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COLLOQUIUM ON TAX POLICY
AND PUBLIC FINANCE

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**UNINTENDED CONSEQUENCES: HOW U.S. TAX LAW ENCOURAGES INVESTMENT IN OFFSHORE TAX HAVENS**

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Number 3

## COLLOQUIUM ON TAX POLICY AND PUBLIC FINANCE

(All sessions meet on Thursdays 4:00-5:50 p.m., Vanderbilt 208, NYU Law School)

1. January 20 – Joseph Bankman, Stanford Law School. Reforming the Tax Preference for Employer Health Insurance.

2. January 27 – Yair Listokin, Yale Law School. Taxation and Liquidity.

3. **February 3 – David Miller, Cadwalader, Wickersham & Taft LLP. Unintended Consequences: How U.S. Tax Law Encourages Investment in Offshore Tax Havens.**

4. February 10 – Michael Keen, International Monetary Fund. Bank Taxation and Regulation.

5. February 17 – Kenneth Scheve, Yale University Political Science Dep't. Envy and Altruism in Hard Times (with Xiaobo Lu).

6. February 24 – Allison Christians, Wisconsin Law School. Hard Law, Soft Law, and No Law: The World of International Tax Dispute Resolution.

7. March 3 – Adam Rosenzweig, Washington University Law School. Thinking Outside the (Tax) Treaty.

8. March 10 – Eric Zolt, UCLA Law School. Charitable Deductions for Foreign Assistance.

9. March 24 – Kirk Stark, UCLA Law School. Bribing the States to Tax Food.

10. March 31 – Len Burman, Maxwell School of Syracuse University. Integrating Tax Expenditures into the Budget Process.

11. April 7 – Jennifer Blouin, Wharton School, University of Pennsylvania. [Paper TBD on multinationals.]

12. April 14 – Joshua Blank, NYU Law School. Not Seeing Is Believing: A Behavioral Theory of Tax Privacy.

13. April 21 – Leandra Lederman, Indiana University Law School. IRS Opportunism: What Respect Should Courts Accord Rulings and Regulations Issued During Litigation?

14. April 28 – Cheryl Block, Washington University Law School. The Intersection of Federal Income Tax Policy and Bailouts.

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## I. Introduction.

In his one-and-only speech on tax policy, President Obama expressed outrage that U.S. taxpayers could organize and operate foreign corporations in tax havens to reduce their U.S. tax liabilities, and vowed to shut down the "loophole."[1] However, the Obama Administration has dropped the very proposal that the President introduced that day,[2] and has since introduced proposals that actually *encourage* U.S. taxpayers to operate through foreign tax haven corporations to reduce their federal and state tax liabilities.

For example, the Administration's proposal to reduce the value of itemized tax deductions for high-income individual taxpayers will be entirely avoidable by a taxpayer who

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* I would like to thank Ari Brandes for his research, and Jean Bertrand, Shlomo Boehm, William Burke, Robert Scarborough, and Lee Sheppard for their comments. This paper was presented to the Tax Forum on October 4, 2010.

1 See Remarks by the President on International Tax Policy Reform (May 4, 2009), *available at* http://www.whitehouse.gov/the_press_office/Remarks-By-The-President-On-International-Tax-Policy-Reform ("For years, we've talked about shutting down overseas tax havens that let companies set up operations to avoid paying taxes in America. That's what our budget will finally do. On the campaign, I used to talk about the outrage of a building in the Cayman Islands that had over 12,000 business – businesses claim this building as their headquarters. And I've said before, either this is the largest building in the world or the largest tax scam in the world. And I think the American people know which it is. It's the kind of tax scam that we need to end. That's why we are closing one of our biggest tax loopholes.").

2 The Fiscal Year 2010 Budget contained a proposal to treat certain "check-the-box" foreign entities as corporations for U.S. federal income tax purposes. See General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, at 28 (May 2009). This proposal was dropped from the Fiscal Year 2011 Budget. See General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (Feb. 2010); Barbara Angus, Tom Neubig, Eric Solomon & Mark Weinberger, "The U.S. International Tax System at a Crossroads," 2010 TNT 64-4 (Apr. 5, 2010) ("Major modifications in this year's international tax proposals include the elimination of the proposal to curtail use of the check-the-box rules."). John D. McKinnon, "Plan Would Raise Taxes on Businesses," Wall Street Journal (February 2, 2010) ("[L]ast year, the Administration's proposal to increase multinational companies' taxes on their overseas earnings by about $210 billion floundered amid furious opposition from business lenders.").

organizes a foreign corporation and has the foreign corporation incur the itemized deductions that would otherwise have been incurred directly by the taxpayer.[3]

In fact, the tax code is riddled with features that allow U.S. taxpayers to reduce their tax liability by operating through tax haven companies. Some of the provisions are historic anomalies. For example, the ability of U.S. taxpayers to use a controlled foreign corporation ("CFC") to effectively claim deductions that could not be claimed directly by relying on the "earnings and profits" limitation on inclusions of Subpart F income more reflects the anachronistic legal construct of Subpart F than a deliberate tax policy to encourage taxpayers to form offshore corporations.[4]

Others, like the ability of tax-exempt organizations to avoid "debt-financed income" by investing through a foreign tax haven "blocker" corporation that itself borrows, and the ability of U.S. taxpayers to avoid the corporate tax that applies to "taxable mortgage pools" ("TMPs") by organizing their TMPs offshore, are better understood as inadvertent loopholes than considered legislative grace.[5]

Some incentives to operate offshore are indeed intentional. For example, regulations that were finalized at the end of the Bush administration expressly permit a CFC to shift income into a low tax jurisdiction and avoid current U.S. tax through a contract

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3 General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (February 1, 2010) ("Limit the Tax Rate at Which Itemized Deductions Reduce Tax Liability to 28 Percent"). The proposed increase in the highest marginal rates for individuals has a similar effect.

4 These provisions are discussed in Part III.I.

5 These provisions are discussed in Part III.C and Part III.K.

For an exposé on the use of foreign blockers by the Bloomberg Family Foundation, see Aran Roston, "Bloomberg's Offshore Millions," The New York Observer (April 20, 2010), http://www.observer.com/2010/politics/bloomberg%E2%80%99s-offshore-millions. The article quotes former New York District Attorney Robert Morganthau as having "made a lot of effort to shut down that loophole" and as having raised the issue with "four U.S. secretaries of the Treasury."

manufacturing agreement with a manufacturer in a high-tax jurisdiction. These regulations sanction the use of a tax haven company to reduce U.S. taxes in the name of competitiveness.

In this paper I catalogue the many ways that U.S. federal and state tax law encourages taxpayers to operate through foreign tax haven companies to reduce their U.S. federal and state tax liabilities, and I do my best to explain the history and policy underlying these rules. Many of the rules I discuss allow U.S. taxpayers to frustrate substantive tax policies by operating through foreign corporations. However, in a few instances, the results that taxpayers obtain by using foreign corporations are arguably more reasonable than those that arise directly. These situations raise questions about the wisdom of the underlying substantive rules.

I then take the President at his word and assume that, absent a compelling policy reason, U.S. taxpayers should not be able to organize and operate foreign corporations to reduce their U.S. federal tax liabilities. I conclude by offering a number of suggestions to eliminate the inadvertent incentives that encourage U.S. taxpayers to form foreign corporations and operate through them solely for tax purposes. For the most part these suggestions are intended to be "low hanging fruit" for Congress and the IRS. Thus, the suggestions do not change fundamental tax policies, and I don't tackle deferral head-on. But I do start my discussion there.

## II. Deferral: The Principal Tax Incentive to Operate Through a Foreign Corporation.

U.S. taxpayers are entitled to defer (and avoid paying tax on) their share of the income of foreign corporations, subject to the limitations of Subpart F and the passive foreign investment company (or "PFIC") rules. Subpart F and the PFIC rules generally reflect a balance between subsidizing U.S. corporations that operate "active" businesses abroad (by permitting them to defer their tax liability) and requiring current taxation of (i.e., denying deferral for) "passive" investment income and other "mobile" income — income that can be easily moved to a tax haven jurisdiction, but that is not connected to an active business in that jurisdiction.[6] The subsidy (and the resulting incentive to organize and operate through a foreign corporation) is justified on the basis of "competitiveness": that is, if U.S. corporations were required to pay tax currently on their offshore earnings, they could not compete with multinationals headquartered in jurisdictions that either impose no home country tax on income earned outside their borders or permit deferral until the income is repatriated.[7] The subsidy for deferral (and the resulting incentive to operate through a foreign corporation) is least justifiable where the underlying income is in fact mobile, or local tax can be eliminated or reduced.

Broadly speaking, there are two strategies to maximize deferral. The first, practiced by 10% United States shareholders of CFCs that are potentially subject to Subpart F, is to generate low-taxed income that is not Subpart F income. The second strategy is to avoid the CFC and PFIC rules entirely. These strategies are discussed in turn.

### A. Deferral Under Subpart F.

For 10% United States shareholders in a CFC, the benefits of deferral are maximized if non-Subpart F income can be shifted to a low-tax jurisdiction; this benefit can be multiplied through tax-deductible leverage in the United States.

**1. In General.** The definitions and scope of the CFC rules are familiar to many practitioners; they are only briefly recounted here.

Subpart F applies to those United States persons that own directly, indirectly, or constructively 10% or more of the voting power of a "controlled foreign corporation" (a "CFC"). These shareholders are referred to as "10% United States shareholders." Very generally, a CFC

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6 See generally, Daniel N. Shaviro, Decoding the U.S. Corporate Tax 133 (Urban Institute Press 2009). This is also the balance between capital export neutrality and capital import neutrality. See Message from the President of the United States Relative to our Federal Tax System, H.R. Doc. No. 140, 87th Cong., 1st Sess. 7 at 30 (1961).

7 Clifton J. Fleming, Robert J. Perone, Stephen C. Shay, "Deferral: Consider Ending It, Instead of Expanding It," 86 Tax Notes 837 (February 7, 2000).

is a foreign corporation more than 50% of the equity of which, measured by vote or value, is owned directly, indirectly, or constructively by 10% United States shareholders.[8] If a corporation is a CFC, then the 10% United States shareholders are generally required to report annually their pro rata share of the CFC's "Subpart F income."[9] Thus, for U.S. taxpayers that are 10% United States shareholders, deferral is achieved by avoiding Subpart F income.

2. **The Magnitude of Deferral Under Subpart F.** Subpart F income was intended to represent "mobile income" — income that can be moved easily to tax haven jurisdictions.[10] Conversely, non-Subpart F income — that is, income entitled to deferral — was intended to represent immobile income. But, as the following charts suggest, that intent is not reality and U.S. taxpayers are readily able to move non-Subpart F income to low-income jurisdictions and achieve deferral.

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8 Section 957. However, for the purposes of taking into account "insurance income," if more than 75% of the foreign corporation's income is Subpart F income, the corporation is a CFC if more than *25*% of the total combined vote or value of the stock is owned directly, indirectly, or constructively by United States persons that each possess directly, indirectly, or constructively 10% or more of the combined voting power of all classes of voting equity in the corporation. Section 957(b).

All references to section numbers are to the Internal Revenue Code of 1986, as amended, or the regulations proposed or promulgated thereunder.

9 <u>See</u> section 951.

10 HR Conf. Rep. No. 213, 103d Cong., 1st Sess. 633 (1993) ("Subpart F income typically is foreign income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax relative to the U.S. rate.").

| U.S. Company Foreign Profits Relative to Jurisdiction Gross Domestic Product[11] | |
|---|---|
| Weighted average for G-7 Countries | 0.6% |
| Ireland | 7.6% |
| Cyprus | 9.8% |
| Barbados | 13.2% |
| Luxembourg | 18.2% |
| Island of Jersey | 35.3% |
| Bahamas | 43.3% |
| Marshall Islands | 339.8% |
| British Virgin Islands | 354.7% |
| Cayman Islands | 546.7% |
| Bermuda | 645.7% |

This chart suggests that U.S. corporate profits are being disproportionately diverted to tax haven countries, as U.S. companies earn on average more than 1000% more profits in Bermuda as compared to G-7 countries based on relative GDP.

| Return on Assets (1998)[12] | |
|---|---|
| Average for U.S. manufacturing subsidiaries | 8.4% |
| Cayman Islands | 16.67% |
| Switzerland | 17.9% |
| Ireland | 23.8% |

This chart also suggests that a disproportionate share of profits is being shifted to low-tax jurisdictions. It is otherwise hard to explain how U.S. subsidiaries in Ireland on average return almost 300% more than U.S. subsidiaries generally. The Tax Notes economist Martin Sullivan estimates that in 2001, more than $107 billion, or 46% of the foreign profits of U.S.

[11] Jane G. Gravelle, Tax Havens: International Tax Avoidance and Evasion, Congressional Research Service 13-14 (July 9, 2009).

[12] Martin Sullivan, "U.S. Citizens Hide Hundreds of Billions in the Caymans," Tax Notes, p. 96 (August 25, 2008).

multinationals ended up in eleven “tax haven” jurisdictions with an average tax rate of only 8.1%.[13]

The magnitude of deferred tax is stunning. By one estimate, U.S. companies currently enjoy deferral for at least $1 trillion in offshore profits.[14] Economists estimate that ending deferral would generate between $11 billion and $60 billion of revenue each year,[15] which could be used to reduce the corporate tax rate by 1.5% (from 35% down to 33.5%).[16]

The deferral is concentrated in the health care, information technology and energy industries.

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13 Martin A. Sullivan, “Economic Analysis: U.S. Multinationals Move More Profits to Tax Havens,” Tax Notes (February 9, 2004).

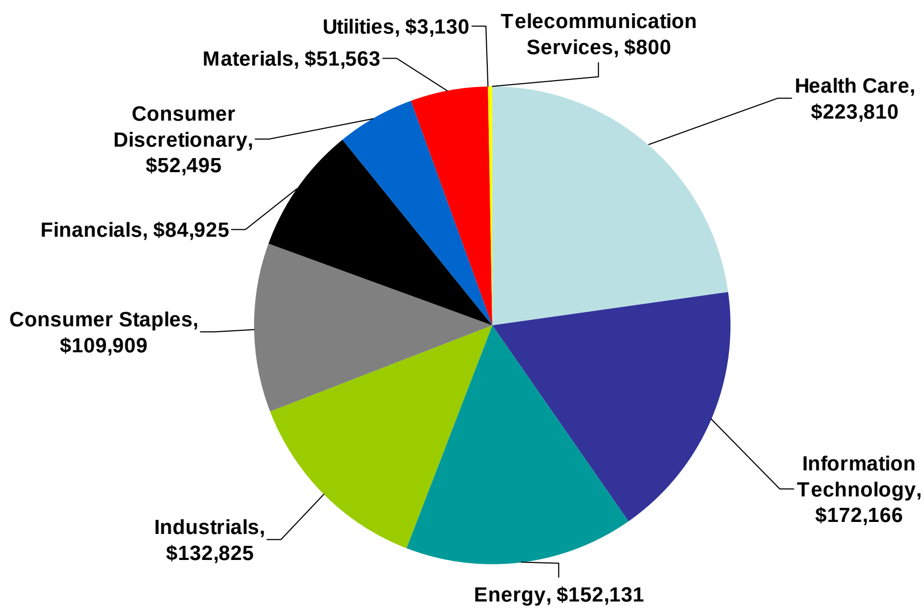
14 Jesse Drucker, American Companies Dodge $60 Billion in Taxes Even Tea Party Would Condemn, Bloomberg.com (May 13, 2010), http://www.bloomberg.com/apps/news?pid=20601109&sid=aEfZbpkSLCBQ.

15 Joint Committee on Taxation Estimates of Federal Tax Expenditures for 2009-2013 (ending deferral would generate approximately $11 billion in FY2010, or over $60 billion from 2011-2015), page 29, January 11, 2010, *available at* http://www.bondbuyer.com/pdfs/JTC.pdf. Harry Grubert and Rosanne Altschuler, “Corporate Taxes in the World Economy,” in Fundamental Tax Reform: Issues, Choices, and Implications, ed. John W. Diamond and George R. Zodrow, Cambridge, MIT Press (2008) ($11 billion for 2002 which Jane Gravelle translates into $26 billion for 2007); Jane G. Gravelle, Tax Havens: International Tax Avoidance and Evasion, Congressional Research Service 13-14 (September 3, 2010) (citing estimates of between $11 billion and $14 billion); see Kimberly Clausing, Multinational Firm Tax Avoidance and Tax Policy, National Tax Journal (December 2009) ($60 billion for 2004, based on applying a 35% tax rate to an estimated $180 billion in corporate profits shifted out of the United States); Charles W. Christian and Thomas D. Schultz, “ROA-Based Estimates of Income Shifting by Multinational Corporations,” IRS Research Bulletin, 2005 http://www.irs.gov/pub/irs-soi/04christian.pdf ($87 billion shifted in 2001, or $30 billion revenue loss based on 35% corporate tax rate); Simon J. Pak and John S. Zdanowicz, U.S. Trade with the World, An Estimate of 2001 Lost U.S. Federal Income Tax Revenues Due to Over-Invoiced Imports and Under-Invoiced Exports, October 31, 2002 ($53 billion lost revenue in 2001).

16 The President’s Economic Recovery Advisory Board, The Report on Tax Reform Options; Simplification, Compliance, and Corporate Taxation 92 (August 29, 2010) (“Ending deferral would permit a revenue-neutral reduction in the corporate rate by about 1.5 percentage points”).

17 Credit Suisse, “Taxes Going Up: The Obama Budget Proposals” p. 5 (February 5, 2010).

**$984 Billion in Undistributed Foreign Earnings for S&P 500 Companies, by Sector per 2008 10-K**[16]
*US$ in millions*




**S&P 500 Companies with Undistributed Foreign Earnings Over $20 Billion**[18]
*US$ in millions*

| Company | Ticker | 2008 Undistributed Foreign Earnings |
|---|---|---|
| General Electric | | $75,000 |
| Pfizer Inc. | | 63,100 |
| Johnson & Johnson | | 27,700 |
| Citigroup Inc. | | 22,800 |
| Chevron Corp. | | 22,428 |
| Merck & Co. | | 22,000 |
| Cisco Systems | | 21,900 |
| International Bus. Machines | | 21,900 |
| Procter & Gamble | | 21,000 |

Robert Willens estimates that Pfizer increased its net income in 2009 by 13% (from $7.6 billion to $8.6 billion), Lilly by 21% (from $3.6 billion to $4.3 billion) and Oracle by 14% (from $4.9 billion to $5.6 billion) as a result of deferral.[19]

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[18] Credit Suisse, "Taxes Going Up: The Obama Budget Proposals" p. 5 (February 5, 2010).

[19] Jesse Drucker "Profit Exports Import U.S. Tax Cuts for Pfizer, Lilly, Oracle," Bloomberg.com, http://www.bloomberg.com/apps/news?pid=20601109&sid=a7td7E8_4EeI&pos=10.

**3. The Instruments of Deferral.** There are four principal culprits that permit deferral.

**a. Transfer Pricing.** Kimberly Clausing estimates that $60 billion in U.S. tax revenue is lost through transfer pricing annually,[20] and Harry Grubert estimates that about half of the difference between U.S. profits earned in low-tax and high-tax countries is attributable to transfers of intellectual property and intangibles.[21] That is, the data suggests that U.S. multinationals routinely develop intellectual property in the United States, and then transfer the intellectual property to a low-tax jurisdiction (such as Ireland) at a favorable transfer price.[22] Some of these companies further deduct the research, development and advertising costs that establish the brand name (and claim credits), which reduce the U.S. multinational's domestic tax cost.[23]

These conclusions have anecdotal support.[24] One-third of the repatriations under section 965 were in the pharmaceutical industry and 20% were in the computer and electronic equipment industry.[25] And, the Joint Committee on Taxation has recently documented how six different multinational public companies used transfer pricing with tax haven subsidiaries to minimize their U.S. federal income tax.[26]

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[20] See Kimberly Clausing, "Multinational Firm Tax Avoidance and Tax Policy," National Law Journal (December 2009).

[21] Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting and the Choice of Locations," National Tax Journal. vol. 56, March 2003, Part II, pp. 221-242.

[22] See Joint Committee on Taxation "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," (JCX-37-10) (July 20, 2010) ("JCT Transfer Pricing Report").

[23] JCT Transfer Pricing Report.

[24] Jesse Drucker, "American Companies Dodge $60 Billion in Taxes Even Tea Party Would Condemn," Bloomberg.com (May 13, 2010).

[25] Donald J. Marples and Jane Gravelle, CRS Report R40178, "Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis" (February 11, 2009).

[26] JCT Transfer Pricing Report.

**b. Allocation of Interest Expense.** Favorable allocations of interest expense multiply the benefits of deferral.

Under current law, if a U.S. parent borrows to make an equity contribution to a foreign subsidiary that benefits from deferral, the U.S. parent can claim current interest deductions on its debt. This interest expense offsets domestic income, even if the income generated by the borrowing will not be subject to current tax under the CFC rules. Estimates suggest that favorable allocations of interest expense result in the second biggest revenue losses after transfer pricing.[27]

**c. Contract Manufacturing and Commissionaire Arrangements.** Contract manufacturing and commissionaire arrangements offer another means to shift income to a low-tax jurisdiction without generating Subpart F income.[28] Regulations that were finalized at the end of 2008 provide that the sales income earned by a CFC that contributes substantially to manufacturing activities of the underlying product is not Subpart F income so long as the CFC does not have a branch in a high-tax jurisdiction where the manufacturing is conducted.[29] Moreover, under the regulations, a CFC may substantially contribute to manufacturing activities conducted by a related high-taxed manufacturer without causing the CFC to have a branch in the manufacturer's jurisdiction.[30] Thus, the regulations permit a CFC located in a low-tax

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27 Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting and the Choice of Locations," National Tax Journal, vol. 56, Part II, pp. 221-242, (March 2003).

28 Under a commissionaire arrangement, a subsidiary in a low-tax jurisdiction earns commission income for arranging the sales of goods, rather than taking title to the goods and selling them for a profit. See generally Office of Tax Policy, Department of the Treasury, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study," p. 65 (December 2000).

29 See Treasury regulations section 1.954(a)(4).

30 See Treasury regulations section 1.954-3(b)(1)(ii)(c)(3)(f), Example (6) and temporary Treasury regulations section 1.954-3T(b)(1)(ii)(c)(3)(v), Example (6). See also Treasury Decision 9438, 73 Fed. Reg. 79, 342 (making clear that if employees resident in a CFC's low-tax home jurisdiction travel to a high-tax jurisdiction but do not cause the CFC to have a branch in the high-tax jurisdiction then their activities are taken into account for purposes of the substantial contribution test).

jurisdiction to earn low-taxed non-Subpart F sales income if it enters into a contract manufacturing agreement with a manufacturer in a high tax jurisdiction, and then "contributes substantially" to that manufacturing activity (for example, by flying executives to the high-tax jurisdiction to oversee the manufacturing).

**d. Hybrid Entities and Instruments.** The check-the-box election and hybrid instruments and entities are other tools that permit income to be shifted on a tax-free basis to low-tax jurisdictions without generating Subpart F income.[31]

Subpart F was developed at a time when there was more or less worldwide agreement as to which entities were subject to an entity-level tax and which were not. Subpart F is premised on that common understanding. Thus, in 1964, if a U.S. multinational organized a low-tax holding company and a series of high-tax subsidiaries and stripped earnings out (and reduced the effective tax rate) of the operating subsidiaries by having them pay interest to the low-tax holding company, the holding company earned Subpart F income.

The check-the-box regulations violate that premise. The check-the-box regulations allow a foreign subsidiary of a CFC to be disregarded for U.S. tax purposes but be "regarded" for local tax purposes. Thus, if a high-tax foreign operating subsidiary that is disregarded for U.S. tax purposes pays interest to its CFC parent, and that interest is deductible for local tax purposes, the high-tax operating subsidiary may become a low-tax company, but the low taxed "interest" income escapes a Subpart F taint.[32] Similar results can be achieved with instruments that are treated as indebtedness for local law purposes and as equity for U.S. tax purposes. (In this case, again, a foreign subsidiary of a CFC might be treated as paying

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[31] See generally Office of Tax Policy, Department of the Treasury, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study," p. 62 (December 2000).

[32] See Jane G. Gravelle, Tax Havens: International Tax Avoidance and Evasion, Congressional Research Service 13-14 (July 9, 2009).

deductible interest for local law purposes but "flow-through" dividends for U.S. tax purposes.) President Obama had proposed to deny a check-the-box election for offshore subsidiaries, but has since relented and the Administration has withdrawn the proposal.[33]

**4. The Bipartisan Tax Fairness and Simplification Act of 2010**. On February 23, 2010, Senators Ron Wyden (D-OR) and Judd Gregg (R-NH) introduced the "Bipartisan Tax Fairness and Simplification Act of 2010" (S. 3018), which would effectively end deferral beginning in 2011.[34] This is a bold and obviously controversial proposal with little prospect of success.[35]

**5. The President's Economic Recovery Advisory Board Report.** On August 29, 2010, the President's Economic Recovery Advisory Board issued its Report on Tax Reform Options. The Advisory Board took up the deferral ball, and then punted it long and far. The Board's report identified how deferral, coupled with transfer pricing and "expense location",

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33 Press Release, White House, Remarks by the President on International Tax Policy Reform (May 4, 2009), available at http://www.whitehouse.gov/the_press_office/Remarks-By-The-President-On-International-Tax-Policy-Reform.

34 Section 204(c) of S. of 3018 provides:

(c) **Deferral of Active Income of Controlled Foreign Corporation**. – Section 952 (relating to Subpart F income defined) is amended by adding at the end of the following new subsection:

"**(e) Special Application of Subpart. – (1) In General**. – For taxable years beginning after December 31, 2010, notwithstanding any other provision of this subpart, the term "subpart F income" means in the case of any controlled foreign corporation, the income of such corporation derived from any foreign country."

"**(2) Applicable Rule**. – Rules similar to the rules under the last sentence of subsection (a) and (d) shall apply to this subsection."

35 One might wonder how Senators Wyden and Gregg would have the audacity to propose such a thing in the face of objections by 287 U.S. companies and business associations. See letter from Promote America's Competitive Edge Coalition ("PACE"), "280+ Organizations Cite Need for Competitive Tax Policies if American Employers are to Grow and Create Quality U.S. Jobs" (press release) (March 9, 2010). The answer appears to be that the bill would also reduce the federal corporate tax rate to 24% and Senator Wyden's number one corporate contributor is Nike, and Senator Gregg's is Fidelity, and neither signed the letter. See OpenSecrets.org, http://www.opensecrets.org/politicians/contrib.php?cid=N00007724&cycle=2010&type=C&newMem=N&recs=100 (Senator Wyden's number one corporate contributor is Nike); http://www.opensecrets.org/politicians/summary.php?type=C&cid=N00000444&newMem=N&cycle=2010 (Senator Gregg's number one corporate contributor is FMR Corp.).

significantly reduce the U.S. tax base, but then gave equal time to four competing options: (i) a territorial system, (ii) a worldwide system with a lower corporate tax rate, (iii) a limitation on or the end of deferral with a retention of the current corporate tax rate, or (iv) the retention of the current system with a lower corporate tax rate. On December 3, 2010, the President's National Commission on Fiscal Responsibility and Reform recommended that the United States adopt a "territorial system," under which active foreign income would be exempt from tax (rather than only deferred under current law), but passive foreign-source income could be subject to tax immediately (as under current law).[36] Another report, written by The Debt Reduction Task Force of the Bipartisan Policy Center, and 10-chaired by Senator Pete Domenici and Dr. Alice Rivlin, recommended that the United States retain the current "worldwide" system.[37]

### B. Avoiding Subpart F and the PFIC Rules.

If the first strategy to maximize deferral is to generate low tax income that is not Subpart F income, the second is to avoid the CFC and PFIC rules entirely.

**1. Avoiding Subpart F.** U.S. taxable investors generally may avoid current inclusion under Subpart F by retaining less than 10% of the voting interests of a foreign corporation, or by ensuring that the combined ownership of all of the 10% United States shareholders (including the taxpayer) does not exceed 50% of the vote or value of the foreign corporation.[38]

The ability of these taxpayers to enjoy deferral does not reflect the affirmative policy judgment that they should be entitled to deferral but, rather, the pragmatic view that it

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[36] National Commission on Fiscal Responsibility and Reform, "The Moment of Truth" pp. 32-33 (December 3, 2010).

[37] The Debt Reduction Task Force, Restoring America's Future, Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System, p. 35 (BiPartisan Policy Center, November 2010).

[38] Thus, a U.S. person may own as much as 49.9% of the vote and value of a foreign corporation without the foreign corporation being treated as a CFC so long as there is not another U.S. person that owns or is treated as owning 10% or more of the voting power of the foreign corporation.

would not be practical to require these taxpayers to report the income. Under this premise, if a U.S. taxpayer owns less than 10% of a foreign corporation's voting stock, or the 10% United States shareholders in the aggregate own 50% or less of the foreign corporation, it might be difficult for the U.S. shareholders to demand an accounting of the foreign corporation's Subpart F income.

But avoiding Subpart F is not sufficient to avoid current inclusion (or something worse): the PFIC rules also must be skirted.

**2. The PFIC Rules Generally.** The PFIC rules apply to U.S. shareholders of PFICs regardless of the shareholder's percentage ownership or the percentage ownership of all U.S. taxpayers. A foreign corporation is a PFIC if 75% or more of its income consists of passive income (which includes dividends, interest, rents, royalties) or the average percentage of assets held by the corporation during the taxable year that produce passive income is at least 50%.[39]

In general, a U.S. taxpayer that invests in a PFIC and makes a timely "qualified electing fund" (a "QEF") election[40] is required to include in gross income in each taxable year (i) as ordinary income, the U.S. investor's pro rata share of the PFIC's ordinary earnings and (ii) as long-term capital gain, the U.S. investor's pro rata share of the PFIC's net capital gain, whether or not distributed.[41] This paper refers to a PFIC that is subject to a QEF election as a "QEF PFIC."

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[39] Section 1297(a)(2).

[40] A taxpayer may make a QEF election for any taxable year at any time on or before the due date (determined with regard to extensions) for filing the tax return for such taxable year. Section 1295(b)(2). A QEF election is made by attaching the PFIC Annual Information Statement and Annual Intermediary Statement and a completed Form 8621 to the taxpayer's federal income tax return for the year. See Treasury regulations section 1.1295-1(f).

[41] Section 1293(a). In certain cases in which a QEF does not distribute all of its earnings in a taxable year, the electing U.S. investor may also be permitted to elect to defer payment of some or all of the taxes on the QEF's income, subject to a non-deductible interest charge on the deferred amount. Section 1294.

A U.S. taxpayer that invests in a PFIC and does not make a timely QEF election is potentially subject to significantly worse treatment: these taxpayers are required to report any gain on the disposition of their interests in the PFIC as ordinary income, rather than capital gain.[42] In addition, these taxpayers are required to compute the tax liability on this gain and any "excess distributions"[43] as if the items had been earned ratably over each day in the U.S. shareholders holding period, and the tax on the items is imposed at the highest ordinary income tax rate for each taxable year prior to the current year to which the items are allocated, regardless of the rate otherwise applicable to the shareholder investor.[44] Further, the U.S. investor is subject to a non-deductible interest charge (at the rate for underpayments of tax) as if such income tax liabilities had been due with respect to each such prior year.[45] Because this regime denies individual investors long-term capital gains rates and because the underpayment rate significantly exceeds the borrowing cost for most investors, unless a PFIC distributes all or substantially all of its income each year and no meaningful appreciation in the value of its stock is expected, U.S. taxable investors in the PFIC overwhelmingly prefer to make a QEF election.

So, the PFIC rules generally result in the current U.S. taxation of mobile income. However, the PFIC rules have a notable exception that allows U.S. taxpayers to organize tax haven corporations and defer what is effectively mobile income.

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[42] Section 1291(a)(2).

[43] An "excess distribution" is the amount by which distributions during a taxable year in respect of the equity interest exceed 125% of the average amount of distributions in respect thereof during the three preceding taxable years (or, if shorter, the U.S. investor's holding period for the interest). Section 1291(b).

[44] See section 1291(a)(1) and (c)(2).

[45] Section 1291(c)(3). For purposes of these rules, gifts, exchanges pursuant to corporate reorganizations, and the use of the equity interests as security for a loan may be treated as a taxable disposition of the interests. In addition, a stepped-up basis in the equity interests is not available upon the death of an individual U.S. investor. See proposed Treasury regulations sections 1.1291-3(b)(1), 1.1291-3(d)(1); section 1298(b)(6).

**3. The Active Insurance Company Exception.** Passive income does not include income earned in the active conduct of an insurance business by a corporation that is "predominately engaged" in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.[46] The legislative history to section 1297 — but not the statute or the regulations — provides that a foreign corporation does not satisfy the insurance company exception if it maintains financial reserves in excess of the reasonable needs of its insurance business.[47]

In the late 1990s, hedge fund managers organized offshore insurance companies that issued stock to U.S. investors. The offshore insurance companies wrote some low-risk reinsurance, and invested the proceeds of the stock issuance in hedge funds, which they held as reserves. This practice was publicized.[48] In April 200 and again in May 2001, Representative Richard Neal introduced legislation that would have denied a deduction for premiums paid by U.S. insurers to related foreign issuers of U.S. risk.[49] Later, in 2003, the IRS issued a notice indicating that it would "scrutinize these arrangements."[50]

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[46] Section 1297(b)(2)(A) and (B).

[47] Staff of Joint Comm. on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986 at 1025 (1987); S. Rep. No. 100-445 (1988) ("[I]ncome derived by entities engaged in the business of providing insurance will be passive income to the extent the entities maintain financial reserves in excess of the reasonable needs of their insurance business."). See also Treasury regulations section 1.801-4(a) (defining "life insurance reserves" as amounts that are set aside too cover future actuarially predicted liabilities or are otherwise "required by law" if the insurance company is regulated by a U.S. state, the District of Columbia, or a U.S. territory).

[48] See Hal Lux, "The great hedge fund reinsurance tax game," Institutional Investor (April 1, 2001).

[49] H.R. 4192 was introduced in the House of Representatives by Nancy Johnson and Richard Neal on April 5, 2000 during the 106th Congress. The Reinsurance Tax Equity Act of 2001, H.R. 1755, was introduced in the House of Representatives by Nancy Johnson and Richard Neal during the 107th Congress. Representative Neal was influenced by the ability of U.S. shareholders of these companies to defer their income. At the time he said:

> When U.S. taxpayers invest in hedge funds, they pay taxes each year at realized profits, usually at the ordinary income tax rates. However, if they invest in shares of an offshore reinsurance company in a tax haven country like Bermuda, they pay nothing on trading profits until they sell shares of the company and those profits are taxed at the capital gains rate. Congress has

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In September 2007, the Senate Finance Committee held hearings on foreign reinsurance companies, focusing on the use of reinsurance to strip earnings from U.S. insurance companies to their parent reinsurers located in a tax haven country.[51] In July 2009, Representative Neal reintroduced his bill (now H.R. 3424).[52]

And finally, in the Fiscal Year 2011 budget proposals, the Administration proposed a variation of the Neal bill.[53] Although the Neal bill and the Administration's proposal would prevent earnings stripping by U.S. affiliates of offshore reinsurance companies, they would preserve the PFIC exception and U.S. taxpayers' ability to defer their income from offshore reinsurance companies.

Today, there are at least twenty-one publicly traded offshore reinsurance companies.[54] All of these companies avoid CFC status and take the position that they are not PFICs. Four (Willis, ACE, White Mountains, and XL) of the twenty-one companies have several thousand employees each, but the rest have under a thousand employees and many have fewer than two hundred employees. A large number of the employees of these other seventeen

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> taken the position several times over the past few years that investors should not get better tax treatment by investing indirectly than they would have gotten if they had made a direct investment in an asset.

See Lee A. Sheppard, News Analysis: Hedge Funds In Insurance Wrappers, 96 Tax Notes 1671 (September 23, 2002).

50 Notice 2003-34, 2003-1 C.B. 990.

51 Charles Gnaedinger, "U.S. Senate Finance Committee Scrutinizes Offshore Activities," 48 Tax Notes Int'l 13 (October 1, 2007).

52 H.R. 3424, introduced in the House of Representatives by Richard Neal. See also Joint Committee on Taxation, Present Law and Analysis Relating to The Tax Treatment of Reinsurance Transactions Between Affiliated Entities (JCX-35-10), available at www.jct.gov.

53 See Department of the Treasury, General Explanations of the Administration's Proposals at p. 45 (February 2010).

54 Validus Holdings, Ltd.; Platinum Underwriters Holdings Ltd.; Everest Reinsurance Holdings Inc.; Montpelier Re Holdings Ltd.; RenaissanceRe Holdings Ltd.; PartnerRe Ltd.; Axis Capital Holdings Ltd.; Arch Capital Group Ltd.; Aspen Insurance Holdings Ltd.; Allied World Assurance Co. Holdings Ltd.; Maiden Holdings, Ltd.; Enstar Group Ltd.; Endurance Specialty Holdings Ltd.; Flagstone Reinsurance Holdings Ltd.; XL Capital Ltd.; ACE Ltd.; American Safety Insurance Holdings Ltd.; White Mountains Insurance Group Ltd.; Willis Group Holdings Plc.; and Syncora Holdings Ltd.

companies are typically resident in the United States. For example, Partner Re (a Bermuda corporation) has close to a thousand employees, but there are fewer than 70 in Bermuda, and about 300 in the United States.[55] To take another example, Validus, which has a market capitalization of over $3.6 billion, has only 280 total employees and only 70 in Bermuda. (A more traditional reinsurance company, like White Mountains, requires over 5,000 employees to maintain a smaller market capitalization.)[56] Some of these offshore reinsurance companies tout their "fund strategies" as prominently as their underwriting.[57]

Although the legislative history of section 1297(b)(2) suggests that only the size of a company's reserves is relevant in determining the scope of the active insurance exception,[58] Subpart F uses the same phrase — "engaged in the active conduct of an insurance business"[59] — to define the insurance exception from Subpart F income. To qualify under the Subpart F test, if insurance policies are issued by a CFC and cover risks other than "applicable home country risks" (meaning risks in connection with property or liability arising out of activity in, or the lives or health of residents of, the home country of the insurance company or a qualifying branch),[60] to avoid Subpart F income, the CFC or its branch must conduct substantial activity in its home country that constitutes substantially all of the activities necessary to give rise to the

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[55] PartnerRe Ltd., Annual Report, at 6 (February 27, 2009).

[56] Validus Holdings, Ltd., Annual Report, at 20 (March 1, 2010).

[57] See, e.g., Max Re Capital Ltd Prospectus at 59-60 ("approximately 46% of our investment portfolio was invested in our alternative investment portfolio managed by Moore Capital"; describing six different "fund strategies," including "Long/Short Equities," "Convertible Arbitrage," "Global Macro," "Merger Arbitrage," Multi-Strategy Arbitrage" and "Opportunistic Investing").

[58] Staff of Joint Comm. on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986 at 1025 (1987); S. Rep. No. 100-445 (1988) ("[I]ncome derived by entities engaged in the business of providing insurance will be passive income to the extent the entities maintain financial reserves in excess of the reasonable needs of their insurance business.").

[59] Section 952(c)(1)(B)(v).

[60] Section 953(e)(3)(B).

income generated by the contract.[61] Moreover, the Subpart F test requires that a reinsurer derive 50% of its aggregate net written premiums from covering home country risks. This restrictive definition has not yet been applied to the PFIC rules, although the suggestion has been made.[62]

## III. The Other Incentives To Operate Through a Foreign Corporation.

Deferral is no longer the only reason that U.S. taxpayers organize and operate through foreign corporations. There are now more than a dozen reasons that a U.S. taxpayer might operate through a foreign corporation, even without any deferral.

### A. Avoid Federal Limitations on Miscellaneous Itemized Deductions.

U.S. individual taxpayers (as well as trusts and estates) are permitted to deduct "miscellaneous itemized deductions" only to the extent the deductions exceed 2% of their adjusted gross income.[63] Miscellaneous itemized deductions are all deductions other than (i) trade or business deductions and the other deductions allowed in determining adjusted gross income and (ii) deductions for interest expense, taxes, casualty and theft losses, charitable donations, amortizable bond premium (and some others listed in section 67(b)).[64] Thus, expenses paid to an investment manager to manage an investment portfolio are subject to the "2% floor". So an individual with adjusted gross income of $5 million who pays $20,000 in management fees on a $10 million portfolio will be denied a deduction entirely for the $20,000 payment unless the individual has more than $80,000 of other miscellaneous itemized deductions.

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[61] Section 953(e)(2)(c).

[62] Lee A. Sheppard, "News Analysis: Hedge Funds In Insurance Wrappers," 96 Tax Notes 1671 (September 23, 2002).

[63] Section 67(a); section 641(b). Moreover, beginning again in 2011, miscellaneous itemized deductions are reduced by the lesser of (i) 3% of adjusted gross income minus a specified threshold amount and (ii) 80% of the amount of the itemized deductions otherwise allowable. Section 68.

[64] Section 63(d) (defining itemized deductions as the deductions other than those allowable in arriving at adjusted gross income); section 67(b) (defining miscellaneous itemized deductions as certain itemized deductions).

However, the miscellaneous itemized deduction limitation can be avoided if an individual organizes a foreign corporation to hold a portfolio of securities and causes the foreign corporation to pay the management fees and other miscellaneous itemized deductions that the individual would have incurred directly. Even if the individual is subject to tax on all of the net income of the foreign corporation under Subpart F or the QEF rules, because a foreign corporation may claim a deduction for miscellaneous income itemized deductions, so long as the corporation has sufficient income to offset the expenses, organizing a foreign corporation to incur the expenses is an effective way to avoid the limitation.

Moreover, under the portfolio interest exemption and the section 864(b)(2) safe harbor, a U.S. individual may organize a foreign corporation to hold and trade a pool of bonds managed by a U.S. manager without incurring U.S. federal income or withholding tax. If a U.S. individual organized a foreign corporation to hold U.S. equities, the dividends paid to the foreign corporation would be subject to U.S. withholding tax (and this tax cost could exceed the benefit). However, Congress has invited the Administration to draft a safe harbor that would exempt substitute dividend payments received by foreign corporations on certain U.S. equity swaps from withholding tax.[65] Therefore, an individual may very well be able to use a foreign corporation to avoid the miscellaneous itemized deduction limitation for a portfolio of U.S. equity positions without tax cost.

### B. Avoid Alternative Minimum Tax Limitations on Deductibility.

Miscellaneous itemized deductions are not deductible for purposes of the alternative minimum tax.[66] However, an individual that is subject to the alternative minimum tax can organize a foreign corporation to incur the expense, use it to offset the foreign corporation's

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[65] Section 871(l)(3)(B). See also General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (Feb. 2010).

[66] Section 56(b)(1)(A)(i).

income and thereby effectively claim the deduction, notwithstanding the alternative minimum tax.

### C. Avoid the "Taxable Mortgage Pool" Rules.

The real estate mortgage conduit ("REMIC") rules contain safeguards to ensure that the phantom income earned by holders of residual interests is taxable in all events.[67] Congress created the taxable mortgage pool (or "TMP") rules of section 7701(i) to prevent taxpayers from setting up similar entities to evade these rules.[68] The mechanism to achieve this result is to treat any entity that looks like a REMIC, but is not a REMIC, as a corporation for federal income tax purposes.[69] Thus, the TMP rules do provide a significant discentive to forming a domestic TMP.

However, the TMP rules contain a very significant loophole. Rather than provide that a TMP is taxable as a domestic corporation, the rules provide only that a TMP is taxable as a corporation. Thus, a foreign TMP that is not engaged in a trade or business in the United States

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[67] First, the REMIC rules prohibit a REMIC residual interest from being transferred to a governmental entity that is not subject to federal income tax. Section 860E(e)(1) (tax imposed on transfers to "disqualified organizations"); Section 860E(e)(5) (defining disqualified organizations). Second, the portion of the income from a residual that constitutes an "excess inclusion" is subject to (i) tax in the hands of tax-exempt investors; (ii) a 30% withholding tax in the hands of foreigners; and (iii) may not be offset by any unrelated losses or loss carryovers, (and is not entitled for an exemption or reduction from withholding tax under a treaty). See section 860E (the taxable income and alternative minimum taxable income may not be less than the excess inclusion income for the year); Section 860G(b) (foreigners subject to 30% withholding tax) In addition, excess inclusion income of an insurance company cannot be offset with an increased deduction for variable contract reserves. Section 860E(f).

[68] Very generally, an entity (or portion of an entity) is a TMP if it is not a REMIC and (1) substantially all of its assets are debt obligations (or interests in debt obligations), (2) more than 50% of those obligations or interests are real estate mortgages, (3) the entity is the obligor under debt obligations with two or more maturities, and (4) payments on those debt obligations bear a relationship to payments on the debt obligations and the obligor holds the assets. See section 7701(i)(2)(A).

[69] Special rules exist for REITs that are TMPs. Under Treasury regulations (which have not yet been issued), the equity holders of a REIT or registered investment company ("RIC") are subject to the same rules that apply to holders of residual interests in REMICs. These rules are designed to ensure that federal income tax is paid on the excess inclusion income. See section 860E(d).

is not subject to corporate income tax and can be used to create a REMIC-like vehicle that permits the holders of its equity can avoid paying tax on its phantom income.[70]

Thus, the TMP rules provide a very specific incentive for U.S. taxpayers to organize TMPs in foreign tax havens. It is precisely for this reason that CDOs of mortgage-backed securities were (and had to be) organized as foreign corporations.[71]

### D. Avoid Cancellation of Indebtedness Income.

Cancellation of indebtedness ("COD") income arises if a taxpayer, or a party related to the taxpayer, purchases the taxpayer's debt at a discount to the debt's adjusted issue price.[72]

Section 108(e)(4) contains the related party rules. These rules treat a partnership that wholly-owns a corporation as related to that corporation.[73] Private equity funds are commonly organized as partnerships. Their portfolio companies are generally organized as corporations. Thus, if a private equity fund that is organized as a partnership purchases at a discount the debt of its wholly-owned portfolio company (that is treated as a corporation), the portfolio company will realize COD income.

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70 See Peaslee & Nirenberg at 683 ("Section 7701(i) classifies a TMP as a corporation, but does not say whether the corporation is domestic or foreign. Accordingly, following the usual Code definitions, a TMP organized under U.S. domestic law would be a domestic corporation and any other TMP would be foreign. . . . . A foreign TMP would be subject to U.S. tax only on certain passive income from U.S. sources and on income effectively connected with a U.S. trade or business it conducts [and] . . . a foreign corporation whose sole business activity is investing and trading in loans and securities would not itself be subject to any U.S. tax (including withholding tax).").

71 It follows (of course) that if Congress had only provided that a TMP is taxable as a domestic corporation, CDOs of mortgages and mortgage-backed securities would never have existed, the cheap mortgage financing of the 2000's would not have been available, and the recession would never had occurred.

72 There are a number of exceptions to COD income, but they often require a quid pro quo, such as a dollar-for-dollar reduction of tax attributes. See generally section 108(b).

73 See section 108(e)(4) (referencing relationships described in section 267(b)); section 267(b)(10) (a corporation and a partnership are related if the same persons own more than 50% in value of the corporation and more than 50% of the capital interest or the profits interest in the partnership); section 267(c)(1) (stock owned by a partnership is considered as owned proportionately by the partners).

However, two corporations are related for purposes of the COD rules only if five or fewer individuals own more than 50% of their vote and value.[74] Thus, a private equity fund (treated as a partnership) that wishes to purchase the discounted debt of its wholly-owned portfolio company could organize an Irish "section 110 company" (treated as a corporation) that qualifies for the benefits of the U.S.-Irish tax treaty to purchase the debt.[75] So long as five or fewer people do not own more than 50% of the vote and value of the private equity fund, the Irish section 110 company will not be treated as related to the portfolio company, and the portfolio company will not realize COD income upon the purchase of its debt at a discount by the Irish section 110 company.[76]

This transaction works because of the mechanical and restrictive definition of relatedness for two corporations, but only if the foreign corporation is not subject to meaningful local tax (i.e., it is a foreign corporation located in a low-tax jurisdiction) and it benefits from a U.S. tax treaty so that payments of interest to it are exempt from U.S. withholding tax.[77]

### E. Reduce "Unearned Income" Subject to the 3.8% Medicare Tax.

Under the Reconciliation Act of 2010, starting in 2013, new section 1411(c) will impose an additional 3.8% tax on individuals, estates and trusts on the lesser of (i) their "net

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[74] See section 108(e)(4); section 267(b)(3) (two corporations are related if they are members of the same controlled group) section 267(f) (defining control group by reference to section 1563(a), but substituting a 50% threshold for the usual 80% threshold under 1563(a)); section 1563(a)(2) (corporations are related only if five or fewer individuals or trusts own more than 50% of the vote and value of the two corporations).

[75] The foreign corporation needs a tax treaty to avoid U.S. withholding tax on the interest paid to the foreign corporation. Although the foreign corporation would not be treated as related to the portfolio company for purposes of section 108(e)(4), the two corporations would be related for purposes of section 881(b)(2)(C).

[76] See generally Lee A. Sheppard, "News Analysis: Should COD Income Be Deferred?" Tax Notes Today, 2009 TNT 29-4 (February 12, 2009).

[77] The foreign corporation needs a tax treaty to avoid U.S. withholding tax on the interest paid to the foreign corporation. Although the foreign corporation would not be treated as related to the portfolio company for purposes of section 108(e)(4), the two corporations would be related for purposes of section 881(b)(2)(C).

investment income" or (ii) the excess of their "modified adjusted gross income"[78] over $250,000 for a joint return or surviving spouse, $125,000 for a married individual filing a separate return, and $200,000 otherwise.[79] In other words, individuals filing joint returns will generally be subject to an additional 3.8% "Medicare tax" on their net investment income (also referred to as "unearned income"), to the extent that the net investment income, when added to the individual's other modified adjusted gross income, exceeds $250,000.

Section 1411(c) defines "net investment income" to include (i) any gross income from interest, dividends, annuities, royalties, and rents (unless the income is derived from a trade or business that is not a passive activity or a trade or business of trading in financial instruments or commodities), (ii) other gross income derived from a trade or business that is a passive activity or consists of a trade or business of trading in financial instruments or commodities, and (iii) net gain attributable to the disposition of property (other than "active" "non-trading" trade or business property), reduced by the deductions allowable for federal income tax purposes and which are properly allocable to the gross investment income.

Thus, if a high-income individual earns $100,000 of gross interest income in 2013 from a hedge fund, but the interest income is subject to a $20,000 management fee that is a miscellaneous itemized deduction that the individual investor is not otherwise able to deduct, the individual would be subject to an additional Medicare tax of $3,800 (i.e., $100,000 x 3.8%), notwithstanding the fact that the investor will receive only $80,000 after payment of the manager's fee (and therefore the investor will bear Medicare tax at a rate of 4.75% on his or her "economic" income).

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78 Modified adjusted gross income is adjusted gross income plus income excluded under section 911(a)(1) (less the deductions disallowed under section 911(d)(6) with respect to the excluded income).

79 Section 1411.

However, if the individual invests in a foreign corporation that is a CFC or QEF PFIC, he or she would arguably be exempt from the additional Medicare tax on unearned income and, if not exempt, would certainly pay less tax.

First, as a preliminary matter, it is possible that Subpart F and QEF inclusions are not subject to the 3.8% Medicare tax. The tax applies to interest, dividends, annuities, royalties and rent, but Subpart F and QEF inclusions are not listed. When Congress has intended to treat Subpart F and QEF inclusions as dividends, it has done so expressly.[80]

The IRS has taken seemingly contrary positions as to whether Subpart F inclusions are dividends. Most recently, in Notice 2004-70 (which deals with whether dividends from foreign corporations qualify as qualified dividend income under section 1(h)(11)(C)), the IRS held that "for purposes of section 1(h)(11), Subpart F inclusions are not dividends and therefore cannot constitute qualified dividend income." This statement was not based on the policies underlying section 1(h)(11), but was based simply and exclusively on the fact that, "[n]either section 951(a)(1) nor the corresponding regulations characterize a Subpart F inclusion as a dividend." (The IRS didn't have to address QEF inclusions because section 1(h)(11)(C)(iii) excludes PFICs from the definition of a qualified foreign corporation.)

However, the IRS has taken the opposite view on the treatment of Subpart F inclusions as dividends (when considering whether they give rise to UBTI):

> Although the subpart F income will not be distributed and is technically not a dividend, such income can be characterized as a constructive dividend due to the interaction of [sections 951(a)(1)(A)(i) and 951(a)(2), and sections 512(b)(1) and 512(b)(13)] of the Code. These sections produce a situation in which the income would be taxable on the part of shareholders as if it had been distributed by the subsidiary as a dividend, therefore,

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80 See section 851(b) (flush language) (expressly treating amounts included in gross income under section 951(a)(1)(A)(i) or section 1293 as dividends to the extent that, under section 959(a)(1) or section 1293(c), there is a distribution out of the earnings and profits of the taxable year which are attributable to the amounts so included).

> the income is functionally equivalent to a dividend. Consequently, this income will not be treated as unrelated business taxable income under section 512.[81]

Finally, while net investment income also includes gross income derived from a passive activity or from a business of trading financial instruments or commodities, it appears that the statute contemplates only the passive activities or the trading business of the taxpayer.[82] Thus, the fact that the PFIC might be engaged in a passive activity or securities trading does not appear to affect the taxpayer. (And, in any event, many hedge funds are investors and are not engaged in a trade or business.)

Despite this technical uncertainty as to whether Subpart F and QEF inclusions are treated as dividends for purposes of the Medicare tax, it seems clear as a policy matter that they should be (unless they are derived in the ordinary course of an active business conducted by the taxpayer). Otherwise, taxpayers could entirely escape the tax by investing in CFCs and QEF PFICs.[83] This policy could be effected with a technical amendment similar to the flush language of section 851(b), or by regulations.

However, even if Subpart F and QEF inclusions are subject to the 3.8% Medicare tax on unearned income, because management fees reduce earnings and profits, an investor that

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[81] Private letter ruling 8836037 (June 14, 1988). There are other private letter rulings to this effect, see, e.g., private letter ruling 9407007 (November 12, 1993), and one to the contrary (private letter ruling 9043039 (July 30, 1990)). Congress cited the private letter rulings that treat Subpart F inclusions as dividends favorably in the Conference Report to the Small Business Job Protection Act of 1996, H.R. Rep. 104-737, 104th Cong. 2d Sess. p. 294 n. 50 (August 1, 1996).

[82] Section 1411(c)(1)(ii) refers to "other gross income derived from a trade or business" described in section 1411(c)(2); section 1411(c)(2) refers to "a passive activity. . . with respect to the taxpayer," or a trade or business of trading in financial instruments or commodities (emphasis added).

[83] The Medicare tax applies only to gross income. If Subpart F and QEF inclusions are not themselves subject to the Medicare tax, distributions by a CFC or PFIC are distributions of previously taxed income that are excluded from gross income and the distributions would therefore also escape tax.

See section 959(a) (previously taxed income is excluded from gross income); section 1293(c) (if a taxpayer demonstrates that a distribution from a PFIC is paid out of profits of the company which were included in income under section 1293(a), the distribution is treated as a distribution which is not a dividend and, to the extent of the taxpayer's basis, is not included in gross income).

invests in a foreign corporation and earns $100,000 subject to a $20,000 management fee would be subject to only a $3,040 Medicare tax, rather than the $3,800 in Medicare tax that would have been imposed had the investor directly made the investment and directly incurred the management fees (3.8% x $100,000). In other words, the foreign corporation allows an investor to net his or her investment expenses against other income and gain for purpose of determining the 3.8% Medicare tax on unearned income.

### F. Avoid the Proposals to Limit Itemized Deductions to 28% and Charitable Deductions to 12%.

The Administration's 2011 Fiscal Year budget proposed to limit the value of itemized deductions (including miscellaneous itemized deductions, but excluding interest expense and charitable contributions) to 28%.[84] The President's National Commission on Fiscal Responsibility and Reform proposed to replace the charitable deduction with a 12% non-refundable tax credit that would be available only to the extent contributions exceed 2% of a taxpayer's AGI.[85] As with the limitation on miscellaneous itemized deductions, these limitations will be entirely avoidable by a U.S. taxpayer who incurs the expense indirectly through a profitable foreign corporation that uses the expense to reduce its earnings and profits and, consequently, the Subpart F or QEF inclusions of its shareholder.

Thus, if a high-income U.S.-resident individual who is unable to deduct itemized deductions or charitable deductions causes his or her wholly-owned foreign corporation to incur an expense that would give rise to an itemized deduction for the shareholder, or makes a charitable deduction, the value of the reduction in the foreign corporation's earnings and profits will be 35% (equal to the highest marginal income tax rate in 2011), plus (starting in 2013) 3.8%

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84 General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (February 1, 2010) ("Limit the Tax Rate at Which Itemized Deductions Reduce Tax Liability to 28 Percent").

85 The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth" p. 31 (December 3, 2010).

times any net investment income offset by the expense. If the expense were incurred directly by the U.S. owner, the value of the deduction would be 28% or 12%, or less.

**G. Avoid State Law Limitations on Deductions.**

**1. In General.** New York State denies residents with adjusted gross income of more than $1 million 50% of their charitable contribution deduction and all of their other itemized deductions.[86] A number of other states limit the ability of individuals to claim miscellaneous itemized deductions.[87] For high income residents in New York and these other states, organizing a foreign corporation to incur the expenses will effectively permit the resident to deduct its share of the deductions that would otherwise be denied.

**2. An Example.** The year is 2013. The highest marginal income tax rate is 39.6%, the 3.8% Medicare tax is in effect, Congress has passed the Obama Administration's proposal to limit the value of itemized deductions to 28%, and the highest marginal New York State and City tax rate for an individual is the current rate of 12.618%.

An individual intends to invest $1 million in a hedge fund that purchases U.S. debt on the secondary market, and is an investor for U.S. tax purposes. The manager charges a 2% investment management fee based on capital invested. The investor is a resident of New York City and his miscellaneous itemized deductions (including his share of the management

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[86] For example, in New York, taxpayers with New York adjusted gross income that is greater than $1 million are unable to claim New York itemized deductions otherwise allowable except for 50% of the amount of their charitable contributions allowed under section 170. See N.Y. Tax Law section 615(f)(3). Only 25% of charitable deductions are allowable for taxpayers with New York adjusted gross income above $10 million. N.Y. Tax Law section 615(g)(2).

[87] Ariz. Rev. Stat. Ann. §43-1042(A); Ark. Code Ann. §26-51-436; Cal. Rev. & Tax. Cd. §17073; Del. Code Ann. 30 §1107; Ga. Code Ann. §48-7-27(a); Hawaii 235-2.3; Idaho Form 40 Instructions; Iowa Admin code 701-41.11; Kan. Stat. Ann. §79-32,118; Kan. Admin. Regs. §92-12-27); Ky. Rev. Stat. Ann. §141.010(11); Md code tax-gen 10-218(b)(3); Minn. Stat. §290.01, Subd. 19; Minn. Stat. §290.01, subd. 22); Miss. Code Ann. §27-7-17(3); Missouri (Mo. Rev. Stat. §143.141); Mont. Code Ann. §15-30-2131; Mont. Code Ann. §15-30-2132); Neb. Rev. Stat. §77-2716.01(3); North Dakota (N.D. Cent. Code §57-38-01(12)); Or. Rev. Stat. §316.695(1)(c)(A); R.I. Gen. Laws §44-30-2.6(c)(2)(C); S.C. Code Ann. §12-6-560; S.C. Code Ann. §12-6-570); Vt. Stat. Ann. 32 §5811(21)); Va. Code Ann. §58.1-322(D); Va. Admin. Code 23 §10-110-143).

fee) will not exceed 2% of his adjusted gross income. The following chart illustrates the benefits of investing in an offshore corporation as opposed to a domestic partnership. Assume that the offshore corporation is a PFIC and the U.S. investor has made a QEF election with respect to it.

| Income | Distribution | Domestic Partnership | Foreign Corporation |
|---|---|---|---|
| $100,000 | $80,000[88] | | |
| | Federal Income Tax | $36,066.96[89] | $28,853.57[90] |
| | New York State and City Tax | $12,618.00[91] | $10,094.40[92] |
| | 3.8% Medicare tax | $3,800.00[93] | $3,040.00[94] |
| | Aggregate Tax | $52,484.96 | $41,987.97 |
| | After-Tax Economic Income | $27,515.04[95] | $38,012.03[96] |
| | Effective Rate | 65.61% | 52.48% |
| | Tax Savings | | $9,971.68 |
| **Income** | **Distribution** | **Domestic Partnership** | **Foreign Corporation** |
| $20,000 | $0[97] | | |
| | Federal Income Tax | $7,213.39[98] | $0 |
| | New York State and City Tax | $2,523.60[99] | $0 |
| | 3.8% Medicare Tax | $760.00 | $0 |
| | Aggregate Tax | $10,496.99 | $0 |
| | After-Tax Economic Income | -$10,496.99 | $0 |
| | Effective Rate | Infinite | 0% |
| | Tax Savings | | $10,496.99 |

These examples clearly demonstrate the benefit to a New York City resident of investing through a foreign corporation rather than directly. However, the second example, in

88 $100,000 - $20,000 management fee.

89 ($100,000 x 39.6%) – (28% x $100,000 x 12.618%). (8.97% New York State tax plus 3.648% New York City tax).

90 ($80,000 x 39.6%) – (28% x 80,000 x 12.618%).

91 $100,000 x 12.618%.

92 $80,000 x 12.618%.

93 $100,000 x 3.8%.

94 $80,000 x 3.8%.

95 $80,000-$52,484.96

96 $80,000-$41,987.97

97 $20,000 – $20,000 management fee.

98 ($20,000 x 39.6%) – (28% x $20,000 x 12.618%).

99 $20,000 x 12.618%.

particular, does cause some pause. It illustrates a situation where the taxpayer has not earned any economic income (because the income of $20,000 is offset by an equal amount of expenses), but if the taxpayer invests directly, he or she is subject to over $10,000 of tax. An investment through a foreign corporation avoids this tax on "phantom income."

The tax arises because the income is offset by management fees, the management fees constitute miscellaneous itemized deductions and, for this taxpayer, miscellaneous itemized deductions are disallowed.

The denial of deductions for miscellaneous itemized deductions was intended to simplify the tax law and "relieve taxpayers of the burden of recordkeeping [for small amounts]."[100] These policies are not in play in these two examples, which involve a single item of significant magnitude.[101] As a result, it is worth at least considering whether the result obtained by using a foreign corporation should be the rule rather regarded as a loophole.

### H. State Tax Deferral.

Some states permit deferral, even for passive income. For example, Hawaii does not impose tax on the income of a PFIC until it is distributed.[102] Thus, these states affirmatively encourage their residents to keep their investments abroad.

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[100] Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 at p. 78 (May 4, 1987).

[101] It is worth mentioning that the original proposal contained a floor of only 1% and would have raised $13.202 billion. Report of the Committee on Ways and Mems on H.R. 3838 (The Tax Reform Act of 1985), Rept. 99-426, 99th Cong., 1st Sess. (December 7, 1985). The final version contained the 2% floor and was expected to raise $20.462 billion. Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 at p. 81 (May 4, 1987).

[102] See Haw. Rev. Stat § 235-2.3(b)(29) and (33) (Subpart F and the PFIC rules are inoperative); Hawaii Form N-11, p. 23 ("Owners of Certain Foreign Corporation": "Federal law requires that shareholders of [CFCs and PFICs] recognize certain income earned by these companies before the companies distribute dividends. Hawaii has no comparable provisions.").

### I. Using the Earnings and Profits Rules To Avoid Other Limitations on Deductions and Losses.

**1. The Earnings and Profits Rules Generally.** As mentioned above, 10% United States shareholders in CFCs are required to report and pay tax on their pro rata portion of the CFC's Subpart F income, and U.S. taxpayers holding interests in QEF PFICs are required to report and pay tax on the PFIC's ordinary income and net capital gains. However, in each case, inclusions are limited to the extent of the CFC's or PFIC's earnings and profits for the taxable year. The concept of earnings and profits is at its heart based on cash-flow, "to approximate a corporation's power to make distributions which are more than just a return on investment."[103]

The earnings and profits limitation effectively permit current Subpart F income to be offset by current non-Subpart F losses. For example, if a CFC earns $100 of interest income and has a net $100 loss on non-Subpart F manufacturing activity, the CFC's United States shareholders are not required to recognize the Subpart F income.[104]

Congress has realized that the disparity between the calculation of taxable income and earnings and profits creates shelter potential, particularly for individual shareholders, and in certain specific cases has adjusted the earnings and profits rules to conform more closely to economic income to prevent taxpayers from sheltering income.[105]

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[103] Beck v. Commissioner, 52 T.C. 1, 6 (1969), aff'd per curiam, 433 F.2d 309 (5th Cir. 1970).

[104] See Lange, Gordon, Pronley, Layden & Broenen, "Foreign Corporation Earnings and Profits," 932 2d Tax Management Portfolio A-116 (2008).

[105] See section 964(a). Very generally, sections 952(c)(3) and 964(a) provide that a CFC's or QEF PFIC's earnings and profits are determined under the same rules as for domestic corporations, except that adjustments for LIFO recapture and installment sales, and the completed contract method of accounting, are disregarded, and earnings and profits are not decreased by illegal bribes, kickbacks or other payments described in section 162(c). The first set of adjustments (for LIFO recapture, installment sales and the completed contract method of accounting) are designed to prevent CFCs from recognizing earnings and profits (but no taxable income) in an early year (and thereby allowing 10% United States shareholders to avoid a Subpart F inclusion in the early year), and taxable income but no current earnings and profits in a later year, allowing 10% United States shareholders to avoid an inclusion in the later year by reason of the earnings and profits limitation.

However, while Congress has denied a variety of deductions, it has failed to conform the earnings and profits rules. This neglect allows taxpayers to use foreign corporations to generate deductions for earnings and profits purposes that are not allowable for federal income tax purposes. These "earnings and profits deductions" may be used to offset the positive earnings and profits of a CFC or QEF PFIC and effectively allow shareholders to use foreign corporations to produce deductions that otherwise would have been denied. Specific examples follow.

**2. Section 382 Avoidance.** Section 382 limits the amount of net operating losses ("NOLs") and certain recognized built-in losses that a corporation can use if it experiences an "ownership change."[106] As a preliminary matter, is unclear whether section 382 applies to limit the losses and recognized built-in losses of a foreign corporation that is not engaged in a trade or business in the United States. However, the IRS has suggested that it does and, in any event, section 382 appears to be relevant for purposes of determining Subpart F income.[107]

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[106] An ownership change occurs if the percentage of the stock of the loss corporation owned by one or more 5% shareholders increased by more than 50 percentage by the 5% shareholders over a three-year rolling period. See section 382(g).

[107] Section 382(e)(3) provides that, except as otherwise provided in regulations, in determining the value of any old foreign loss corporation, there is taken into account only items treated as connected with the conduct of a trade or business in the United States.

One could read section 382(e)(3) to mean that foreign corporations that are not engaged in a trade or business in the United States are not subject to section 382. This view would have some support from the legislative history to the repeal of the chain deficit role of section 952(d). One reason for the repeal was that, "Loss trafficking with respect to foreign corporations is not restricted by any rule corresponding to the special anti-loss trafficking rule (Code sec. 382) applicable to U.S. corporations." See H. Cong. Rep. No. 99-841 at II-623 (1986).

However, in Chief Counsel Advice 2002-38025 (June 14, 2002), the IRS suggested that section 382(e)(3) means that the section 382 limitation for a foreign corporation without a U.S. trade or business is zero and, in Field Service Advice 003300, 1996 FSA Lexis 192 (December 17, 1996), the IRS held that "section 382 probably would apply in computing a CFC's taxable income under Reg. section 1.952-2(b)."

I thank Robert Scarborough for pointing out this issue and the one discussed in the subsequent footnote.

Nevertheless, section 382 does not appear to limit the reduction of earnings and profits.[108] Thus, a foreign corporation is, apparently, permitted to deduct from earnings and profits its recognized built-in losses even if the foreign corporation experiences an ownership change. Since 10% United States shareholders of a CFC and U.S. shareholders of QEF PFICs include in income only their pro rata portion of the CFC's or QEF PFIC's current year earnings and profits, U.S. taxpayers that operate a business through a foreign corporation generally have a greater ability to use losses than had they operated the business directly. The ability to use recognized built-in losses to reduce income for earnings and profits purposes also encourages trafficking in the stock of offshore corporations with built-in losses.

**3. Avoid the Limitation on the Deductibility of Personal Interest Expense.** Individuals are not permitted deductions for "personal interest" expense.[109] However, interest expense is deductible without limitations for purpose of determining earnings and profits. Therefore, if an individual shareholder of a foreign corporation causes the foreign corporation to borrow funds, distributes them, and the shareholder uses them for personal purposes, the corporation's interest expense on the borrowing will reduce its earnings and profits and therefore reduce the income that the shareholder reports each year. Accordingly, by having

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[108] Regulations section 1.312-6(a) provides that earnings and profits are dependent upon the taxpayer's method of accounting. If section 382 represented a method of accounting, then a section 382 limitation would apply equally to the calculation of earnings and profits. However, the regulations refer only to the cash, accrual and installment methods of accounting, and the accounting rules governing insurance companies, as methods of accounting. And when Congress has intended to defer a loss for earnings and profits purposes, it has done so expressly. See, e.g., section 312(f) (flush language) (losses disallowed under section 1091 do not reduce earnings and profits); section 312(n)(1) (construction period carrying charges do not reduce earnings and profits). Therefore, it appears that section 382 is not treated as a method of accounting for purposes of section 312.

[109] See section 163(h). Personal interest expense is any allowable interest expense, other than (i) interest property allocable to a trade or business, (ii) investment interest, (iii) passive activity interest expense, (iv) qualified residence interest expense, (v) underpayment interest expense under section 6601, and (vi) education loan interest expense.

the foreign corporation borrow the funds, the shareholder will effectively be able to indirectly deduct personal interest expense that could not be deducted directly.

**4. Avoid the Limitation on the Deductibility of Organization and Syndication Expenses.** Syndication costs are not deductible or amortizable and, if a company's organization costs exceed $55,000, the organizational costs must be amortized over a 180-month period.[110]

However, all of a company's syndication and organization costs are fully deductible for purposes of determining earnings and profits and therefore an individual taxpayer who invests in a foreign corporation with sufficient income will effectively be able to deduct its share of the foreign corporation's organization and syndication expenses.

**5. Avoid the Straddle Rules.** The straddle rules defer the ability of investors to recognize losses on the disposition of a position in a straddle and limit the deductibility of interest expense allocable to property that is part of a straddle.[111] These losses and expenses are, however, fully deductible for earnings and profits purposes and therefore a taxpayer who invests in a foreign corporation with sufficient income can effectively deduct its share of the foreign corporation's straddle losses and interest expense allocable to the straddle.

**6. Avoid the Limitations on Capital Loss Deductibility.** An individual is permitted to deduct only $3,000 of capital losses against ordinary income,[112] and corporations cannot deduct any capital losses against ordinary income. However, capital losses of a CFC or QEF PFIC reduce the foreign corporation's earnings and profits without restriction. Therefore, a U.S. investor in a CFC or QEF PFIC will effectively be able to deduct and offset the capital

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[110] See section 709(b)(1)(A) & (b)(3); Treasury regulations section 1.709-2(a).

[111] See section 1092 and section 263(g).

[112] Section 1211(b).

losses of the foreign corporation against the foreign corporation's ordinary income without limitation.

**7. Avoid the Section 264 Limitations on Deductibility of Interest.** In general, section 264(a)(1) denies deductions for premiums on life insurance policies and annuity contracts if the taxpayer is directly or indirectly a beneficiary under the policy or contract. Thus, a U.S. taxpayer that purchases a life insurance policy and directly pays premiums on it will be denied deductions for the premiums. However, the IRS has held that amounts that are disallowed under section 264 nevertheless reduce earnings and profits.[113] Therefore, if a U.S. taxpayer organizes a foreign corporation to purchase a life insurance policy, although the foreign corporation will not be able to deduct the premium payments, the premium payments will reduce its earnings and profits (assuming it has positive earnings and profits in the year the premiums are paid). This reduction in earnings and profits will, in turn, reduce the U.S. taxpayer's income inclusions.[114]

In addition, section 264(a)(2)-(4) denies interest expense deductions for interest paid or accrued on indebtedness that is incurred or continued to purchase or carry life insurance and annuity contracts. However, in Situation 4 of Revenue Ruling 2004-47, one member of an affiliated group borrowed funds from a third party and loaned them to another member of the affiliated group, which purchased tax-exempt bonds. The owner of the tax-exempt bonds was

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[113] General Counsel Memorandum 36314 ("The proposed revenue ruling concludes that expenses for key man and employee life insurance premiums in excess of cash surrender value, which are nondeductible under Code section 264, reduce corporate earnings and profits. We agree that these expenses clearly deplete the income available for distribution to stockholders and, thus, are a proper reduction of earnings and profits. This point is well-settled and is accepted by the Service."); private letter ruling 7312200210A ("Among the items requiring a downward adjustment in earnings and profits are premiums on term life insurance which are disallowed in computing taxable income by section 264 of the Code.").

[114] Because death benefits on a U.S. life insurance policy paid to a foreign corporation are subject to a 30% withholding tax, the U.S. taxpayer will probably wish to organize the foreign corporation in a treaty jurisdiction so as to qualify for benefits under a treaty.

denied interest expense deductions under section 265(a).[115] Revenue Ruling 2004-47 provides that the lending member is treated as using the borrowed funds to make a loan to its affiliate (and not to purchase or carry tax exempt obligations), and therefore, the lending member is not also denied interest expense deductions on its third party loan.[116]

The statutory language of section 264(a) is virtually identical to the language of section 265(a). Therefore, if a U.S. corporation organizes a foreign corporation, borrows funds, loans those funds to the foreign corporation, and the foreign corporation uses the funds to purchase life insurance, Revenue Ruling 2004-47 appears to provide that the U.S. corporation is not denied interest deductions under section 264(a). The foreign corporation would be denied interest deductions under section 264(a) for the interest paid to its U.S. shareholder, but these payments of interest would still reduce its earnings and profits (and therefore reduce the U.S. shareholder's inclusions). Effectively, the foreign corporation indirectly permits the U.S. shareholder to deduct interest on debt used to purchase a life insurance policy.

Very generally, section 264(f) denies a U.S. taxpayer and its 50% controlled and controlling affiliates a portion of their unrelated interest expense if the taxpayer owns life insurance policies with unborrowed cash surrender values.[117] A U.S. shareholder that owns a

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115 Revenue Ruling 2004-47, 2004-21 I.R.B. 941. See section 265 (denying interest expense on indebtedness incurred or continued to purchase or carry tax-exempt obligations).

116 See Revenue Ruling 2004-47, Example 4. ("If the funds borrowed by a member of an affiliated group are directly traceable to a loan to another member that is a dealer in tax-exempt obligations, 265(a)(2) does not apply to disallow the interest expense of the lending member, but does apply to disallow a portion of the interest expense of the dealer.").

117 See section 264(e)(5), (f)(8).

Under section 264(f), a taxpayer's disallowed interest expense is equal to the taxpayer's total interest expense (including the interest expense of its 50% controlled and controlling affiliates) multiplied by a fraction, the numerator of which is the "unborrowed policy cash values of life insurance and annuity contracts" and the denominator of which is the sum of the unborrowed policy cash values and the average adjusted bases of all of the taxpayer's other assets. Section 264(f)(2).

The term "unborrowed policy cash values" is defined as "the excess of (A) the cash surrender value of such policy or contract determined without regard to any surrender charge, over (B) the amount of any loan in respect of such policy or contract." If the unborrowed policy cash values do not reasonably

*(continued on next page)*

foreign subsidiary that holds insurance policies is potentially subject to interest disallowance under section 264(f).

However, to the extent a member of the controlled group has been disallowed interest deductions under section 264(a), the disallowed interest is not taken into account for purposes of applying section 264(f),[118] and the fraction for determining the amount of interest expense to be denied under subsection (f) is adjusted.[119] Although the language is not entirely clear, the effect of the adjustment appears to turn off section 264(f) to the extent that interest is denied under section 264(a).[120] Under this reading, because the foreign corporation has been denied interest deductions under section 264(a), the U.S. shareholder is not subject to disallowance under section 264(f), even though the U.S. shareholder effectively obtains the benefits of interest deductions through the reduction of the foreign subsidiary's earnings and profits by the interest expense paid to the U.S. shareholder.

**8. Avoid the AHYDO Rules.** An "applicable high yield discount obligation" ("AHYDO")[121] is a debt obligation that is issued by a corporation, will mature more than five years from the date of its issuance, has a yield to maturity that is equal to or exceeds

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approximate the policy's actual value, then the greater of the amount of insurance company liability or the insurance company reserve with respect to such policy is used instead.

118 See section 264(f)(6).

119 Section 264(f)(6)((A)(ii). Specifically, the coordination rule states that "the amount otherwise taken into account under paragraph (2)(B) [the denominator] shall be reduced (but not below zero) by the amount of such indebtedness."

120 It appears that loans and other indebtedness incurred or continued to purchase or carry a life insurance or annuity contract are treated as "loans in respect of such policy or contract" and reduce the numerator of the fraction used to calculate disallowed interest expense for purposes of applying section 264(f).

Section 265 contains a coordination rule similar to that contained in section 264. The coordination rule in section 265 unambiguously reduces both the numerator and denominator of fraction used to calculate disallowance under subsection (b), and therefore, operates to reduce the amount of interest expense disallowed under subsection (b) to account for interest expense already disallowed under subsection (a). Congress's intent to provide mitigating, not penalizing, coordination rules to account for previously disallowed interest expense is evidenced in the operation of section 265.

121 See generally section 163(e)(5).

5% more than the applicable federal rate ("AFR") in effect for the month during which the debt is issued, and is issued with "significant" original issue discount ("OID").[122]

Generally, the AHYDO rules deny the issuer a deduction for the OID on the AHYDO until interest is actually paid.[123] Moreover, if the yield on an AHYDO is greater than the AFR by more than 6%, the issuer is disallowed a deduction for the portion of the interest payable on the AHYDO in excess of six percent over the AFR (the "disqualified portion").[124] However, earnings and profits are generally reduced by OID, and the AHYDO rules do not affect earnings and profits calculations. So, a U.S. taxpayer can avoid the AHYDO limitations by organizing a foreign corporation to incur the AHYDO debt.

### J. Avoid FBAR Filings.

The recently proposed FBAR regulations also encourage U.S. taxpayers to organize foreign entities: quite inadvertently, they permit United States persons to entirely avoid their FBAR reporting requirements by organizing foreign entities that beneficially own the United States person's foreign financial accounts, but don't hold title to the accounts.

By way of background, the Bank Secrecy Act of 1970 provides that the Secretary of the Treasury must require U.S. residents and citizens to keep records and file reports when that person makes a transaction (or maintains a relationship) with a foreign financial agency.[125]

Proposed regulations issued on February 25, 2010 generally require U.S. citizens, resident aliens and entities created, organized or formed under the United States, a State, the District of Columbia, and the U.S. territories and possessions (each a "United States person") to file Form TD F 90-22.1 — the "Foreign Bank and Financial Accounts Report" (or "FBAR") —

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[122] See section 163(i).

[123] Section 163(e)(5)(A)(iii).

[124] Section 163(e)(5)(A)(ii).

[125] 31 U.S.C. section 5314(a).

with respect to any "foreign financial account"[126] in which they have a "financial interest" or signature authority.

A United States person has a financial interest in a foreign financial account if (i) the United States person is the record owner or has legal title, (ii) someone other than the United States person is the owner of record or holder of title and this other person is acting as agent, nominee, attorney, or in another capacity on behalf of the United States person, or (iii) the United States person owns a substantial interest in an entity and that entity is the record owner or holder of legal title of a foreign financial account.[127]

There is also an anti-abuse rule that provides that a United States person that causes an entity to be created for a purpose of evading the FBAR rules is deemed to have a financial interest in any foreign financial account for which the entity is the owner of record or holder of legal title.[128]

However, the proposed regulations apparently permit a United States person to entirely avoid its FBAR reporting requirements by organizing a foreign entity (of which the

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[126] A foreign financial account includes certain bank accounts, securities accounts and "other financial accounts" located in a foreign country. See Draft Instructions to the Report of Foreign Bank and Financial Accounts — Form TDF90–22.1 (FBAR) ("A financial account includes, but is not limited to, a securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution (or other person performing the services of a financial institution) . . . . A foreign financial account is a financial account that is located outside of the United States.").

[127] The ownership threshold is more than 50% of the vote or value for a corporation, more than 50% of the interest in profits or capital for a partnership, or a beneficial interest in more than 50% of a trust's assets or current income. 31 CFR 103.24(e)(2)(ii) ("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] corporation in which the United States person owns directly or indirectly more than 50 percent of the voting power or the total value of the shares [or] a partnership in which the United States person owns directly or indirectly more than 50 percent of the interest in profits or capital."); 31 CFR 103.24(e)(2)(iv) ("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 in which the United States person either has a beneficial interest in more than 50 percent of the assets or from which such person receives more than 50 percent of the income.").

[128] 31 CFR 103.24(e)(3) ("A United States person that causes an entity . . . to be created for a purpose of evading [FBAR reporting] shall have a financial interest in any bank, securities, or other financial account in a foreign country for which the entity is the owner of record or holder of legal title.").

United States person could own all of the equity), and by finding a third party to hold legal title to the entity's foreign financial accounts as agent of the foreign entity.[129] In this case, the United States person would not be required to file an FBAR because, although it owns 100% of the vote and value of the foreign entity, the foreign entity is not the record owner or holder of legal title (i.e., the attribution rules apply only if the entity is the record owner or holder of legal title).[130] Moreover, the agency rule would not require the United States person to file an FBAR because (i) the agent is holding title only for the foreign entity, (ii) the proposed regulations clearly respect entities (going so far as to respect disregarded entity as entities for FBAR purposes), and (iii) foreign entities are not required to file FBARs. Finally, even if the foreign entity was created with the sole purpose to avoid FBAR reporting, the anti-abuse rule would not apply because the anti-abuse rule attributes a financial interest back to a United States person only if the abusive entity is actually the owner of record or holder of legal title, and in this example the abusive entity is neither.[131]

### K. Avoid UBTI.

**1. UBTI Generally.** Pension funds, universities, foundations and other tax-exempt entities are subject to tax at regular corporate rates on their "unrelated business taxable income" (UBTI).[132] UBTI may arise in one of two ways. First, a tax-exempt organization earns

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[129] Lee A. Sheppard, "FBAR Regulations Preserve Tax Evasion Opportunities," 2010 Tax Notes Today 49-1 (March 15, 2010) ("[I]f a nominee holds title to the account on behalf of a foreign corporation that is 50 percent owned by a U.S. person, a hyperliteral reading of the rules would say that no one is required to file FBAR for that account. The antiabuse rule would not catch this case, because it only applies when the entity is the legal owner of the account.").

[130] See 31 CFR 103.24(e)(1) ("A United States person has a financial interest in each bank, securities or other financial account in a foreign country for which he is the owner of record or has legal title whether the account is maintained for his own benefit or for the benefit of others.").

[131] See 31 CFR §103.24(e)(3).

[132] Sections 511(a)(1); Treasury regulations section 1.511-1. See also sections 512 and 513. Charitable remainder trusts must forfeit all of their UBTI. Section 664(c)(2)(2) (imposing a 100% excise tax on a charitable remainder trust's UBTI).

UBTI if it engages directly, or indirectly through a partnership, in certain active business activities that are not related to its tax-exempt purposes.[133] Second, under the debt-financed income rules of section 514, if a tax-exempt organization borrows money to make an investment or invests in a partnership that borrows money to make investments, the income or gain from the "debt-financed" investment is generally UBTI (and is subject to tax) to the proportionate extent of the borrowing, notwithstanding the fact that the income or gain might otherwise be passive investment income.[134]

However, a tax-exempt organization may avoid UBTI entirely by investing in a foreign corporation that itself borrows (or invests in a partnership that borrows) and does not engage in activities or make investments that would subject the foreign corporation to U.S. federal corporate income tax or a material amount of U.S. withholding tax. In this case, because the tax-exempt organization does not borrow, and earns only dividends or Subpart F income from the foreign corporation (which does not give rise to UBTI),[135] the tax-exempt organization

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[133] Sections 512(a) and 513(a); section 512(b); Treasury regulations section 1.512(b)-1 (excluding certain income, such as capital gains, dividends, royalties, interest income, certain rental income, securities lending income, annuities, income from notional principal contracts, loan commitment fees, options and certain other "passive investment income," from the definition of unrelated business taxable income). However, certain of these payments do give rise to UBTI if they arise from related parties and are deductible by them. Section 512(b)(13).

[134] Section 514(b) and (c); section 512(c) (the borrowing activities of a partnership are attributed to its tax-exempt partners for purposes of calculating UBTI).

More specifically, "debt-financed property" generally includes any income producing property with respect to which there is "acquisition indebtedness" at any time during the year (or during the preceding 12 months, if the property is disposed of during the year). "Acquisition indebtedness" is defined to include (a) "indebtedness incurred in acquiring or improving the property"; (b) "indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred *but for* such acquisition or improvement", and (c) "indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred *but for* such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement" (emphasis added). Section 514(b) and (c).

[135] Private letter ruling 8836037 (June 14, 1988). There are other private letter rulings to this effect, see, e.g., private letter ruling 9407007 (November 12, 1993), and one to the contrary (private letter ruling 9043039 (July 30, 1990)). Congress cited the private letter rulings that treat Subpart F inclusions as dividends favorably tax in the Conference Report to the Small Business Job Protection Act of 1996, H.R. Rep. 104-737, 104th Cong. 2d Sess. p. 294 n. 50 (August 1, 1996).

can entirely avoid the UBTI that would result had it borrowed directly. These foreign corporations are inevitably organized in the Cayman Islands or another tax haven jurisdiction and are universally referred to as "blockers" because they act to "block" the UBTI (and for foreign investors any U.S. federal income tax) that would otherwise arise.

Although the use of a blocker is potentially subject to challenge under section 269 and the business purpose doctrine, in three private letter rulings, the IRS respected a tax-exempt organization's blocker where the blocker provided the tax-exempt organization with the following three "non-tax business purposes": (i) an additional layer of limited liability protection, (ii) greater flexibility in disposing of the investment (because the general partner's consent was required to transfer the underlying fund but the tax-exempt could sell its interest in the blocker without obtaining consent), and (iii) management of the tax-exempt's investments.[136] These benefits of blockers almost always exist to some extent, but they most often pale next to the tax benefit. Although new questions will arise from the codification of the economic substance doctrine,[137] the ability of tax-exempt organizations to avoid debt-financed income by investing through blockers is so universally accepted that it is unlikely that the IRS would begin to challenge it.

**2. History and Purpose of the Debt-Financed Income Rules.** The history of the debt-financed income rules reflect a trend in tax legislation that is familiar to the modern reader: Tax-exempt organizations engaged in a transaction that was clearly abusive and Congress reacted with "nuclear bomb" legislation that not only obliterated the targeted transaction but also affected a wide range of other transactions. Congress then, piecemeal,

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[136] See private letter rulings 2002-51-016 (September 23, 2002), 2002-52-096 (September 26, 2002) and 2003-15028 (January 13, 2003).

[137] Section 7701(o).

reversed part of the original legislation, but left intact a meaningful portion that today remains, without any clear tax policy underlying it.

Section 514 was enacted with the rest of the UBTI rules in 1950.[138] But in 1950, section 514 was targeted at "Supplemental U Leases" (or "business leases"). In a Supplemental U Lease, a for-profit owner would sell developed real estate to a tax-exempt organization and immediately lease it back. The purchase was financed almost entirely by an unrelated commercial lender. The former owner used the rental income on the property to make lease payments to the tax-exempt organization, which used them to service the debt. These transactions effectively permitted the seller to convert a portion of the income from the property, which was taxable at very high ordinary income rates, into lower-taxed capital gains. At the time, the lease-terms for Supplemental U Leases were generally more than five years and so the 1950 legislation was narrowly targeted, treating only debt-financed property with a lease term of more than five years as UBTI.

This narrow reach of section 514 did not prevent what became known as "charitable bootstrap transactions". In the '50s, corporations were subject to a maximum federal income tax rate of 52% and individuals were subject to a maximum federal income tax rate of 90%, but the maximum capital gains rate for individuals was 25%. In a charitable bootstrap transaction, a tax-exempt organization would purchase the shares of a taxable corporation for a small down payment, plus a nonrecourse note payable entirely from the profits generated from the business. The tax-exempt organization would then liquidate the purchased corporation on a tax-free basis, and lease the assets to a new corporation run by the former owners for a five-year term. The new corporation would pay 80% of its operating profits to the tax-exempt

[138] The history of the UBTI rules is documented in Summer A. Lepree, "Taxation of United States Tax-Exempt Entities' Offshore Hedge Fund Investments: Application of Section 514 Debt-Financed Rules to Leveraged Hedge Funds and Derivatives and the Case for Equalization," 61 Tax Lawyer 807 (2007-2008).

organization as lease payments, and the tax-exempt organization would, in turn, use 90% of the lease payments to make payments on the note. After the five-year term of the lease, the tax-exempt organization would retain the business. Although this transaction accelerated gain for the seller, it made sense on an after-tax basis because of the 90% ordinary income rates but 25% capital gains rates.[139] Thus, before engaging in the transaction, for every $100 that was earned by a corporation and distributed to the shareholders, $95.20 was subject to tax, and $4.80 was received on an after-tax basis. A charitable bootstrap transaction permitted the shareholders to receive 72% of the corporation's income (90% of 80%), subject only to a 25% tax. Thus, of each $100 earned by the business, the taxpayer would receive $54.96 after tax (assuming a zero tax basis), the tax-exempt would receive $8.00, and the government would receive $37.04 in taxes ($26.64 paid by the shareholder and $10.40 paid by the corporation).

This chart illustrates the benefits of the transaction during the five-year term:

| | **Before** | **After** |
|---|---|---|
| **Income** | $100.00 | $100.00 |
| **Tax payable by corporation** | $52.00[140] | $10.40[141] |
| **Amount retained by tax-exempt** | $0 | $8.00[142] |
| **Tax payable by shareholders** | $43.20[143] | $26.64[144] |
| **After-tax proceeds retained by the shareholders** | **$4.80**[145] | **$54.96**[146] |

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139 45 T.C. at 574 (quoting Aldon Homes, Inc. v. Commissioner, 33 T.C. 582, 597 (1959)).

140 $100 x 52%.

141 [$100-$80 rent] x 52%.

142 Spread between rent received ($80) and payments on the note ($72).

143 $48 x 90%.

144 $18.00 [$72.00 payments on note x 25% tax (assumes zero basis)] + $8.64 [90% tax on dividend of $9.60].

145 The corporation paid 52% tax (or $52.00) on income of $100, and the shareholder paid 90% tax on the remaining $48.00 of after-tax income for total tax of $95.20.

146 $72.00 [25% x $72] + $9.60 – [90% x $9.60].

This was exactly the transaction in Brown v. Commissioner.[147]

In 1953, Clay Brown and the other shareholders in Clay Brown & Company, a California lumber company, sold all of their stock to the California Institute for Cancer Research for $5,000 and a 10-year $1.3 million nonrecourse note. The Institute also agreed that it would immediately liquidate the corporation and lease the assets for five years to a new corporation organized by Clay Brown's attorneys. This new corporation agreed that it would pay the Institute rent equal to 80% of its operating profit (before depreciation and taxes) and the Institute would use 90% of these payments (or 72% of the operating profits from the business) to make payments on the note. In addition, Clay Brown himself managed the new corporation and had the right to name any successor manager.[148] The IRS argued that no sale had occurred. The Court held for the taxpayer. Although the Court did believe that the transaction was problematic, it was afraid of the consequences of holding that the sale was not a sale for tax purposes. Justice White, writing for the court, closed his opinion with this sentence: "We . . . deem it wise to leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications."[149]

In 1966, after the Supreme Court's Brown decision, the Treasury Department appeared before Congress and essentially agreed with Justice White that, while the Clay Brown transaction was troubling, denying sale or capital gain treatment would have collateral consequences. Instead, Treasury sought to prevent these transactions by attacking the tax-exempt organization's exemption. It expressed support for two bills introduced in the House of

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147 380 U.S. 563 (1965).

148 As it turned out, the lumber market rapidly declined after the sale. The shareholders of Clay Brown & Company and the Institute agreed that the properties would be sold, the Institute would retain 10% of the proceeds and the remainder would be used to repay the note. Ultimately, the shareholders received $936,131.85 of the $1.3 million that was owed to them.

149 380 U.S. at 579.

Representatives that would extend the debt-financed income rules to all types of investments that were not directly related to the tax-exempt's charitable purposes.

Witnesses at the Ways and Means Committee hearing pointed out that the bills went far beyond preventing Clay Brown transactions. For example, the New York State Bar Association submitted draft legislation that would limit the tax to a percentage of the income from property acquired in a debt-financed transaction where the retirement of the debt was not determinable in advance (i.e., contingent on the earnings of the acquired property), or the tax-exempt's property was operated by another entity, but would earn UBTI if operated directly.[150] A representative of the Bar Association testified on the "unreasonable and inequitable" aspects of the proposed legislation, pointing out that it would impose tax on the American National Red Cross if it borrowed funds to buy General Motors stock.

> It is felt that this approach goes far beyond what is required in order to eliminate the Clay Brown abuse. What we have here is a technique which penalizes borrowing, as such, by exempt organizations, even if it is solely for the purpose of acquiring the most passive of investments.[151]

Nevertheless, Congress passed the legislation.

Congress revised the debt-financed income rules in 1980 at the behest of pension plans and the real estate lobby, which argued that pension plans should be able to invest without tax in certain leveraged real estate partnerships to diversify their volatile stock and bond portfolios and as a hedge against inflation.[152] Treasury opposed a narrow exception to the debt-financed rules:

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[150] House of Representatives, Committee on Ways and Means, Unrelated Debt-Financed Income of Tax-Exempt Organizations, Hearing Before the Committee on Ways and Means 42 (August 29, 1966)

[151] Hearings at 43.

[152] Miscellaneous Tax Bills V: Hearings Before the Subcomm. on Taxation and Debt Management of the S. Finance Comm., 96th Cong. 269, 314 (February 29, 1980) ("1980 Hearings") (statement of Thomas J. Goldberg, President, Smith Barney Real Estate Corp.).

*(continued on next page)*

> As a matter of policy, we think the character of income in the hands of a collective investment vehicle should remain the same in the hands of the participants as it would be if they had made the investment directly . . . .[153]
>
> The real question for [Congress] to consider is whether we want to tax the income that pension funds earn on leveraged real estate investments . . . [I]f the answer is no, we ought to take a broad approach and not continue to proliferate narrow exceptions.[154]

Congress ultimately rejected this argument, accepted the investment banks' proposal, and enacted section 514(c)(9).[155] As originally enacted, section 514(c)(9) was limited to pension plans.

In 1984, educational institutions sought to have section 514(c)(9) expanded to cover them. Treasury again resisted what it referred to as the "piecemeal repeal" of section 514 and expressed concern about partnerships being used to transfer tax benefits from tax-exempts to taxable investors. Congress again rejected Treasury's pleas, but responded to the abuse concerns by imposing restrictive requirements on partnership allocations to prevent abuse.

While this history lacks a clear and unambiguous statement by Congress to impose UBTI on tax-exempts that directly or indirectly finance their passive investment in stocks and securities, it does rather conclusively demonstrate that Congress did intend for the UBTI rules to apply to all debt-financed transactions unless, as is the case with section 514(c)(9), a

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More specifically, at the time, the unrelated debt-financed income provisions did not apply to retirement plan funds that were held by an insurance company in a segregated asset trust (under section 801(g)) or a common trust fund maintained by a bank (under section 584), but pension funds were subject to the debt-financed income rules if they participated in a partnership that bought leveraged real estate. See 1980 Hearings at 105 (Summary of S. 650). The investment banks argued for equal treatment for pension plans that invested in a leveraged partnership managed by an investment bank.

The IRS has since held that common trust funds do generate UBTI. See Revenue Ruling 98-41, 1988-2 C.B. 256.

[153] 1980 Hearings at 316 (statement of Daniel I. Halperin, Deputy Assistant Secretary of Treasury); see also 1980 Hearings at 285 (statement of Daniel I. Halperin, Deputy Assistant Secretary of Treasury).

[154] 1980 Hearings at 295, 316 (statement of Daniel I. Halperin, Deputy Assistant Secretary of Treasury).

[155] S. Rep. No. 96-1036, at 2a (1980).

specific exception is provided. Unfortunately, it also suggests that section 514 was crafted less by prudent tax policy and more by politics.

**3. H.R. 3497.** On July 31, 2009, Sander Levin, now the Chair of the House Ways and Means Committee, introduced H.R. 3497, which would exclude from the definition of "acquisition indebtedness" any indebtedness incurred or continued by a partnership in which a tax-exempt organization is a limited partner (directly or indirectly through another partnership) in purchasing or carrying any share of stock in a corporation, widely held or publicly traded partnership or trust, indebtedness, interest rate, currency or equity notional principal contract or actively traded commodity.

The bill would, therefore, eliminate the need for a tax-exempt organization to use a foreign blocker to invest in a hedge fund partnership that, in turn, borrows to make its investments.

However, the bill would go beyond merely maintaining the status quo and eliminating the inconvenience of investing through a foreign blocker. Instead, the bill would reduce tax liability for tax exempts. Under current law, a tax-exempt can avoid tax on debt-financed investments through a foreign blocker only to the extent that the blocker is not subject to tax. Thus, if a tax-exempt organization invests today in a foreign blocker that borrows to purchase U.S. dividend-paying equity securities, the tax-exempt will be indirectly subject to a 30% U.S. withholding tax on its share of dividend income. Under the bill, a tax-exempt could avoid this tax by investing directly in a hedge fund partnership.

On the other hand, by exempting a tax-exempt organization from UBTI only if it invests through a partnership (but not if it borrows and buys securities directly), the bill creates perverse incentives and invites criticism that it acts to subsidize the hedge fund industry.

## IV. Hurdles, Costs and Inconveniences of Investing Through a Foreign Corporation.

Enjoying tax benefits by investing through a foreign corporation is possible only if certain hurdles, namely section 269 and the economic substance doctrine of new section 7701(o), are cleared. And even then, there are distinctive costs and inconveniences to using a foreign corporation.

### A. The Hurdles: Section 269 and the Economic Substance Doctrine.

**1. Section 269.** Section 269(a)(1) provides that if any person or persons directly or indirectly forms a corporation, or acquires stock possessing at least 50% of the vote or value of a corporation, and the principal purpose for the acquisition is evasion or avoidance of federal income tax by securing the benefit of a deduction, credit, or other allowance which such person would not otherwise enjoy, then the IRS may disallow the deduction, credit or other allowance.[156]

Could the IRS use section 269 to deny many benefits that an individual, domestic corporation or tax-exempt may obtain by organizing a foreign corporation and investing in it? Probably not.

First, section 269 applies only if the taxpayer (or taxpayers) acquire 50% or more of the vote or value of the corporation. So section 269 likely does not apply if U.S. investors hold only a minority investment in a foreign blocker.

Second, even if a U.S. taxpayer (or U.S. taxpayers) acquire control of a foreign blocker, in Commodores Point Terminal Corp. v. Commissioner,[157] the Tax Court held that the predecessor to section 269 did not apply where the allowance was not dependent upon the taxpayer acquiring control. In Commodores Point, the taxpayer acquired 58% of Piggly Wiggly

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[156] Section 269 applies to the formation of a new corporation. See James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960) (incorporation of a real estate holding company constitutes an acquisition under section 269).

[157] 11 T.C. at 417.

Corporation and claimed a dividends paid credit when Piggly Wiggly paid dividends. The IRS sought to invoke the predecessor to section 269 to disallow the credit. The court held for the taxpayer:

> The dividends received credit claimed by petitioner in its 1944 return was in no sense dependent upon petitioner's acquisition of a controlling interest in the Piggly Wiggly Corporation. Petitioner would have received dividends and would have been entitled to claim a dividends received credit proportionately as great from any number of shares less than an amount constituting a controlling interest. There is no evidence nor does respondent suggest that petitioner received its dividends by virtue of its controlling interest.[158]

Third, several courts have held that section 269 does not apply to a benefit that merely results in deferral of tax, as opposed to reduction in ultimate tax liability.[159] So the

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[158] 11 T.C. 411 (1948).

In Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957), the court held that the predecessor to section 269 did disallow a surtax exemption and minimum excess profits credit where the taxpayer contributed property to a wholly-owned subsidiary. Although the tax court had held for the taxpayer under the reasoning in Commodore Points, the Fourth Circuit reversed on the ground that Coastal Oil Storage could claim the surtax exemption and minimum excess profits only by reason of the parent's contribution of property to it and because Congress specifically indicated that section 129 (the predecessor to section 269) was intended to deny the surtax exemption and minimum excess profits credit. However, Commodores Point does remain good precedent for tax-exempts that invest in foreign blocker corporations — the tax exempt's allowance (i.e., exemption from UBTI) is not dependent on contribution of property, and there is no mention of UBTI in the legislative history to section 269.

[159] Rocco, Inc. v. Commissioner, 72 T.C. 140 (1979) ("a benefit which defers the tax burden does not result ultimately in the avoidance or evasion of tax"); Siegel v. Commissioner, 45 T.C. 566 (1966), acq. 1966-2 C.B. 3 (same); Bijou Park Properties v. Commissioner, 47 T.C. 207 (1966) (section 269 does not apply where "the benefit involves nonrecognition of income and not a 'deduction, credit or other allowance'"); Cherry v. United States, 265 F. Supp. 969 (C.D. Ca. 1967) ("statutory provisions dealing with non-recognition of gain . . . are not encompassed or rightfully described by the terms 'deduction', 'credit' or 'allowance' and, quite plainly section 269 does not deal with nonrecognition concepts"). Compare Treasury regulations section 1.269-1(a) (the term "allowance" refers to anything in the internal revenue laws which has the effect of "diminishing" tax liability) with proposed regulations section 301.6111-3(c)(7) ("[a] tax benefit includes deductions, exclusions from gross income, nonrecognition of gain, . . ., and any other tax consequences that may reduce a taxpayer's Federal tax liability by affecting the amount, timing, character, or source of any item of income, gain, expense, loss, or credit.").

While the IRS has asserted that an acquisition for the purpose of relying on a nonrecognition provision is subject to section 269, the IRS candidly acknowledged that its position is contrary to case law. See, e.g., Technical Advice Memorandum 200204002 (October 4, 2001) ("The Service recognizes the existence of counter authorities to the use of section 269 to prevent nonrecognition treatment . . . . The Service disagrees with these authorities").

formation and use of a CFC merely to defer non-Subpart F income does not implicate section 269.

Fourth, as discussed above, the IRS has repeatedly ruled in private letter rulings that it would respect the use of a wholly-owned foreign corporation by a tax-exempt organization to avoid UBTI where the foreign corporation provided an added layer of limited liability, provided greater flexibility in disposing of the underlying investment, and permitted management of the taxpayer’s investments. These non-tax business purposes apply to virtually all investments through foreign corporations. If they are sufficient to allow a tax-exempt to establish that the principal purpose for setting up a wholly-owned foreign blocker is not the avoidance of federal income tax by securing the benefit of an allowance which the taxpayer would not otherwise enjoy, then they must be sufficient for a taxable investor to make the same showing.

Finally, regardless of whether the IRS could assert that section 269 denies the benefits of investing through a foreign corporation, it should not. The benefits of investing through a foreign corporation that I describe in this paper are generally applicable, long-standing, pretty clear as a matter of law, and generally reflect a strong historic basis (such as in the earnings and profits limitation to inclusion and inapplicability of miscellaneous deduction limitation to expenses incurred by a foreign corporation). Section 269 is a blunt and messy weapon: it is fundamentally factual, introduces inherent uncertainty and, if successfully invoked, denies benefits without regard to costs. In short, if the benefits described in this paper are inappropriate, the substantive law should be changed.

**2. Economic Substance.** The Health Care Reconciliation Act of 2010 codified the economic substance doctrine. Under new section 7701(o), if the economic substance doctrine is relevant to a transaction, it will be satisfied only if (1) the transaction changes the taxpayer’s economic position in a meaningful way (apart from federal income tax consequences) and (2) the taxpayer has a substantial non-federal tax purpose for entering into the transaction.[160] The potential for profit is treated as a substantial non-tax purpose only if the present value of the reasonably expected pre-tax profit from the transaction is "substantial" as compared to the present value of the expected net tax benefits that would be allowed if the transaction were respected.[161] In addition, fees, other transaction expenses, and foreign taxes, are treated as expenses in determining pre-tax profit.[162]

If a transaction does not have economic substance under this test, new section 6662(i) imposes a 40% penalty on understatements attributable to the transaction, unless the taxpayer has adequately disclosed to the IRS the relevant facts affecting the tax treatment of a transaction, in which case the penalties are 20% of the understatement.[163]

Does an investment through a foreign blocker principally to reduce taxes have economic substance? So long as the underlying investment is entered into for profit, almost certainly yes.

The Joint Committee of Taxation's explanation of section 7701(o) provides that, "The provision is not intended to alter the tax treatment of certain basic business transactions that, under long standing judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages."[164] Among the transactions that satisfy this criteria is "a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment".

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160 Section 7701(o)(1)(A), (B).

161 Section 7701(o)(2)(A).

162 Section 7701(o)(2)(B). Also, under section 7701(o), any state or local tax income tax effect that is related to a federal income tax effect is treated in the same manner as a federal income tax effect, and a financial accounting benefit is not treated as a non-tax purposes for a transaction.

163 Section 6662(i).

164 Staff of the Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions Contained in the 'American Workers, State and Business Relief Act of 2010,' As Passed By the Senate on March 10, 2010," JCX-11-10 at p. 189 (March 11, 2010).

The Joint Committee Staff cited Siegel v. Commissioner,[165] as authority for the proposition and include a "but see" citation to Commissioner v. Bollinger.[166]

In 1956, Sam Siegel, planned to enter into a joint venture with a Cuban farmer under which Siegel would invest $25,000-$30,000 for a 20% stake in a Cuban farm.  Siegel wished to keep this joint venture separate from his own produce business, to limit his personal liability, to protect his reputation and credit, and to protect his license under the Perishable Commodities Act.  Siegel thought he would organize a Cuban corporation.  He consulted a Miami attorney who recommended that Siegel form a Panamanian corporation instead because of Panama's banking facilities, and for tax reasons; presumably, the Panamanian corporation wouldn't be subject to material Panamanian tax, and could permit Siegel to defer his own U.S. taxes.  (Subpart F and the PFIC rules had not yet been enacted.)

The venture was wildly successful and two years later it distributed over $500,000 in profit to Siegel's Panamanian corporation, where Siegel left it.  Nevertheless, the IRS included the distribution directly in Siegel's gross income either because the Panamanian corporation was a sham or because section 269 applied.

In short order, the Tax Court dismissed both arguments.  The court grudgingly accepted Siegel's nonbusiness reasons for holding his interests through a corporation:[167]

> To be sure, we are not so naïve as to think that tax consequences were not taken into account in organizing [the Panamanian corporation], and the record suggests that tax considerations did play a part.  The only apparent purpose for the formation of a Panamanian corporation rather than a U.S. corporation was to avoid payment of any tax on the income from the joint venture as it was earned.  But, prior to the Revenue Act of 1962, adding section

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[165] 45 T.C. 566 (1966), acq. 1966-2 C.B. 3.

[166] 485 U.S. 340 (1988).

[167] 45 T.C. at 574 ("We have accepted the conclusion on the record, although without strong conviction, that [Siegel] was in fact moved by these considerations in substantial part, in incorporating [the Panamanian corporation].")

> 951 to the 1954 Code, there was a loophole in the Code which permitted that result, and petitioner was free to take advantage of it. The question before us is not to be clouded by the use of a foreign corporation, rather than a domestic corporation, to escape U.S. taxation, except as it may bear on the question whether that corporation was in fact "formed for a substantial business purposes or actually engage[d] in substantive business activity."[168]

The Tax Court then concluded that since Siegel's corporation was indeed formed for substantial business purposes and actually engaged in substantive business activities, it was not a sham and could not be disregarded.[169]

Most foreign blockers and other foreign corporations that are formed to make investments have just as much substance as Sam Siegel's corporation, and they provide analogous tax benefits. In light of the Siegel case, and the IRS's own private letter rulings approving of foreign blockers to avoid debt-financed income, the IRS would have a difficult time attacking most foreign investment corporations on economic substance grounds. Although the Staff of the Joint Committee attempted to limit the Siegel case to the use of a foreign corporation "to make a foreign investment" and that in fact is what the Panamanian corporation was used for, the Tax Court's reasoning is not so limited: The Tax Court held that so long as a foreign corporation is formed for a substantial business purposes or actually engaged in substantive business activity, it would be respected. There is no suggestion that the business must occur outside of the United States.[170]

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[168] 45 T.C. at 574 (quoting Aldon Homes, Inc. v. Commissioner, 33 T.C. 582, 597 (1959)).

[169] The court also concluded that because Siegel's only benefit was deferral, section 269, "by its terms, does not apply here." 45 T.C. at 574.

[170] The Staff's "but see" citation to Bollinger with the parenthetical, "agency principles applies to title-holding company under the facts and circumstances," is similarly perplexing. The taxpayer in Bollinger attempted to reduce state taxes by establishing corporations to hold title to certain real property. The documents all made clear that the corporations were acting as agent of a partnership (which was the beneficial owner of the property), and the Court held for the taxpayer. While Bollinger might provide support for disregarding a foreign corporation under agency principles, it does not concern the economic substance doctrine.

Finally, for the same reasons that the IRS should not assert section 269 to deny a taxpayer the benefits of investing through a foreign corporation, it should not use the economic substance doctrine. The economic substance doctrine introduces inherent uncertainty into meaningful business decisions. A tax-exempt organization's decision to invest in a leveraged hedge fund through a foreign corporation (as opposed to an unleveraged investment in a hedge fund partnership) always depends (and often depends entirely) on whether the income will be taxable. That answer should be clear, but if it is subject to the economic substance doctrine, it will not be.

### B. The Costs of Investing Through a Foreign Corporation.

Investing through a foreign corporation does present some costs. First, losses of a foreign corporation do not offset the shareholder's income and gain from other sources. Second, any dividends received by the foreign corporation from a U.S. corporation are subject to a 30% U.S. withholding tax.[171] Third, if the foreign corporation is engaged in a trade or business in the United States, it is subject to a 35% federal corporate net income tax, possibly state and local taxes, and potentially a 30% branch profits tax. Finally, long-term capital gains do not pass through a CFC.

**1. No Pass Through of Losses.** The most significant disadvantage for a U.S. taxable investor that invests in a foreign corporation is the inability to claim losses prior to a disposition or complete redemption of its interest in the foreign corporation. A U.S. taxpayer

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[171] If the foreign corporation fund qualifies for the benefits of an income tax treaty, U.S. source dividends received by the foreign corporation fund may be eligible for a reduced rate of withholding tax. For example, if the foreign corporation were organized in Ireland as a "section 110 company" or collective investment unit trust that qualifies for the benefits of the income tax treaty with Ireland, U.S. source dividends received by the fund would be eligible for a 15% rate of withholding. See Convention Between the Government of the U.S. and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Article 10.

may hold several PFICs through a single foreign corporation. In this event, the U.S. taxpayer will have to make a timely QEF election with respect to each PFIC to avoid the denial of capital gains rule and the "penalty" interest charge.[172] (The holding company PFIC is not permitted to make a QEF election on behalf of its shareholders with respect to its PFIC investments.)[173] For purposes of the PFIC rules, the U.S. taxpayers will be treated as owning directly the PFICs that are owned by the holding company. Moreover, even if a QEF election is made with respect to each PFIC, if one of the underlying PFICs has a loss and another a gain, the investor will be required to report the gain but will not be able to offset the loss on the other. Instead, the investor's basis in the foreign holding company will increase by its share of the holding company's gain that is reported. Only upon a sale or redemption of the taxpayer's interest in the holding company PFIC will the prior income or gain inclusion give rise to reduced capital gain or increased loss.

**2. Dividend (and Other) Withholding Tax.** Foreign corporations are subject to U.S. withholding tax on dividends, which has been a meaningful disincentive for U.S. taxpayers to hold their U.S. equity portfolios in a foreign corporation. However, equity swaps can be used to avoid the withholding tax and, if regulations under new section 871(l) provide a safe harbor under which equity swaps will be respected, then U.S. taxpayers will be able to hold equity portfolios (in swap form) through foreign corporations without U.S. withholding tax.

U.S. withholding tax on other financial instruments held by foreign corporations has also served as a disincentive, but the availability of low-tax vehicles in tax treaty jurisdictions can be used to avoid the withholding tax.

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[172] See Treasury regulations section 1.1295-1(d)(3) (a QEF election only applies to the foreign corporation for which the election was made).

[173] See section 1295; Treasury regulations section 1.1295-1(d).

For example, death benefits paid on a life insurance contract on a U.S. life is normally subject to a 30% withholding tax, but if a U.S. investor holds the policy through an Irish "section 110 company" or Irish "investment unit trust" that qualifies for the benefits of the U.S.-Irish tax treaty, the U.S. investor can avoid the U.S. withholding tax without incurring Irish tax.[174]

**3. U.S. Trade or Business Risk.** A U.S. taxpayer that holds a portfolio through a foreign corporation exposes itself to the risk that the foreign corporation is treated as engaged in a trade or business in the United States. The consequences of that treatment would be disastrous. In this case, the foreign corporation would be subject to a U.S. federal corporation tax on its effectively connected income, potentially subject to state and local taxes, and could be subject to the branch profits tax.

**4. No Pass-Through of Capital Gains for an Interest in a CFC.** CFCs do not permit their United States shareholders to receive flow-through treatment of the net (long-term) capital gains of the CFC and, therefore, U.S. individual investors whose portfolios are expected to generate meaningful amounts of long-term capital gain generally avoid owning a 10% interest in the foreign corporation (to avoid United States shareholder status) or otherwise take steps to avoid CFC status. (QEF PFICs do pass-through their net capital gains.)[175]

**5. No U.S. Foreign Tax Credits for Individuals, or for Corporations with Less Than 10% of the Voting Power.** U.S. individuals that invest in a foreign corporation (and

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[174] See Robert A.N. Cudd, "Recent Developments Affecting Life Insurance Investors," Lexis 2010 TNT 26-6 (January 13, 2010) (discussing the use of an Irish company to purchase and own life insurance policies and single premium immediate annuities.)

[175] It should be noted, however, that in order for an investor to make a QEF election, the foreign corporation must agree to make certain information available to the investor. See section 1295(a); Treasury regulations section 1.1295-1(g).

U.S. corporations with less than 10% of the voting power of a foreign corporation) are not entitled to U.S. foreign tax credits for the foreign taxes paid by the foreign corporation.[176]

### C. The Inconveniences of Investing Through a Foreign Corporation: Compliance.

**1. "FATCA" Reporting and Withholding Requirements.** In general, under the "FATCA" provisions of the "Hiring Incentives to Restore Employment Act" (the "HIRE Act"),[177] beginning on January 1, 2013, a 30% withholding tax will be imposed on U.S.-source interest, dividends, rents and other "fixed or determinable, annual or periodical" income, and the gross proceeds from the sale or other disposition of any property that produces U.S.-source interest or dividends (e.g., stock or debt of a U.S. corporation), that are paid directly or indirectly to a "foreign financial institution," unless the foreign financial institution enters into an agreement with the U.S. Treasury Department.[178] The term "foreign financial institution" includes most foreign hedge funds and other foreign investment vehicles.[179]

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176 See section 902 (deemed paid foreign tax credit available only for domestic corporation which owns 10% or more of the voting stock of a foreign corporation).

Finally, borrowing through a foreign corporation rather than directly may reduce a U.S. corporate taxpayer's ability to use its U.S. foreign tax credits, at least until section 894(f) becomes effective (if ever). (I thank William Burke for this observation.)

177 FATCA stands for Foreign Account Tax Compliance Act of 2009. The provisions discussed in this section were originally introduced in FATCA, but were enacted as part of the HIRE Act. FATCA was never enacted.

178 Section 1471(a). (The 30% withholding tax does not, however, apply to payments on (and the proceeds from) "obligations" that are outstanding on March 18, 2012.) The term "obligations" is not defined in the HIRE Act.

179 Section 1472(d) broadly defines a "foreign financial institution" to include any foreign entity that (i) accepts deposits in the ordinary course of a banking or similar business, (ii) holds financial assets for the account of others as a substantial portion of its business, or (iii) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting or trading in financial assets (including securities, partnership interests, commodities, or any interest in such securities, partnership interests or commodities). Therefore, in addition to foreign investment and commercial banks and foreign insurance companies, most foreign hedge funds, foreign "blocker corporations," foreign collateral debt obligation issuers, foreign private equity funds, and other foreign securitization vehicles are treated as "foreign financial institutions" that must enter into an agreement with the U.S. Treasury Department or be subject to the withholding provisions. Any foreign financial institution that is more than 50% owned by a foreign financial institution or is greater than 50% commonly owned with the financial institution is considered part of the same "expanded affiliate group" as the foreign financial institution and is subject to the same

*(continued on next page)*

The agreement that foreign financial institutions will be required to enter into with the U.S. Treasury Department requires them to report to the IRS the name, address, taxpayer identification number, value of the equity interest and (except to the extent provided by the IRS), the gross receipts and withdrawals with respect to the equity interest in the foreign financial institution for each United States person and any "substantial United States owner" of a "United States owned foreign entity" that directly or indirectly holds equity in the foreign financial institution.[180] The agreement will also require a foreign financial institution to comply with verification and due diligence procedures (including know-your-customer, anti-money laundering, anti-corruption and similar rules), reporting requirements, requests by the IRS for additional information,[181] and to attempt to obtain a waiver in any case where foreign law would otherwise prevent the required reporting and, if the waiver is not obtained within a reasonable period of time, to close the account.[182]

Finally, under their agreements with the Treasury Department, foreign financial institutions will be required to (i) deduct and withhold 30% from any U.S.-source payment and 30% of the gross proceeds from the sale of any U.S. stock or debt instrument paid to any investor that fails to provide the requested information (a "recalcitrant investor") or any holder that is itself a foreign financial institution and has not entered into a similar agreement with the U.S. Treasury Department or (ii) elect to receive its U.S.-source payments (including gross proceeds

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reporting and withholding requirements. Thus, if a foreign financial institution enters into an agreement with the U.S. Treasury Department, all other foreign financial institutions that are also members of the expanded affiliate group are required to comply with the agreement.

[180] Section 1471(c)(1).

[181] Section 1471(b)(1)(B); see "Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the Hiring Incentives to Restore Employment Act, Under Consideration by the Senate," Joint Committee on Taxation, February 23, 2010.

[182] Section 1471(b)(1)(F).

from sales of U.S. stock and debt) subject to 30% withholding on the portion that is allocable to the recalcitrant investor or noncompliant foreign financial institution.[183]

These rules effectively require a foreign financial institution that directly or indirectly receives U.S.-source income to enter into the agreement with the U.S. Treasury Department and require all of its investors to certify whether they are a United States person or United States owned foreign entity, even if the foreign financial institution does not directly receive any U.S.-source income.

For example, assume that a U.S. investor organizes a foreign corporation to own interests in offshore hedge funds that are treated as foreign corporations for U.S. tax purposes. The foreign corporation will not itself be required to enter into an agreement with the U.S. Treasury Department because it will not directly receive U.S.-source payments or the proceeds from the sale of U.S. stocks or securities. However, if one of the underlying offshore hedge funds it owns receives U.S.-source payments, then the underlying hedge fund will be required to enter into an agreement with the U.S. Treasury Department and this underlying hedge fund will withhold on payments to the foreign corporation unless the foreign corporation has itself entered into an agreement with the U.S. Treasury Department (or complies with such other requirements as the IRS may in the future prescribe).[184] Moreover, because the foreign corporation is a foreign financial institution, it will be required to disclose information about any United States person that owns any interest in it.

The 30% withholding tax also applies to U.S.-source payments (and the proceeds from the sale of U.S. stocks and securities) made to a "non-financial foreign entity" with a

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183 Sections 1471(b)(1)(D) and (b)(3).

184 The foreign corporation will be a foreign financial institution. Under section 1471(b)(1)(D), the hedge funds will be required to deduct and withhold on any "passthru payments" (i.e., payments reflecting U.S.-source income) made to a foreign financial institution (i.e., the foreign corporation) that fails to enter into an agreement with the U.S. Treasury Department).

"substantial United States owner"[185] unless the foreign entity provides the withholding agent with the name, address and taxpayer identification number of its "substantial United States owners."[186]

**2. IRS Form 926.** A U.S. investor that purchases an interest in a foreign corporation for cash is generally required to file IRS Form 926 – *Return by a U.S. Transferor of Property to a Foreign Corporation,* if (i) immediately after the purchase the investor owns (directly, indirectly, or by attribution) 10% or more of the total voting power or total value of the corporation or (ii) the investor (or any related person) transfers more than $100,000 to the corporation during the 12-month period ending on the date of such transfer.[187]

**3. IRS Form 5471.** A U.S. investor that owns or is treated as owning at least 10% by vote or value of the equity of a foreign corporation is generally required to file an information return on IRS Form 5471 – *Information Return of U.S. Persons with Respect to Certain Foreign Corporations,* and provide additional information regarding the corporation

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[185] Very generally, a substantial United States owner is a 10% owner. More specifically, it is, (i) with respect to a corporation, any "specified United States person" that owns, directly or indirectly, more than 10% of the vote or value of a corporation, (ii) with respect to a partnership, a specified United States person that owns, directly or indirectly more than 10% of the profits interests or capital interests of the partnership, (iii) with respect to a grantor trust, any specified United States person that is an owner or, (iv) with respect to a trust that is not a grantor trust, to the extent provided by the IRS, any specified United States person that holds, directly or indirectly, more than 10% of the beneficial interests in the trust.

A "specified United States person" is any United States person, other than (i) a corporation whose stock is regularly traded on an established securities market (or any member of the expanded affiliated group (as defined under section 1471(e)(2)) of such corporation, (ii) any section 501(a) tax-exempt organization or an IRA, (iii) the United States and its wholly-owned agencies and instrumentalities, (iv) States and possessions, (v) banks, (vi) REITS, (vii) RICs, (viii) common trust funds, and (ix) charitable remainder trusts. See section 1473(2) and (3).

[186] This withholding tax also begins on January 1, 2013 and does not apply to payments on (and the proceeds from) obligations that are outstanding on March 18, 2012.

[187] See section 6038B; Treasury regulations section 1.6038B-1(b)(3). Failure to file IRS Form 926 subjects the taxpayer to a penalty equal to 10% of the fair market value of the property at the time of the exchange, up to a maximum of $100,000, unless the failure was due to intentional disregard (in which case, there is no maximum). Section 6038B(c)(1) and (2). However, the penalties do not apply if the failure to disclose is due to reasonable cause and not willful neglect. Section 6038B(c)(2).

annually on IRS Form 5471 if the investor is treated as owning (actually or constructively) more than 50% by vote or value of the equity of the corporation.[188]

**4. IRS Form 8621; PFIC Annual Reporting.** Any U.S. investor that is a direct or indirect shareholder of a PFIC must file IRS Form 8621 – *Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund* – for each year in which the investor (i) recognizes gain on a direct or indirect disposition of PFIC stock, (ii) receives certain direct or indirect distributions from a PFIC, or (iii) makes certain PFIC related elections.[189]

Moreover, in taxable years beginning on or after March 18, 2010, any U.S. investor that is a shareholder in a PFIC must file an annual information return containing such information as the IRS may require.[190] Hopefully, this annual return will also be on Form 8621, but the IRS has not yet identified the form or the information required to be included.

**5. Section 6038D – Information Reporting with Respect to Foreign Financial Assets.** Section 6038D (which was enacted as part of the HIRES Act) requires individual taxpayers to disclose as part of their income tax return the aggregate value of their "specified foreign financial assets" that exceeds $50,000.[191] Specified foreign financial assets

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188 See sections 6038(a) and (e); section 6046(a)(1)(B); Treasury regulations section 1.6038-2(a). The penalty for failure to file IRS Form 5471 is $10,000 per year and increases up to $50,000 if the failure is not corrected within 90 days following notification from the IRS. Section 6679(a). The penalty does not apply if the failure is due to reasonable cause. Section 6679(a)(1).

189 See Instructions to IRS Form 8621; proposed Treasury regulations section 1.1291-1(i). There is currently no specific penalty for failure to file IRS Form 8621.

190 Section 1298(f). See Notice 2010-34, 2010-17 I.R.B. 612 (April 6, 2010) ("shareholders of a PFIC that were not otherwise required to file Form 8621 annually prior to March 18, 2010, will not be required to file an annual report as a result of the addition of section 1298(f) for taxable years beginning before March 18, 2010.")

191 See section 6038D(a). An individual's foreign financial assets are presumed to be worth more than $50,000 unless the individual provides sufficient information to demonstrate the value of the assets. Section 6038D(e).

include stock in a foreign corporation, unless the stock is held in an account maintained by a U.S. financial institution.[192]

## V. Suggestions for Improvement.

1. The earnings and profits limitation on inclusions of Subpart F and QEF income allows U.S. taxpayers to use foreign corporations to effectively deduct amounts that could not be deducted directly. This ability frustrates the tax policy underlying the denial of the deductions. The earnings and profits limitation also allows United States shareholders in CFCs to avoid Subpart F inclusions (sometimes indefinitely).

The earnings and profits limitation on inclusions of Subpart F and QEF income should be repealed so that United States shareholders of CFCs report Subpart F income to the extent of the CFC's taxable income,[193] and shareholders in QEF PFICs report all income and net capital gain of the PFIC to the extent of its taxable income and gain.[194]

To prevent Subpart F income from being taxable when there are offsetting losses from non-Subpart F operations, prior year losses could be carried over and used under section 172 to offset current gain.[195] The rules that allocate distributions to various pools of earnings and profits could be eliminated because all distributions would be tax-free to the extent of section 951 income inclusions. Distributed amounts in excess of Subpart F income would be treated as dividends to the extent of earnings and profits.[196] Finally, section 960(a)(1) could be

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[192] Section 6038D(b)(2)(A).

[193] Likewise, investments in the United States property would be includable to the extent of taxable income. Foreign tax credits would be based on the proportion that the CFC's includable income bears to the CFC's total taxable income for the year.

[194] This is not an entirely novel suggestion. See Earnings and Profits Working Group of the American Bar Association, "Elimination of 'Earnings and Profits' from the Internal Revenue Code," 39 Tax Lawyer 285 (Winter 1986). See also Walter J. Blum, The Earnings and Profits, Limitation of Dividend Income: A Reappraisal, 53 Taxes 68 (1975); William D. Andrews, "Out of its Earnings and Profits: Some Reflections on the Taxation of Dividends," 69 Harv. L. Rev. 1403 (1955-56).

[195] See "Elimination of 'Earnings and Profits'," 39 Tax Lawyer at 322-24.

[196] See "Elimination of 'Earnings and Profits'," 39 Tax Lawyer at 324.

amended to provide that the flow-through of foreign tax paid for foreign tax credit purposes is the proportion that the taxable income included under section 951 for the year bears to the total taxable income for the year.[197]

If this suggestion is not adopted, an alternative suggestion is that the earnings and profits for CFCs and QEF PFICs not be reduced by disallowed deductions and deferred losses. Although this suggestion sounds less radical, it would actually add significant complexity to the earnings and profits calculation and is at odds with the underlying foundation of the earnings and profits concept that earnings and profits simply represent the earned cash available to pay a dividend.

2. Individual U.S. taxpayers should not be able to avoid the limitations on the deductibility of capital losses by investing through foreign corporations. To prevent this, Congress could provide that a CFC or QEF PFIC must report to taxpayers their share of the CFC's or QEF PFIC's capital losses, and these capital losses may be used to offset only capital gains of the CFC or QEF PFIC for that year. Congress could further provide that a taxpayer's share of the capital losses of a CFC or a QEF PFIC carry forward to offset the taxpayer's share of capital gains in future years.

3. Individual U.S. taxpayers should not be able to avoid the limitations on the deductibility of miscellaneous itemized deductions, personal interest expense or charitable deductions by investing through foreign corporations. To prevent this, Congress could provide that CFCs and QEF PFICs must report to individual taxpayers (and trusts and estates) the deductions of their CFCs and QEF PFICs that would be itemized deductions, or personal interest expense if incurred directly. In turn, the shareholders that are individuals, trusts or estates would report their share of the gross income and gains (in the case of a CFC) or gross income and net

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[197] See "Elimination of 'Earnings and Profits'," 39 Tax Lawyer at 324. Other technical changes are described in "Elimination of Earnings and Profits."

capital gains of a CFC or QEF PFIC and if the CFC or QEF has net income or net gain, independently report their share of the CFC's or PFIC's deductions, subject to the limitations on the deductibility of the expenses. The S corporation reporting rules could serve as a model for these rules. But before making these changes, Congress should reexamine the miscellaneous itemized deduction limitation because it produces results that are hard to justify as a matter of simplification or otherwise.

4. Once federal law provides for the separate reporting of itemized deductions incurred through a CFC or QEF PFIC, the states that limit the deductibility of itemized deductions should apply their limitations to these deductions.

5. If Congress enacts the Obama Administration's proposal to limit the value of itemized deductions to 28% for high-income individuals or the National Commission on Fiscal Responsibility and Reform's proposal to limit charitable deductions, the limitations should apply equally to deductions incurred through a CFC or QEF PFIC.

6. Congress should enact a technical correction to the Health Care Reconciliation Act, or Treasury and the IRS should write regulations, to clarify that Subpart F and PFIC QEF inclusions are subject to the 3.8% Medicare tax.

7. The IRS should use the Subpart F definition of an active insurance company for purposes of determining whether offshore reinsurance companies qualify for purposes of the active insurance company exception from a PFIC under section 1297(b)(2)(B).

8. United States persons should not be able to use foreign corporations to avoid their FBAR filing requirements. The final FBAR regulations should provide that a United States person has a financial account (and therefore is subject to FBAR reporting) if the United States person owns 50% of the vote or value of a foreign corporation and that foreign corporation is the beneficial owner of a foreign financial account, regardless of whether the foreign corporation has title to the account. The final regulations should also expand the FBAR anti-

avoidance rule to provide that a United States person that uses an entity with a principal purpose of avoiding the reporting rules should be treated as having a financial interest in any accounts that the entity holds or in which it has a beneficial ownership interest (and therefore is subject to FBAR filing requirements with respect to those accounts).

9. Tax-exempt organizations should not be able to avoid their federal income tax by investing through foreign corporations. To merely eliminate the current incentive for tax-exempt organizations to organize and invest through foreign corporations, Congress could amend section 514 to provide that income received directly or through a partnership is not debt-financed income to the extent that the income would not be effectively-connected income or subject to U.S. withholding tax if earned by a foreign corporation. More broadly (but also more controversially), Congress should either repeal the debt-financed rules (subject to certain special rules to prevent Clay-Brown and similar transactions), or retain the debt-financed income rules and apply them through CFCs to treat a tax-exempt United States shareholder as having incurred its share of the indebtedness of the CFC. In addition, if the debt-financed rules are applied through CFCs, then Congress should write a rule that would deem that an investment in a PFIC is entirely debt-financed (and that the tax-exempt investor is subject to tax with respect to the PFIC to the same extent as a taxable investor) unless the PFIC provides its tax-exempt shareholder with information on the amount of its outstanding indebtedness, in which case the tax-exempt shareholder's allocable share of the indebtedness would be imputed to it (unless the income to which the indebtedness relates is effectively connected to a U.S. trade or business and subject to tax).

10. Under current law, certain taxpayers can organize a foreign corporation to purchase the debt of their subsidiaries at a discount and avoid the COD income that would arise for the subsidiary if they bought the subsidiary's debt directly. This ability to avoid the COD income rules arises from the restrictive definition of relatedness in section 108(e)(4), and the

most natural way to fix it would be to expand the related-party test in section 108(e)(4). Lee Sheppard has suggested that the broad control test in section 482 be used.[198] However, even a test that treated two or more corporations as related if 50% or more of their voting power is owned by any partnership, would significantly limit the ability of U.S. private equity funds to avoid COD income by forming a low-tax foreign corporation to purchase the debt of a portfolio company.

11. The existing TMP rules encourage U.S. investors to use a foreign tax-haven company to create a REMIC-1ike vehicle and avoid the U.S. corporate tax that would otherwise apply to a domestic TMP.

There are four alternative policy decisions that Congress could make with respect to tax haven TMPs.

First, Congress could amend section 7701(i) to provide that a foreign TMP is taxable as a domestic corporation. But this would be overkill,[199] and extraordinarily difficult to enforce.

Second, Congress could expand the rules that apply to TMP REITs and apply them to the U.S. equity owners of foreign TMPs. These rules would ensure, at a minimum, that any U.S. taxpayer that owns an interest in a foreign TMP would pay tax on its share of the excess inclusion income of the TMP. Imposing the excess inclusion rules on U.S. shareholders of foreign TMPs would diminish the current attractiveness of foreign TMPs over U.S. mortgage

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[198] Lee A. Sheppard, "News Analysis: Should COD Income Be Deferred?" Tax Notes Today, 2009 TNT 29-4 (February 12, 2007).

[199] The REMIC rules ensure that the excess inclusion income that results when a fixed-rate pool of mortgages is financed with "time-tranched" debt is subject to tax in all events. However, if foreign TMPs were subject to a corporate tax, their income would often be subject to two levels of tax (rather than the single tax imposed by the REMIC rules). Moreover, the TMP rules are far broader than the REMIC rules so entities that could not even qualify as REMICs would be subject to tax.

REITs, but would add significant complexity. (Applying the excess inclusion rules to foreigners that own equity in foreign TMPs would be impossible to police.)

Third, Congress could repeal the TMP rules entirely. In this case, foreign corporations would not offer any particular advantage over U.S. entities. In light of the uncertain policies underlying the TMP rules, there is some appeal to this alternative. (Moreover, REMICs would still offer a tremendous advantage over domestic TMPs because regular interests in REMICs are treated by statute as indebtedness for federal income tax purposes.) Nevertheless, repealing the TMP rules would undermine the REMIC rules and a significantly greater amount of phantom income would escape U.S. tax than otherwise. So, this alternative would be expected to cost meaningful revenue without any overriding policy benefit, and therefore is particularly unattractive.

Finally, Congress could do nothing. In this instance, the U.S. tax law would continue to encourage U.S. taxpayers to organize foreign corporations to reduce their U.S. tax liability. However, in this single case, the alternatives are worse.