

Tax Management

International Journal

BNATAX
Management®
America's Tax Authority

Vol. 38, No. 5

May 8, 2009

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Tax Management International Journal (ISSN 0090-4600) is published monthly, at the annual subscription rate of \$764 per year, for a single print copy by The Bureau of National Affairs, Inc., 1801 South Bell St., Arlington, VA 22202. **Periodicals Postage Paid** at Arlington, VA and at additional mailing offices. **POSTMASTER:** Send address changes to Tax Management International Journal, BNA Customer Service, 9435 Key West Ave, Rockville, MD 20850.

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ARTICLES

The Contract Manufacturing Regulations: An Oversized Solution

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Working with speed uncommon in the rulemaking process, the IRS and Treasury recently finalized regulations addressing contract manufacturing arrangements under the foreign base company sales income (FBCSI) rules. The final regulations (Final Regulations) and temporary regulations (Temporary Regulations) were released only 10 months after they had been proposed.¹ They are effective for taxable years of controlled foreign corporations (CFCs) beginning after June 30, 2009, and for taxable years of U.S. shareholders in which or with which such taxable years of the CFCs end. Compared to the timeframe by which multinational manufacturing companies measure their lifecycle, the effective date is, effectively, immediate.

In their rush to establish a vast set of new rules, the IRS and Treasury created an unwieldy regulatory framework, the complexity of which confuses the most important underlying issues. A simple solution, based on the plain language of §954(d) and guided by the legislative history of Subpart F, would have alleviated confusion among the government, taxpayers, and their tax advisors.

This article will discuss the Final and Temporary Regulations, review the history of §954(d), and argue

* The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP or any other member firm of Ernst & Young Global Limited.

¹ Revisions and additions to Regs. §§1.954-3 and -3T adopted by T.D. 9438, 73 Fed. Reg. 79334 (12/29/08), from proposed rules at REG-150066-08, 73 Fed. Reg. 10716 (2/28/08). All references to “Section” or “§” herein are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

that the regulations are unnecessarily oversized. Instead of expanding the universe of manufacturing exceptions to FBCSI and further complicating the branch rules, the regulations should have focused on resolving two basic problems. First, the Final Regulations should have recognized that consignment manufacturing arrangements, absent potential application of the branch rules, did not generate FBCSI under the existing law. Simply put, these arrangements do not involve the purchase and sale of property to or from a related party, one of the key requirements under §954(d). In doing this, the regulations would have dismissed the irrelevant issues that obscure this fact and lead to continued confusion (e.g., whether or not attribution of activities is appropriate and necessary, and whether this creates a branch of the CFC). Second, the Final Regulations should have established a simpler rule for determining whether contract manufacturing arrangements qualify for the manufacturing exception to FBCSI. This article will show how a test based on non-physical manufacturing factors (such as those identified in Rev. Rul. 75-7 and §199) would have worked very well in these circumstances. With regard to the branch rules, the Temporary Regulations should have established a simpler method for determining circumstances where a CFC has created an artificial shift of taxable income away from the location of manufacturing activities, consistent with the purpose of §954(d)(2). Moreover, regulations which proliferate the number of times the branch rules might apply should not have been issued until other fundamental issues with the branch rule were addressed (such as the allocation of income).

The Final Regulations — Where Are We Now?

The Final Regulations introduced the substantial contribution exception (Substantial Contribution Exception) to the list of existing exceptions from FBCSI. Based on the statutory requirements (which are confirmed by the existing regulations), a CFC does not have FBCSI when it: (1) purchases or sells personal property that was manufactured, produced, constructed, grown, or extracted in the CFC’s country of incorporation (Same Country Source Rule);² or (2) purchases or sells property for use, consumption, or

² Regs. §1.954-3(a)(2).

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disposition in the CFC's country of incorporation (Same Country Use Rule).³ Under the prior regulations, a CFC could also avoid generating FBCSI by selling personal property that was manufactured, produced, or constructed by the CFC in whole or in part from personal property that the CFC purchased (Manufacturing Exception).⁴ In order to be considered to have manufactured the property, the prior regulations required only that the CFC sold property that was "in effect not the property that it purchased."⁵ This could only happen in two ways: (1) property owned by the CFC was substantially transformed before its sale (Substantial Transformation);⁶ or (2) property owned by the CFC was used as a component part in the manufacture of another item of property, which was subsequently sold by the CFC (Component Parts Assembly).⁷ Only Component Parts Assembly required that the activity be performed by the CFC itself.

The Final Regulations modified the Substantial Transformation provision in a manner clearly intended to extend the concept to encompass contract manufacturing arrangements in addition to consignment manufacturing arrangements. In the Treasury's and IRS's view, this was not entirely clear in the 2008 proposed regulations (or under existing law). However, the technical corrections to the proposed regulations, which were incorporated into the Final Regulations, made several revisions to clarify that a CFC does not need to hold title to property before its transformation in order to accomplish the requisite Substantial Transformation. For example, the technical corrections revised the results of *Example 3* under Prop. Regs. §1.954-3(a)(4)(iv)(c) to provide that manufacturing activities do not need to be "undertaken with respect to [a product] between the time the raw materials were purchased and the time [the product] was sold."

The Substantial Contribution Exception only applies if the CFC itself would have been considered to have manufactured, produced, or constructed the personal property before sale had its own employees conducted the manufacturing activities that actually were conducted by the manufacturer.⁸ For this requirement, the manufacturer can only have manufactured the

product by Substantial Transformation or Component Parts Assembly.⁹ If the Substantial Contribution Exception applies, then the CFC may avoid generating FBCSI by showing that the facts and circumstances "evince that the [CFC] makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal property sold."¹⁰ The determination of whether a substantial contribution has been made "involves, but will not necessarily be limited to" consideration of the following activities:

1. Oversight and direction of the activities or process pursuant to which the property is manufactured, produced, or constructed;
2. Activities that are considered in, but are insufficient to satisfy, the substantial transformation or component parts tests;
3. Material selection, vendor selection, or control of raw materials, work-in-process, or finished goods;
4. Management of manufacturing costs or capacities (for example, management of the risk of loss, cost reduction or efficiency initiatives associated with the manufacturing process, demand planning, production scheduling, or hedging raw material costs);
5. Control of manufacturing-related logistics;
6. Quality control (for example, sample testing or establishment of quality control standards); and
7. Developing, or directing the use or development of, product design and design specifications, as well as trade secrets, technology, or other intellectual property for the purpose of manufacturing, producing, or constructing the personal property.¹¹

The Final Regulations provide broad (and generally taxpayer-favorable) rules regarding the application of the Substantial Contribution Exception. For example, the performance of any of the indicia of manufacturing activities by a CFC's employees are to be taken into account by the CFC in the aggregate in determining whether it satisfies the Substantial Contribution Exception. This is true regardless of the location in which the employees are located when conducting such activities. In addition, the performance or lack of performance of any single activity or of any particular number of activities is not in and of itself determinative. According to the Preamble, "there is no single

³ Regs. §1.954-3(a)(3).

⁴ Regs. §1.954-3(a)(4)(i).

⁵ *Id.*

⁶ Regs. §1.954-3(a)(4)(ii).

⁷ Regs. §1.954-3(a)(4)(iii). Component Parts Assembly includes a safe harbor, which applies when conversion costs incurred in connection with the property (i.e., direct labor and factory burden) constitute 20% or more of the total costs of goods sold. *Id.*

⁸ Regs. §1.954-3(a)(4)(iv)(a).

⁹ *Id.*

¹⁰ *Id.*

¹¹ Regs. §1.954-3(a)(4)(iv)(b).

activity that will be accorded more weight than any other activity in every case or that will be required to be performed in all cases.” The Preamble further provides that there is “no minimum threshold” of functions needed to be performed by the employees with regard to a particular activity before such functions are taken into account. Rather, all employee functions are taken into account and assigned an appropriate weight. The weight accorded to the performance of any “quantum of activity” will vary with the facts and circumstances of the particular business and will be based on the economic significance of the particular function to the manufacture of the property. Most importantly, the Final Regulations clarify that more than one person can satisfy the Substantial Contribution Exception with regard to the manufacture of the same product. The fact that other persons make a substantial contribution will not preclude a CFC from making a substantial contribution as well.¹²

The Temporary Regulations — Brand New Branch Rules

Under §954(d)(2), FBCSI may also include income derived by a CFC that conducts its activities through a branch (or similar establishment) located outside its country of incorporation. Specifically, FBCSI includes income earned by a CFC where the CFC carries on activities through a branch outside the country of its organization and such use of the branch has substantially the same effect as if the branch were a wholly owned subsidiary corporation deriving such income.¹³

The existing regulations expanded upon the statutory rules and provided specific rules with regard to a CFC that conducts its activities through: (1) a sales branch; (2) a manufacturing branch; and (3) one or more sales branches in addition to one manufacturing branch.¹⁴ In general, to determine whether use of the branch has substantially the same tax effect as if it were a wholly owned subsidiary of the CFC, the regulations require the application of a tax rate disparity test (RDT), which compares the hypothetical effective tax rate that would apply to sales income had it been earned in the jurisdiction where manufacturing activities occur with the actual effective tax rate where the CFC is created or organized.¹⁵ To the extent that a CFC “fails” the RDT, i.e., the actual effective tax rate is significantly lower than the hypothetical effective tax rate, the income allocated to the branch (in the case of the sales branch rules) or the remainder (think

“head office”) of the CFC (in the case of the manufacturing branch rule) would be classified as FBCSI, because the branch (or remainder) would be treated as a separate corporation which is making sales “on behalf of” a related person under §954(d)(1).

The Temporary Regulations set forth new rules addressing situations where a CFC has multiple manufacturing branches each of which performs manufacturing activities with respect to the same item of personal property. Because the location of manufacturing is crucial to applying the RDT, the rules operate to determine which one location will be considered the manufacturing branch for each sales branch. If only one branch of the CFC (or only the remainder of the CFC) independently satisfies a Manufacturing Exception with regard to an item of property, then the location of manufacture is the location of that branch (or remainder of the CFC).¹⁶ If more than one branch of the CFC (or at least one branch and the remainder of the CFC) each independently satisfies a Manufacturing Exception with respect to an item of personal property, then the location of manufacture is deemed to be the location that imposes the lowest effective rate of tax on the income allocated to such branch (or remainder of the CFC).¹⁷ Finally, if none of the branches (or the remainder of the CFC) independently satisfies a Manufacturing Exception, but the CFC as a whole would make a substantial contribution to the manufacture of the personal property, then the location of manufacture is the “tested manufacturing location,” unless the “tested sales location” provides a “demonstrably greater contribution to the manufacture of the personal property.”¹⁸ If the tested sales location provides a demonstrably greater contribution, then the tested sales location is the location of manufacture and the branch rules will not operate to treat the sales branch as a separate corporation. A “demonstrably greater contribution” is determined by weighing the relative contributions to the manufacture by the tested sales location and the tested manufacturing location, using the facts and circumstances test set forth in the Substantial Contribution Exception.¹⁹

For purposes of this test, the tested manufacturing location is the location of any branch (or remainder of the CFC) that contributes to the manufacture of the personal property and that would: (1) be treated as a separate corporation from the remainder of the CFC (or the sales branch if it is treated as the remainder) after applying the RDT; and (2) impose the lowest effective rate of tax on the income allocated to such

¹² See generally Regs. §1.954-3(a)(4)(iv)(c).

¹³ §954(d)(2).

¹⁴ Regs. §1.954-3(b)(1)(i) and (ii).

¹⁵ *Id.*

¹⁶ Regs. §1.954-3T(b)(1)(ii)(c)(3)(ii).

¹⁷ *Id.*

¹⁸ Regs. §1.954-3T(b)(1)(ii)(c)(3)(iii).

¹⁹ *Id.*

branch. The tested sales location is the location of the purchasing or selling branch (or similar establishment) or the remainder of the controlled foreign corporation by or through which the purchasing or selling activities are carried on with respect to the personal property.²⁰ Presumably, there can be more than one tested sales location for any single item of personal property.

The Manufacturing Exception — How Did We Get Here?

Section 954(d)(1) provides that FBCSI includes “income . . . derived in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person.”²¹ In addition, the purchased property must be manufactured outside the country under whose laws the CFC is organized (the statutory basis for the Same Country Source Rule) and must be sold for use, consumption, or disposition outside such foreign country (the statutory basis for the Same Country Use Rule).²²

There is no basis for a Manufacturing Exception in the language of the statute. In fact, there is no basis for *any* “exception” to FBCSI in the statute, but for the carve-out given to producers of agricultural commodities which are not grown in the United States in commercially marketable quantities.²³ The statute merely sets out the four types of related-party purchases and sales that fall within its scope. (Note that it is incorrect, therefore, to identify the Same Country Source Rule and the Same Country Use Rule as “exceptions” to FBCSI — they are part of the definition of FBCSI.)

Nevertheless, the drafters of the original 1964 regulations viewed the language of §954(d)(1) as providing another limitation on the scope of FBCSI. Thus, the original regulations did contain a substantial transformation provision. The IRS and Treasury, in an apparent attempt to distance themselves from the passive nature of the original substantial transformation provision, refer to this as the “its” defense. As stated previously, FBCSI includes income from the “purchase of personal property from a related person and its sale to any person” and the “purchase of personal property from any person and its sale to a related per-

son.” Although it would seem clear that the primary purpose of each of these clauses is to define the type of related-party transactions that are elemental in the classification of FBCSI, the use of the word “its” has caused quite a bit of confusion. Many believe that the plain meaning of the statute suggests that if the property purchased by the CFC is in some manner different from the property sold by the CFC, then the income arising from the sale of such property should not be FBCSI. Moreover, because such an interpretation of these two clauses rests upon a strict passive-voice reading of the pronoun “its” within each clause, there is no room left for any indication as to *who* would have to perform the transformation. Thus, proponents of the “its” defense argued that the transformation of the property could be conducted by any person.

The idea that manufacturing would play some role in determining whether sales income should be classified as FBCSI likely comes from the legislative history to §954(d). Both the House of Representatives Report and the Senate Report on §954 provide the following:

The “foreign base company sales income” referred to here means income from the purchase and sale of property, without any appreciable value being added to the product by the selling corporation. This does not, for example, include cases where any significant amount of manufacturing, major assembling, or construction activity is carried on with respect to the product by the selling corporation. On the other hand, activity such as minor assembling, packaging, repackaging or labeling will not be sufficient to exclude the profits from this definition.²⁴

Under this rationale, it appears that Congress intended there to be some form of an exception to FBCSI based on the economic investment that the CFC makes in the property. The statement “without any appreciable value being added to the product by the selling corporation” appears to establish a guideline for distinguishing between “bad” sales income (i.e., income earned by a CFC that did not add any appreciable value to the product) and “good” sales income (i.e., income earned by a CFC that did add appreciable value to the product, regardless of whether there was a related-party transaction). The next sentence clearly states that manufacturing, major assembling, or constructing are mere *examples* of a CFC adding appreciable value to a product.

²⁰ *Id.*, as modified by technical corrections. See 74 Fed. Reg. 11843 (3/20/09).

²¹ §954(d)(1).

²² §954(d)(1)(A) and (B).

²³ *Id.*

²⁴ S. Rep. No. 1881, 87th Cong., 2d Sess. (1962) H.R. 10650 at 84, and also H. Rep. No. 1447, 87th Cong., 2d Sess. (1962) H.R. 10650 at 62.

Section 954(d), however, does not explicitly state that there should be a “value added” exception, whether in the form of manufacturing, major assembling, or constructing. However, any underlying concern that the legislative history would be overlooked was quickly alleviated as interpretive regulations (the 1964 Regulations) under §954(d) rather swiftly introduced the Manufacturing Exception (i.e., the provisions on Substantial Transformation and Component Parts Assembly, discussed above). The 1964 Regulations specifically provide that FBCSI does not include income of a CFC derived in connection with the sale of personal property manufactured by the corporation from personal property that it purchased. Regs. §1.954-3(a)(4)(ii) provides that “[i]f purchased personal property is substantially transformed prior to sale, the property sold will be treated as having been manufactured, produced, or constructed by the selling corporation.” There is no indication that the activities must be conducted by the selling corporation.

The examples contained in the 1964 Regulations indicate that substantial transformation involves an irreversible change in the nature of the products purchased. The 1964 Regulations provide the following examples of substantial transformation: (1) the conversion of wood pulp into paper products; (2) the production of nuts, bolts, and screws from steel rods; and (3) the processing and canning of fresh tuna fish.²⁵ Even the Component Parts Assembly provision is framed in language suggesting that manufacturing is the standard by which the exception should be determined. Regs. §1.954-3(a)(4)(iii) provides that a CFC may satisfy the regulatory manufacturing exception for the “manufacture of a product when purchased components constitute part of the property sold.” In this case, the 1964 Regulations specifically provide that “if purchased property is used as a component part of personal property which is sold, the sale of the property will be *treated as the sale of a manufactured product . . . if the operations conducted by the selling corporation . . . are substantial in nature and are generally considered to constitute the manufacture, production, or construction of property.* [Emphasis added.]”

The 1964 Regulations seemingly turned the “value added” exception on its head. If the regulations had followed the logic set forth in the legislative history to §954(d), then they would have framed the exception to FBCSI as being one where the selling corporation added appreciable value to the product before its sale. Manufacturing, major assembling, and constructing would have been mere examples of appreciable value having been added to property. Instead,

manufacturing has become the standard by which the exception is measured, and the degree of transformation is now dispositive in determining whether manufacturing actually occurred. The example has become the rule.

Attribution and the Branch Rules

How Did Attribution Enter the Picture?

Despite what appears to be clear wording in §954(d) and the 1964 Regulations that the manufacturing of the personal property does not need to be conducted by the selling corporation in order to qualify as an exception to FBCSI, the IRS has struggled with the issue as long as the regulations have been in place.

In Rev. Rul. 75-7,²⁶ a CFC purchased raw materials from related persons outside of its country of organization, contracted with an unrelated manufacturer located outside of its country of organization to process the raw materials into a finished product, and then sold the finished product to unrelated persons outside of its country of organization. Under the terms of the arrangement, the contract manufacturer was paid a conversion fee. The raw materials, work-in-process, and finished product remained the property of the CFC at all times. The CFC alone had complete control over the time and quantity of production as well as complete quality control over the conversion process. The IRS ruled that “since the arrangement between X and Y is one of principal and agent,” the activities performed by the contract manufacturer should be considered to be performed by the CFC. Thus, the CFC was treated as having substantially transformed the personal property. The ruling further concluded that, because the CFC conducted the manufacturing activity outside of its country of organization, it was considered to do so through a branch or similar establishment. Because the effective tax rate in the manufacturing country did not fail the RDT, the manufacturing activity was not considered to have substantially the same tax effect as a wholly owned subsidiary.²⁷

The IRS’s conclusions in Rev. Rul. 75-7 resulted from a decade’s worth of volleying between the IRS Director for the Income Tax Division and the Chief Counsel’s office. In fact, the questions that Rev. Rul. 75-7 addressed were originally presented to the IRS in a private letter ruling request in 1964, the same year that the first set of regulations under §954 were re-

²⁵ Regs. §1.954-3(a)(4)(ii) Exs. (1), (2), and (3).

²⁶ Rev. Rul. 75-7, 1975-1 C.B. 244.

²⁷ *Id.*

leased. In PLR 6412105700A,²⁸ the Director of the Tax Rulings Division also ruled that the CFC did not generate FBCSI on the sale of the finished product, but he reached this conclusion using a completely different analysis. Rather than focusing on the branch and the RDT, PLR 6412105700A provided that “a careful examination of all the information submitted discloses that the property to be sold . . . is clearly not the property which [the CFC] purchased.” Therefore, Substantial Transformation was clearly satisfied.

The ruling noted, however, “There remains to be decided whether the 1954 Code provisions relating to foreign base company sales income and the regulations thereunder, permit someone other than the CFC to perform the functions whereby the purchased property is substantially transformed prior to its sale.”²⁹ The ruling did not address the issue, however, and instead surmounted the problem by attributing the activities performed by the manufacturer to the selling corporation. It concluded that there could be no FBCSI on these facts.

Two years later, the Income Tax Division submitted the same question to the Chief Counsel’s office.³⁰ In its response, the Chief Counsel’s office objected to the conclusion that the arrangement would not generate FBCSI. Specifically, the GCM states that any conclusion regarding FBCSI “can only be made after consideration of the branch rules.”³¹ The Chief Counsel’s office stated that the agency principles “should . . . be invoked in applying the branch rule” because they had been used to attribute the activities of the manufacturer to the selling corporation for purposes of the Substantial Transformation provision. Not doing so, claimed the Chief Counsel, would result in an imbalance in the application of the branch rules and the Manufacturing Exception, thus “enlarging out of all proportion the manufacturing exception.” The GCM, however, did not address the musings in the 1964 ruling regarding whether the CFC itself had to be the manufacturer. Thus, the primary question of whether the CFC must transform the product in the first place was subordinated by the assumption that attribution must occur and that it resulted in the application of the branch rules.

The revenue ruling was not issued in 1966. Instead, eight years later, the Chief Counsel’s office released a new memorandum, which included a proposed text of Rev. Rul. 75-7. In GCM 35961, the Chief Counsel’s office again reviewed the same fact pattern, and suggested a new rationale for the proper analysis of the

Manufacturing Exception and the branch rules. In this new GCM, the Chief Counsel’s office reiterated its position that the branch rules must be invoked whenever a CFC conducts activities outside of its country of incorporation, whether conducted directly or through a related or unrelated party. In fact, the GCM made the rather strong statement that “[the Chief Counsel’s office] is not bothered by the fact that in the typical case involving an application of the branch rule the manufacturing activity is conducted by a permanent establishment of the CFC rather than by an unrelated corporation on behalf of the CFC.”³² It believed that “in either case, the CFC will be incurring a separate tax on the manufacturing, either directly or indirectly as a cost of the manufacturing, and thereby separating the taxation of its manufacturing and selling activities.”³³

The development of the attribution and branch rule issues in Rev. Rul. 75-7 is curious. Recall that neither the 1964 Regulations nor §954(d) actually required that a CFC be the manufacturer to avoid FBCSI. PLR 6412105700A confused this fact by questioning whether it was true, and then not answering the question. Nonetheless, the existing law only required that the property sold be different from the property purchased. Arguably, Rev. Rul. 75-7 obfuscated the issues by attributing the activities of one entity to another. If there had not been attribution, then perhaps the branch rules would not have been invoked. Perhaps the real motivation for Rev. Rul. 75-7 was to make taxpayers believe that the use of another entity could create a branch for the CFC.

Attribution Causes Branch Confusion

Another aspect of Rev. Rul. 75-7 would later prove significant. Even assuming that attribution of the manufacturing activities to the CFC was necessary to avoid foreign base company sales income, the ruling did not predicate such attribution on the finding of a branch or similar establishment. The ruling expressly stated that “since” the CFC was considered to be manufacturing, then a branch would be deemed to exist; it explicitly did not rule that without a branch, there could be no attribution of manufacturing activities.

Several years later, the Tax Court addressed the IRS’s ruling with regard to the creation of a branch. In *Ashland Oil*,³⁴ a CFC entered into a contract with an unrelated manufacturer located outside of the CFC’s country of organization. The contract manufacturer provided finished products for the CFC using intangibles owned by the CFC (i.e., intellectual prop-

²⁸ PLR 6412105700A, Dec. 10, 1964.

²⁹ *Id.*

³⁰ GCM 33357 (10/24/66).

³¹ *Id.*

³² GCM 35961 (8/23/74).

³³ *Id.*

³⁴ *Ashland Oil, Inc. v. Comr.*, 95 T.C. 348 (1990).

erty) and raw materials purchased under the direction of the CFC. The contract manufacturer was reimbursed its costs for the purchase of the goods and also paid a fixed fee for its manufacturing services. The IRS challenged the taxpayer's position that the contract manufacturer was not a "branch" of the CFC for purposes of the FBCSI rules. Siding with the taxpayer, the Tax Court held that the manufacturer was not a "branch" because the ordinary definition of the term "branch" does not include an unrelated corporation operating under an arm's-length contractual arrangement. Similarly, the court ruled that the contract manufacturer could not be a "similar establishment" because this required "an establishment that bears the typical characteristics of an ordinary-usage branch, yet goes under another name for [legal or business] purposes."³⁵ Ultimately, the Tax Court ruled that the CFC did not generate FBCSI because it did not purchase or sell property to a related party. The Tax Court held similarly in *Vetco*,³⁶ finding that a wholly owned subsidiary of a CFC in a contract manufacturing arrangement cannot be treated as a branch or similar establishment of the CFC for purposes of the FBCSI rules.³⁷

The IRS immediately indicated informally that they would react to *Ashland* and *Vetco* by revoking or modifying Rev. Rul. 75-7. As contract manufacturing issues began coming up in audits after *Ashland* and *Vetco*, the IRS began taking the position that the logic sequence of Rev. Rul. 75-7 was actually reversed from its express language, i.e., that acceptance of a branch for purposes of the FBCSI branch rules was a prerequisite for attribution of any activities to the CFC from another entity, and that such attribution was in fact required in order for the CFC to have any income that was not Subpart F income. It was rumored that taxpayers in settlement discussions with the IRS were being presented with the choice of: (1) ignoring *Ashland* and *Vetco*, thereby accepting the application of the branch rules to separate subsidiaries; or (2) losing the ability to attribute manufacturing activities of another entity to the CFC altogether. In fact, the IRS filed a motion for summary judgment in a Tax Court case on the theory that, in the absence of a branch, there could be no manufacturing income earned by the CFC as a matter of law.³⁸ The Tax Court denied this motion without issuing an opinion, and the case settled before trial. Without an opinion explaining the basis for the denial of the summary judgment motion, it is not possible to determine whether the court determined that the IRS's formulation of the law was in-

correct or whether there were issues of material fact that would have to be resolved before a legal conclusion could be reached.

In 1997, the IRS revisited the branch issue and the holdings in *Ashland* and *Vetco*. In Rev. Rul. 97-48,³⁹ the IRS stated that it was revoking its ruling in Rev. Rul. 75-7 and choosing to follow (and extend) the holdings in *Ashland* and *Vetco*. Specifically, the IRS ruled that "[the] activities of a contract manufacturer cannot be attributed to a controlled foreign corporation for purposes of either section 954(d)(1) or section 954(d)(2) of the Code to determine whether the income of a controlled foreign corporation is foreign base company sales income." The reasoning provided by the IRS was that "Rev. Rul. 75-7 allows the activities of a contract manufacturer performed outside the controlled foreign corporation's country of incorporation to be attributed to the controlled foreign corporation without treating those activities as performed through a branch or similar establishment of the controlled foreign corporation."⁴⁰

As a result of the IRS's ruling in Rev. Rul. 97-48, it became clear that the government's position was that taxpayers could not rely solely upon the attribution of manufacturing activities to satisfy the Manufacturing Exception. However, the IRS did not go so far as to require the CFC to be conducting all of the manufacturing activities itself. In addition, under the 1964 Regulations, attribution does not even seem to be relevant when, for example, the substantial transformation activities are undertaken for the CFC by a contract manufacturer. Therefore, since Rev. Rul. 97-48, it has remained unclear whether a CFC could satisfy the Manufacturing Exception without directly carrying out the physical manufacturing specified in the regulations.

The Substantial Contribution Exception Is an Oversized Solution To a Small Problem

The Final Regulations establish a complicated array of rules that are intended to address, with one fell swoop, the myriad problems that arose in the wake of Rev. Rul. 75-7, *Ashland*, *Vetco*, and Rev. Rul. 97-48. Having lost in court on the branch rules, the IRS and Treasury needed to "win" on the Manufacturing Exception. Thus, the IRS and Treasury had to stop taxpayers from being able to use the Manufacturing Exception by shutting down use of the passive Substantial Transformation provision (and publicly referring to this as a "rejection of the 'its' defense"), eradicat-

³⁵ *Id.* at 357.

³⁶ *Vetco, Inc. v. Comr.*, 95 T.C. 579 (1990).

³⁷ *Id.* at 590-593.

³⁸ *The Limited, Inc. v. Comr.*, T.C. Dkt. No. 12004-94.

³⁹ Rev. Rul. 97-48, 1997-2 C.B. 89.

⁴⁰ *Id.*

ing any reference to the significance of the form of a product, establishing the requirement that the CFC's employees must conduct all activity, and eliminating any notion of attribution.

Doing this was no small feat. In the Preamble to the proposed regulations, the IRS and Treasury indicated that the position taken by taxpayers regarding the "its" defense and Regs. §1.954-3(a)(4)(i) was "contrary to existing law, and results from an incorrect reading of [the statute and regulation]." ⁴¹ In support of this statement, the IRS and Treasury contended, "Section 954(d)(1) requires only a purchase of personal property and the sale of that personal property by the CFC with no indication as to form." ⁴² They further claimed that §954(d)(1)(A) limits FBCSI to income derived in connection with the purchase or sale of property manufactured outside the CFC's country of incorporation. This allowed the IRS to reiterate its conclusion from Rev. Rul. 75-7, namely, that §954(d)(1) "is concerned with the segregation of purchase or sales and manufacturing into different jurisdictions, not merely with whether the property was manufactured." ⁴³ Finally, the IRS and Treasury indicated that Regs. §1.954-3(a)(4) provides the *only* set of rules under which a change in form of property is relevant for purposes of determining FBCSI. ⁴⁴

Changes had to be made throughout the regulations to accommodate the new position. For example, the Final Regulations added this sentence to Regs. §1.954-3(a)(1)(i), describing FBCSI in general:

For purposes of the preceding sentence, except as provided in paragraphs (a)(2) and (a)(4) of this section, personal property sold by a controlled foreign corporation will be considered to be the same property that was purchased by the controlled foreign corporation *regardless of whether the personal property is sold in the same form in which it was purchased, in a different form than the form in which it was purchased, or as a component part of a manufactured product.* [Emphasis added.]

Similarly, in Regs. §1.954-3(a)(1)(iii), the Final Regulations modified *Examples 1* and *2* by surgically removing the language "in the form in which purchased" from each fact pattern. In Regs. §1.954-3(a)(4)(i), the Final Regulations excised language which stated that a foreign corporation will be consid-

ered to have manufactured "personal property which it sells if the property sold is in effect not the same property which it purchased." In its place, the Final Regulations provided that a "controlled foreign corporation will not be treated as having manufactured . . . personal property which the corporation sells *merely because the property sold is in a different form than the form in which it was purchased.* [Emphasis added.]"

With regard to attribution, the Final Regulations stated that manufacturing activities must be performed by the CFC itself in order for it to qualify for the Manufacturing Exception. For support of this position, the IRS and Treasury in the Preamble to the proposed regulations cited the legislative history of §954(d), stating that "[i]n a case in which a CFC purchases parts or materials which it then transforms or incorporates into a final product, income from the sale of the final product would not be [FBCSI] if the corporation substantially transforms the parts or materials, so that, in effect, the final product is not the property purchased." ⁴⁵

To this end, the Final Regulations amended the existing Manufacturing Exception rules to provide that a CFC will qualify for the Manufacturing Exception only if the CFC, acting through its own employees, manufactures the product within the meaning of Regs. §1.954-3(a)(4)(i). Moreover, according to the Final Regulations, "[a] controlled foreign corporation will have manufactured . . . personal property which the corporation sells only if such corporation satisfies the provisions of paragraph (a)(4)(ii), (a)(4)(iii), or (a)(4)(iv) of this section through the activities of *its employees* . . . with respect to such property. [Emphasis added.]" ⁴⁶

As discussed, §954(d) does not indicate that manufacturing is even a possible exception to FBCSI. Obviously, it cannot therefore discuss by whom the manufacturing would have to be performed in order to meet the exception. The legislative history only provides us with a hint that Congress intended §954(d) to capture income earned by a CFC from a related party transaction, where no appreciable value had been added to the property by the CFC before its sale. The 1964 Regulations established a standard very close to this stated purpose in providing that a CFC would be considered to have manufactured personal property which it sold only if the personal property was not in effect the same property it purchased. There never has been any indication that the CFC had to perform the manufacturing.

⁴¹ Preamble's Explanation of Provisions, at A (second paragraph), for REG-150066-08, 73 Fed. Reg. 10716 (2/28/08).

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*, at A (third paragraph).

⁴⁵ Preamble's Explanation of Provisions, at A (fourth paragraph), for REG-150066-08, 73 Fed. Reg. 10716 (2/28/08) (citing S. Rep. No. 1881, 87th Cong., 2d Sess. (1962)).

⁴⁶ Regs. §1.954-3(a)(4)(i).

Neither should there have been. It simply does not make sense to require the CFC to perform manufacturing activities in order to avoid generating FBCSI. In a typical consignment manufacturing arrangement, a foreign corporation will purchase raw materials, contract with a manufacturer to process the raw materials into a finished product, and then sell the final product. During this process, the foreign corporation retains title to the raw materials during the manufacturing process and bears the risk of loss. The foreign corporation must also pay the manufacturer to transform the raw materials into the finished product. Would it make sense to say that the foreign corporation's income should be classified as FBCSI in this situation merely because it did not actually perform manufacturing activities? After all, the foreign corporation did add value to the personal property by paying to have it transformed. Attribution is not required in this case, nor would it make sense. A simple, plain language interpretation of §954(d) and its legislative history should suffice to exclude consignment arrangements from the FBCSI regime.

The treatment of contract manufacturing arrangements is less clear. In a typical contract manufacturing arrangement, the foreign corporation may contract with a related or unrelated manufacturer to create a final product that the foreign corporation intends to sell to its customers. The foreign corporation develops the product plans and design specifications, and then instructs the contract manufacturer on how to finish the product. The contract manufacturer will typically obtain the raw materials and hold title to them during the manufacturing process; however, the foreign corporation may even dictate where and how the contract manufacturer completes this task. After the product has been completed, the contract manufacturer transfers title to the corporation, and the corporation then sells it to its customers.

Under the plain language of §954(d), this arrangement may be viewed as generating FBCSI if the foreign corporation purchases from or sells to a related party (or if it does so on behalf of a related party under the branch rules) and the other requirements are satisfied (i.e., the Same Country Source Rule and the Same Country Use Rule do not apply). Nevertheless, there are situations when the selling corporation has so much involvement with the development of the product and the oversight of the manufacturing process that it would go against the purpose of §954(d) to classify its sales income as FBCSI. In other words, if the foreign corporation undertakes a significant amount of non-physical manufacturing with regard to a product, it cannot be said that the corporation did not add appreciable value to the product before its sale. In this case, the non-physical manufacturing factors, already set forth in the Substantial Contribution

Exception, would make a good test for determining whether a contract manufacturer has run afoul of the purpose of §954(d). However, it would make more sense if this test only applied as an exception to FBCSI in these circumstances, rather than in all circumstances where any foreign corporation fails to satisfy the Manufacturing Exception, regardless of whether it has entered into a consignment manufacturing arrangement, a contract manufacturing arrangement, or if it even has a related-party purchase or sale (as it currently stands).

The Branch Rule Can Also Be Simplified

The Temporary Regulations have created a huge conundrum: CFCs will find themselves with many more branches, and yet there is still no certainty on fundamental questions, such as how to allocate income between the branches and the remainder of the CFC, and how to perform the RDT. It appears that a substantial motivation for the issuance of the Temporary Regulations was to deal with the absence of a branch for consignment manufacturers. The rules seem overly complex for this purpose. Having defined substantial contribution, the regulations then provide multiple sets of rules for applying the RDT: rules for single manufacturing branches, multiple manufacturing branches, single and multiple sales branches, and single and multiple products. While the term "branch" is not defined, it appears that activities which would fall short of the definition of a "taxable presence" or permanent establishment might be considered a branch. No wonder such complex rules are needed to deal with the very real possibility of a veritable multiplex of manufacturing and/or sales branches.

The legislative history of §954(d)(2) indicates that the branch rule is intended to prevent CFCs from segregating sales activities from the remainder of the CFC, where the sales activities would be subject to a lower effective tax rate in another country. It also begs the question why Congress thought this to be necessary; after all, the activity does not lower U.S. tax. It only lowers foreign tax. Nonetheless, the Code is clear: if sales activity is separated from the CFC, the branch rule can create FBCSI. The Temporary Regulations appear to suggest that a very minimal level of activity may constitute a manufacturing branch that somehow may abuse the Manufacturing Exception. Here, the IRS and Treasury have gone far beyond the concern voiced in the legislative history and the statutory authorization.

More importantly, the Temporary Regulations fail to fully recognize, as the Preamble to the proposed regulations suggests was intended, the realities of

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modern manufacturing. Many businesses now select their manufacturing locations for reasons completely unconnected to tax minimization. For example, manufacturing may be located in areas that are close to the raw material or component sources or low-cost manufacturing service providers. Supply chain logistics may be located where efficient and low-cost warehousing and transportation service providers are located. Sales operations may or may not be located centrally, depending upon whether the company requires direct customer interface. To say that manufacturing is moved away from the customer or sales office due to tax planning is out of step with the modern way of doing business. Therefore, the impact of creating more manufacturing branches seems to be at odds with recognizing how business is done. In fact, the opposite would be desirable: the elimination of the manufacturing branch rules.

If the IRS and Treasury really believe that a manufacturing branch rule is needed, a simple approach would be the best approach. If a CFC has entered into a consignment or contract manufacturing arrangement, and the principal in the contract manufacturing arrangement is a branch (using a concrete definition, such as that of a permanent establishment) or disregarded entity of the CFC, rather than the CFC itself, then the branch rule could treat the branch or disregarded entity as a manufacturing branch. If the principal is the CFC itself, then only sales branch rules should apply. If the CFC is a physical manufacturer, then, of course, the manufacturing branch rules would continue to apply to a branch that performs any physical manufacturing. Now, there's a solution that isn't oversized.

Designing Foreign Tax Credit Rules in China: The Case of Foreign Loss Limitations

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INTRODUCTION

Over the last few years, China's large trade surplus against other countries, as well as its high domestic savings rate even relative to its high investment rate, have resulted in a very substantial foreign currency reserve that puts the country in the position of a significant capital exporter. The huge amount of foreign currency assets held by the Chinese government — near \$1.9 trillion at the end of 2008 — and a breathtaking series of acquisitions made by Chinese firms overseas are now salient items in international business reporting and public discussion. China's new posture as an exporter of capital has also ushered in a new phase of development in the country's international tax regime; "outbound" tax policy — how Chinese corporate and individual residents are taxed on income earned abroad — increasingly attracts the attention of taxpayers and practitioners.

The foreign tax credit (FTC) system stands at the center of this area of law. The Enterprise Income Tax Law (EIT Law) adopted in 2007 inherits most of the FTC provisions from prior law, while also introducing a number of innovations. The most obvious among the innovations is a provision allowing Chinese enterprises to obtain indirect FTC for tax paid by their foreign subsidiaries.¹ While this provision has understandably attracted much attention, and practitioners have been looking forward to more detailed regulations prescribing its workings,² it is not as though China had a well-functioning FTC system in place already, and simply needed to add the concept of

deemed-tax-paid to that system.³ Quite the contrary, under prior law, a large number of issues that affected the basic workings of even the direct FTC system were either unresolved, or inadequately resolved. Permitting indirect FTCs will multiply the occasions on which these fundamental issues will arise, as well as the layers of uncertainty they generate.

Some of these prior problems are technical in nature. For example, a crude formula for the foreign tax credit limitation malfunctioned⁴ in implementing the per-country limitation when losses were generated by some of the taxpayer's operations. Because regulations issued by the Ministry of Finance (MOF) and State Administration of Taxation (SAT) did not address how such problems were to be dealt with, taxpayers and local tax bureaus had to come up with their own solutions.⁵ But other issues in the old FTC system were technical only in appearance; they would be regarded as serious policy issues in countries with advanced income tax systems. Without attempting completeness, one could identify at least the following items as being of policy significance and in need of resolution in the near future.⁶

- **How the source of income is determined.** While the basic EIT regulations contain certain rules on the source of income,⁷ they are very incomplete. For example, other than a rule for the transfer of equity investments, there are no rules for sourcing gain (or loss) from the transfer of intangible property, be it non-equity securities, intellectual property, or other rights. The rule for transfers of inventory, which sources income from such transfers to the place where "transactional activities" occur,⁸ is also badly in need of clarification. These rules directly determine the FTC consequences for Chinese taxpayers entering into the relevant transactions, and therefore could affect the very decisions for entering into them.
- **How expenses (including interest and R&D expenses) are allocated to a taxpayer's activities in different countries.** While some language in

³ The concept of deemed-tax-paid has long been present in China's income tax treaties.

⁴ This crude formula has been inherited by the EIT Law and can be found in Article 78 of the EIT Law IR.

⁵ See, e.g., Beijing State Tax Bureau, Jinguoshui [1998] 063 (instruction to disregard FTC limitation formula when there is a domestic loss).

⁶ There are policy issues (e.g., what types of taxes are creditable) that are not always under active consideration even in advanced income tax systems. While what taxes are creditable also awaits clarification under Chinese regulations, it may be argued that it is not really a *live* policy issue.

⁷ EIT Law IR, Art. 7.

⁸ *Id.*, Clause (1).

¹ EIT Law, Art. 24.

² See the Enterprise Income Tax Law Implementation Regulations (State Council, Decree No. 512, Nov. 28, 2007) (herein referred to as the "EIT Law IR"), Art. 80 (direct and indirect ownership must exceed 20% for deemed-paid credit provision to apply; further regulations to be issued regarding ownership requirements).

the EIT Law and implementing regulations could be read as requiring taxpayers to trace expenses to the particular income generated,⁹ it is unclear whether this is seriously implemented. More often, expenses are allocated as recorded on the books, which could lead to mismeasurements of income as well as tax avoidance opportunities.

- **What tax accounting methods should be applied to determine foreign income or loss.** Although the integrity of an income tax system generally requires that the same set of tax accounting rules apply to compute income and loss worldwide, following this principle in China is problematic because of the incompleteness of Chinese tax rules. Domestically, this incompleteness often results, in real practice, in computations of income and loss that are to the taxpayers' disadvantage. If foreign income and loss were also subject to this conservative approach, domestic tax liability on foreign income could end up higher than it should be.
- **Whether the per-country limitation on applying FTCs will have exceptions.** The EIT Law Implementation Regulations state that while the per-country limitation generally applies to claims of FTCs, MOF and SAT may prescribe exceptions.¹⁰ Clearly, the government realizes that the per-country limitation may be too stringent and in conflict with policy goals with respect to outbound investments in some circumstances. What these policy goals are, and how the per-country limitation may be correspondingly relaxed, remain open to discussion.
- **Whether profits and losses from different countries are allowed to offset each other.**

This article will focus on this last item for two reasons. First, the issue of loss offsets is unfamiliar to many Chinese tax practitioners, and its relation to the FTC is not always understood. Second, corresponding to the unfamiliarity and subtlety of the issue, an important statutory provision in the EIT Law, which prohibits the use of foreign branch losses to offset domestic income, has gone widely unnoticed. In other words, among all the issues of policy significance listed above, a policy decision regarding the last item, limitations on loss offset, has already been made and encoded in the statute, while the importance of the decision is still insufficiently recognized and its merit

largely undiscussed. Bringing attention to the issue is thus an urgent, albeit a partially remedial, matter.

However, the extent to which profits and losses from different countries are allowed to mutually offset each other has something in common with all other policy issues (whether or not listed above): its resolution requires an articulation of China's tax policy (or policies) towards the different types of outbound investment.¹¹ Does the tax regime aim to encourage overseas business ventures? Or is it neutral with respect to whether Chinese taxpayers decide to invest in China or abroad? Or are overseas investments perceived to threaten the domestic tax base, and, therefore, the preservation of fiscal revenue is given high priority in designing outbound tax rules? I hope to illustrate, through the particular example of the loss limitation rules, the difference between these policy goals.

In the first section below, I describe the statutory prohibition on the use of foreign losses to offset domestic income, the problem with its purported rationale, its predecessor under prior law, and basic ways to assess the provision. In the second section below, I show that the best argument for the limitation on foreign losses is that it avoids improper results with respect to the FTC mechanisms. However, such results can be avoided through other means, such as a loss recapture or resourcing device, which not only more accurately measures income but also has been practiced elsewhere in China's tax system. Moreover, I argue that there is no good case for other types of limitations on cross-border loss offsets either. In the final section, I discuss why, among aversion, neutrality, and an attitude of encouragement towards outbound investments, China's tax authorities might be expected to exhibit more often the first type of orientation.

EIT LAW ARTICLE 17 AND ITS POSSIBLE EXTENSION

Article 17 of the EIT Law states that when an enterprise computes its tax liability based on the income and losses of all of its operations, the losses of a business unit outside China are not allowed to offset profits of business units within China. No such limitation existed under the previous tax regime for foreign-invested enterprises. Even though, as discussed below, a related limitation was deployed in the regime applicable to domestically funded enterprises, it was laid out only in a ministerial circular and did not have the status of a statutory rule. The appearance in the EIT Law of this limitation on foreign losses is thus striking

⁹ See EIT Law, Art. 8 (expenses must be related to the earning of (gross) income to be deductible); EIT Law IR, Art. 27 (the relationship between expenses and income must be direct).

¹⁰ EIT Law IR, Art. 78.

¹¹ Different policies may apply to different types of investments. For example, foreign direct investment (FDI) may be treated differently from foreign portfolio investment.

ing. Although, in China, there is still no official recording of legislative history in reliance on which legislative intent can be used in legal interpretation, there is an official annotation of the EIT Law published shortly after the Law's adoption. The annotation contains a discussion of Article 17 and justifies the law on the ground that foreign branch losses are easy to manipulate and difficult to verify.¹²

This justification is difficult to accept for a number of reasons. Manipulation of losses should be countered by applying proper accounting rules. Even if, generally, auditing the income and losses of foreign operations is difficult, the degree of difficulty depends on actual circumstances and is not always insuperable. It does not make sense, therefore, to deal with administrative difficulties that arise only in some circumstances by uniformly denying taxpayers the right to the proper measurement of their income whenever foreign branch losses could affect the computation of such income. Moreover, as a matter of general practice, China has not dealt with administrative difficulties by introducing distortions into fundamental tax law. For example, like many countries that have only recently implemented the value added tax (VAT), China has had difficulty combating fraud in tax refund claims on exports. Partly as a result of this, China has long abandoned full zero-rating on exports in practice and offers only partial refunds. However, the basic VAT regulations still provide for the right to zero-rating on exports, subject to exceptions made by the government.¹³ Moreover, the adjustment of refund rates has generally been accomplished through temporary regulations. It is hard to believe that manipulation of foreign losses in the income tax context constitutes a problem of a far greater magnitude, requiring a more drastic, statutory solution.

The justification of the limitation on foreign branch losses in terms of administrative difficulties also has problematic implications. If such losses are easily manipulated, should they be disallowed from offsetting foreign income as well? The official annotation undermines its own argument in this regard by stating that a foreign loss may still offset income arising from the

same foreign country.¹⁴ This leaves it unclear not only whether loss and income from different foreign countries might mutually offset each other, but also what type of reasoning one is to follow.

Aside from the "official" exegesis of Article 17, another approach to its interpretation is to consider its predecessor in a MOF/SAT announcement issued in 1997 ("Circular 116").¹⁵ That document was issued under the previous enterprise income tax regime for domestically owned firms and did not apply to foreign-invested enterprises (FIEs were subject to no loss limitation with respect to foreign income or losses). The circular stated that, in computing taxable income, losses may offset profits among foreign operations, but there may be no offsetting of losses against profits in either direction across the Chinese border.¹⁶ There are thus some significant differences between the Circular 116 provision and Article 17 of the EIT Law. However, the former points to a set of concerns in light of which Article 17 can be better understood.

We could start by noting that Article 17 does not speak in terms of the source of income and loss. Generally, a foreign branch could have both Chinese- and foreign-source income, as could a domestic branch.¹⁷ Circular 116, by contrast, refers not to foreign or domestic branches but to profit and losses from inside and outside China. It is natural to interpret this more precisely as addressing foreign- or Chinese-source income and loss. Understood this way, the Circular 116 provision is a rule of more general application, because it addresses the deductibility of a wider range of foreign losses. For example, under current EIT Law source rules, a loss from the sale of a foreign company's stock should be treated as foreign-source.¹⁸ Whereas Article 17 is silent with respect to this type of loss, Circular 116 would limit its deductibility against domestic income. Moreover, as we will see below, one can argue in favor of such a limitation in terms of the operation of FTC mechanisms, once it is interpreted as addressing foreign-source losses.

We should, of course, also note that Circular 116 explicitly prohibits using a domestic-source loss to offset foreign-source income, while permitting the

¹² Shi Yaobin, Sun Ruibiao, and Liu Zhao, *Annotations and a User's Guide to the Enterprise Income Tax Law of the People's Republic of China (zhonghuarenmingongheguo qiyesuodeshuifa shiyijishiyongzhinan)* (Law Press: Beijing; first printing Apr. 2007), pp. 81-2: "Tax administration for foreign branches is relatively difficult; the motive to create artificial losses through manipulation thus easily arises, resulting in encroachment of the domestic tax base."

¹³ See Provisional Regulations on the Value Added Tax (as revised pursuant to State Council Order No. 538, Nov. 10, 2008), Art. 2, clause (3).

¹⁴ Shi, Sun, and Liu, *Annotations and a User's Guide*, fn. 12, above, at p. 82.

¹⁵ MOF/SAT, "(Revised) Temporary Measures for Computing and Collecting Tax on Foreign Income," *Caishuizi* [1997] 116 (11/25/97).

¹⁶ *Id.*, para. 2.

¹⁷ See EIT Law IR, Article 7, on source of income rules. Presumably, however, the purported concern of Article 17 relates mainly to foreign-source losses, because the *Chinese-source* loss of a foreign branch should not be difficult to verify.

¹⁸ EIT Law IR, Art. 7, clause (3).

offsetting of loss against income across foreign operations, including across foreign countries.¹⁹ Thus, not only can Article 17 be subsumed under the limitation on foreign-source loss from offsetting domestic income, that limitation itself can be seen in the context of a broader set of limitations. Specifically, there are three distinct limitations:

- Limitation (1): Foreign-source loss cannot offset domestic-source income
- Limitation (2): Domestic-source loss cannot offset foreign-source income
- Limitation (3): Foreign-source loss from one operation (or country) cannot offset foreign-source income from a different operation (or country).²⁰

In developing detailed rules regarding the computation of foreign-source income and FTC limitations (which are yet to be issued under the EIT Law), it is not unlikely that the government would consider all three types of limitations.²¹ To the extent that the prior law's adoption of both limitations (1) and (2) (in Circular 116) has not been debated and criticized, both limitations may be continued. Although Circular 116 explicitly rejected limitation (3), it clearly could be revived if fear about manipulation of foreign losses is genuine. Moreover, there has been an absence of detailed rules dealing with the consequences of loss offset among foreign operations. As discussed in Section II below, such detailed rules may be perceived by some as too complex in light of the per-country limitation on foreign tax credits, giving another reason for reconsidering limitation (3).

¹⁹ In a prior document repealed by Circular 116 (MOF and SAT, *Caishui* [1995] 56), a provision disallowed offsets between "losses and profits of foreign enterprises." It was unclear whether this merely stated the tautology that the tax liabilities of distinct foreign legal entities could not be computed on a combined base, or whether it disallowed loss offsets among foreign (branch) operations of the same taxpayer. This language was removed in Circular 116. Moreover, local tax bureaus have explicitly interpreted Circular 116 as allowing loss offsets across foreign countries. See Shandong Provincial Local Tax Bureau, Notice regarding Several Problems in Enterprise Income Tax Administration (*Ludishuifa* [1999] 160, Dec. 3, 1999).

²⁰ In the discussion below, we assume that domestic losses are generally allowed to offset domestic income, subject to specific exceptions, such as the disallowance of deductions related to non-taxable income. This assumption holds under the regulations issued under the EIT Law so far.

²¹ Given that limitations on loss offset work to the detriment of taxpayers, it may be questioned whether such further regulatory extension is authorized. The MOF and SAT probably regard Article 20 of the EIT Law as sufficient authorization ("The specific scope and criteria for determining income and deductions and the tax treatment of capital assets in this chapter shall be prescribed by the finance and tax agencies under the State Council.").

In other words, Article 17 may not be the end of the story in terms of limitations on foreign loss. An understanding and evaluation of Article 17 may require understanding and evaluating its possible extension. Moreover, if, as the next section argues, such extension would be unjustified, its adoption should also be prevented, if possible.

The starting point for any evaluation of the above limitations should be the acknowledgment that all three potentially result in the overstatement of a taxpayer's worldwide income when applied to a particular tax period. They thus potentially increase a taxpayer's liability. *Prima facie*, each of these limitations violates the so-called principle of horizontal equity: taxpayers with the same income are taxed differently depending on the mix of where their profits and losses are earned. The idea that persons with the same income should be taxed in the same way, no matter where the income is earned, has at least traditionally been offered as a justification for adopting worldwide taxation in the first place.

More importantly, the limitations violate standards of efficiency, such as capital export neutrality: foreign income is disadvantaged relative to domestic income if it cannot be offset by domestic loss; risky foreign investments are disadvantaged if losses from such investments cannot offset domestic or other foreign income. The limitations are thus non-neutral with respect to domestic and foreign investments.

Because equity and efficiency considerations go to the heart of any system taxing worldwide income, limitations on loss offset should not be adopted lightly. Nonetheless, at least versions of Limitation (1) seem to have been adopted in countries other than China (e.g., Germany²² and Australia²³). Moreover, there is an argument in favor of Limitation (1) (and potentially Limitation (3)) that counters the fundamental equity and efficiency considerations. The argument is that foreign income is primarily subject to foreign (source country) taxation, and the resident country has at best residual taxing power. There is thus a meaningful distinction between the part of the tax base that is domestic from the part that is foreign. To allow foreign loss to offset domestic income would likely encroach on the domestic tax base, and therefore is unacceptable from a revenue perspective. This,

²² See National Foreign Trade Council, "The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part Two: Relief of International Double Taxation," p. 260 (with respect to German tax rules, "foreign branch losses are not deductible . . . branch losses can be carried forward for offset against future income of the respective branch. Thus, a benefit for the branch loss, albeit delayed, is ultimately obtained.").

²³ See Ault and Arnold, "Comparative Income Taxation: A Structural Analysis" (2d Edition) (*Kluwer Law Int'l* 2004), p. 367.

of course, is the reason why no country allows unlimited FTCs, and all countries generally limit the FTC to the amount of domestic tax that would be imposed on foreign income.

The key to this argument is how the encroachment on the domestic tax base occurs. As shown in the section below, it is more credible to explain this in terms of how the FTC mechanism works than to allege manipulation of foreign losses. Even for the real problem created by FTC rules, however, there are better solutions than limiting the deductibility of foreign losses. Therefore, the argument does not succeed. Moreover, the argument also fails to justify Limitations (2) and (3). Although special rules may be needed to accommodate any loss offset across borders, the increase in technical complexity is hardly unmanageable.

LOSS LIMITATION VERSUS LOSS RECAPTURE

How unlimited loss offsets could result in encroachment on the domestic tax base has to be under-

Chart I

Year	Country X Income	Country X tax	PRC-source income	No loss limitation		Limitation (1) applies	
				Taxable income	PRC tax	Taxable income	PRC tax
1	-1,000	0	1,000	0	0	1,000	250
2	1,000	0	1,000	2,000	500	1,000	250

As Chart I shows, under either method there is no encroachment on the PRC domestic tax base: over two years, there is net X-source income of zero and PRC-source income of 2,000, and the right amount of tax (500) is collected from the domestic income. What the loss limitation does is to defer the loss deduction and therefore accelerate income and tax liability, in deviation from the actual sequence of worldwide income realized by the taxpayer.

Chart II contains the standard illustration of how basic FTC rules could lead to diminution of the domestic tax base in the face of a foreign loss. While keeping the taxpayer's income and loss profile the same, the scenario in Chart II assumes that, under

stood in connection with FTC rules. We illustrate this through the scenarios depicted in the following charts, in all of which the People's Republic of China (PRC) and foreign tax rates of 25% are assumed.

Chart I depicts a scenario where a PRC taxpayer records in country X a loss of 1,000 in Year 1 and profits of 1,000 in Year 2. The taxpayer has PRC-source income of 1,000 in each of the two years. Chart I assumes that, under X's tax law, X-source loss in Year 1 offsets X-source income in year 2 in determining tax liability in X; therefore, no tax is paid in X for the 1,000 of income in Year 2. It further assumes that, if PRC tax rules were to prohibit the offsetting of foreign loss against domestic income, it would allow a carryover of the unused foreign loss from year 1 to year 2. With these assumptions, the chart shows the taxpayer's taxable income and PRC tax liability for years 1 and 2, computed either with or without Limitation (1) discussed in the last section (which prohibits deducting a foreign loss against domestic income).

country X's law, the loss in Year 1 does not offset the income in Year 2 in determining tax liability in X. There are a number of real-world circumstances where this might occur. The income from Year 2 may not be subject to net-income taxation (e.g., it is portfolio income). Or it could be that the X-source income consists of the repatriation of profit generated by a separate subsidiary (thus, credit for the X tax is claimed on a deemed-paid basis). Or one can imagine that our charts have oversimplified, and the foreign income earned in Year 2 is from a different foreign country, Y, which, of course, would not consider the X-source loss from Year 1.

Chart II

Year	Country X Income	Country X tax	PRC-source income	No loss limitation		Limitation (1) applies	
				Taxable income	PRC tax	Taxable income	PRC tax
1	-1,000	0	1,000	0	0	1,000	250
2	1,000	250	1,000	2,000	250 (250 FTC used against 250 liability on foreign income)	1,000	250 (excess FTC: 250)

If, for any of these reasons, country X tax is paid in Year 2, and if a FTC is allowed for such tax in China, then over two years only 250 of PRC tax is paid on the 2,000 of PRC-source income. This is shown in the “No loss limitation” column of Chart II. The country X loss in Year 1 is genuine and there is no manipulation. However, foreign-source income is effectively overstated over time, and domestic income understated. Consequently, the taxpayer gets to use tax paid to X to shelter PRC-source income from tax. By contrast, Limitation (1) treats the taxpayer as having zero X-source income in Year 2, turning the 250 of X tax paid into excess credits to be carried over into future years. The PRC-source income of 2,000 is consequently fully taxed in the PRC.

Chart II, therefore, appears to justify Limitation (1) by its function to protect the PRC tax base. But there

is an alternative solution to the problem,²⁴ as illustrated in the “No loss limitation” column in Chart III. Instead of a limitation on the loss-offset during Year 1, a rule could provide that to the extent foreign loss has offset domestic income in Year 1, subsequent foreign-source income should be recharacterized as domestic-source income for FTC purposes. Thus, in our example, if the 1,000 of X-source income in Year 2 is recharacterized as PRC-source income, the 250 of X tax paid would not be creditable and must be carried over, similar to the results under loss limitation. Consequently, the right amount of tax is collected on the 2,000 of PRC-source income over two years and the domestic tax base is left intact.

²⁴ This is the approach adopted in the United States since 1976. See U.S. Internal Revenue Code of 1986, §904(f).

Chart III

Year	Country X Income	Country X tax	PRC-source income	No loss limitation but with re-sourcing of foreign income		Limitation (1) applies	
				Taxable income	PRC tax	Taxable income	PRC tax
1	-1,000	0	1,000	0	0	1,000	250
2	1,000	250	1,000	2,000	500 (excess FTC: 250)	1,000	250 (excess FTC: 250)

Comparing the “No loss limitation” and “Limitation (1) applies” columns of Chart III, one sees that one difference between the loss recapture and the loss limitation approaches is that the latter defers the deduction for the foreign loss to Year 2 and thus accelerates income and tax liability. The latter approach thus gets the timing of income wrong, relative to the former approach. But more importantly, if the taxpayer does not generate foreign-source profit after Year 1, the loss limitation rule would completely fail to recognize this loss for tax purposes. Although the domestic tax base is preserved, it is done at the expense of a serious mismeasurement of the taxpayer’s income overall. The recapture approach avoids this problem.

It may be asked, therefore, why China should not adopt the loss recapture approach, given that it both protects the domestic tax base and more accurately measures worldwide income, thus avoiding the loss limitation’s potential to discourage foreign investment.

An answer that cannot be plausibly given is that a recapture mechanism is too complex and alien to the Chinese system. China’s tax accounting has already practiced the recapture approach to deal with a problem within the domestic context. Under the tax system before the EIT Law took effect, foreign enterprises and foreign-invested Chinese enterprises (FIEs) received tax preferences depending on the nature of their Chinese operations as well as the locations and

timing of such operations. Therefore, a foreign firm's or an FIE's different operations in China could have been subject to different tax rates. Both types of firms were nonetheless allowed to file combined tax returns that aggregated branch profits and losses. This created the possibility that loss from a low-taxed operation would offset income from a high-taxed one. A special rule, therefore, required that if this happened, subsequent income earned by the low-taxed operation would be first recharacterized as income from the high-taxed operation.²⁵

The concept of loss recapture is also relevant to assessing the need for imposing Limitations (2) and (3) described in the last section. For example, one argument for Limitation (3), regarding loss offsets among foreign countries, may be the following. Because China adopts the per-country limitation on the claim of FTCs, there is normally residual Chinese tax collectible on income from low-tax countries. Income from high-tax countries, on the other hand, would normally not give rise to residual Chinese taxation. If losses from high-tax countries are allowed to offset income from low-tax countries, China may lose the revenue that it is otherwise entitled to collect from income earned in low-tax countries. Clearly, this concern is similar to the concern about aggregating profits and losses from branches subject to different tax rates, and Chinese law already shows that it can be dealt with by a loss recapture, as opposed to a loss limitation, approach.²⁶

It seems hard at first to find *any* justification for Limitation (2), which prohibits the use of domestic

losses to reduce foreign income. It fails to display neutrality with respect to domestic and foreign investments (which both fairness and efficiency seem to require), and it does nothing to protect the domestic tax base. But there is a surprising argument for Limitation (2): when the FTC mechanism is taken into account, the limitation sometimes delivers results that are *more favorable* for taxpayers, as well as conceptually more correct. This can be seen in the scenario depicted in Chart IV.

Unlike the previous charts, the Chinese taxpayer here realizes income of 1,000 from country X in both Years 1 and 2, but has a domestic loss and income of 1,000, respectively, in the two years. The penultimate row contrasts the "No loss limitation" approach with the "Limitation (2) applies" approach, while the last row contrasts the latter with a "No limitation but with recapture" approach. The penultimate row of Chart IV shows that when a domestic loss offsets foreign income, foreign income may be understated and domestic income overstated over time. Under the pure "No loss limitation" approach, the taxpayer is treated as having 1,000 each of domestic and foreign income over the course of two years, whereas in fact it has zero domestic income and 2,000 of foreign income. This could prevent the taxpayer from using foreign tax credits otherwise available: in the scenario depicted, the taxpayer has 250 of excess credits at the end of Year 2. If Limitation (2) applies, by contrast, the mix of domestic and foreign income may be more accurately computed, and the taxpayer can end up paying *less* tax worldwide compared to the pure "No loss limitation" approach.

²⁵ See Implementation Rules for the Income Tax Law on Enterprises with Foreign Investment and Foreign Enterprises (State Council Order No. 85, 1991), Arts. 91 and 93.

²⁶ While Circular 116 permitted loss offsets across foreign

countries, it did not propose a loss recapture system similar to that used for foreign and foreign-invested enterprises operating in China.

Chart IV

Year	Country X Income	Country X tax	PRC-source income	No loss limitation		Limitation (2) applies	
				Taxable income	PRC tax	Taxable income	PRC tax
1	1,000	250	-1,000	0	0 (excess FTC: 250)	1,000	0 (FTC used: 250. Domestic loss carry-over: 1,000)
2	1,000	250	1,000	2,000	250 (FTC used: 250; excess FTC: 250)	1,000	0 (FTC used: 250)
2 (alternative with recapture)	1,000	250	1,000	2,000	0 (FTC used: 500, with 250 from Year 1)	1,000	0 (FTC used: 250)

Even in this scenario, however, Limitation (2) is not without problems: if the taxpayer subsequently realizes no domestic income that absorbs the carried-over domestic loss, it would have an unused 1,000 of loss carryover, which could be just as bad as the unused FTC under the pure “No loss limitation” approach. Now compare both approaches with the “No limitation but with recapture” approach in the last row. Under the recapture rule used here, domestic income is recharacterized as foreign income to the extent a domestic loss previously offset foreign income, thus allowing the full crediting of foreign tax paid. The use of this rule allows the accurate measurement, over time, of both the total worldwide income and the proportions of domestic and foreign income within this total. Loss recapture again seems superior to loss limitation.²⁷

The conclusions of this section can be summarized as follows:

- (1) Despite their apparent violation of equity and efficiency criteria, the three types of loss limitations described above may reflect intelligible concerns about protecting the tax base (Limitations (1) and (3)) or simply preventing incorrect results (Limitation (2)), once the functioning of the FTC mechanism is taken into account;
- (2) However, all these concerns could be addressed through a loss recapture system, which more accurately measures income and, therefore, appears more neutral and equitable;
- (3) Such a recapture system is not alien to the Chinese tax system;
- (4) In light of these conclusions, the enactment of Article 17 of the EIT Law indeed seems unfortunate, and it seems important to prevent its extension, *a la* Circular 116, in future regulations concerning the computation of foreign income and FTC limits.

OUTBOUND TAX POLICY GOALS: NORMATIVE DIMENSIONS

Throughout our discussion in the last two sections, we have taken for granted the goal of correctly measuring income so as not to create tax disadvantages for Chinese firms’ foreign investments. The stance of neutrality with respect to choices between foreign and domestic investments is reflected in many of the international aspects of the EIT Law. The general framework of worldwide taxation combined with the FTC, for example, as well as specialized regimes such

as that regarding controlled foreign corporations,²⁸ are generally understood as embodying neutrality norms.²⁹ On the other hand, questions could be raised: putting aside what the law says, what is China’s current tax policy towards outbound investments? And whatever official statements have been made in this regard, what *should* that policy be? After all, neutrality need not be regarded as a goal in itself, let alone the only goal; one could always question whether the stance of neutrality is appropriate in China’s actual circumstances.

Consider an easily understood, albeit atheoretical, trichotomy of possible policy effects that outbound tax rules may achieve: (1) encouraging overseas investments; (2) being neutral with respect to such investments; and (3) discouraging such investments. Which of these effects should China aim for? The trichotomy is atheoretical because it only describes the effect of different rules without mentioning their underlying rationale. In theoretical discussions, economists have used different principles of efficiency to justify rules that have effects of either type (1) or type (2).³⁰ For example, rules that exempt income earned on overseas investments from domestic taxation, which could have the effect of encouraging overseas investments over domestic ones, are associated with the so-called principle of capital import neutrality (CIN).³¹ They are justified on the ground of their potential to induce efficient patterns of savings. Alternatively, rules that subject a given taxpayer’s income, wherever derived, to the same rate of tax are associated with the principle of capital export neutrality (CEN). They are shown to induce efficient allocations of capital, if certain assumptions are met. These efficiency criteria often cannot be met simultaneously, and economists debate about which criterion it is more reasonable to pursue, given real world circumstances.

Rules with effects of type (3), i.e., those that discourage overseas investments, are normally not justi-

²⁸ See EIT Law, Art. 45, and EIT Law IR, Art. 116-8.

²⁹ See, e.g., U.S. Treasury Department (2000), “The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study” (available at <http://www.treas.gov/offices/tax-policy/library/subpartf.pdf>), especially Chapter 3.

³⁰ For accessible overviews of such discussions, see Shaviro, “Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?” 60 *Tax L. Rev.* 155 (2007), and Altshuler, “Recent Developments in the Debate on Deferral,” 87 *Tax Notes* 255 (2000).

³¹ If home countries all exempted their residents’ overseas investment income, income that could be earned from any given investment opportunity would be subject to the same rate of tax — that of the country where that investment was located — regardless of the country in which the investor resided. All sources from which capital can be “imported,” therefore, would be put on an equal footing.

²⁷ Recapture of domestic losses was enacted in the United States through Internal Revenue Code §904(g), effective in 2007.

fied on efficiency grounds. Even if investments made overseas instead of at home may reduce the amount of tax revenue collected in the home country, this is generally not regarded as sufficient reason to discourage investments abroad.³² However, the pursuit of revenue motivates tax agencies, and if, in order to preserve revenue, such agencies adopt rules that effectively discourage foreign investments (whether or not intending such effects), no one should be greatly surprised. Our earlier question could thus be reformulated as: to what extent is the design of outbound tax rules in China determined by the norms of economic efficiency, and to what extent is such design driven instead by the desire to preserve revenue?

The principles of CEN and CIN are known in China and are supposed to have some influence on the design of international income taxation.³³ As mentioned above, neutrality with respect to decisions to invest in China or overseas also informs the overall structure of outbound tax rules. However, as we have seen in connection with Article 17 of the EIT Law (and its predecessor in Circular 116), there are also rules that appear largely driven by the desire to preserve revenue. What explains the choice between these conflicting objectives?

In reflecting on these questions, one inevitably faces the fact that the pursuit of efficiency as recommended by standard economic theory may seem distinctly unpromising in China. Efficiency in international taxation requires minimizing tax-induced distortions to otherwise efficient allocations of resources. However, the allocation of resources in the realm of Chinese outbound investments is subject to serious regulatory distortions, even before the introduction of taxes. The most obvious aspect of this is China's capital control regime. Taxpayers are not free to make foreign investments, and therefore could not freely choose between domestic and foreign investments. Moreover, they are not free to choose between different locations for foreign investments either.³⁴ It is not clear whether the heavy government approval requirements to which outbound investments are subject bias the choice of such investments in any systematic way,

³² The idea that foreign tax paid on foreign investments constitutes a cost to the home country of the investor is associated with the concept of "national neutrality." The concept has had few advocates. See Shaviro, fn. 30 above, for discussion.

³³ See SAT Staff, "Choice of Policy Goals in Taxing the Foreign Income of Chinese Residents," *Int'l Tax'n (Shewai Shuiwu)*, 2006(4), pp. 27-30.

³⁴ For the most recent proposal for subjecting foreign investment projects to central or provincial government approval requirements, see Ministry of Commerce, Administrative Measures for Overseas Investments (Draft) (<http://hzs.mofcom.gov.cn/aarticle/xxfb/200901/20090105993774.html>), published on Jan. 7, 2009, for public comment.

or whether they simply impose uniform transactional ("red tape") costs. Nonetheless, it is worth remembering that the range of transactions that China's outbound tax policy affects has already been narrowed by other regulatory requirements, and that the transactions in this range may already represent different choices from what the firms would have freely made.

A less obvious obstacle to the pursuit of efficiency objectives in China's outbound tax policy is the fact that most entities that obtain permission to invest overseas are large state-owned enterprises (SOEs),³⁵ which dominate both foreign direct investment and foreign portfolio investment. There are reasons to think that, as taxpayers, SOEs respond to taxes differently from private firms. This is because, in addition to collecting tax from them, the government also owns the SOEs. It is well known that the government and SOE managers bargain as to how much of SOEs' profits are to be distributed to the government as shareholder.³⁶ This bargaining tends to carry over to tax administration, too, so that paying tax is sometimes regarded as a way of making distributions.³⁷ If, then, an SOE manager can "get credit" for tax paid — because any tax paid benefits the public fisc just like a dividend distributed — the manager may be less averse to paying taxes than private firms. Conversely, an SOE manager is also more likely to obtain a special tax exemption from the government, because he can argue that less tax paid only increases retained earnings, which belong to the government anyway.

In short, weak corporate governance and protection of the rights of the SOEs' shareholder — the government — may render SOEs' response to taxes quite different from what is standardly assumed in economic theory. In the international context, a sense of skepticism could thus arise: are policy instruments that are neutral for private firms necessarily neutral for SOEs? Do policy instruments that encourage foreign investments for private firms necessarily encourage SOEs' foreign investments?

In light of both China's regulatory restrictions on the range of outbound transactions that can take place, and the special class of taxpayers (i.e., SOEs) that dominate existing outbound transactions, it may be difficult for principles of efficiency to gain wide sympathy among tax policymakers, tax administrators, and even taxpayers themselves. This makes it more

³⁵ See Morck, Randall, Bernard Yeung, and Minyuan Zhao, "Perspectives on China's Outward Foreign Direct Investment," *J. Int'l Bus. Stud.*, 39(3) (2008), pp. 337-350.

³⁶ See the World Bank, SOE Dividends: How Much and to Whom? (World Bank Policy Note, 2005), available at www.worldbank.org.cn/english/content/SOE_En_bill.pdf.

³⁷ See Liu Zuo, "SOE's Switch from Surrendering Profits to Paying Taxes," *Tax'n Res. (Shuiwu Yanjiu)* 2004(10), pp. 27-33.

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understandable that the tax authority would often adopt measures that give priority to the protection of revenue. The past and present limitations on loss offset that we examined in the previous sections look wrong in that they deviate from what standard theories recommend. One could harbor well-justified reservations, however, about whether these classic recommendations apply in the Chinese setting.

Future liberalization of Chinese outbound investments may render standard tax policy recommenda-

tions more cogent. For example, when Chinese individuals are allowed to invest overseas through approved investment funds, principles of CEN and CIN may be more applicable. In the immediate future, however, general policy towards the export of capital will likely remain hesitant and wavering, headline-grabbing deals notwithstanding. Tax policy will constitute no exception to this general policy ambiguity.

MEXICO-U.S. INVESTMENT Mexican Tax Perspective

Mexico's New Transfer Pricing Reporting Obligations Will Result in Increased Audit Activity

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Mexico has approved new transfer pricing reporting requirements that will present a significant compliance burden not just for taxpayers but for their registered public accountants (RPAs) as well. Given the newly required reported information, the Tax Administration Service (SAT) is expected to significantly increase its audit activities with regard to cross-border and domestic intercompany transactions. Mexico is probably the only country that requires taxpayers to have their financial statements audited for tax purposes by an RPA that generally is a partner in an independent accounting firm.

Exhibits 16 and 16-A of the 2008 Omnibus Tax Ruling, published February 20 and March 2, 2009, respectively, include the new Statutory Tax Report Filing System (SIPRED, from its Spanish acronym) for the 2008 tax report. These new forms include unexpected — and, in our opinion, excessive — requests for information that RPAs and taxpayers must disclose in detail. The new SIPRED obligates taxpayers to disclose information on transactions with domestic or foreign related parties for purposes of compliance with income tax and business flat tax laws, and at the same time requires RPAs to complete a new Transfer Pricing Questionnaire on whether their client, in their opinion, has complied with such obligations. These requirements as a matter of course will result in a significant additional administrative burden for both taxpayers and RPAs — and within a short time frame, as the forms must be filed by June 30, 2009, notwithstanding the possibility that this deadline may be postponed for 2009, or that some information requirements may be eliminated, pending the outcome of ne-

gotiations between the Mexican Institute of Public Accountants and the tax authorities.

The detail and structure of this information are intended to facilitate the tax authorities' exercise of their inspection powers regarding specific transactions with related parties, and establish the tax authorities' new expectations regarding the RPA's role in reviewing compliance with transfer pricing obligations. Taxpayers and their advisors ought to have been aware of the possibility that these new requirements would be imposed during the audit planning process in the second half of fiscal 2008.

The information and questions posed to both taxpayers and RPAs provide clues regarding the type of issues the SAT normally examines during a transfer pricing audit.

The SIPRED provides a “checks-and-balances” system regarding transfer pricing information. On the one hand, it requires the taxpayer to disclose specific information and declare whether it has complied with the arm's-length principle and contemporaneous documentation obligations; on the other hand, it requires the RPA to independently declare whether the taxpayer has complied with such obligations. The information to be provided by the taxpayer is included in Exhibits 5, 34, and 34.1, and that required from the RPA is included in the Transfer Pricing Questionnaire.

The required information includes the items discussed below.

Related-Party Transactions Information (Exhibit 34)

In Exhibit 34, the taxpayer must report, for income tax and flat-tax purposes, domestic and foreign related-party transactions that created income or a deduction, including for each transaction the amount, the method used, a “Yes” or “No” statement regarding compliance with the arm's-length principle, and, if applicable, the tax adjustment made to income or deductions to comply with the arm's-length principle.

Exhibit 34 confirms the tax authorities' longstanding position that transfer pricing analysis should be based on a “transactional” approach that requires a separate analysis for each type of transaction. Thus, taxpayers are requested to make a declaration concerning their compliance with the arm's-length principle for each type of transaction listed in Appendix IV of SIPRED.

Appendix IV contains a list of 37 revenue or income transactions and 39 cost or expense transactions. The list of transactions, in addition to those previously reported in the information return on transactions with foreign related parties, now includes information on items that, in our opinion, cannot be

considered “per se” as transactions subject to transfer pricing analysis, even if they create an income or expense item for tax purposes. The question arises as to what the taxpayer or RPA should do to testify whether such transactions were agreed to at arm’s-length or whether the tax authorities will deny the deductibility of some of those items because no contemporaneous transfer pricing documentation was available to support their arm’s-length claim. Examples of such “transactions” include:

- *Gain or loss resulting from a capital reduction or liquidation of foreign resident companies.* Generally speaking, such gain or loss is determined by subtracting the reimbursement paid to shareholders from the capital contributions. How can a taxpayer test whether the amount of the reimbursement is at arm’s length when such “transactions” are by their very nature controlled, and no comparables are available?
- *Dividend income.* Dividends received by a Mexican corporation from another Mexican corporation are not taxable in the hands of the recipient. Why should a taxpayer test a nontaxable event? Moreover, such transactions should not be tested in accordance with transfer pricing provisions, because they do not create a transfer pricing income item or deduction. On the other hand, dividend income received from a non-Mexican corporation is taxable, but, again, how can the taxpayer apply the arm’s-length test to a controlled transaction, with no available comparables? Is it possible to test whether a dividend distribution is transacted at arm’s-length?
- *Annual accruable or deductible adjustment for inflation on loans and debts with related parties.* The inflation adjustment is intended to determine the effect of inflation on accounts receivable and payable. The computation consists of multiplying such accounts by the changes in the National Consumer Price Index (published by the Central Bank) during the year. Should a taxpayer test whether the inflation index is at arm’s length? Of course not. Then why does the SAT request this information from taxpayers? The only logical explanation is that the SAT needs the information to make a secondary adjustment (consisting of disallowing the deduction of an inflationary loss) upon a primary adjustment on related-party transactions that are recorded as an account receivable or payable. However, the tax authorities’ need for such information does not justify their burdening the taxpayer to test the inflationary loss or gain as a related-party “transaction” and to prepare contemporaneous documentation accordingly.
- *Exchange gain or loss resulting from related-party transactions.* A discussion similar to that for

the previous item is applicable to this “transaction.” The exchange gain or loss is computed using the exchange rate published by the Central Bank. Should a taxpayer test whether such exchange rate is at arm’s length? No. Again, it is possible that the SAT needs such information to make a secondary adjustment as described.

Appendix IV also includes other items of income and deductions that traditionally have not been tested in transfer pricing reports. For example, the taxpayer must state whether tax depreciation is arm’s length; it is quite common that the arm’s-length nature of the purchase of a machine is tested at the time of purchase and no tracing is done in the future when accounting for the depreciation. A similar discussion is applicable for other reportable transactions, such as those involving fixed assets, securities, shares, and immovable property.

As previously mentioned, Exhibit 34 also requires taxpayers to disclose whether a “tax” adjustment was made to comply with the arm’s-length principle. The arm’s-length principle contained in article 215 of the Mexican Income Tax Law obligates taxpayers “that enter into related party transactions to determine, *for purposes of this Law*, its taxable revenues and allowed deductions *considering* the prices and considerations that *would have* been used with or between independent parties in comparable transactions.” (Emphasis added.) In our opinion, such language can only be read as requiring taxpayers to comply with the arm’s-length principle for tax purposes only (“for purposes of this Law”); thus, inasmuch as income and deductions are determined at market value, there is no need to make a correlative adjustment in the accounts and records of the taxpayer. The fact that Exhibit 34 requires taxpayers to disclose any adjustments made for tax purposes is consistent with our interpretation.

As part of Exhibit 34, taxpayers must now disclose the year in which related-party transaction amounts were accrued or deducted for income tax purposes, and in what year they were recorded for flat-tax accounting purposes.

RPAs also must submit a statement, in the Transfer Pricing Questionnaire regarding, whether each of their client’s transactions with related parties was agreed to in accordance with the arm’s-length principle, and whether tax adjustments were made to comply with this principle.

Segmented Financial Information

Taxpayers also must provide a segmented profit-and-loss statement regarding domestic and foreign transactions, separating those with related parties from those with independent parties, and including in-

formation at the net profit or loss level (Exhibit 5). The lack of guidance on how to prepare such segmentation is creating significant difficulties for taxpayers that do not keep accounting records in such a way as to produce segmented income statements at the net profit or loss levels. Moreover, this information does not necessarily match or coincide with that used to perform a transfer pricing analysis, for which information is segmented only at a gross profit or loss level when applying the cost-plus or resale-minus methods, or at an operating profit or loss level when applying the transactional net margin or profit-split methods. In addition, there is no guidance on whether segmented financial information should be provided when the tested party is a non-Mexican resident entity.

As part of Exhibit 34.1, the taxpayer must state whether segmented financial information was used in its transfer pricing analysis of domestic and foreign related-party transactions, including a description of the procedures followed and whether the taxpayer's RPA audited the segmented statements. Similarly, the RPA must indicate in the Transfer Pricing Questionnaire whether the segmented financial information used in the study was audited, explain the reasonableness of that segmentation, and confirm whether the taxpayer's information system allows reasonable segmentation of the profit-and-loss statement.

A description of the cost of goods sold derived from sales to related parties is required, as well as the transfer pricing method used to support this transaction (limited to the first three methods listed in Article 216 of the Income Tax Law).

Contemporaneous Documentation and Nondeductibility of Related-Party Transactions

As part of Exhibit 34.1, the taxpayer must state whether it keeps contemporaneous documentation on domestic and foreign related-party transactions. As part of the Transfer Pricing Questionnaire, the RPA must submit a statement whether the taxpayer's arm's-length compliance is based on study of transactions with foreign related parties or on one of the methods established in the Income Tax Law for transactions with Mexico-resident related parties. The RPA also must state whether the taxpayer complies with the arm's-length principle under the provisions of the Business Flat Tax Law. The RPA may answer only "Yes" or "No" regarding compliance with the arm's-length and documentation obligations and must have supporting information for any "Yes" answer.

Surprisingly, if answering that the taxpayer does not keep contemporaneous documentation on its foreign related-party transactions, the RPA now must also state whether the taxpayer claimed a deduction

for such transactions. This confirms the authorities' position that the Mexican taxpayer's claiming a deduction on expenses or costs incurred with a foreign related party is conditioned on keeping contemporaneous documentation. This position is derived from an isolated court case based on pre-2002 legislation. In our opinion, disallowance of related-party expenses on the basis of lack of contemporaneous documentation is an excessive consequence for multinationals doing business in Mexico. In addition, the transfer pricing penalty legislation in Mexico was intended to provide a reduction in penalties when contemporaneous documentation was kept, as opposed to overpunishing taxpayers. There is still a long way to go to conclude whether the nondeductibility criteria will stand in the Mexican courts.

Consistency of Related-Party Information

Exhibit 34.1 requires the taxpayer to provide specific statements and information on its related-party transactions.

A statement must indicate whether the figures included in the related-party information return are the same as those in the transfer pricing report and in Exhibit 34. The taxpayer must explain any discrepancies among those sources of information. The RPA must confirm in the Transfer Pricing Questionnaire whether the information and data included in those sources of information are consistent.

The new forms delve into the consistency of the information, and whether the amounts and transactions in the information return, the tax report, and the study are the same. In the event of discrepancies, an explanation is requested.

The RPA is also required to confirm whether all intercompany transactions are recorded in the taxpayer's accounting records and, if there is an adjustment, whether it is recorded in the taxpayer's accounting and in the accounting-tax reconciliation.

Specific Transactions

The new provisions require disclosure of specific information by the taxpayer and RPA in connection with the following transactions:

- In the case of back-to-back loans, the interest accrued as dividends, as well as the interest amount deemed dividends;
- For prorated expenses, expenses incurred abroad and whether they were deducted by the taxpayer;
- For financial derivative transactions, information regarding losses, revenues, and payments that come from derivative transactions; and

- Regarding thin capitalization rules, all information used to prepare the appropriate calculations and any nondeductible interest.

Under Mexico's Income Tax Law, prorated expenses are nondeductible if incurred with a non-Mexican-resident taxpayer. Thus, a taxpayer that declares it deducted expenses such as management fees or technical services on an allocation or prorated basis with a foreign related party must be fully aware that such information will be used by the tax authorities to immediately trigger an audit and disallow the expenses accordingly. This article does not discuss possible solutions to claiming a deduction of prorated expenses under the double taxation treaties entered into by Mexico.

Taxpayers also must indicate: (1) whether they carried out maquila¹ transactions; (2) the option within Article 216-Bis of the Income Tax Law selected for compliance; (3) costs, expenses, sales, cash flows, operating profit, and profitability factors specific to the selected option; and (4) calculation of the tax incentives for income tax and flat-tax purposes. If the maquiladora did not choose any of the options established in Article 216-Bis, the RPA must provide information on the nonresident that constituted a permanent establishment in Mexico and the revenues attributable to this PE. The assumption that a nonresident principal constitutes a PE in Mexico if it does not elect one of the options provided for in Article 216-Bis is, in our opinion, inadequate. A PE determination should be made based on facts and circumstances, under both domestic legislation and double taxation treaties entered into by Mexico.

The taxpayer must declare whether it has obtained a favorable transfer pricing ruling (equivalent to an advance pricing agreement, or APA) from the SAT, or whether it has supporting documentation for transactions with domestic and foreign related parties.

Finally, the taxpayer must disclose information (including the Federal Taxpayer Identification Number)

¹ A factory that imports materials and equipment free of duties and tariffs, and later exports the manufactured product.

on the individuals who prepared, or provided advice on the preparation of, its transfer pricing documentation.

Intangible Assets

The RPA also must disclose the most "significant" intangible assets owned or used by the taxpayer, as well as the royalties collected or paid. However, the new requirement includes no definition of "significant"; thus, taxpayers must review carefully the information to be provided by the RPA. It is likely that such information will be used to determine a potential exit tax upon a business reorganization or closure; apparently, then, the taxpayer should disclose only "valuable" intangible assets.

A list of intangibles is included in Appendix XI of the SIPRED, and includes those related to market and client assets, contracts, technology, and personnel.

Other Items in Transfer Pricing Questionnaire

The Transfer Pricing Questionnaire requires the RPA to confirm whether the taxpayer included, in its transfer pricing documentation, information on functions performed, assets used, and risks assumed by each type of transaction and, if applicable, by the related party, as well as the method applied to each transaction type and the classification of the methodologies. It also requires confirmation of whether transactions with related parties were carried out at arm's length. If those transactions were not carried out at arm's length, the RPA must confirm the note or disclosure included in the tax situation or in the tax report.

On a related note, the 2008 annual tax return form includes new reporting requirements for transactions with related parties. The annual tax return form requires, among other items, a profit-and-loss statement and balance sheet, segmented by related and unrelated parties, domestic and foreign, and the transfer pricing method utilized for maquiladoras.

LEADING PRACTITIONER COMMENTARY

FIRPTA in the 21st Century, Installment Six: FIRPTA Withholding Where a §892 Investor Is a Partner

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This is the sixth in a series of commentaries intended to highlight some of the questions that arise in modern practice under FIRPTA where the answers are unclear, and where the Treasury Department and the IRS could usefully provide guidance addressing a host of questions that has existed for many years. This article will focus on the application of the Code's withholding rules in situations involving partnerships having one or more partners who are foreign sovereigns entitled to the benefits of §892 of the Code.¹

Two Common Situations. This article will focus on two common fact patterns where the application of the Code's withholding rules is unclear, and which require IRS guidance.

Situation One. A §892 investor, F, is a 3% limited partner in Partnership XYZ, which owns, as its sole asset, 100% of the single class of shares of stock in Corporation C, which is a U.S. real property holding corporation (a "USRPHC") within the meaning of §897(c). Corporation C is not a "controlled commercial entity" with respect to F.² F sells its partnership interest in Partnership XYZ to an unrelated person, B, at a substantial gain. Must B withhold tax under §1445?

Situation Two. Same facts as in Situation One, except that Partnership XYZ sells all the C shares to an unrelated party at a substantial gain, 3% of which is allocated to F. Must Partnership XYZ withhold tax under §1446 or §1445 on the allocation of the gain to F?

Situation One — Regular FIRPTA Withholding. As a matter of law, F should be exempt from U.S. tax on the sale of its partnership interest. Although §892 does

not extend to sales of partnership interests,³ the §892 regulations generally treat partnerships as aggregates. Therefore, F should be treated as selling its share of the C stock. It is clear that gain on the sale of stock of a non-controlled entity, even a USRPHC, is exempt under §892.⁴

In PLR 9643031, the IRS ruled without discussion that "[t]he disposition of an interest in [a partnership] by [a §892 entity] will not qualify for the exemption under section 892. Section 1.892-3T(a)(2)." The ruling did not state that the sale of the partnership interest was taxable to the §892 partner, and indeed it would clearly not have been, because the partnership in question owned only passive investment assets. A foreign person thus would not have been subject to tax on the sale whether or not §892 applied. To the extent the ruling somehow implies that the sale would have been taxable if the partnership had owned a USRPHC, in my view the ruling is simply wrong.

Pity the poor withholding agent B (and pity B's tax advisor even more). Section 1445(a) requires B to withhold FIRPTA tax if F is selling a U.S. real property interest (a "USRPI"). Section 897(g) provides authority to the IRS to write regulations pursuant to which F is treated as selling a USRPI to the extent F's interest is attributable to USRPIs held by the partnership (here, 100%). The regulations provide that if 50% or more of the value of the gross assets of a partnership consists of USRPIs and 90% or more consists of USRPIs plus cash, withholding will be required upon a sale by a foreign partner of his partnership interest.⁵

However, another regulation issued in the same Treasury Decision contains a special rule for §892 entities. According to that regulation, a §892 entity is not subject to withholding if it "disposes of a U.S. real property interest that is not subject to taxation as specifically provided by the regulations under section 892" and presents a certificate to the buyer to such effect.⁶ The clear intent of this regulation is to exempt §892 entities from FIRPTA withholding when they sell stock of a non-controlled USRPHC. But, for two reasons, it is difficult to conclude with certainty that the exemption applies where the §892 entity is selling a partnership interest.

First, the §892 regulations arguably do not "specifically provide" an exemption that covers this case. Those regulations state that the sale of a partnership interest is not covered by §892; it is only by proper application of the aggregate theory (which by the way

¹ Throughout, it will be assumed that the §892 partner is not a "controlled commercial entity," including by reason of Regs. §1.892-5T(b)(1). *But see* the concluding paragraph, and a forthcoming installment on that regulation.

² *See* the definition in §892(a)(2)(B).

³ Regs. §1.892-3T(a)(2).

⁴ Regs. §1.892-3T, including -3T(b), *Ex. (1)*.

⁵ Regs. §1.1445-11T.

⁶ Regs. §1.1445-10T(b)(1).

is embedded in the FIRPTA withholding regulations) that one can conclude such a sale would be covered. Second, it is not entirely clear that the sale of a partnership interest is the sale of a USRPI; the statute merely says that it should be treated as the sale of a USRPI to the extent attributable to USRPIs. For some withholding agents, this may be enough to convince them that failure to withhold will not land them in jail. For others, the §892 seller may well be told to secure a withholding certificate from the IRS in advance of the purchase, or suffer withholding and apply for a refund.

If Partnership XYZ is a publicly traded partnership (a “PTP”), the regulations extend the benefit of the publicly traded USRPHC rules to the partnership. Under Regs. §§1.897-1(c)(2)(iv) and 1.1445-2(c)(2), B will not be required to withhold tax as long as F owns less than 5% of the interests in Partnership XYZ. Moreover, the §892 regulations treat an interest in a PTP as a “security,”⁷ although it is unclear whether that makes any difference to the analysis, since those same regulations exclude from the scope of §892 any gain from the disposition of a partnership interest.⁸ The regulations are internally inconsistent. It is difficult to guess why one portion of the regulations would go out of its way to treat an interest in a PTP as a security while the preceding portion of the same regulations treats the gain from the sale of *any* partnership interest as outside the scope of §892.

Situation Two — FIRPTA and Partnership Withholding. Both §§892 and 1445 treat a partnership as an aggregate. Therefore, one would expect that if a partnership were to sell stock of a USRPHC that was not a controlled commercial entity as to any §892 partner, that partner’s share of the partnership’s gain would not be subject to FIRPTA or to withholding. However, there is no clear path to arrive at such a conclusion, at least as to the absence of a withholding obligation.

When a partnership sells a USRPI, both §§1445 and 1446 apply concurrently. The relevant regulations make clear that when both Code sections apply, §1446 and the regulations thereunder “trump” §1445 and the regulations thereunder.⁹ The §1446 regulations specifically refer to §892 partners, but appear to have been written by a drafter who either: (1) was unaware of the exception for sale of stock of USRPHCs; or (2) was aware of the exception, but for some reason thought it inapplicable where the partnership is the seller. Those regulations provide that “the submission of a Form W-8EXP will have no effect on whether

there is a §1446 tax due with respect to such partner’s allocable share of partnership ECTI.”¹⁰

Regs. §1.1445-5(c)(1)(ii) requires a partnership to withhold FIRPTA tax on any disposition of a USRPI to the extent of a foreign partner’s distributive share of gain. The §1445 regulations, as noted above, contain a special rule for §892 entities. However, the exception by its terms applies only when a §892 entity sells a USRPI. And not surprisingly, §892 and the regulations thereunder are silent on the question.¹¹

It thus appears that Partnership XYZ must withhold a full 35% tax under §1446 on the gain allocable to F. There is no provision in the regulations for avoiding withholding by delivery of a withholding certificate or any other form of affidavit. F’s sole remedy would appear to be to file a U.S. tax return and apply for a refund.¹²

It should be obvious that this is an unhealthy state of affairs. It breeds contempt for the tax law and regulations. It may also encourage highly wasteful planning. Some §892 investors may insist that, before the partnership sells any non-controlled USRPHC stock, the partnership distribute in kind to the partner the number of shares allocable to it, so that the partner can sell the shares directly and benefit from §892.¹³ In those cases where the USRPHC shares are not the sole asset of the partnership, and there was no intention to distribute all of the cash proceeds of the sale, or in any case in which allocations are not purely “straight up,” this will entail an undertaking by the partner to recontribute the sale proceeds back to the partnership. Talk about form over substance! What a waste!

Conclusion. It’s obvious I don’t think much of these regulations — or really the absence of regulations. The discontinuities presented by these simple

¹⁰ Regs. §1.1446-1(c)(2)(ii)(G).

¹¹ The §892 regulations contain a rule that attributes a partnership’s commercial activity to its partners, rendering any partner that is not an “integral part” of the foreign government a controlled commercial entity if the partnership engages in any commercial activity. Regs. §1.892-5T(d)(3). However, this rule is not implicated here, because the mere ownership of C shares is not a commercial activity.

¹² Regs. §1.1446-2(b)(2)(iii) provides that a foreign partner’s allocable share of a partnership’s ECI does not include income or gain exempt from U.S. tax. It can be argued that this provision excuses the general partner from withholding on the §892 partner’s share of the gain. However, this provision does not appear designed to cover partner-level exemptions like §892, and the applicable operative provision (cited at footnote 10 above) appears to require withholding even where the partner is a §892 organization. Moreover, even if this provision excused withholding under §1446, there is nothing that would excuse withholding under §1445.

¹³ Regs. §1.1445-11T(c) allows the in-kind distribution of a USRPI to be made without withholding tax.

⁷ Regs. §1.892-3T(a)(3).

⁸ Regs. §1.892-3T(a)(2) and (b), *Ex. (1)*.

⁹ Regs. §1.1446-3(c)(2).

examples can be traced to several shortcomings in the regulatory approach. First, the §892 regulations need to be rewritten from the ground up to deal comprehensively, and in an internally consistent way, with partnerships. Second, the FIRPTA regulations need to deal with foreign governments in all contexts to which FIRPTA applies, not just the few that happen to occur to the drafter. Third, although it's probably too late to say it again, the decision that was made to allow the §1446 regulations to trump the §1445 regulations was a mistake. The narrower and more specific rule should always trump the broader rule, and Situation Two is a good illustration of the mischief that can ensue when this is not done. If we're stuck with the §1446 regulations, a new section should be added to them to deal specifically with §892, and to provide that the sale of stock of a non-controlled USRPHC will not be subject to withholding upon the receipt of a properly-filed Form W-8EXP claiming the benefits of that section. The present coordination rule of Regs. §1.1446-4(f)(4) is woefully inadequate and should be rewritten.

It is possible — but unlikely — that the strange absence of withholding tax relief in these cases is attributable to some concern on the part of the IRS that foreign investors may be claiming to be described in §892 when in fact they are not entitled to the benefits of that section. In particular, it seems possible that the IRS believed, at least at one time, that the rule of Regs. §1.892-5T(b)(1), mentioned in footnote 1, would render most partners ineligible for the exemption. If these are or were concerns, they should be abandoned. Section 892 investors take great pains to avoid the latter regulation, and it is easily avoided, once one is aware of it, by ensuring there are other assets in the investing entity. And the answer to the “false claims” concern is that we have a system designed to minimize such occurrences. In any case, ignoring the problem is not a solution.

Should the United States Adopt a “Managed and Controlled” Test for Offshore Investment Funds?

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Generally speaking, the United States imposes its net income tax on the worldwide income of all U.S. corporations — i.e., corporations incorporated in the United States. Our net income tax generally applies to a foreign corporation — i.e., a corporation incorporated outside the United States — only if the corporation is engaged in a U.S. trade or business, and then only as to its U.S.-source and certain limited foreign-

source income that is “effectively connected” with that U.S. business (notable additional instances of taxation being expatriations of former U.S. corporations under §7874 and dispositions of U.S. real property under §897). Moreover, under §864, a foreign corporation is not taxed on income from trading for its own account in the United States in stocks, securities, or (perish the thought) derivatives, including trading through an investment manager or its own employees in the United States who exercise investment discretion.

Not so in the United Kingdom. The U.K. corporation income tax applies to the worldwide income of: (1) any company incorporated in the United Kingdom; and (2) any foreign-incorporated company that is “managed and controlled” in the United Kingdom. Generally speaking, management and control is where the board of directors meets, assuming the board is “managing” the company. If the board is a mere “cipher,” and the real decisions are made elsewhere, management and control will reside where the real decisions are taken. Importantly, the relevant management decisions are those of high-level strategic management, rather than immediate management of day-to-day activities. For foreign investment companies, standard U.K. tax advice is that all “high-level” decisions must be made offshore, the board must meet offshore, and a majority of the board should be non-U.K. residents (e.g., two out of three). In contrast to the board, the company's investment adviser can be in the United Kingdom without causing the company to be taxable on a “U.K. trade” (although the adviser may then be subject to relevant financial services regulation). This “investment manager exemption” generally requires that: (1) the onshore manager act in an independent capacity; (2) the remuneration of the manager be at arm's length; and (3) the interest of the investment manager in the income of the investment company not exceed a certain threshold over time.

Should the United States adopt a variation of the U.K. “managed and controlled” test? On March 2, 2009, Senator Levin introduced the “Stop Tax Haven Abuse Act” (S. 506) (the “Bill”). Congressman Duggott introduced an identical bill (H.R. 1265) on March 3. Treasury Secretary Geithner was quoted on March 5 as saying he “fully supports” the Bill. As widely noted, in 2007 then-Senator Obama was a co-sponsor of a similar 2007 bill from Senator Levin. The new Bill has many of the 2007 provisions, including measures aimed at U.S. taxpayers (mostly individuals) who seek to “hide” assets in offshore tax havens and codification of the “economic substance doctrine.”

The new Bill has a new provision, which would import into U.S. law, I believe for the first time, a variation of the U.K. “managed and controlled” test. Section 103 of the Bill would add to the Code a new

§7701(o), entitled “CERTAIN CORPORATIONS MANAGED AND CONTROLLED IN THE UNITED STATES TREATED AS DOMESTIC FOR INCOME TAX.” A nice clear title. The test for taxing a foreign corporation’s worldwide income is also stated simply: “the management and control of the corporation occurs, directly or indirectly, primarily within the United States.”

Not all foreign corporations would be covered by the new rule. Covered foreign corporations are those where either: (1) the corporation’s stock is regularly traded on an established securities market; or (2) the aggregate gross assets of the corporation (or any predecessor), “including assets under management for investors,” whether held directly or indirectly, at any time during the year or any preceding year is \$50 million or more. The “including” phrase is interesting. Assets which are “of” the corporation presumably means all assets beneficially “owned” by the corporation for tax purposes. So why mention assets “under management for investors”? Perhaps the drafters were concerned to cover cases where assets legally titled in the corporation were being managed for the beneficial owners of the assets, who might not be the owners of the corporation. Does this mean that assets legally held in “street name” by a manager are assets “of” the corporation? Surely a domestic corporation would not be taxed in this situation.

Then there is a “general exception” to the general rule. A corporation is not covered if: (1) the corporation was covered in a preceding year; (2) the corporation is not regularly traded and has and is reasonably expected to continue to have gross assets of less than \$50 million; and (3) the Secretary grants a waiver. What are the criteria under which the IRS will grant or not grant a waiver? Is the IRS to predict (like Warren Buffet) the growth of the assets?

Next is an exception to the \$50 million assets test. That test is treated as not met by a corporation which is a controlled foreign corporation (CFC), if: (1) the parent of the CFC is a U.S. corporation; and (2) the parent has substantial assets (other than cash and stock of foreign subsidiaries) held for use in the active conduct of a U.S. trade or business. So, a CFC of a U.S. investment company parent, which is not engaged in an active U.S. business, may be covered. Likewise, a CFC owned by *any* U.S. partnership, including an investment partnership or a U.S. active business partnership, may be covered. Query if the CFC exception should be so narrowly written.

The Bill gives the Treasury specific direction in determining whether management and control occurs

primarily within the United States. The regulations “shall provide” that: (1) management and control occurs primarily within the United States “if substantially all of the executive officers and senior management of the corporation who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the corporation are located primarily within the United States”; and (2) individuals who are not executive officers and senior management (including individuals who are officers or employees of other corporations in the same chain) shall be treated as executive officers and senior management “if such individuals exercise the day-to-day responsibilities of the corporation.” In addition, the regulations shall provide that management and control occurs primarily within the United States if: (1) the assets of the corporation (directly or indirectly) consist primarily of assets being managed on behalf of investors; and (2) decisions about how to invest the assets are made in the United States.” So the Bill significantly varies the U.K. test — it is not the board of directors that matters, but instead the day-to-day managers. This is indeed closer to the existing U.S. test for foreign-source income that is treated as effectively connected with a U.S. trade or business. But it almost entirely guts the long-standing §864 exception for trading for one’s own account.

To give offshore investment funds and others some time to restructure (if such is possible), the new provision is to be effective for taxable years beginning on or after two years after enactment. In introducing the Bill, Senator Levin said the following: “Section 103 is intended to stop, in particular, the outrageous tax dodging that now goes on by too many hedge funds and investment management businesses that structure themselves to appear to be foreign entities, even though their key decision makers — the folks who exercise control of the company, its assets, and investment decisions — live and work right here in the United States . . . It is unacceptable that such companies utilize U.S. offices, personnel, laws, and markets to make their money, but then stiff Uncle Sam and offload their tax burden onto competitors who play by the rules.” Just the kind of new tax provision we need right now. For all those U.S. investment fund managers who are now unemployed, or under-employed, in New York, Los Angeles, and Kansas City, it’s time to move to London (but please make sure two out of three of the fund’s directors remain in the United States, or elsewhere outside the United Kingdom)!

Branching Out: The Subpart F Contract Manufacturing Regulations v2.0

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I suppose I should be embarrassed to admit it, but almost every time over the years that I've had to deal with the Subpart F sales or manufacturing branch rules, I've had to open the regulations and read through the rules — yet again — to get myself back up to speed on the details. And in the case of these branch rules, as much as anything, the devil really is in the details. So when the IRS issued the proposed Subpart F contract manufacturing rules in February of 2008, I was less than thrilled to see yet another set of branch rules and yet another layer of dazzling complication.

Oh, and some of the proposed rules didn't exactly make sense, even after I carefully parsed my way through them.

I made my thoughts about the early-2008 proposed regulations pretty clear on these pages in the wake of the issuance of those rules.¹ In short, while I gave the government a modest *attaboy* for taking on such a daunting task and making a credible first effort, I concluded that the proposed regulations were just that — a first effort — indicating that a good deal more thoughtful consideration was needed. I also spent some time carping about the lack of guidance provided for purposes of calculating the effective tax rate of a branch around which you're made to "draw a box" under the branch rules, as well as for purposes of figuring out how much income is attributable to such a "branch."

So, now that the IRS has had time to think about it — and sift through what were probably a record number of comments — what have they wrought with version two of the contract manufacturing regulations?

Overall, the Service has done a pretty good job of addressing many of the concerns raised by taxpayers and practitioners about the proposed regulations. So, for example, they've now refined the list of "substantial contribution" activities and clarified certain aspects of the list, as well as the manner in which it is to be applied in practice. They've also provided a definition for the term "employee," which was a big sticking point in the proposed regulations.

All in all, a decent day's work. And all very constructive in the recognition of the economic reality of

the world we live in today, where physical manufacturing is often outsourced but direction and control of the manufacturing process is often the true value-added economic activity that should not, in principle, be viewed as "foreign base company"-type activity.

As to the branch rules, though, in my view what we have remains a work very much still in progress. While the progress does seem to be going in the right direction in my view, the progress is only incremental. In fact, the changes to the proposed branch rules are so extensive that this portion of the rules, unlike most of the remainder, has been issued in proposed and temporary form. Which makes one pause and wonder whether the manufacturing branch rule really is worth all this blood, sweat, and tears.

The Branch Rules: Some Answers but Many More Questions

By way of quick background, recall that if a controlled foreign corporation (CFC) conducts its manufacturing or sales activities outside its country of incorporation through a branch, a special set of rules applies for purposes of determining whether the CFC has foreign base company sales income (FBCSI).

Also recall that the branch rule is specifically authorized by the statute (§954(d)(2)) as enacted in 1962. The statutory language is centered on a sales branch paradigm, rather than on a manufacturing branch paradigm (although the legislative history provides some support for the latter). I'll also point out that in 1962, which was a good bit before my time as a tax guy, it appears there was little thought of virtual outsourced manufacturing, few if any regional or global business models as the operating philosophy of multinationals, and no formal transfer pricing documentation or penalty rules to ensure that profit wasn't shifted inappropriately from one foreign branch to another. Oh yeah, and it was also pre-check-the-box by about 35 years and operating in true branch form was pretty rare.

So now, almost 50 years after the legislative authority was provided for the branch rules, at a time when they will actually be relevant to a majority of U.S. multinationals, we are finally given somewhat detailed and very complex guidance for the first time since 1962. What does the guidance cover and, more importantly, what does it not cover?

The primary driver of the regulations has always been the so-called rate disparity test (RDT), which determines whether you have a branch that you have to worry about. In the good news category, the regulations recognize that there can be more than one substantial contributor to the manufacturing process eligible for the manufacturing exception to FBCSI; in the bad news category, this means that multiple locations within a CFC could be considered to have sub-

¹ Tobin, "The Proposed Contract Manufacturing Regulations: A Journey of a Thousand Miles Begins With a Single Step," 37 *Tax Mgmt. Int'l J.* 407 (July 2008).

stantially contributed, which could give rise to multiple manufacturing branches. Likewise, a CFC can have multiple sales branches because it sells different products from different offices, it purchases a particular component or raw material in one location and sells the finished product in another (note that purchasing activities can also create a “sales” branch), or perhaps even where multiple offices contribute to the marketing or sale of a single product. To their credit, having created greater potential for multiple manufacturing branches through the operation of the new substantial contribution concept, the drafters did include in these regulations rules for prioritizing among multiple manufacturing branches in order to focus the analysis on one such branch. The drafters also helpfully included rules for coordinating the manufacturing branch rule and the sales branch rule. These are both areas where guidance had been lacking for years.

The new regulations include a complicated scheme for determining which manufacturing branch (or aggregation of branches) must be examined under the RDT. Once you determine the manufacturing branch that will be the focus of the analysis, the RDT is then applied by comparing the actual effective tax rate incurred in a sales branch with the hypothetical tax rate that would have been incurred had that income been earned in the appropriate manufacturing branch; if the actual tax rate is too disparate (less than 90% of and more than 5% points lower than the hypothetical tax rate), then a box is to be drawn around the sales branch and Subpart F consequences are analyzed as if there were two separate CFCs. If there are multiple sales branches, this analysis is repeated for each sales branch.

In my view, the basic conceptual approach used in these new branch rules is fairly well thought-out and recognizes the realities of complex global or regional business models, as far as it goes. Of course, the rules will also be incredibly complex to apply in practice for all but the most simple fact patterns.

My biggest concerns, however, are still with respect to the issues the regulations do not address, as well as a potential trap for the unwary created by the regulations in cases where a virtual manufacturer is purchasing and selling from and to unrelated parties.

Areas that are not addressed in the regulations include the definition of what is a branch, details as to how to compute the effective tax rate of a sales branch or the hypothetical tax rate of the manufacturing branch, and details on how to compute the amount of Subpart F income if the RDT is failed and the deemed existence of a second CFC could result in the creation of Subpart F income. Not exactly minor details!

The Preamble to the regulations does indeed acknowledge the lack of guidance on these issues in stating, “The IRS and the Treasury Department con-

cluded that other questions and requests in this area, including further clarification of the methodology for calculation of hypothetical tax rates, and for changes to the assumptions used in applying the tax rate disparity tests and determining the hypothetical effective tax rate, are beyond the scope of this regulatory project.” The Preamble similarly states that defining the term “branch” is outside the regulations’ scope.

My reaction to all this was going to be to say that, in my view, this is unacceptable from a tax policy standpoint. I was then going to go on to note that if these detailed calculation issues are too tough for the IRS national office to figure out for inclusion in the regulations, how can it be acceptable to toss these unanswered questions over the fence for taxpayers and IRS agents to figure out? Admittedly, we have lived without any real guidance on these issues since 1962. However, under existing law, based on the *Ashland* and *Vetco* cases (and notwithstanding the questionable position espoused in Rev. Rul. 97-48, which revoked Rev. Rul. 75-7), a virtual manufacturer should not be considered to have a manufacturing branch, so the issue of the RDT has only infrequently had application. However, the way the new substantial contribution concept is structured in these regulations now will result in many companies needing to grapple with the manufacturing branch rule, only to find themselves on their own in attempting to interpret how to do the most fundamental of calculations.

Then, on March 20, the Service issued “technical corrections” to the regulations, portions of which seem to go way beyond the usual meaning of that term. For example, the Preamble was revised to provide that uniformly available tax incentives should be considered in determining the hypothetical effective tax rate used in applying the RDT; if a ruling is available and the manufacturing branch does not obtain one, then the hypothetical effective tax rate that would be paid by that branch (or remainder of the CFC), were it to derive the sales income, should be the jurisdiction’s effective rate not taking into account the “forgone” relief. It is thus clear that the manufacturing branch (not the sales branch) must affirmatively obtain a ruling that includes sale income. In addition, the Preamble removed the portion of the regulations that said the principles of the §954 regulations addressing the high-tax exception were to be used in determining the effective rate of tax when applying the RDT. The technical corrections also revise the rules to be applied when no location independently satisfies the manufacturing test in such a way that one can now have multiple tested sales locations for the same item of property.

Perhaps my planned carping wasn’t quite strong enough, because, among other things, this last change will likely result in a greater amount of foreign base

company sales income and add even more draconian compliance burdens, and very little has been clarified (or “corrected”).

In any case, notwithstanding these so-called technical corrections — or, to some degree, because of them — companies will really have their hands full in attempting to comply with the new rules.

Consider a simple fact pattern. A CFC European holding company, CFC Holdco, owns a Swiss checked subsidiary that substantially contributes to the manufacturing of a product. Swiss “branch” sells to Belgian sales company, which is also a checked subsidiary of CFC Holdco. Belgian “branch” sells to non-Belgian customers. Assume Belgian “branch” buys for 100 and resells for 175 and deducts 20 for local marketing costs, 25 for interest to CFC Holdco, 10 for royalties to Swiss branch, and 15 in NOL carryovers, which results in net taxable income in Belgium of 5 and Belgian tax of 2. Questions that one might ask — in determining how to apply the RDT — include:

- Do I use local Belgian taxable income rules or U.S. rules to compute the effective tax rate?
- Do I regard disregarded payments in the calculation?
- Do I take into account NOL deductions?
 - Does that answer depend on whether the NOL relates to the sales activity?
- Do I respect the terms of sale for the purchase from Swiss branch and thus the gross margin that the sales branch records?
- How should U.S. or Belgian or Swiss transfer pricing concepts or adjustments enter into the calculation?
- How do I deal with forex issues, in this case between the Euro and the Swiss Franc?
- If I do conclude that the RDT is flunked, how do I compute Subpart F income — which raises all the same questions as above?
- After I have done all that, do I follow the same principles I use above for purposes of §987 in considering what constitutes a branch remittance?

Again, not exactly minor details.

My last whine relates to the trap for the unwary. Assume CFC Holdco in the above example is purchasing all raw materials from unrelated parties and selling all finished products to unrelated parties, albeit through branches. And assume it doesn’t fail the sales branch rule RDT, so it only could have Subpart F income if the manufacturing branch rules apply. Under *Ashland/Vetco* and other existing authority, there would not seem to be a concern about Subpart F in such a case; after all, the CFC is not doing either related party sales or related party purchases. And indeed, if the Swiss “branch” is not a substantial contributor, the manufacturing branch rule would not apply and there would still be no Subpart F risk. However, if the Swiss branch were found to be substantially contributing, all of the calculation headaches above would apply and some Subpart F income could well exist. The irony, of course, is that now the IRS will have an incentive in some cases to assert a CFC is a manufacturer and the taxpayer will need to argue why its alleged contribution is not substantial.

* * *

Going back to one of my opening comments, the world in 1962 was very different from the world today. The substantial contribution rules provide appropriate guidance on when activities of a CFC are substantial enough to not be considered tainted base company activities. But we still can’t figure out how to apply the branch rule income test. At this point, it is appropriate to remember that the authority for the manufacturing branch rule is vague and exists only in the legislative history and not in the statute. I suggest some bolder policy thinking is in order and ask why not just drop the manufacturing branch rule altogether? The policy underlying the branch rule is rooted in concern about the potential for inappropriate shifting of a multinational’s foreign tax base from a high-tax location to a low-tax location. The vigilance of foreign tax authorities, the proliferation of transfer pricing documentation and penalty regimes, and the intense focus on the tax implications of “business restructurings” as evidenced by the recent OECD report on this subject should all provide the IRS with comfort that the complexity and burden required to police this concern are no longer needed. We all have too many other things to worry about these days!

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This section features brief commentary written on a rotating basis by leading international tax practitioners. Advance versions of most items are published in the “Insights and Commentary” section of *BNA Tax and Accounting Center* on the Web.

GUEST COMMENTARY

A Model of Reality for President Obama (and Senator Dorgan) to Use In Evaluating Proposals for U.S. International Tax Reform

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During the 2008 presidential campaign, candidate Obama frequently stated (both on the stump and in the Presidential debates) that he would repeal “tax breaks and loopholes for shipping U.S. jobs offshore.” The references to tax breaks (plural) *and* loopholes (plural) suggested he had in mind at least four provisions of the Internal Revenue Code. However, it was never clear, at least to this author, as to what he was referring. The language communicated some concern with “deferral” (i.e., deferral of U.S. income tax on income earned abroad by foreign subsidiaries of U.S. corporations) but deferral certainly cannot be considered a tax break intended to encourage persons to ship U.S. jobs offshore, nor a loophole. After all, deferral is a very broad principle and results in reduced U.S. income tax on all kinds of operations conducted abroad, even if they do not involve U.S. jobs shipped offshore.

President Obama’s manifest concern with at least some aspect of U.S. international taxation, whatever that might be, was made clear in his budget released on February 26, 2009. That budget included the following, rather mysterious, line item (which was projected to raise \$210 billion over 10 years): “Implement international enforcement, reform deferral, and other tax reform policies.” News reports have indicated that this is to be fleshed out in the course of the budget process.¹ In addition, Peter Orszag, Director of the Office of Management and Budget, announced on March 25 that the White House is in the process of creating a Tax Reform Task Force “to recommend ways to simplify the tax code and reduce tax evasion.”² It is clear, therefore, that in the not-too-distant future, the President will be entertaining some propos-

¹ Goldfarb and O’Toole, “Geithner and Orszag Defend Obama Tax Proposals,” 2009 *TNT* 40-1 (3/4/09); Ferguson, “Deferral Should Be Addressed as Part of Broader International Reform, Neal Says,” 47 *BNA Daily Tax Rpt.* G-6 (3/13/09).

² Ferguson, Rothman, and Grimaldi, “Obama Calls for Tax Reform Task Force to Get Advice on Long-Term Policy Changes,”

als for reform of U.S. international taxation. That being the case, the following “Model of Reality” is offered to help him evaluate the merits and demerits of any such proposals that may be presented to him. The Model is also offered to Senator Dorgan (D-ND) in light of his concern with so-called “runaway plants.” See S. 260, introduced by him in the Senate on January 15, 2009.³

The Model that follows may seem rather basic, but it is this author’s experience that, in the political world at least, it is necessary to present concepts very simply in order to get a point across.

A MODEL OF REALITY FOR EVALUATING PROPOSALS FOR U.S. INTERNATIONAL TAX REFORM

When dealing with issues involving corporations, partnerships, and “hybrid entities,” international tax practitioners (and other tax practitioners) usually think in terms of rectangles, ovals, and triangles. However, rectangles, ovals, and triangles really have nothing to do with reality, and do not help the practitioner “see” reality when dealing with the tax issues. Some model of reality is needed to help the practitioner do this and to get away from the “rectangle, oval, and triangle” mentality.

One model of reality that may be helpful in this regard is an “Indian village” model of reality. One pictures an autonomous Indian (i.e., Native American) village established at the confluence of two rivers and bounded a few miles up from the junction of the rivers by a thick forest. The Indian village, called Pawnee Village, is sovereign and self-governing and free to develop its own tax system. A resident of Pawnee Village, a brave named Brave Pawnee, has his own basket-weaving business, producing baskets in his village and selling them in the Pawnee Village market. Brave Pawnee employs a number of residents of Pawnee Village in his business.

There is another Indian village, Mohawk Village, which is also sovereign and self-governing. A resident of Mohawk village, a brave named Brave Mohawk, also has a basket-weaving business, producing baskets in his village and selling them in the Mohawk Village market.

Brave Pawnee decides to open up a basket-weaving business in a third Indian village, Sioux Village, which is also sovereign and self-governing. Coincidentally, Brave Mohawk decides to do the same thing.

56 *BNA Daily Tax Rpt.* GG-1 (3/26/09).

³ Legislation identical to S. 260 was introduced by Senator Dorgan on February 4, 2009, as an amendment to Senate Amendment 98 (an amendment in the nature of a substitute to H.R. 1, American Recovery and Reinvestment Act of 2009), but was mysteriously withdrawn from Senate consideration on February 5, 2009.

Thus, both Brave Pawnee and Brave Mohawk are producing baskets in Sioux Village and selling them in the Sioux Village market.

One simple use of the Model is to help one see the impact of “ending deferral” (i.e., ending deferral of U.S. income tax on income earned abroad by foreign subsidiaries of U.S. corporations). Assume the following: (1) Sioux Village imposes income tax on income “effectively connected” with a trade or business in Sioux Village and has a low rate of tax, say 10%; (2) Pawnee Village imposes residual taxation on Brave Pawnee at a 35% rate (but with a credit for taxes paid to Sioux Village); and (3) Mohawk Village imposes no residual taxation on Brave Mohawk (i.e., it has a territorial system). Obviously, with the tax advantage Brave Mohawk experiences (only paying tax at a 10% rate on his income earned in Sioux Village while Brave Pawnee pays tax at a 35% rate on his income earned in Sioux Village), Brave Mohawk could seriously underprice Brave Pawnee in the Sioux Village market, and thus Brave Pawnee would be at a significant competitive disadvantage.

For example, suppose the total production costs and operating expenses for both Brave Pawnee and Brave Mohawk in Sioux Village average 70u on a per-basket basis, where “u” is the unit of Sioux Village’s currency. Also suppose a “reasonable” after-tax profit that a business person would expect to make on a per-basket basis is 20u. Brave Mohawk could derive the expected after-tax profit by charging 93u for each basket. However, in order for Brave Pawnee to derive the same after-tax profit, he would have to charge more than 100u. Thus, Brave Mohawk would have a distinct competitive advantage over Brave Pawnee in the Sioux Village market.

Another use of the Model is to help one see the impact of legislation aimed at “runaway plants” (i.e., legislation ending deferral of U.S. income tax on income earned abroad, by foreign subsidiaries of U.S. corporations, on the production of products for the U.S. market). Assume the following: (1) because of the low tax rate in Sioux Village, Brave Mohawk decides to move all of his basket-weaving production for his worldwide market to Sioux Village (and assume that low labor costs in Sioux Village make up for any additional transportation costs incurred); (2) Brave Mohawk also decides to begin selling baskets (made in Sioux Village) in Pawnee Village; (3) because of Brave Mohawk’s distinct price advantage in the Pawnee Village market, Brave Pawnee begins to lose market share there; and (4) in order to remain competitive, Brave Pawnee is considering moving his basket production for the Pawnee Village market to Sioux Village. However, if Pawnee Village taxes Brave Pawnee at a 35% rate on all of his income earned in Sioux Village, then Brave Pawnee would continue to be at a significant competitive disadvantage and might not be able to compete with Brave Mohawk even if he did move his production to Sioux Village. Thus, Brave Pawnee might continue to lose market share in Pawnee Village until he eventually went out of business.

An additional advantage of the Model is that it helps the user keep in mind that there are three aspects of reality associated with a business tax unit (such as a “corporation”): (1) people and property; (2) assets and liabilities; and (3) value.

TAX TREATIES

Current Status of U.S. Tax Treaties and International Tax Agreements

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Editor's Note: New material is indicated in bold italics and is current as of April 13, 2009.

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I. Income Tax Treaties

A. Income Tax Treaties in Force

Country	General Effective Date ¹
Armenia ⁶	01-01-1976

*Australia ⁹	12-01-1983
*Austria ⁹	01-01-1999
Azerbaijan ⁶	01-01-1976
Bangladesh ¹	01-01-2007
*Barbados ^{5, 9}	01-01-1984
Belarus ⁶	01-01-1976
*Belgium ^{9, 10}	01-01-2008
Bermuda ²	01-01-1986
Bulgaria ¹⁴	01-01-2009
*Canada ^{9, 15}	01-01-1985
China, People's Republic of ^{7, 9}	01-01-1987
Cyprus ⁹	01-01-1986
Czech Republic ⁹	01-01-1993
*Denmark ^{9, 11}	01-01-2001
Egypt ⁹	01-01-1982
Estonia ⁹	01-01-2000
*Finland ^{9, 12}	01-01-1991
*France ⁹	01-01-1996
Georgia ⁶	01-01-1976
*Germany ^{4, 9, 13}	01-01-1991
Greece ⁹	01-01-1953
Hungary ⁹	01-01-1980
*Iceland ^{9, 16}	01-01-1976
India ⁹	01-01-1991
Indonesia ⁹	01-01-1990
*Ireland ⁹	01-01-1998
Israel ⁹	01-01-1995
*Italy ⁹	01-01-1986
*Jamaica ^{5, 9}	01-01-1982
*Japan ⁹	01-01-2005
*Kazakhstan ⁹	01-01-1996
Korea ⁹	01-01-1980
Kyrgyzstan ⁶	01-01-1976
Latvia ⁹	01-01-2000
Lithuania ⁹	01-01-2000
*Luxembourg ⁹	01-01-2001
Mexico ⁹	01-01-1994
Moldova ⁶	01-01-1976
Morocco ⁹	01-01-1981
*Netherlands ⁹	01-01-1994
Netherlands Antilles ³	01-01-1955
*New Zealand ⁹	01-01-1984
*Norway ⁹	01-01-1971
Pakistan ⁹	01-01-1959
Philippines ⁹	01-01-1983
Poland ⁹	01-01-1974
Portugal ⁹	01-01-1996
Romania ⁹	01-01-1974
*Russia ⁹	01-01-1994
Slovak Republic ⁹	01-01-1993

TAX TREATIES

Slovenia ⁹	01-01-2002
South Africa ⁹	01-01-1998
Spain ⁹	01-01-1991
Sri Lanka	01-01-2004
*Sweden ⁹	01-01-1996
*Switzerland ⁹	01-01-1998
Tajikistan ⁶	01-01-1976
Thailand ^{8, 9}	01-01-1998
*Trinidad & Tobago ^{5, 9}	01-01-1970
Tunisia ⁹	01-01-1990
Turkey ⁹	01-01-1998
Turkmenistan ⁶	01-01-1976
*Ukraine ⁹	01-01-2001
*United Kingdom ⁹	01-01-2004
Uzbekistan ⁶	01-01-1976
Venezuela ⁹	01-01-2000

* A prior income tax treaty was in force before the general effective date noted above.

¹ The general effective date indicates when the latest income tax treaty with the United States became effective. This general effective date does not necessarily apply to any protocol to the treaty. Some income tax treaties provide for different effective dates for different provisions of the treaty (e.g., taxation at source). The specific treaty and all related protocols should be examined carefully to determine the applicable effective date.

² The tax treaty between the United States and Bermuda (dealing with income of insurance companies) entered into force with certain reservations on December 2, 1988, and is effective as follows: (1) for excise taxes on insurance premiums paid to foreign insurers, for premiums paid or credited on or after January 1, 1986; (2) for income taxes on business profits derived by an insurance enterprise, for profits derived in taxable years beginning on or after January 1, 1988; and (3) for the government mutual assistance provisions with certain exceptions, for taxable years not barred by the statute of limitations of the jurisdiction requesting assistance. A reservation to the treaty provides that the treaty exemption from U.S. insurance excise taxes will *not* apply to premiums allocable to insurance coverage for periods after December 31, 1989.

³ In a note dated June 29, 1987, the Netherlands Antilles and Aruba governments were notified that the U.S. government was terminating the U.S.-Netherlands Antilles and the U.S.-Aruba income tax treaties. The termination of both treaties was effective as of January 1, 1988. On July 10, 1987, the U.S. government modified the June 29 notice of termination to provide that Article VIII of both treaties (which exempts interest paid by U.S. persons to corporations and residents of the Netherlands Antilles and Aruba from U.S. tax) will continue in force after December 31, 1987. A protocol to the U.S.-Netherlands Antilles Income Tax Treaty entered into force and became effective on December 30, 1996. The protocol to the limited income tax treaty terminates the current U.S. tax exemption on interest paid to: (1) Antilles companies that are not U.S.-owned (i.e., not controlled foreign corporations); (2) U.S.-owned Antilles companies on non-Eurobond debt; and (3) U.S.-owned Antilles companies on Eurobond debt issued after October 15, 1984.

⁴ The U.S.-Germany Income Tax Treaty is effective for the eastern states of Germany (the former East Germany) from January 1, 1991.

⁵ The U.S.-U.K. Income Tax Treaty previously applied.

⁶ The U.S.-U.S.S.R. Income Tax Treaty, signed June 20, 1973, applies to the countries of Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan.

⁷ The IRS announced in Notice 97-40 that the United States will continue to treat Hong Kong and China as separate countries for tax treaty purposes and that this U.S.-China Income Tax Treaty will not apply to Hong Kong.

⁸ The U.S. Treasury announced on December 18, 2001, that the U.S.-Thailand Income Tax Treaty will not terminate because Thailand and the United States have exchanged diplomatic notes providing for the implementation of the treaty's exchange of information provisions. The treaty would have automatically terminated from January 1, 2004, if the exchange of information issue had not been resolved. Thailand and the United States had until June 30, 2003, to exchange the diplomatic notes.

⁹ Designated as a "comprehensive income tax treaty . . . which includes an exchange of information program" for purposes of Code §1(h)(11)(C)(i)(II), thereby allowing certain dividends paid by qualified corporations of that country to U.S. citizens and U.S. resident individuals to be taxed for U.S. tax purposes at rates limited to 5% and 15%. (*See* IRS Notice 2006-101.)

¹⁰ A new income tax treaty with Belgium was signed on November 27, 2006, and entered into force on December 28, 2007. The provisions of the tax treaty relating to taxes withheld at source are generally effective for amounts paid or credited on or after February 1, 2008. All other provisions of the tax treaty are generally effective for taxable periods beginning on or after January 1, 2008. However, subparagraph (f) of paragraph 5 of Article 21 (Limitation on Benefits), dealing with the requirement that a "headquarters company" must be subject to the same income tax rules in its country of residence as a company actively engaged in a trade or business in that country, will not have effect until January 1, 2011. A person that would have been entitled to greater benefits under the old U.S.-Belgium Income Tax Treaty may elect to apply the old treaty in its entirety for an additional 12-month period from the date the new treaty would otherwise have been effective under the withholding and general effective dates.

¹¹ A new protocol to the U.S.-Denmark Income Tax Treaty was signed on May 2, 2006, and entered into force on December 28, 2007. The provisions of the protocol relating to taxes withheld at source are effective for amounts derived on or after February 1, 2008. All other provisions of the protocol are effective for taxable periods beginning on or after January 1, 2008.

¹² A new protocol to the U.S.-Finland Income Tax Treaty as signed on May 31, 2006, and entered into force on December 28, 2007. The provisions of the protocol relating to taxes withheld at source are generally effective for amounts paid or credited on or after February 1, 2008. However, the provision providing for a tax exemption for certain corporate dividends is effective retroactively for income derived on or after January 1, 2007. All other provisions of the protocol are effective for taxable periods beginning on or after January 1, 2008.

¹³ A new protocol to the U.S.-Germany Income Tax Treaty was signed on June 1, 2006, and entered into force on December 28, 2007. The provisions of the protocol relating to taxes withheld at source are effective retroactively for amounts paid or credited on or after January 1, 2007. All other provisions of the protocol are generally effective for taxable years beginning on or after January 1, 2008.

¹⁴ An income tax treaty with Bulgaria signed on February 23, 2007, and a related protocol signed on February 26, 2008, entered into force on December 15, 2008. The provisions of the tax treaty and protocol relating to taxes withheld at source are effective for income paid or credited on or after January 1, 2009. All other provisions of the tax treaty and protocol are effective for taxable periods beginning on or after January 1, 2009.

¹⁵ A 5th protocol to the U.S.-Canada Income Tax Treaty was signed on September 21, 2007, and entered into force on December 15, 2008. The provisions of the protocol become effective on various dates in accordance with Article 27 of the protocol. The provisions of the protocol relating to taxes withheld at source are generally effective for amounts paid or credited on or after February 1, 2009. However, the provision providing for the reduction of the tax rate on related party interest from 10% to 7% is effective retroactively for interest derived on or after January 1, 2008. Article 27 should be reviewed to determine other applicable effective dates.

¹⁶ A new income tax treaty and protocol with Iceland were signed on October 23, 2007, and entered into force on December 15, 2008. The provisions of the tax treaty and protocol relating to taxes withheld at source are generally effective for amounts derived on or after January 1, 2009. All other provisions of the tax treaty and protocol are generally effective for any taxable year beginning on or after January 1, 2009. A person that would have been entitled to greater benefits under the old U.S.-Iceland Income Tax Treaty may elect to apply the old treaty in its entirety for an additional 12-month period from the date the new treaty would otherwise have been effective under the withholding and general effective dates. In addition, an individual who was entitled to benefits under Article 21 (Teachers) of the old treaty at the time of the entry into force of the new treaty shall continue to be entitled to benefits under Article 21 of the old treaty until such time as the individual would cease to be entitled to benefits had the old treaty remained in force.

B. Income Tax Treaties Approved by U.S. Senate, Awaiting Exchange of Instruments of Ratification

Country	Date Signed	Status
Italy	08-25-1999	The Senate Foreign Relations Committee considered this new income tax treaty during hearings held on October 27, 1999. The Foreign Relations Committee voted in favor of the new income tax treaty on November 3, 1999. The full U.S. Senate approved the new treaty on November 5, 1999,

subject to a reservation requiring the removal of the “main purpose” test, a treaty anti-abuse rule that would deny treaty benefits in certain tax avoidance transactions. The new treaty was also approved subject to an understanding that the competent authorities would have the authority to obtain and provide information held by financial institutions and others. President Clinton signed the U.S. Instrument of Ratification on December 28, 1999; however, the exchange of Instruments of Ratification did not occur during 1999 and the new treaty has not, as yet, entered into force. On September 24, 2008, a U.S. Treasury official stated that discussions were under way to complete the pending tax treaty with Italy. *Italy announced in March 2009 that it completed its ratification process. Thus, the pending income tax treaty will enter into force upon the exchange of Instruments of Ratification.*

C. Income Tax Treaties Signed, Awaiting U.S. Senate Approval

Country	Date Signed	Status
France (Protocol)	01-13-2009	Protocol signed at Paris, France, on January 13, 2009.
Malta (Treaty)	08-08-2008	Treaty signed at Valletta, Malta, on August 8, 2008. Sent to the U.S. Senate on January 15, 2009, for advice and consent to ratification.
New Zealand (Protocol)	12-01-2008	Protocol signed at Washington, D.C., on December 1, 2008.

D. Income Tax Treaties Under Negotiation

Algeria	First round of negotiations was held the week of September 21, 1992. No recent activities.
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TAX TREATIES

Argentina	Argentina has expressed interest in beginning income tax treaty negotiations. Preliminary talks held on August 10, 1992. The preliminary round of talks planned for the week of August 15, 1994, was postponed. Correspondence sent to Argentina in January 1996. No recent activities.		
Armenia	Armenia has expressed an interest in beginning income tax treaty negotiations. Correspondence has been exchanged. No recent activities.	Israel	Hungary is one of Treasury's top priorities. A follow-up round that had been planned for the week of December 15, 2008, was postponed. On February 26, 2009, a U.S. Treasury official stated that negotiating a new tax treaty with Hungary continues to be one of Treasury's top priorities. <i>Discussions are scheduled to take place the week of November 16, 2009.</i>
Azerbaijan	Azerbaijan has expressed an interest in beginning income tax treaty negotiations. Correspondence has been exchanged. No recent activities.	Korea	Negotiations to discuss a new income tax treaty were held the weeks of March 15, 1999 and March 20, 2000. Rounds were also held the weeks of March 19, 2001 and on June 28 and 29, 2001. <i>Negotiations are scheduled to take place in Washington, D.C., the week of June 1, 2009.</i>
Belarus	Belarus has expressed an interest in beginning income tax treaty negotiations. Correspondence has been exchanged. No recent activities.	Kuwait	First round of negotiations held the week of November 27, 1989. No recent activities.
Brazil	Discussions held the weeks of November 13, 1990, and May 18, 1992. Brazil has expressed the need for a tax sparing provision. Therefore, no further meetings are planned. It is the U.S. Treasury's position that the United States will not enter into a tax treaty with a tax sparing provision, nor will the United States continue negotiations with a country that insists on including such a provision in a tax treaty. No recent activities.	Kyrgyzstan	Former Soviet Republic has expressed interest in beginning income tax treaty negotiations. Correspondence has been exchanged. No recent activities.
Chile	Informal talks occurred in October, 1997. Formal income tax treaty negotiations were held the week of June 7, 1999. Rounds also were held the weeks of November 29, 1999, June 19, 2000, March 5, 2001, and April 19, 2004. U.S. government officials stated on July 11, 2006, that negotiations continue with Chile.	Malaysia	Negotiations were held the week of March 30, 1992. Another round was held during the week of February 28, 1994. Open issues remain on bank secrecy and the offshore sector. No recent activities.
Colombia	Initial meetings were held the week of December 8, 2008. <i>The first full round of negotiations that had initially been planned for March 2009 is now scheduled to take place the week of June 15, 2009.</i>	Moldova	Moldova has expressed an interest in beginning income tax treaty negotiations. No recent activities.
Croatia	Correspondence exchanged. No recent activities.	Norway	U.S. government officials stated on April 5, 2006, that negotiations "have been completed."
Hungary	The United States and Hungary have agreed to negotiate a new income tax treaty. Negotiations were held the week of March 5, 2001, in Budapest. Another round held the week of July 29, 2002. Negotiations were held in Budapest the week of February 4, 2008. U.S. government officials have stated that updating the U.S.-Hungary Income Tax Treaty with a comprehensive limitation on benefits provision is one of Treasury's "top treaty priorities." Treaty negotiations were held in Washington, D.C., during the week of July 7, 2008. Another round was held in Budapest during the week of September 15, 2008. U.S. Treasury officials have stated that negotiating a new tax treaty with	Pakistan	The United States has sent correspondence to Pakistan to resume negotiations. Negotiations were held the week of March 11, 1991. Correspondence has been exchanged. However, no recent movement on these discussions.
		Poland	U.S. government officials stated on November 29, 2005, that preliminary treaty discussions have begun with Poland. U.S. government officials stated on April 5, 2006, that treaty negotiations "have been deferred." On September 24, 2008, a U.S. Treasury official stated that negotiating a new tax treaty with Poland is one of Treasury's top priorities. On December 6, 2008, a U.S. Treasury official stated that discussions with Poland are continuing. Treasury officials have stated that negotiations are tentatively planned for March 2009. On February 26, 2009, a U.S. Treasury official stated that negotiating a new tax treaty with Poland continues to be one of Treasury's top priorities. <i>A round of discussions is planned to take place in July 2009; however, no specific date has, as yet, been set.</i>
		Romania	U.S. government officials stated on November 29, 2005, that preliminary treaty discussions have begun with Romania.

Singapore	A first round of negotiations was held the week of December 14, 1987. No recent activities.
Switzerland	<i>Discussions are scheduled to take place the week of April 28, 2009.</i>
Taiwan	Preliminary negotiations were held the week of July 9, 1990. A second round was held the week of March 23, 1992.
Trinidad and Tobago	There has been correspondence on open issues. No recent activities.
Uzbekistan	Has expressed an interest in beginning income tax treaty negotiations. No recent activities.
Vietnam	Informal meetings held in December 2005.

E. Income Tax Treaties Terminated

Country	Date Terminated	Effective Date
Anguilla	06-30-1983	01-01-1984
Antigua and Barbuda	02-26-1983	08-26-1983
Aruba*	06-29-1987	01-01-1988
Barbados**	06-30-1983	01-01-1984
Belize	06-30-1983	01-01-1984
British Virgin Islands	06-30-1982	01-01-1983
Burundi	06-30-1983	01-01-1984
Dominica	06-30-1983	01-01-1984
Falkland Islands	06-30-1983	01-01-1984
The Gambia	06-30-1983	01-01-1984
Grenada	06-30-1983	01-01-1984
Malawi	06-30-1983	01-01-1984
Malta	11-16-1995	01-01-1997
Montserrat	06-30-1983	01-01-1984
Netherlands Antilles*	06-29-1987	01-01-1988
Rwanda	06-30-1983	01-01-1984
St. Christopher-Nevis	06-30-1983	01-01-1984
St. Lucia	06-30-1983	01-01-1984
St. Vincent and the Grenadines	06-30-1983	01-01-1984
Seychelles	06-30-1983	01-01-1984
Sierra Leone	06-30-1983	01-01-1984
South Africa***	10-15-1986	07-01-1987
Zaire	06-30-1983	01-01-1984
Zambia	06-30-1983	01-01-1984

* Under a modification of the termination notice, Article VIII will remain in force after December 31, 1987. Treasury announced on September 15, 1995, that Article VIII of the treaty with the Antilles would be limited, applying only to interest paid to U.S.-owned Antilles companies on Eurobond debt issued on or before October 15, 1984. The limitation is contained in a protocol that became effective on December 30, 1996. Treasury also announced the complete termination, as of January 1, 1997, of the remaining provision of the income tax treaty with Aruba.

** A new Barbados Income Tax Treaty entered into force on March 28, 1986.

*** A new income tax treaty between the United States and South Africa was entered into and became generally effective as of January 1, 1998.

II. Estate/Gift Tax Treaties

A. Estate/Gift Tax Treaties in Force

The United States has estate, gift, or combined estate and gift, tax treaties in force with the following countries:

Country	General Effective Date
Australia (estate)	01-07-1954
Australia (gift)	12-14-1953
Austria (combined estate and gift)	07-01-1983
Canada (estate) — Terminated	This treaty ceased to have effect with respect to estates of persons dying on or after January 1, 1985; however, see the U.S.-Canada Income Tax Treaty regarding the application of estate and gift taxes.
Denmark (combined estate and gift)	11-07-1984
Finland (estate)	12-18-1952
France (combined estate and gift)*	10-01-1980
Germany (combined estate and gift)	01-01-1979
Greece (estate)	12-30-1953
Ireland (estate)	12-20-1951 (or, upon election, estates of persons dying in 1951 prior to December 20)
Italy (estate)	10-26-1956
Japan (combined estate and gift)	04-01-1955
Netherlands (estate)	02-03-1971
Norway (estate)	12-11-1951
South Africa (estate)	07-15-1952 (or upon election, 06-30-1944)
Sweden (combined estate and gift) — Notice of Termination given**	09-05-1984; ceased to have effect as of January 1, 2008**
Switzerland (estate)	09-17-1952
United Kingdom (combined estate and gift)	11-11-1979

TAX TREATIES

* A protocol to the U.S-France Estate and Gift Tax Treaty was signed on December 8, 2004, and entered into force on December 21, 2006. It is generally effective with respect to gifts made and deaths occurring after entry into force; however, relief provided with respect to surviving non-citizen spouses and the pro rata unified credit is effective with respect to gifts made and deaths occurring after November 10, 1988.

** The U.S. Treasury announced that on June 7, 2007, the United States delivered to the Government of Sweden a Notice of Termination of the Estates, Inheritances, and Gifts Tax Treaty between the two countries. In accordance with Article 15 (Termination) of the treaty, the treaty ceased to have effect as of January 1, 2008. The U.S. Treasury announcement states that since Sweden has abolished its tax on inheritances and gifts, the treaty is no longer needed to prevent double taxation with respect to taxes on estates, inheritances, and gifts.

B. Estate/Gift Tax Treaties Signed, Awaiting Final Action

Country	Date Signed	Status
None		

C. Estate/Gift Tax Treaties Under Negotiation

United Kingdom	Meetings were held in April 2000 to negotiate revisions to the current estate and gift tax treaty.
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III. Exchange of Tax Information Agreements

A. Exchange of Tax Information Agreements in Force

Country	Effective Date
Antigua & Barbuda	02-10-2003
Aruba	09-13-2004
Bahamas	01-01-2004 - Criminal Tax 01-01-2006 - Civil Tax
Barbados	11-03-1984
Bermuda	12-02-1988
British Virgin Islands ¹	03-10-2006
Cayman Islands ¹	03-10-2006
Costa Rica	02-12-1991
Dominica	05-08-1988
Dominican Republic	10-12-1989
Grenada	07-13-1987
*Guernsey	03-30-2006
Guyana	08-27-1992
Honduras	11-11-1991
*Isle of Man	06-26-2006
Jamaica	12-18-1986
*Jersey	06-26-2006

Marshall Islands	03-14-1991
Mexico	01-18-1990
Netherlands Antilles	03-22-2007
*Peru	03-31-1993
*St. Lucia ²	04-22-1991
Trinidad & Tobago	02-09-1990

* Countries that are not included in the "North American area" for purposes of §274(h) relating to the deductibility of certain convention expenses. (See Rev. Rul. 2007-28, issued April 4, 2007.)

¹ Rev. Rul. 2007-28 states that the British Virgin Islands and the Cayman Islands have entered into tax information exchange agreements with the United States that are not of the type described in §274(h)(6)(C)(i) because of certain limitations on the scope of those agreements.

² Rev. Rul. 2007-28 states that it has come to the attention of the IRS that the tax information exchange agreement signed by the United States and Saint Lucia on January 30, 1987, is not in effect within the meaning of §274(h)(6)(A)(i) because the government of Saint Lucia has not enacted legislation to implement the agreement. The IRS will treat Saint Lucia as not included in the North American area under §274(h)(6) with respect to conventions that begin after April 4, 2007, except with respect to expenses for which the taxpayer demonstrates a nonrefundable contractual obligation existing as of April 4, 2007. Representatives of the State Department confirm that the TIEA with Saint Lucia is otherwise in force.

B. Exchange of Tax Information Agreements Signed, Awaiting Final Action

Country	Date Signed	Action Required
Brazil	03-20-2007	Will enter into force upon the exchange of notes between the two countries.
Colombia	03-30-2001	Will enter into force upon the exchange of notes between the two countries.
Gibraltar	03-31-2009	Will enter into force upon the exchange of notes between the two countries.
Liechtenstein	12-08-2008	Will enter into force upon the exchange of notes between the two countries.

C. Exchange of Tax Information Agreements Under Negotiation

Belize	Preliminary discussions held the week of April 13, 1992. No recent activities.
El Salvador	An agreement initialed July 29, 1993. No recent activities.
Nicaragua	An agreement initialed June 14, 1991. No recent activities.
Panama	On January 8, 2002, the U.S. Treasury announced that it had begun discussions with the government of Panama.

IV. Reciprocal Shipping/Aviation Agreements

A. Reciprocal Shipping/Aviation Agreements in Force

Country	Effective Date
Angola	01-01-2006
Argentina	01-01-1987
Bahamas	01-01-1987
Bahrain	01-01-1999
Belgium	01-01-1987
Bolivia	03-31-1999
Cape Verde	01-01-2005
Chile (aviation only)	01-01-1987
China ^{3, 6}	01-01-1981
Colombia	01-01-1987
Cyprus	01-01-1987
Denmark	01-01-1987
El Salvador (aviation only)	01-01-1987
Ethiopia	01-01-1998
Fiji	01-01-1996
Finland	01-01-1987
Ghana	01-01-2001
Greece	01-01-1987
Hong Kong (shipping only) ³	01-01-1987
India	01-01-1987
Isle of Man (shipping only)	01-01-1987
Japan	01-01-1987
Jersey	01-01-1997
Jordan	01-01-1987
Liberia	01-01-1987
Luxembourg	01-01-1987
Malaysia	01-01-1987
Malta	01-01-1997
Marshall Islands (shipping only)	01-01-1987
Mexico ⁴	01-01-1987
Norway	01-01-1987
Pakistan (shipping only)	01-01-1987
Panama	01-01-1987
Peru (shipping only)	01-01-1987
Russia ²	01-01-1991
St. Vincent & the Grenadines	01-01-1987
Saudi Arabia	01-01-1999
Singapore	01-01-1987
Sweden	01-01-1987
Taiwan	01-01-1987
United Arab Emirates	01-01-1994
Venezuela	01-01-1987

Rev. Rul. 2008-17, issued March 7, 2008, modifying and superseding Rev. Rul. 2001-48, which had modified and superseded Rev. Rul. 89-42, as supplemented by Rev. Rul. 97-31 and corrected by An-

nouncement 97-75, provides that the following countries qualify for the reciprocal exemption by virtue of their domestic law: Antigua and Barbuda (shipping only), Aruba, Barbados, Bermuda, Brazil,¹ British Virgin Islands, Bulgaria, Cayman Islands, Chile (shipping only), Croatia, Ecuador (shipping only),⁵ Gibraltar, Israel, Kuwait (shipping only), Monaco, The Netherlands, The Netherlands Antilles, Peru (aviation only), Portugal,¹ Qatar (aviation only), Spain,¹ Surinam, Turkey, Turks & Caicos, Uruguay, Vanuatu and the U.S. Virgin Islands.

¹ Local law exempts corporations only.

² The Russian Federation entered into a diplomatic note effective retroactively to January 1, 1991. This note was terminated on January 1, 1994, the general effective date of the new U.S.-Russia Income Tax Treaty.

³ The IRS announced in Notice 97-40 that the United States will continue to treat Hong Kong and China as separate countries for purposes of the Reciprocal Shipping Exemption and that the Shipping Agreement with Hong Kong will continue to apply.

⁴ Mexico entered into a diplomatic note with the United States. This note was terminated on January 1, 1994, the general effective date of the new U.S.-Mexico Income Tax Treaty.

⁵ The exemption is generally effective for all open years beginning on or after January 1, 1987.

⁶ A shipping and aircraft agreement between the United States and China was signed on March 5, 1982, and became effective retroactively to January 1, 1981. Note that, unlike other shipping and aircraft agreements, this agreement was ratified by the President on September 6, 1983, after receiving the advice and consent of the U.S. Senate (as required for treaties). This agreement is considered a "limited treaty" and in Rev. Rul. 2008-17 the IRS includes China in its list of countries (Table II) currently granting equivalent exemptions by income tax treaty. The U.S.-China Income Tax Treaty (with Protocols) does not include a provision relating to the international operation of ships and aircraft.

B. Reciprocal Shipping/Aviation Agreements Under Negotiation

Costa Rica Negotiations suspended.

Greenland *A Shipping and Air Transport Agreement was signed on December 9, 2008, and is awaiting formal notification that legal procedures for entry into force have been completed by Greenland. The Agreement will be effective for taxable years beginning on or after January 1 of the year following its entry into force.*

Honduras Expressed interest in exchange of notes relating to airlines only.

Hong Kong Discussions on airlines only.

Kenya Expressed interest in exchange of notes relating to airlines only.

Kuwait Active negotiations underway.

Latvia Draft texts of agreement relating to both shipping and airlines have been exchanged and are being reviewed.

TAX TREATIES

Mauritius	Negotiations suspended.
Tonga	Negotiations suspended.

Sweden	01-01-1987
(Sweden—Supplementary Agreement)	11-01-2007
Switzerland	11-01-1980
(Switzerland—Supplementary Agreement)	10-01-1989
United Kingdom	01-01-1985
(United Kingdom—Benefits based on combined periods of coverage)	01-01-1988
(United Kingdom—Supplementary Agreement)	09-01-1997

* Reunification has extended application of the agreement to former East German territory effective October 3, 1990.

V. Social Security Totalization Agreements

A. Social Security Totalization Agreements in Force

Country	Effective Date
Australia	10-01-2002
Austria	11-01-1991
(Austria—Supplementary Agreement)	01-01-1997
Belgium	07-01-1984
Canada with Supplementary Agreement	08-01-1984
(Canada—2nd Supplementary Agreement)	10-01-1997
Chile	12-01-2001
Czech Republic	01-01-2009
Denmark	10-01-2008
Finland	11-01-1992
France	07-01-1988
Germany*	12-01-1979
(Germany—Supplementary Agreement)	03-01-1988
(Germany—2nd Supplementary Agreement)	05-01-1996
Greece	09-01-1994
Ireland	09-01-1993
Italy	11-01-1978
(Italy—Supplementary Agreement)	01-01-1986
Japan	10-01-2005
Luxembourg	11-01-1993
Netherlands (with protocol)	11-01-1990
(Netherlands—Supplementary Protocol)	05-01-2003
Norway	07-01-1984
(Norway—Supplementary Agreement)	09-01-2003
Poland	03-01-2009
Portugal	08-01-1989
South Korea	04-01-2001
Spain	04-01-1988

B. Social Security Totalization Agreements Signed, Awaiting Final Action

Country	Date Signed	Status
Mexico	06-29-2004	The Agreement must be submitted to the U.S. Congress and the Mexican Senate for review.

C. Social Security Totalization Agreements Under Negotiation

Argentina	Meetings for preliminary discussions held during the week of June 9, 1997. No recent activity reported.
Israel	Initial inquires made. No recent interest expressed by Israel.
Italy	U.S. negotiators have proposed a supplementary agreement. No recent activity reported.
New Zealand	Initial inquiries made. Meetings held June 6 and 7, 1991. Discussions held the week of April 27, 1998. No recent activity reported.

The information contained herein is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax adviser. The views and opinions are those of the authors and do not necessarily represent the views and opinions of KPMG LLP.

LEGISLATION

Current Status of Legislation Relating to U.S. International Tax Rules

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Editor's Note: This column reports on significant bills introduced in the 1st Session of the 111th Congress. Bills are listed in chronological order, based on date of introduction. New material is indicated in bold italics, and the column is current as of April 13, 2009.

Bill No.: H.R. 25; S. 296

Name: To promote freedom, fairness, and economic opportunity by repealing the income tax and other taxes, abolishing the Internal Revenue Service, and enacting a national sales tax to be administered primarily by the States ("Fair Tax Act of 2009")

Sponsors: Linder (R-GA) and 39 co-sponsors; Chambliss (R-GA) and three co-sponsors

Action: Introduced in the House of Representatives on January 6, 2009; introduced in the Senate on January 22, 2009.

Effective Date: January 1, 2011 (except as otherwise provided in the bill).

Provisions: This bill would repeal the current income, payroll, and estate and gift taxes, and replace them with a national sales tax levied on the use or consumption in the United States of taxable property or services. A sales tax rate of 23% would apply for the 2011 taxable year, and for taxable years after 2011 the sales tax rate would be the sum of a general revenue rate of 14.91%, the old-age, survivors, and disability insurance rate, and the hospital insurance rate.

The tax would generally apply to the person using or consuming taxable property or services in the United States. No tax would be imposed on property used in a trade or business or purchased for export/use outside the United States. In relevant part, the tax would apply to foreign persons having U.S.-source income at a 23% rate, collected through withholding by the U.S. payor. No withholding tax would be required

on interest paid on portfolio debt investments. The rate of withholding tax could be reduced pursuant to an applicable income tax treaty. In the case of foreign financial institutions, taxable income would arise where the customer is a resident of the United States.

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Bill No.: S. 31; H.R. 683

Name: To amend the Internal Revenue Code of 1986 with respect to the proper tax treatment of certain indebtedness discharged in 2009 or 2010, and for other purposes

Sponsors: Ensign (R-NV); Berkley (D-NV) and one co-sponsor

Action: Introduced in the Senate on January 6, 2009; (identical bill S. 33 introduced in the Senate on the same date); introduced in the House of Representatives on January 26, 2009.

Effective Date: Date of enactment.

Provisions: The bill would amend §108 (income from discharge of indebtedness) by adding new subsection (a)(1)(F) and new subsection (i).

Section 108(a)(1) allows a taxpayer to exclude discharge of indebtedness income from gross income in certain circumstances. According to proposed subparagraph (F), if the indebtedness discharged is applicable financial indebtedness that is discharged after December 31, 2008, and before January 1, 2011, such amount would not be included in the taxpayer's gross income.

New subsection (i) would be added to §108 to provide definitions and rules related to applicable financial indebtedness, including those instances in which an applicable discharge occurs such that new §108(a)(1)(F) applies. Additional rules are provided that would coordinate the exclusions under §108(a)(2) and that would exclude from a corporation's earnings and profits the income from a discharge of indebtedness pursuant to §108(a)(1)(F).

Additionally, any interest (or original issue discount) paid or accrued after December 31, 2008, and before January 1, 2011, on indebtedness that is described in proposed §108(a)(1)(F) by reason of the acquisition of such indebtedness by a foreign person or by a partnership (or other pass-through entity) in which a foreign person is a partner (or other profits or capital owner) would not be subject to §871(h)(3), 881(c)(3)(B), or 881(c)(3)(C) (i.e., the portfolio interest exemption from withholding tax would apply even if paid to 10% shareholders (and certain CFCs) in this limited instance).

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LEGISLATION

Bill No.: H.R. 99

Name: To amend the Internal Revenue Code of 1986 to reduce taxes by providing an alternative determination of income tax liability for individuals, repealing the estate and gift taxes, reducing corporate income tax rates, reducing the maximum tax for individuals on capital gains and dividends to 10%, indexing the basis of assets for purposes of determining capital gain or loss, creating tax-free accounts for retirement savings, lifetime savings, and life skills, repealing the adjusted gross income threshold in the medical care deduction for individuals under age 65 who have no employer health coverage, and for other purposes (“Fair and Simple Tax Act of 2009”)

Sponsors: Dreier (R-CA) and one co-sponsor

Action: Introduced in the House of Representatives on January 6, 2009.

Effective Date: The amendments made by section 7 of the bill would apply to dispositions after December 31, 2008, in taxable years ending after such date.

Provisions: In general, section 7 of the bill would amend the Internal Revenue Code to allow an inflation adjustment to the adjusted basis of certain assets (including C corporation common stock (other than foreign corporation stock, subject to a special rule described below) and tangible property that is a capital asset or used in a trade or business) held by a taxpayer (other than a corporation) for more than three years for purposes of determining gain or loss on the sale or other disposition of such assets. Deductions for depreciation, depletion, and amortization would be determined without regard to the provision. The bill defines the inflation adjustment and sets forth rules regarding short sales, application of the basis adjustments for regulated investment companies, real estate investment trusts, partnerships, and other pass-through entities, and dispositions of assets between related persons.

In the case of stock in a foreign corporation, assets eligible for the inflation adjustment would include only common stock in a foreign corporation that is regularly traded on an established securities market (including American Depository Receipts). However, such eligible assets would not include stock in a passive foreign investment company (PFIC, as defined in §1297) and stock in a foreign corporation held by a U.S. person meeting the requirements of §1248(a)(2).

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Bill No.: S. 58

Name: To amend the Internal Revenue Code of 1986 to modify the application of the tonnage tax on vessels operating in the dual United States domestic and foreign trades, and for other purposes

Sponsors: Inouye (D-HI)

Action: Introduced in the Senate on January 6, 2009.

Effective Date: The amendments proposed by this bill would apply to taxable years beginning after the date of enactment.

Provisions: The bill would modify the application of the tonnage tax on vessels operating in the dual United States domestic and foreign trades.

Subsection (f) of §1355 currently provides for the tax consequences of temporarily operating a qualifying vessel in the United States domestic trade. The bill would amend current subsection (f) of §1355 by providing that an electing corporation would be treated as continuing to use a qualifying vessel in the United States foreign trade during any period of use in the United States domestic trade, and gross income from such United States domestic trade would not be excluded under §1357(a) (i.e., such income would be subject to the regular corporate income tax at graduated rates), but would not be taken into account for purposes of §1353(b)(1)(B) (i.e., determining the number of days during the taxable year that the electing corporation operated the vessel as a qualifying vessel in United States foreign trade) or §1356 (i.e., determining qualifying shipping activities) in connection with the application of §1357 (i.e., determining gross income not subject to the regular corporate income tax) or §1358 (i.e., the allocation of credits, income, and deductions with respect to qualifying shipping activities and other activities of the electing corporation).

The bill would also amend §1358(c), which provides guidance regarding arm’s-length transactions. The bill would strike the statement that §482 applies “in accordance with this subsection” and instead state that §482 applies “to the extent provided in such regulations as may be prescribed by the Secretary.” New subsection (d) would be added to §1358 to provide that the Secretary may prescribe regulations consistent with the provisions of subchapter R, i.e., the tonnage tax regime, for the purpose of allocating gross income, deductions, and credits between or among qualifying shipping activities and other activities of a taxpayer.

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Bill No.: H.R. 470

Name: To amend the Internal Revenue Code of 1986 to provide for permanent tax incentives for economic growth (“Economic Recovery and Middle-Class Tax Relief Act of 2009”)

Sponsors: Garrett (R-NJ) and two co-sponsors

Action: Introduced in the House of Representatives on January 13, 2009.

Effective Date: The amendments made by section 111 of the bill would apply to sales and other dispositions of indexed assets after the date of enactment, in taxable years ending after such date.

Provisions: In general, section 111 of the bill would amend the Internal Revenue Code to allow an inflation adjustment to the adjusted basis of certain assets (including C corporation common stock (other than foreign corporation stock, subject to a special rule described below) and tangible property that is a capital asset or used in a trade or business) held by a taxpayer (other than a corporation) for more than three years for purposes of determining gain or loss on the sale or other disposition of such assets. Deductions for depreciation, depletion, and amortization would be determined without regard to the provision. The bill defines the inflation adjustment and sets forth rules regarding short sales, application of the basis adjustments for regulated investment companies, real estate investment trusts, partnerships, and other pass-through entities, and dispositions of assets between related persons.

Notwithstanding the general rule described above, assets eligible for the inflation adjustment would include common stock in a foreign corporation that is regularly traded on an established securities market (including American Depositary Receipts). However, such eligible assets would not include the following: (1) stock of a foreign investment company; (2) stock in a PFIC; (3) stock in a foreign company held by a U.S. person meeting the requirements of §1248(a)(2); and (4) stock in a foreign personal holding company.

Section 111 of the bill provides that any asset acquired after December 31, 2009, would be excluded from the definition of the term “indexed asset” for which an inflation adjustment could be made to its adjusted basis for purposes of determining gain or loss on its sale or disposition.

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Bill No.: H.R. 507

Name: To amend the Internal Revenue Code of 1986 to allow a temporary dividends received deduction for taxable years beginning in 2008 or 2009

Sponsors: Brady (R-TX) and five co-sponsors

Action: Introduced in the House of Representatives on January 14, 2009; legislation similar to H.R. 507 was introduced by Senator Boxer and three co-sponsors on February 3, 2009, as an amendment to Senate Amendment 98 (in the nature of a substitute to H.R. 1, American Recovery and Reinvestment Act of 2009), but failed on a procedural vote on the same date.

Effective Date: The amendments made by the bill would apply to taxable years ending after the date of enactment.

Provisions: The bill would amend §965(f) to provide that, in the case of any taxable year beginning after September 30, 2008, a taxpayer may elect to apply §965 to the taxpayer’s last taxable year that begins before the date of enactment of §965(f) or the taxpayer’s first taxable year that begins during the one-year period beginning on such date. The election may be made for a taxable year only if it is made on or before the due date, including extensions, for filing the tax return for such taxable year.

The bill would also amend §965(b) to require certain employment levels to be maintained. Specifically, the bill provides that if, during the period consisting of the calendar month in which the taxpayer first receives a distribution described in §965(b)(1) and the succeeding 23 calendar months, the taxpayer does not maintain an average employment level at least equal to the taxpayer’s prior average employment, an additional amount equal to \$25,000 multiplied by the number of employees by which the taxpayer’s average employment level during such period falls below the prior average employment shall be taken into income by the taxpayer during the taxable year that includes the final day of such period. The amount taken into income shall not exceed the aggregate amount allowed as a deduction pursuant to §965(b)(1). “Prior average employment” is defined as the taxpayer’s average number of employees during the period consisting of the 24 calendar months immediately preceding the calendar month in which the taxpayer first receives a distribution described in §965(b)(1). All domestic members of a controlled group are treated as a single taxpayer in determining a taxpayer’s average employment level and prior average employment.

In addition, “June 30, 2003” would be replaced with “June 30, 2008” each place it appears in §965. The definition of the base period years in §965(c)(2)(A) would be amended such that: (1) they would be among the six (rather than five) most recent taxable years ending on or before June 30, 2008; and (2) the taxable year for which an election was made before the enactment of new §965(c)(2)(A)(ii)(III) would be disregarded. Finally, the “indebtedness determination date” found in §965(b)(3)(B) would be changed from October 3, 2004, to January 13, 2009.

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Bill No.: S. 260

Name: A bill to amend the Internal Revenue Code of 1986 to provide for the taxation of income of controlled foreign corporations attributable to imported property.

Sponsors: Dorgan (D-ND) and 13 co-sponsors

Action: Introduced in the Senate on January 15, 2009; legislation identical to S. 260 was introduced by

LEGISLATION

Senator Dorgan on February 4, 2009, as an amendment to Senate Amendment 98 (in the nature of a substitute to H.R. 1, American Recovery and Reinvestment Act of 2009), but was withdrawn from Senate consideration on February 5, 2009.

Effective Date: The amendments made by the bill would apply to taxable years of foreign corporations beginning after the date of enactment, and to taxable years of U.S. shareholders within which or with which such taxable years of such foreign corporations end.

Provisions: The bill would amend the Internal Revenue Code to include in foreign base company income a controlled foreign corporation's ("CFC's") imported property income. The bill would define "imported property income" as income, in the form of profits, commissions, fees, or otherwise, derived in connection with:

- (1) manufacturing, producing, growing, or extracting imported property;
- (2) the sale, exchange, or other disposition of imported property; or
- (3) the lease, rental, or licensing of imported property.

The bill would specifically exclude from the definition any foreign oil and gas extraction income and any foreign oil-related income (within the meaning of §907(c)).

For these purposes, "imported property" would include property imported into the United States by a CFC or a person related to that CFC. Imported property would also include property imported into the United States by a person unrelated to a CFC that was acquired from the CFC if at the time the property was acquired it was reasonably expected that the property would be imported into the United States or would be used as a component in other property that would be imported into the United States. Imported property would not include an agricultural commodity that is not grown in the United States in commercially marketable quantities. "Import" would be defined to mean entering, or withdrawal from a warehouse, for consumption or use. The term also would include any grant of the right to use intangible property (as defined by §936(h)(3)(B)) in the United States.

An exception would apply for property imported into the United States that, before it is substantially used in the United States, is sold, leased, or rented by the CFC or related person for direct use, consumption, or disposition outside the United States. A second exception would apply to property imported into the United States that a CFC or related person uses as a component in other property that it sells, leases, or rents outside the United States.

In coordination with this new type of foreign base company income, the bill would add a new separate foreign tax credit "basket" for this category of income.

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Bill No.: H.R. 1058

Name: To amend the Internal Revenue Code of 1986 to repeal the inclusion in gross income of Social Security benefits and tier 1 railroad retirement benefits ("Seniors Financial Security Act of 2009")

Sponsors: Franks (R-AZ) and 17 co-sponsors

Action: Introduced in the House of Representatives on February 13, 2009.

Effective Date: The amendments made by the bill would apply to benefits received after December 31, 2008, in taxable years ending after such date.

Provisions: The bill proposes to repeal §86, which relates to the taxation of Social Security and tier 1 railroad retirement benefits. Pursuant to such repeal, certain international provisions would also be repealed, including §§861(a)(8) (treating Social Security benefits as U.S.-source), 871(a)(3) (relating to taxation of Social Security benefits received by non-resident aliens), and 1441(g) (relating to withholding of tax on nonresident aliens).

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Bill No.: H.R. 1208

Name: To strengthen existing legislation sanctioning persons aiding and facilitating nonproliferation [sic] activities by the Government of Iran, and for other purposes ("Iran Threat Reduction Act of 2009")

Sponsors: Ros-Lehtinen (R-FL) and 48 co-sponsors

Action: Introduced in the House of Representatives on February 26, 2009.

Effective Date: The amendments made by sections 403 and 404 of the bill would apply to taxable years beginning after the date of enactment.

Provisions: Section 403 of the bill would deny certain tax benefits to taxpayers engaged in business activity with Iran that is prohibited by U.S. law, and section 404 of the bill would impose more onerous taxation on foreign corporations engaged in business activity with Iran that is prohibited by U.S. law.

Section 403: Denial of Tax Benefits for Taxpayers Engaged in Business Activity with Iran Prohibited by U.S. Law

Section 403 of the bill would amend §901 by introducing a new subsection (m) (Taxpayers Engaged in

Business Activity With Iran Prohibited by United States Law). Taxpayers that are members of an expanded affiliated group, any member of which, on any day during the taxable year, is engaged in business activity with Iran that is prohibited by U.S. law, would not be allowed a §901(a) credit for any income, war profits, or excess profits taxes paid or accrued (or deemed paid under §902 or 960) to any country if such taxes are with respect to income attributable to a period any part of which occurs during such taxable year. Sections 275 and 78 would not apply to any tax that is not allowable as a credit pursuant to §901(m).

An expanded affiliated group means an affiliated group as defined in §1504(a) (without regard to subsections (b)(2), (b)(4), and (c)), except that §1504(a) is applied by substituting “more than 50 percent” for “at least 80 percent” each place it appears.

Business activity would be defined as:

- An entity that: (1) has in effect a contract that includes the responsibility for the development of petroleum resources, petroleum refining capacity, or liquefied natural gas located in Iran (as the case may be); or (2) has in effect a contract providing for the general supervision and guarantee of another person’s performance of a contract as previously described.
- The purchase of a share of ownership, including an equity interest, in the development of petroleum resources, petroleum refining capacity, or liquefied natural gas located in Iran.
- Having in effect a contract providing for the participation in royalties, earnings, or profits in the development of petroleum resources, petroleum refining capacity, or liquefied natural gas located in Iran, without regard to the form of the participation.

Business activity would also include the entry into, performance of, or financing of a contract to sell or purchase goods, services, or technology. In addition, an amendment or other modification that is made, on or after the date of the enactment of §901(m), to an agreement or contract would be treated as the entry of an agreement or contract.

For purposes of defining a business activity, an “entity” is: (1) a natural person; (2) a corporation, business association, partnership, society, trust, financial institution, insurer, underwriter, guarantor, and any other business organization; (3) any foreign subsidiary of any entity described in (2); (4) any governmental entity operating as a business enterprise, such as an export credit agency; and (5) any successor to any entity described in (2), (3), or (4).

New §901(m)(5) would grant to the Secretary the authority to issue regulations to carry out the purposes

of §901(m), including regulations that impose appropriate reporting requirements.

Section 403 of the bill would also amend §952(a) by expanding the definition of Subpart F income. Specifically, new paragraph (6) of §952(a) would include as Subpart F income the income of a controlled foreign corporation derived from all foreign countries during any period during which new §901(m) applies to such corporation.

Finally, §403 would add to the Code new §6726 (Failure to Report Information Under Section 901(m)). Any person who failed to report information under new §901(m) (as prescribed by the regulations thereunder) would be subject to a penalty of \$100,000 for each day in the noncompliance period with respect to which the failure relates. The noncompliance period would mean, with respect to any failure, the period beginning on the date such failure first occurs and ending on the date such failure is corrected.

Section 404: Tax on Income Derived by Foreign Corporations from Business Activity with Iran Prohibited by United States Law

Section 404 of the bill would add new §884A to the Code. Pursuant to new §884A, in the case of a foreign corporation that is engaged in business activity with Iran prohibited by U.S. law, the U.S. tax imposed on income derived from such prohibited activity (that would otherwise be subject to U.S. taxation) would be determined as follows:

- The rate of tax imposed under §§881(a), 884(a), and 1442(a) would be increased from 30% to 45%;
- Subsections (b), (c), (d), and (e) of §881 would not apply;
- Tax imposed pursuant to §882 would be imposed at a 45% rate; and
- Sections 883 (exclusions from gross income) and 1442(c) would not apply.

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Bill No.: S. 506; H.R. 1265

Name: To restrict the use of offshore tax havens and abusive tax shelters to inappropriately avoid Federal taxation, and for other purposes (“Stop Tax Haven Abuse Act”)

Sponsors: Levin (D-MI) and four co-sponsors; Doggett (D-TX) and 59 co-sponsors

Action: Introduced in the Senate on March 2, 2009 (on March 11, 2009, the Senate Finance Committee circulated draft legislation in response to S. 506; a bill has not yet been introduced); introduced in the House of Representatives on March 3, 2009.

Effective Date: See “Provisions.”

Provisions: This bill, in relevant part, would restrict the use of offshore tax havens and abusive tax shelters to inappropriately avoid U.S. income taxation.

Offshore Secrecy Jurisdictions

The bill would establish a list of “Offshore Secrecy Jurisdictions.” Treasury would have the authority to amend this list of jurisdictions. The current three-year statute of limitations would be extended to six years in tax assessment or collection cases involving Offshore Secrecy Jurisdictions. Financial institutions that open bank, brokerage, or other financial accounts, or that create non-publicly traded entities, in an Offshore Secrecy Jurisdiction for a U.S. person, would be required to report the transaction to the Internal Revenue Service. The bill would also eliminate relying on a tax advisor’s opinion as a means of establishing reasonable cause under §6664 for transactions involving Offshore Secrecy Jurisdictions. Finally, with regards to Offshore Secrecy Jurisdictions, the bill would establish rebuttable evidentiary presumptions for tax and securities proceedings for non-publicly traded entities.

The proposed amendments regarding the presumptions pertaining to entities and transactions involving Offshore Secrecy Jurisdictions would take effect on the date of enactment. The proposed amendments regarding allowing more time for investigations involving Offshore Secrecy Jurisdictions would apply to returns filed after the date of enactment and to returns filed on or before such date if the period specified in §6501 for assessment of such taxes has not expired as of such date.

Treatment of Foreign Corporations Managed and Controlled in the United States as Domestic Corporations

The bill would amend §7701 to treat a foreign corporation that is either publicly traded (publicly traded test) or has \$50 million or more in aggregate gross assets at any time during the taxable year or any preceding taxable year (gross assets tests) as a domestic corporation if the management and control of the corporation occur primarily in the United States. A foreign corporation previously meeting these requirements would not be treated as a domestic corporation, however, if: (1) the corporation is not publicly traded; (2) the corporation has, and reasonably expects to continue to have, aggregate gross assets of less than \$50 million; and (3) the Treasury Secretary grants a waiver to such corporation. In addition, the gross assets test would not apply to a controlled foreign corporation if the U.S. parent corporation has substantial assets (other than cash and cash equivalents and other

than stock of foreign subsidiaries) held for use in the active conduct of a trade or business in the United States.

The amendments to §7701 would provide authority to the Treasury Secretary to prescribe regulations for determining when management and control occur primarily within the United States. Specifically, such regulations would provide that management and control occur primarily within the United States if the executive officers and senior management of the corporation who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the corporation are located primarily within the United States. In addition, individuals who are not executive officers and senior management of the corporation (including individuals who are officers or employees of other corporations in the same chain of corporations as the corporation being evaluated) would be treated as executive officers and senior management if such individuals exercised the day-to-day responsibility of the corporation being evaluated. Finally, the management and control of a corporation would be treated as occurring primarily in the United States if the assets of such corporation (directly or indirectly) consisted primarily of assets being managed on behalf of investors and decisions about how to invest the assets were made in the United States.

The amendments described above would apply to taxable years beginning on or after the date that is two years after the date of enactment.

Withholding

The bill would require banks, securities firms, and other withholding agents to report U.S. beneficial owners of, and U.S.-source income of, non-publicly traded foreign entities if U.S. persons owned interests in the entities or their foreign financial accounts.

This amendment would take effect with respect to amounts paid into foreign-owned accounts after December 31 of the year of enactment. The amendment would take effect with respect to accounts opened or entities formed or acquired after December 31 of the year of enactment.

Trusts

Concerning the provisions with respect to trusts, the bill would amend §679 so that certain U.S. persons receiving foreign trust assets would be treated as trust beneficiaries. The bill would add to §679 language that would treat any U.S. person receiving cash or other property from a foreign trust, or receiving the use thereof, as a beneficiary of such trust, regardless of whether such person is a named beneficiary, except to the extent that such person paid fair market value for the benefit received.

Closing the Offshore Dividend Tax "Loophole"

The bill would mandate consistent tax treatment of dividends, dividend equivalents, and substitute dividends by defining "dividend" to include dividend equivalents and substitute dividends for purposes of §§871 and 881. The term "dividend" in any income tax convention would also be construed to include dividend equivalents and substitute dividends.

A "dividend equivalent" would include any payment made pursuant to a notional principal contract that is contingent upon, or referenced to, the payment of a dividend on stock or the payment of a dividend on property that is substantially similar or related to stock. For purposes of defining a dividend equivalent, a notional principal contract is a financial instrument that provides for the payment of amounts by one party to another party at specified intervals calculated by reference to a specified index based on a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. A dividend equivalent with respect to the stock of one or more domestic corporations would be treated as sourced within the United States.

A "substitute dividend" would be defined as a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend that the owner of the transferred security is entitled to receive during the term of the transaction. A securities lending transaction is a transfer of one or more securities described in §1058(a), or a substantially similar transaction. A sale-repurchase transaction is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash. A substitute dividend payment would be sourced in the same way as a dividend with respect to the transferred security to which the substitute dividend relates.

The Treasury Secretary would be authorized to issue regulations to prevent the possible over-withholding of taxes on dividend equivalents and substitute dividends. The regulations would allow a reduction of withholding to the extent a taxpayer could establish that the dividend to which a dividend equivalent or substitute dividend relates was previously withheld upon under §871 or 881.

The Treasury Secretary would be instructed to issue proposed regulations within 90 days after the date of enactment, and final regulations not later than 150 days after the date of enactment. Such regulations would require withholding in cases where dividend equivalent payments under notional principal contracts are netted with other payments under the same instrument, where fees and other payments are netted to disguise the characterization of a payment as a substitute dividend, and where option or forward contracts (or similar arrangements) achieve the same or substantially similar economic results as the notional principal contracts covered under §871, as described above.

With regards to qualified intermediaries, the bill would require that the Treasury Secretary (or the Secretary's designee) ensure that any qualified intermediary withholding agreement that the United States enters into or renews after the date of enactment with a foreign financial institution or foreign branch of a U.S. financial institution conforms to the amendments made by the bill in order to ensure appropriate withholding on dividend equivalents and substitute dividends.

The amendments described above would apply to payments made on or after the date that is 90 days after the date of enactment.

Reporting of Activities with Respect to PFICs

The bill would amend §1298 to require that persons who are passive foreign investment company ("PFIC") shareholders, or who directly or indirectly form, transfer assets to, are beneficiaries of, have a beneficiary interest in, or receive assets or the use thereof from a PFIC file a report containing such information as the Treasury Secretary requires.

The amendments described above would be effective on the date of enactment.

Penalties, Sanctions, and Summons Procedures

The bill would increase penalties under §§6700 and 6701 for promoting tax shelters, or knowingly aiding the understatement of tax liability. These amendments would apply to activities that take place after the date of enactment.

The Treasury Department would be authorized to impose financial sanctions on foreign jurisdictions or financial institutions that are found to be impeding U.S. tax enforcement.

With regards to summons procedures, the bill would strengthen the procedures for John Doe summonses. These proposed amendments would apply to summonses issued after the date of enactment.

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Codification of Economic Substance

The bill would codify the economic substance doctrine and impose a 30% penalty on underpayments resulting from transactions lacking economic substance. The penalty would be reduced to 20% for disclosed transactions. These proposed amendments would apply to transactions entered into after the date of enactment.

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Bill No.: H.R. 1798

Name: *To amend the Internal Revenue Code of 1986 to eliminate the limitation on the foreign earned income exclusion and for other purposes ("Working American Competitiveness Act")*

Sponsors: *Meeks (D-NY)*

Action: *Introduced in the House of Representatives on March 30, 2009.*

Effective Date: *Taxable years beginning after the date of enactment.*

Provisions: *The bill would amend §911 to eliminate the dollar limitations on the amount of "foreign earned income" that a qualified U.S. citizen or resident can elect to exclude from U.S. gross income. The bill would also eliminate the exclusion from gross income for the "housing cost amount."*

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Bill No.: H.R. 1874

Name: *To provide federal contracting preferences for, and a reduction in the rate of income tax imposed on, Patriot corporations, and for other purposes ("Patriot Corporations of America Act of 2009")*

Sponsors: *Schakowsky (D-IL) and six co-sponsors*

Action: *Introduced in the House of Representatives on April 2, 2009.*

Effective Date: *Taxable years beginning after the date of enactment.*

Provisions: *Section 4 of the bill would add new subparagraph (B) to §7701(a)(4) to treat a foreign corporation as a domestic corporation if the Secretary of the Treasury determined that such corporation was created or organized as a foreign corporation principally for the purpose of avoiding being treated as a domestic corporation.*

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Bill No.: H.R. 1944

Name: *To amend the Internal Revenue Code of 1986 to permanently extend the subpart F exemption for active financing income*

Sponsors: *Neal (D-MA) and five co-sponsors*

Action: *Introduced in the House of Representatives on April 2, 2009.*

Effective Date: *The amendments would apply to taxable years of a foreign corporation beginning after the date of enactment, and to taxable years of U.S. shareholders with or within which such taxable years of the foreign corporation end.*

Provisions: *Under §954(h)(9) of current law, the Subpart F exemption for certain income derived in the active conduct of a banking, financing, or similar business only applies to taxable years of a foreign corporation beginning after December 31, 1998, and before January 1, 2010. The bill would strike paragraph (9), thus making the Subpart F exemption permanent.*

Similarly, under §953(e)(10) of current law, the Subpart F exemption for certain income derived in the active conduct of an insurance business (contained in §953 and §954(i)) applies only to taxable years of a foreign corporation beginning after December 31, 1998, and before January 1, 2010. The bill would strike paragraph (10), thus making the Subpart F exemption permanent.

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