person acting in an agency or fiduciary capacity, including nominees and trustees, from claiming the right of privilege as the basis for declining an information request–unless the provisions of Article 7 (Possibility of Declining a Request) apply. This paragraph also effectively prevents any claim that bank secrecy should be considered protected as a matter of public policy for purposes of Article 7[693]–which, as noted in the Commentary, should only be invoked in extreme cases, such as an information request motivated by political or racial persecution.[694]

OECD Progress Report

On April 2, 2009, in conjunction with the G20 meeting in London, the OECD issued a progress report on the 84 jurisdictions that participate in the Global Forum in Implementing the Internationally Agreed Tax Standard. The progress report divides countries into three categories: those that have substantially implemented the internationally agreed tax standard, those that have committed to the standard but have not yet substantially implemented the standard, and those that have not committed to the standard. The progress report tracks the progress of jurisdictions in implementation of the OECD standards as evidenced by the number of treaties or TIEAs to which the jurisdiction is a party that meet the standards as outlined above. As of the latest report, dated August 24, 2009, all jurisdictions surveyed have committed to the standard.[695]

At the time of the progress report, the G20 also announced a commitment to develop a "toolbox of effective countermeasures" for consideration. These measures to be considered included increased disclosure requirements on the part of taxpayers and financial institutions to report transactions involving noncooperative jurisdictions; withholding taxes in respect of a wide variety of payments; denying deductions in respect of expense payments to payees resident in a noncooperative jurisdiction; reviewing tax treaty policy; asking international institutions and

[690] OECD Model TIEA, Article 5 (Exchange of Information Upon Request).

[691] The principle of dual criminality derives from the law regarding extradition and grounds for refusal to grant a request. Extradition is generally permitted only if the crime for which a person is to be extradited is treated as a similarly serious offense in the state in which the fugitive has sought refuge. *Restatement (Third) of the Foreign Relations Law of the United States*, sec. 476 (1987). The principle is relevant to a request for exchange of tax information only if the treaty in question limits the scope of its permitted exchanges to criminal tax matters.

[692] Commentary to OECD Model TIEA, Article 5, paragraph 1, at (¶39-40).

[693] Commentary to OECD Model TIEA, Article 5, paragraph 4, at (¶46).

[694] Commentary to OECD Model TIEA, Article 7, paragraph 4, at (¶91).

[695] OECD, *A Progress Report on the Jurisdictions Surveyed by OECD Global Forum in Implementing the Internationally Agreed Tax Standard* (August 24, 2009), available at http://www.oecd.org.

regional development banks to review their investment policies; and, giving extra weight to the principles of tax transparency and information exchange when designing bilateral aid programs.[696] In advance of the G-20 Summit to be held in Pittsburgh, Pennsylvania on September 24 and 25, 2009, the finance ministers and central bank governors of the G-20 countries issued a declaration calling for, among other things, (1) an effective program of peer review and other measures to address governments' failures to comply with financial regulatory and tax information exchange standards, including the possible use of countermeasures against identified tax havens starting in March 2010 and (2) an effort to ensure that developing countries benefit from tax transparency, possibly including through a multilateral instrument.[697]

The OECD Forum on Tax Administration ("FTA") held its fifth meeting on May 28-29, 2009. The FTA vision is "to create a forum through which tax administrators can identify, discuss and influence relevant global trends and develop new ideas to enhance tax administration around the world."[698] In the communiqué issued at the conclusion of the meeting, the members indicated their commitment to look for new ways to co-operate with each other and increase their collective actions.[699] At a press conference following the meeting, the participants acknowledged the global nature of tax noncompliance and agreed that there needs to be coordination among nations. The FTA provides tax administrators a forum for sharing information and for developing common strategies for combating tax evasion.

The OECD Global Forum on Transparency and Exchange of Information held a meeting in Mexico City on September 1 and 2, 2009 with the objective of establishing a monitoring and peer review process.[700] The concept of "peer review" has been endorsed by the G20, and this

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[696] G-20 Heads of State, "Declaration on Strengthening the Financial System," April 2, 2009.

[697] G-20, Meeting of Finance Ministers and Central Bank Governors, "Declaration on Further Steps to Strengthen the Financial System," London, September 4-5, 2009. The declaration came shortly after German Chancellor Angela Merkel, U.K. Prime Minister Gordon Brown, and French President Nicolas Sarkozy argued in a September 3 letter that at the Pittsburgh summit G-20 leaders should agree on a comprehensive list of countermeasures that could be implemented starting March 2010 against jurisdictions that failed to satisfy international standards on the exchange of information. See Charles Gnaedinger, "EU Powers Seek G-20 Discussion of Tax Haven Countermeasures," Tax Analysts Document No. 2009-19828.

[698] OECD Forum on Tax Administration, Fifth Meeting, *FTA Communique*, p. 7 (May 29, 2009).

[699] *Ibid*., p. 2. The FTA agreed to continue 1) to work together to improve tax administration, taxpayer services and tax compliance - both nationally and internationally (including undertaking further work to share information and expertise to enable revenue bodies to prevent, detect and respond to non-compliance, including in relation to offshore arrangements); 2) to promote strong corporate governance in the area of tax (with a view to ensure tax compliance is included as an aspect of good corporate governance); and 3) to support tax administration in developing economies (sharing relevant FTA products, experience and expertise).

[700] The Global Form agreed to form a Peer Review Group to develop the methodology and detailed terms of reference for a robust, transparent and accelerated process. The peer review will be in two phases. Phase 1 will examine the legal and regulatory framework in each jurisdiction, will commence in 2010, and will be completed for all members within the initial three-year mandate. Phase 2 will evaluate the implementation of standards in practice and will also commence in 2010. Other objectives of the meeting included (1) agreeing on restructuring the OECD Global Forum to expand its membership and to ensure its members participate on an equal footing, and (2) identifying mechanisms for speeding the negotiation and conclusion of agreements to exchange information and for enabling developing countries to benefit from the new more cooperative tax environment. OECD Centre for Tax

process will focus on international agreements, domestic legal framework, and exchange of information in practice.

The recent announcements by jurisdictions previously reluctant to commit to OECD standards of transparency suggests that political tolerance for shielding tax avoidance from exposure has been exhausted. The United States has recently concluded agreements with Liechtenstein, signed on December 8, 2008, and with Gibraltar, signed March 31, 2009.[701] The agreement with Gibraltar is its first such agreement. In addition, the United States and Luxembourg signed a protocol amending the U.S.-Luxembourg treaty to conform that treaty with the exchange of information article in the U.S. model.[702] The U.S. has announced the initialling of a protocol with Switzerland providing for exchange of information in accordance with OECD standards."[703] The network of exchange of information has expanded substantially, with over 20 TIEAs signed in 2008 and 25 in 2009.[704]

<u>OECD initiatives</u>

In 2006, the OECD's Committee on Fiscal Affairs established the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors ("ICG") to address barriers that affect the ability of portfolio investors to effectively claim treaty benefits.[705] The ICG published a report in early 2009 that identified many of the same problems that led to the establishment of the QI program in the United States, namely that a domestic withholding agent has difficulty obtaining and presenting resident documentation for beneficial owners when that owner may be several layers removed from the withholding agent, and that passing documentation up through intermediaries is inconsistent with

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Policy, Summary of Outcomes of the Meeting of the Global Forum on Transparency and Exchange of Information for Tax Purposes Held in Mexcio on 1-2 September 2009, (September 2, 2009), available at http://www.oecd.org/dataoecd/44/39/43610626.pdf.

[701] Signed on December 8, 2008, the Liechtenstein TIEA requires each State to provide information that is foreseeably relevant to either a civil or criminal tax matter. Although Liechtenstein has publicly stated that it still retains the right for a Liechtenstein court to decide the legitimacy of the request from the United States, there are no unique terms in the Liechtenstein TIEA that provide for any extraordinary review beyond the "foreseeably relevant" standard. As a result of Liechtenstein entering into this TIEA, the U.S. has agreed to extend Liechtenstein's treatment as an eligible QI jurisdiction until December 31, 2009; prior to this agreement, that status was set to expire on December 31, 2008. According to the terms of the TIEA, Liechtenstein must change its banking secrecy laws that prevent it from complying with the agreement; specifically, Article 13 of the TIEA states: "Legislation necessary to comply with and give effect to the terms of this Agreement shall be enacted by December 31, 2009, to the extent necessary."

[702] U.S. Treasury Press Release, TG- 143, May 21, 2009.

[703] Treasury Press Release TG-177 (June 19, 2009).

[704] OECD, *OECD's Current Tax Agenda*, p. 16 (2009).

[705] OECD, *Report of the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors on Possible Improvements to Procedures for Tax Relief for Cross-Border Investors* (January 12, 2009) (hereafter the *ICG Report*).

the intermediary's goal of protecting customer information. Additionally, some countries' legal systems do not address the existence of intermediaries and may treat a nominee owner as the beneficial owner, some countries do not provide relief at source, and some countries require multiple tax declarations and notarized documentation. The result is that the burdensome tax procedures up and down chains of intermediaries to achieve treaty benefits are unlikely to be followed.

The ICG Report provides recommendations regarding best practices for implementing an authorized intermediary program which draw on various models including the U.S. QI program and the Japanese "qualified foreign intermediaries" system.[706] The ICG Report claims that a major benefit of these systems is that beneficial ownership information is maintained at the bottom of the chain allowing facilitation of treaty benefits without disclosure of proprietary customer information to potential competitors.

The preferred method for providing treaty benefits is to provide relief at source, or when that is not possible, at least to consider measures making refund systems more efficient. The ICG Report recommends allowing authorized intermediaries to claim treaty benefits on behalf of customers on a pooled basis similar to the current U.S. QI pooled reporting. Although the ICG Report recommends the pooling approach, it recommends that investor-specific information be provided to the source country that would then have information available for automatic exchange of information programs. It is recommended that information reporting be enhanced through increased use of TINs. Additionally, the ICG Report recommends moving away from requiring certificates of residence to a system that relies on self-declarations. The authorized intermediaries would be authorized by the tax authorities of the source country through a contract with that country that includes specific and detailed procedures for establishing investors' eligibility for treaty benefits. The work and international discussions to date on important elements of a reliable financial intermediary system are incomplete. In particular, further development is necessary on topics such as acceptable documentation, due diligence, procedures, and guidelines for independent review, as well as issues of liability and accountability.

<u>United Nations</u>

The United Nations work on tax matters was generally conducted through an ad hoc group of tax experts under the Economic and Social Council of the United Nations until 2004. In that year, the ad hoc group was reorganized as the United Nations Committee of Experts on International Cooperation in Tax Matters ("U.N. Tax Experts") in response to a report (the "McIntyre Report") issued by the ad hoc group, "Institutional framework for international tax cooperation."[707] The McIntyre Report identified the need for a permanent body with staff and

[706] The Depository Trust Company, a U.S. clearing organization, also has arrangements in place with over a dozen countries wherein the governments provide either relief at source or an accelerated refund procedure in exchange for the Depository Trust Company providing pooled information regarding entitlement to treaty and domestic law tax relief on dividends or interest.

[707] Michael McIntyre, "Institutional framework for international tax cooperation," report to U.N. Ad Hoc Group of Experts on International Cooperation in Tax Matters, 11th meeting, Geneva, 15-19 (December 2003).

budget to enable it to address concerns of smaller or developing economies. While recognizing the expertise and influence of the OECD, the McIntyre Report observed that developing countries were generally unable to participate in the OECD except as observers, thus contributing to a perception that those states were disenfranchised and undermining their acceptance of the legitimacy of standards attributable to work by the OECD. The new organization would build on existing work of the ad hoc group, but with the express purpose of giving voice to developing countries and to countries with transitional economies (in general, those moving to market-based policies) while respecting the work going on in other forums such as the OECD. It would serve an ancillary role as clearing house for information on tax techniques, provide a list of international tax experts to advise transitional economies, and offer workshops for developing countries. It has met annually since its reorganization.

The United Nations has also adopted a model tax convention, updated in 2001–U.N. Model Income and Capital Tax Convention ("U.N. Model").[708] As adopted in 2001, Article 26 provided for exchange of information "in particular for the prevention of fraud or evasion of such taxes" and requires the competent authorities to consult to determine how to do so, while safeguarding information. Commentary to the U.N. Model said that the OECD standards were intended to be incorporated in the U.N. Model in substance, although it did not specifically address the use of domestic bank secrecy as a basis for refusing to exchange information.[709] In late 2008, the U.N. Tax Experts committee approved revisions to Article 26 for inclusion in the next version of the U.N. Model that make it clear that domestic bank secrecy rules are not a basis for a treaty partner to refuse to respond to a request for information.[710] A principal difference between the U.N. and either the OECD or U.S. models is its inclusion of certain provisions, outside of Article 26, that are crafted to provide a suitable template for agreements with developing countries.[711] The standards of transparency reflected in the current U.N. Model are accepted by the G-20 as consistent with international standards.[712]

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[708] 2008 U.N. Model Income and Capital Tax Convention, 2001 WTD 116-41; Doc 2001-16597. Its predecessors include the initial model tax treaty to eliminate double taxation, developed under the auspices of the League of Nations in 1928.

[709] Comment 1, U.N. Model Tax Convention Commentary, Article 26, p. 356 states,

> Article 26 of the United Nations Model Convention reproduces Article 26 of the OECD Model Convention with three substantive changes in paragraph 1, namely, the insertion of the phrase "in particular for the prevention of fraud or evasion of such taxes" in the first sentence, the insertion of the phrase "However, if the information is originally regarded as secret in the transmitting State" in the fourth sentence and the addition of a new sentence (sixth and last sentence). The latter sentence is the key to the approach advocated by the Group; it would stress the importance of the competent authorities in implementing fully the provisions on the exchange of information and will give them the necessary authority.

[710] United Nations Committee of Experts on International Cooperation in Tax Matters, *Report on the Fourth Annual Session*, (Geneva, Switzerland, October 20-24, 2008) E/29008/45, E/C.18/2008/6).

[711] For a comparison of the U.N. and OECD models, see Bart Kosters, "The United Nations Model Tax Convention and Its Recent Developments," *Asia-Pacific Tax Bulletin* (January/February 2004).

[712] G-20 Heads of State, *Declaration on Strengthening the Financial System* (April 2, 2009), stating "We call on countries to adopt the international standard for information exchange endorsed by the G-20 in 2004 and

Joint International Tax Shelter Information Centre

The United States is a member in a multilateral group that formed to combat tax evasion and abusive transactions. That group, the Joint International Tax Shelter Information Centre ("JITSIC") was founded in 2004, and established an office in Washington, D.C. In addition to the United States, the original members were Australia, the United Kingdom, and Canada. Each member has a bilateral treaty with each other member, permitting a free exchange of best practices and observations. If there is sufficient commonality in an issue or a specific taxpayer, there are procedures to conduct a simultaneous examination that will involve significant cooperation between the participating tax administrations. The success of this initiative led to its expansion in 2007, when Japan became a member and a second office was established in London, England. China previously participated as an observer at JITSIC, and South Korea will be an observer this year. As membership has grown and the program has matured, the scope of issues that JITSIC addresses has also expanded. It now explicitly includes offshore arrangements, high-net worth individuals, tax administration, and transfer pricing.[713] The Commissioner has also announced that JITSIC countries will perform joint audits, in an effort to more effectively and efficiently process issues of common interest.

European Union

In its foundational documents, the European Union ("EU") established access to information and transparency as important principles.[714] Since then, it has made several attempts to address the perceived evasion of direct taxes (e.g., income taxes) facilitated by bank secrecy laws of its member states and others. Its work on the problem has led it to the conclusion that the issues are not susceptible to resolution at the member state level, and require resolution at the EU level. In recent years, its approach has focused on harmonizing direct taxes on savings, and modernizing the ways in which administrative assistance is provided. The current economic crisis has added urgency to those efforts.

Following the G-20 summit in London, the European Commission published its views on good governance relating to tax matters. It identified the following elements of good governance: transparency, exchange of information, and fair tax competition, consistent with the statements of the EU Finance Ministers earlier.[715] With respect to the first principle, it endorsed

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reflected in the UN Model Tax Convention." The statement from 2004 in turn adopted the OECD standards. G-20, *Statement on Transparency and Exchange of Information for Tax Purposes* (November 21, 2004).

[713] Jeremiah Coder, "Exam Coordination and Information Sharing Are Crucial, International Officials Say," 2009 *Tax Notes Today* 89-13 (May 12, 2009), reporting comments of the U.S. and Canadian competent authorities before the Tax Section of the American Bar Association meeting in Washington, D.C.

[714] "Declaration on the right of access to information," *Treaty on European Union*, entered into force November 1, 1993, OJ C. 191, 29 July 1992 [hereinafter Maastricht Treaty]. ("O.J.C." refers to the Official Journal of the EU for Information and Notices, in contrast to O.J.L., which is the Official Journal of EU Legislation.)

[715] Commission of the European Communities, "Promoting Good Governance in Tax Matters" (April 28, 2009) COM(2009) 201 final ("EU Good Governance").

changes to corporate law and prudential regulations. It endorsed peer reviews as the mechanism to ensure fair tax competition. In support of improved exchange of information, it pointed to its work to modernize its directives on taxation of savings income and administrative assistance on tax matters. Both of these measures are described in greater detail below.

In addition to recommending that work on EU internal initiatives continue, the EU Good Governance statement recommended that the EU explore EU-level arrangements with third countries consistent with the principles of good governance, both with established financial centers such as Hong Kong, Macao, and Singapore, and with countries eligible for development aid.[716]

European Union Savings Directive

With respect to harmonizing the taxation of savings, the EU Savings Directive and the recent proposal to amend that directive are critical.[717] The Directive requires either automatic exchange of information or withholding tax for interest-bearing accounts held by a national of another member state. Pending amendments would improve transparency with respect to the ultimate beneficial owners of entities from certain jurisdictions perceived to be susceptible to abuse, including U.S. Virgin Islands, Delaware, and Nevada;[718] clarify when a paying agent can be charged with knowledge that a payment will be forwarded to another entity; expand the scope of the directive to cover financial instruments equivalent to those already covered; and prescribe certain procedural aspects to ensure that information exchanged pursuant to the directive is meaningful and timely.

In June 2003, the European Council issued a directive designed to ensure that all interest earned by a citizen of a member state from an account held in any other member state would be subject to a minimal direct tax ("Savings Directive"). A directive is a non-self-executing resolution of the European Council that member states must implement, whether by national legislation or regulatory action.[719] The Savings Directive is intended to ensure that interest income earned by a citizen of one jurisdiction from an institution in another jurisdiction is subject to tax by the citizen's jurisdiction of residence by requiring both information reporting by the financial institution to the residence jurisdiction and automatic exchange of such information

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[716] EU Good Governance, sec. 4.

[717] The proposed amendments were adopted by the Commission on November 13, 2008, and approved by the European Parliament after a single reading, with amendments, on April 24, 2009. The European Council is instructed to prepare and issue an amended directive consistent with the text approved by the Parliament. A6-0244/2009. A report of the Economic and Social Committee dated May 13, 2009, questioned whether the risk of capital flight and the administrative burdens are warranted unless third countries adopt reciprocal arrangements. CES0884/2009.

[718] As previously discussed, legislation has been introduced in the Senate to assist law enforcement in curbing the misuse of U.S. corporations and limited liability companies, including a requirement that persons forming such entities generally must identify their beneficial owners. S. 569, "Incorporation Transparency and Law Enforcement Assistance Act," 111th Congress, 1st Sess., (March 11, 2009).

[719] Maastricht Treaty, Article 249.

reports among the member states. Member states were required to implement the directive by July 1, 2005.

A special longer transition period was provided for the several member countries whose jurisdictions had bank secrecy. Belgium, Luxembourg, and Austria do not permit exchange of information without a specific request for information on a specific taxpayer. Instead of agreeing to automatic exchange of information, those jurisdictions agreed to act as withholding agents with respect to accounts in their jurisdictions. The taxing authorities in Belgium, Luxembourg, and Austria collect and pay over tax to the home jurisdiction of the account holder without identifying that account holder. Taxing authorities in the three jurisdictions are nevertheless entitled to receive the automatic exchange of information about their own citizens from the other states.[720] The recent amendments extend the transition period until the later of the end of 2014, the date that all member states and other identified jurisdictions, such as Hong Kong, Singapore, and the Channel Islands states, are in accord with OECD standards, or when the European Parliament unanimously concludes that the United States is committed to exchange of information upon request with all EU member states in accord with OECD standards.

During the transitional period, the members that do not participate in the automatic exchange are required to impose a tax of 15 percent (2005-2008), 20 percent (2009-2011), and 35 percent after June 2011, on interest payments received by EU residents from payers located in Austria, Belgium, or Luxembourg unless the account holders agree to the exchange of information related to their accounts.[721] Seventy-five percent of the withheld tax is then paid over to the countries in which the account holders reside. The recently approved amendments would reduce the portion that the withholding state may retain to 10 percent. The Savings Directive requires a report on the operation of the directive every three years; the recently approved amendments will also require a study by the end of 2010 comparing the relative advantages of automatic exchange and withholding tax.

Beneficial ownership

The need to address beneficial ownership arose because the Savings Directive, which currently requires reporting as to interest earned by individuals, could be easily circumvented by use of a legal entity organized in a non-EU country. Under the proposal, paying agents will be required to "look-through" legal entities organized in certain jurisdictions outside the EU and report with respect to any beneficial owners who are individuals residing in another EU member state. The determination of beneficial ownership will be made based on the application of the "know-your-customer" rules already applicable to the paying agent. By limiting the look-through only to certain entities and jurisdictions, overly broad reporting on business structures should be avoided. The list of non-EU jurisdictions that trigger these look-through requirements

[720] Council Directive 2003/48/EC of 3 June 2003, OJ L 157 (26-6-2003).

[721] Rules similar to the rules for Austria, Belgium, and Luxembourg apply under EU savings agreements with Andorra, Liechtenstein, San Marino, Monaco, and Switzerland and under bilateral agreements between individual EU states and the 10 dependent and associated territories of the United Kingdom and the Netherlands (Anguilla, Aruba, the British Virgin Islands, the Cayman Islands, Guernsey, the Isle of Man, Jersey, Montserrat, the Netherlands Antilles, and the Turks and Caicos Islands).

are provided in Annex I to the proposed protocol. Their inclusion in the list is based on the view that "appropriate taxation of interest income . . . is not ensured" in those jurisdictions[722] and is subject to review by the European Commission. Two States from the United States are among the jurisdictions listed–Nevada and Delaware.

Paying agents

In an attempt to clarify the responsibilities of the paying agent to avoid duplicative reporting, non-reporting, or inconsistent treatment of interest received from EU or non-EU countries, the proposal would replace Article 4, which defines "paying agent." Consistent with the need to apply know-your-customer rules in certain situations, as described above, a payment made to one of the entities listed in Annex I will be deemed to be payment to the beneficial owner; anyone making such a payment will be within the scope of the term. The new definition will require EU members to adopt national rules to avoid overlapping duties of paying agents. If the payment is made to another economic operator, the payor may be a paying agent if he has evidence that the payee will in turn pay the income to or for the benefit of a beneficial owner who is an individual resident in another member state. The concept of "paying agent upon receipt" with regard to payments made through intermediaries is clarified to provide that the recipient of such income may also be a paying agent, if the income received would not be subject to tax by the country in which its management is located. Pension funds and charities are not subject to this rule. Certain qualified investment funds described in the article defining interest are also exempt from the rule.

Debt equivalent financial instruments

Several steps are made to provide consistent treatment of financial instruments equivalent to debt. First, Article 6 is amended to define interest as income that is substantially equivalent to income from debt if, from an investor's point of view, the risk of the investment is known and is not higher than that of a debt claim. Such instruments would include financial instruments that, on date of issuance, define the terms for return on capital and satisfy certain thresholds ensuring repayment of the capital invested. Second, with respect to income from investment funds, the Commission proposal would have provided uniform treatment for such income by expanding the scope to include all collective investments in transferable securities, regardless of the form of the fund or scheme, if they are subject to registration or regulation within any EU member state. Income from funds organized outside the EU is already covered by the Savings Directive. The scope of this change has been scaled back by the recent amendments, and the extent to which any insurance contracts are covered is doubtful.

Procedural modifications

A number of procedural changes are also proposed to improve the usefulness of the information exchanged and to lessen the administrative burdens associated with the exchange. Paying agents will be expected to provide identities, residences, and the share of ownership for all beneficial owners of accounts and to distinguish between payments that represent full

[722] Explanatory Memorandum, Commentary Par. 2.1; Art. 1(11), amending Articles 18a and 18b.

proceeds of a sale or redemption or only gain or income. For those countries collecting and paying over a withholding tax in lieu of information exchange, the withholding procedures for the transition period will be amended to conform to the other changes proposed. In addition, the use of a certificate of nonresidence will no longer provide an exception to withholding tax. An owner of an account can avoid the withholding tax only by agreeing to exchange of information. New articles are proposed that will govern the technical aspects of exchange and withholding as well as the maintenance of the various annexes that identify jurisdictions and entities to which special rules or procedures are applicable. The amendments do not require use of a TIN, but if such information is available when the account is opened, the number is to be included in the information exchanged.

Mutual assistance in tax matters proposal

The development and implementation of the Savings Directive brought to light how badly the EU rules on mutual assistance in tax matters had fallen out of date. The existing rules have been in effect since 1977.[723] Studies by a working group on administrative cooperation in the field of direct taxation identified numerous problems with the existing Directive, both legal and practical, that were impeding the general efforts to combat tax fraud and to implement the Savings Directive in particular.[724] These problems include the existence of far more bilateral agreements than existed in 1977, creating a patchwork of conflicting obligations and standards among the member states, as well as the increase in the volume of cross-border activity since 1977. The Working Group, after consultation with member governments, determined that the nature of the problems required a uniform response that could be appropriately provided at the EU level rather than by the individual member states, without unfairly burdening any one member. Thus, the proposal would impose uniform standards for providing assistance for all taxes and refunds. Those standards include a commitment not to invoke bank secrecy as a basis for not responding to a request for assistance. Furthermore, the study identified the need to reconcile the various positions concerning the use of any information so exchanged, including whether it is subject to further disclosure to a third country, or in enforcement proceedings in the receiving state. The changed legal relationship among the member states within the European Union and the various innovations in electronic technology combined also support a broad revision of the outdated rules. Accordingly, the EU is now proposing a sweeping replacement of the 1977 directive in its entirety.[725]

[723] Directive on Mutual Assistance, 77/799/EEC, December 19, 1977. In addition to the work to harmonize taxation on savings income and to modernize mutual assistance programs, the EU is also taking steps to strengthen cooperation on indirect taxes. Such taxes are not relevant to this summary, and the related directives will not be discussed further.

[724] Council Working Party on fraud, May 2000 report (Document 8668/00); Commission Communications of 2004 and 2006, COM (2004)/611 final and COM(2006)254final, respectively.

[725] Proposal for a Council Directive on administrative cooperation in the field of taxation, COM(2009)29; 2009/0004/CNS February 2, 2009; awaiting decision by European Parliament, as of April 27, 2009. Interim proposals were discussed in Commission Communications in 2004 (COM (2004)611 final) and 2006 (COM (2006)254final).

The effort to improve and modernize mutual assistance would be accomplished by a current proposal to replace the existing directive on mutual tax administrative assistance. Among other things, that proposal would eliminate bank secrecy as a basis for refusing to provide assistance, would ensure that information provided could be used in enforcement proceedings, and would introduce a most favored nation status concept. This concept requires that a member state provide the same degree of cooperation to other members as it would to any partner in a bilateral agreement.

The proposal addresses both the practical and legal issues in a number of ways. First, it establishes a broad scope, in Chapter I. It will apply to both direct and indirect taxes (other than VAT and excise taxes),[726] and will be consistent with the existing regulations on VAT and excise taxes. It adopts as its model for cooperation the OECD Convention on Mutual Administration Assistance in Tax Matters.

Second, it prescribes a framework for the nature of any exchanges of information that may occur. It differs from the usual bilateral exchange of information, in that it imposes time limits within which members must respond to specific requests[727] and mandates systemic ("automatic") exchanges as to tax refunds and categories of income and capital to be identified by "comitology," a process that entails appointing an EU committee that develops secondary rules needed to implement the directive at a transnational level, and which could be subject to European Parliament veto. It permits nonsystemic ("spontaneous") exchanges of information that one member identifies as likely to be of interest to another member state. It also provides general guidelines for establishing joint inquiries, by agreement of the states, and for advising one another of significant developments in domestic administration that may be of consequence to the other state.

Among its most important provisions are the limits it places on the grounds for refusing to cooperate with the exchange provisions and the protection it prescribes for the information, but the exact working of those limitations remains to be seen. With respect to all types of exchanges, the proposed revisions limit the extent to which a state may argue that disclosure would be contrary to public policy and provide that lack of a domestic tax interest in the type of information sought is no longer an adequate reason to refuse to provide the information. The fact that the information is held by a financial institution is also not a basis for refusal, but the limitation is said to be "without prejudice" to the separately stated principle that a requested state need not do anything that would be contrary to its own legislation if done in its own tax investigation.[728] Therefore, if a state would bar collection of bank information for use in a

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[726] The explanatory memorandum accompanying the proposal explains that it is the intent of the revised proposal to ensure that the scope is now broad enough to cover all indirect tax, whether or not already covered by other EU legislation, such as the VAT Regulation 1798/2003 and Excise Tax Regulation 2073/2004. The discussion did not provide an example of an indirect tax other than VAT or excise tax.

[727] Information should be exchanged within six months of the request or sooner if the state already possesses the responsive information; a refusal or inability to respond should be relayed no later than one month of the request.

[728] Article 17, sec. 1 and Article 16, sec. 2.

domestic tax case, it seemingly could refuse to collect bank information needed to honor the exchange requirements, but only with respect to its own nationals. A state could comply with the automatic exchange of information as to foreign depositors without agreeing to provide information on its own citizens who may have tax debts in other states. In addition, the obligation to provide information is moot if cooperation would impose a disproportionate administrative burden or if the requesting authority has not exhausted its usual sources of information. The state that receives information in an exchange is entitled to use the information to enforce its laws, including disclosure of the information in proceedings, without having to obtain separate permission from the sending state to do so.

Fourth, the proposal tries to harmonize the cooperation within the EU with that of its members and outside nations. It introduces a 'most favored nation' concept, in that each member state is required to provide at least the same level of cooperation within the EU that it would provide to any of its bilateral treaty partners. Information received from nonmembers under bilateral agreements is required to be shared within the EU.

Finally, it establishes the EU responsibility for helping the states develop consistent use of forms, language, and technological means of transmission. States will provide feedback to one another on their exchange programs, and provide the Commission with annual assessments of the effectiveness of automatic exchanges, which will monitor best practices.