

# SPECIAL REPORTS

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## Check-the-Box and Hybrids: A Second Look at Elective U.S. Tax Classification for Foreign Entities

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In the waning days of 1996, the U.S. Treasury and the IRS issued the final check-the-box regulations, which would go into effect on January 1 of the following year. Under these regulations, an eligible business entity would be able to elect its federal income tax classification — that is, whether to be taxed as a corporation or as a partnership. This elective regime was touted as a major simplification of the tax classification rules, and generally has proven true in practice. It did not go unnoticed, however, that a liberalized ability to achieve a desired tax classification would put additional stress on the operation of the corporate and partnership tax laws.<sup>1</sup>

After significant debate, and despite their own expressed reservations, the IRS and Treasury extended the application of the final CTB regulations to foreign business entities, meaning that a foreign entity could choose how it would be taxed in the U.S. just as a domestic entity could. This policy choice has created significant cross-border tax planning opportunities. This article explores both the policy rationale behind the decision to include foreign entities under the CTB system and how well that rationale has held up in the 14-plus years since the final regulations were issued. More specifically, this article focuses on the use of hybrid entities — single business entities that are treated in-

consistently by two taxing authorities — as vehicles for tax arbitrage after the promulgation of CTB.

Section I of this article provides a background on the CTB regulations in the domestic context and on how entities were classified before CTB. Section II discusses the policy supporting the extension of CTB to foreign entities, and it introduces concerns over the use of hybrid entities. Section III looks more deeply and more technically at the planning opportunities hybrids present within the framework of subpart F and the foreign tax credit. Finally, Section IV, with 14 years' hindsight, reexamines the arguments set forth to justify the extension of CTB to foreign entities in light of the concern over hybrids.

### I. Background

A business entity's classification as either a corporation or a partnership is important for both tax and nontax reasons. Most fundamentally, a corporation provides for the limited liability of its owners, while a partnership does not. From the tax perspective, the income of a partnership is not taxed at the partnership level. Instead, the income is viewed as flowing through to the partners, and those partners are taxed on their shares of the partnership income, whether or not it is actually distributed. The income of a corporation, on the other hand, is subject to both a corporate-level tax and a tax at the shareholder level when that corporate income is distributed.

#### A. Pre-CTB Regime

From 1960 to the passage of the CTB regulations, an entity's tax classification as either a corporation or a partnership was determined by the multi-factor *Kintner*

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<sup>1</sup>Staff of the Joint Committee on Taxation, "Review of Selected Entity Classification and Partnership Tax Issues," JCS-6-97, 1 (Apr. 8, 1997) (hereinafter "JCT Study") (recognizing that the ability to choose partnership or corporate tax treatment made it more important to identify and eliminate rules creating "anomalous results" in each).

regulations, so named because they were a response to the Ninth Circuit's decision in *U.S. v. Kintner*.<sup>2</sup> The *Kintner* regulations enumerated six characteristics of a corporate venture:

- the presence of associates;
- an objective to carry on business;
- continuity of life;
- centralization of management;
- limited liability; and
- free transferability of interests.<sup>3</sup>

Because the first two characteristics are common to both corporations and partnerships, the test turned on the remaining four factors — an entity possessing three or more was treated as a corporation, two or fewer was treated as a partnership.<sup>4</sup> While the application of the *Kintner* regulations was theoretically simple, in practice there was significant complexity and uncertainty (as well as significant opportunity for tax planning) in determining whether an entity possessed any given factor.<sup>5</sup>

Putting additional stress on the multi-factor test was the rise of the limited liability company and limited liability partnership, which narrowed the distinction between partnerships and corporations by offering both limited liability and taxation as a partnership.<sup>6</sup> State LLC statutes would typically provide for both limited liability and centralized management, but not free transferability of interest or continuity of life.<sup>7</sup> As a result, the LLC would meet only two *Kintner* factors and, consequently, would be classified as a partnership for federal tax purposes. These entities amplified taxpayers' ability to effectively elect their federal tax status, and they provided this opportunity to a much wider population by virtue of greater simplicity and

lower cost.<sup>8</sup> After all 50 states enacted statutes permitting LLCs,<sup>9</sup> an entity could choose to be taxed as a corporation by incorporating under state statute, or it could choose to be taxed as a partnership by organizing under, and tailoring operative documents to meet the requirements of, a state LLC statute.

## B. Creation and Operation of CTB

Sensing the obsolescence of the *Kintner* regulations and concerned about the continued costs of entity classification for both taxpayers and the government, the IRS and Treasury issued Notice 95-14 in early 1995. Notice 95-14 recognized that LLCs had diminished the traditional distinctions between corporations and partnerships, which had provided the foundation for the *Kintner* regulations, and that taxpayers were able to achieve partnership tax treatment with entities that more closely resembled the corporate form. As a result, the IRS and Treasury announced they were contemplating a move to an elective classification regime to replace what they viewed as an outdated, complex, and costly system that had become effectively elective anyway.<sup>10</sup>

The result, effective January 1, 1997, was the CTB Treasury regulations under section 301.7701. Under the CTB regulations, domestic and foreign eligible entities are able to elect to be taxed as a partnership (or, if the entity has only a single member, as a disregarded entity) or a corporation for federal tax purposes. To be eligible, entities must meet three requirements:

- the entity must exist separately from its owners;
- it must be a business entity<sup>11</sup>; and
- it must not be a deemed corporation.<sup>12</sup>

The chief instances of deemed corporations are entities formed under state corporate statutes and foreign per se corporations, as defined by a comprehensive list in Treas. reg. section 301.7701-2(b)(8).<sup>13</sup>

<sup>2</sup>*Id.* at 7; see also *U.S. v. Kintner*, 216 F.2d 418 (9th Cir. 1954) (regarding the tax classification of a Montana business association for purposes of the taxation of a pension plan).

<sup>3</sup>Treas. reg. section 301.7701-2 (as amended in 1996).

<sup>4</sup>JCT Study, *supra* note 1, at 8.

<sup>5</sup>New York State Bar Association, "Report on the 'Check the Box' Entity Classification System Proposed in Notice 95-14," *Doc 95-8285, 95 TNI 172-13*, Section III.A (Sept. 5, 1995) (hereinafter "NYSBA comment") (noting that the factors required "legal judgments based upon subtle distinctions"). See also Steven A. Dean, "Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification," 35 *Hofstra L. Rev.* 405, 430-431 (2005) (observing that taxpayers who could afford the cost of being well-advised could use the *Kintner* regulations to avoid a corporate-level tax, but that legal and commercial relationships were often distorted as a result of tailoring operative legal documents to meet specific factors).

<sup>6</sup>See Rev. Rul. 88-76, 1988-2 C.B. 360 (classifying a Wyoming LLC as a partnership for federal tax purposes after analysis under the *Kintner* factors).

<sup>7</sup>JCT Study, *supra* note 1, at 10-11.

<sup>8</sup>See William A. Klein and Eric M. Zolt, "LLCs, LLPs and the Evolving Corporate Form," 66 *U. Colo. L. Rev.* 1001, 1012 (1995) (acknowledging that the *Kintner* regulations already afforded a measure of electivity to the well-advised, but that LLCs and LLPs made electivity more accessible to the less well-advised).

<sup>9</sup>JCT Study, *supra* note 1, at 11 (discussing how after Rev. Rul. 88-76, the IRS issued similar rulings on LLCs state by state until the promulgation of the CTB regulations).

<sup>10</sup>Notice 95-14, 1995-1 C.B. 297.

<sup>11</sup>Treas. reg. section 301.7701-2 (defining a business entity as any entity that is not a trust under the definition provided in Treas. reg. section 301.7701-4).

<sup>12</sup>Henry J. Lischer Jr., "Elective Tax Classification for Qualifying Foreign and Domestic Business Entities Under the Final Check-the-Box Regulations," 51 *SMU L. Rev.* 99, 106-111 (1997).

<sup>13</sup>There are 87 per se foreign corporations listed in Treas. reg. section 301.7701-2(b)(8).

Some default classifications apply if no affirmative election is made on behalf of an eligible entity. Eligible domestic entities default away from taxation as a corporation; a single-member entity will be taxed as a disregarded entity; and a multi-member entity will be taxed as a partnership. Eligible foreign entities, on the other hand, default to corporate taxation if all members have limited liability, to partnership taxation if one or more members bears personal liability, and to taxation as a disregarded entity if there is only one member and he bears personal liability.<sup>14</sup>

### C. Policy Objectives of CTB

The CTB regulations were designed to respond to the flaws inherent in the *Kintner* regulations. The principal benefit of the CTB regulations cited by proponents was increased simplicity. The wholly formalistic approach to entity classification is easier for taxpayers to understand than the facts and circumstances analysis of the *Kintner* regulations, which often held even more complexity than was apparent at first blush.<sup>15</sup> Increased simplicity also means a reduced compliance burden for taxpayers. Rather than hiring an attorney at significant cost to draft an entity's organizational documents to achieve the desired tax classification, the same result can be realized with a few strokes of a pen.<sup>16</sup> Relatedly, CTB is considered more efficient because taxpayers can achieve the identical result at a lower cost, and the IRS's administrative costs in classifying an entity will also be reduced.<sup>17</sup>

CTB also provides a more certain entity classification than did the *Kintner* regulations. The criteria required to qualify to make a CTB election are simple and explicit. Once a classification election is made, it continues until an entity elects for a different classification<sup>18</sup> or is no longer eligible to elect its classification. A change in circumstances that would cause an eligible entity to become ineligible to make an election, for example the conversion of a partnership into a deemed corporation, is unlikely to go unnoticed to that entity. The *Kintner* regulations, conversely, required that an

entity constantly monitor its activities to ensure compliance with the demands of the multi-factor test.<sup>19</sup>

Finally, the CTB regulations afford a measure of fairness and neutrality between sophisticated and unsophisticated taxpayers. Under the *Kintner* regime, taxpayers were often able to achieve their desired tax classification, but only with significant planning expense. That associated cost meant electivity was, in practice, only available to those who could afford to be well-advised. CTB, however, makes electivity available at minimal cost and to a much broader population of taxpayers.<sup>20</sup>

## II. International Context

Business enterprises, of course, do not always operate exclusively within the United States. For example, multinational corporations, by definition, have a presence in a number of different countries, often operating through and generating income from separately incorporated subsidiaries. From the very beginning, there was uncertainty over whether it was appropriate to extend application of the CTB regulations to foreign business entities for purposes of determining their U.S. tax classification.<sup>21</sup> Notice 95-14 outlined three "special considerations" in the foreign area that the IRS and Treasury had to contemplate:

- the fact that foreign law lacks a counterpart to the U.S. state law corporation, which is automatically classified as a corporation under CTB;
- the increased likelihood of the U.S. and a foreign country classifying a single entity inconsistently under an elective system; and
- the enhanced flexibility to have foreign entities classified as the taxpayer desires for U.S. tax purposes.<sup>22</sup>

### A. Pre-CTB Foreign Entity Classification

Before the CTB regulations, foreign business entities were treated as unincorporated entities for U.S. tax purposes, regardless of their status in the foreign jurisdiction. The entities were then subject to the same *Kintner* multi-factor test to determine their U.S. tax classification.<sup>23</sup> Authorities, however, used the local law of the jurisdiction in which the entity was established, rather than U.S. law, to determine whether any given *Kintner*

<sup>14</sup>Treas. reg. section 301.7701-3(b).

<sup>15</sup>See NYSBA comment, *supra* note 5, at Section III.A (noting that issues unresolved by case law and rulings often arose). See also William S. McKee et al., *Federal Taxation of Partners and Partnerships*, para. 3.06 (1997) (contrasting the "largely formalistic" *Kintner* regulations with the "purely formalistic" CTB regulations).

<sup>16</sup>See Dean, *supra* note 5, at 443 (explaining that CTB allowed entities to achieve partnership tax treatment without having to alter business arrangements).

<sup>17</sup>See Notice 95-14, 1995-1 C.B. 297 (noting that the IRS issued 17 rulings on state LLC statutes after Rev. Rul. 88-76).

<sup>18</sup>An entity that has made an effective election must generally wait 60 months before being permitted to make a different election. Treas. reg. section 301.7701-3(c)(iv).

<sup>19</sup>Dean, *supra* note 5, at footnote 198.

<sup>20</sup>JCT Study, *supra* note 1, at 17; Notice 95-14, 1995-1 C.B. 297.

<sup>21</sup>See, e.g., Notice 95-14, 1995-1 C.B. 297 (requesting comments on whether to extend CTB to foreign entities).

<sup>22</sup>*Id.*

<sup>23</sup>Rev. Rul. 88-8, 1988-1 C.B. 403 (obsoleted by Rev. Rul. 98-37, 1998-2 C.B. 133, following the issuance of the CTB regulations).

factor was established.<sup>24</sup> Not surprisingly, the necessity of analyzing foreign law added a layer of complexity to the *Kintner* analysis.

## B. Policy Justification for Extending CTB

With the exception of the enumerated per se corporations, the final CTB regulations included foreign entities as “eligible entities” that could elect their U.S. tax classification. The rationale behind extending CTB to foreign entities largely mirrors the reasons supporting CTB in the domestic context. Once again, simplicity and efficiency were the hallmarks. On top of the complexity inherent in the multi-factor test, foreign entity classification under the *Kintner* regulations required the examination of foreign law. Analysis of foreign law, of course, added another level of cost for taxpayers.<sup>25</sup> Just as in the domestic context, however, taxpayers willing to spend the money continued to be able to effectively elect the classification of the foreign entity.<sup>26</sup> CTB was intended to eliminate complexity and reduce cost. Under the CTB regulations, examination of foreign law is unnecessary, and consequently, classification is much less costly for taxpayers and for the IRS when issuing rulings and on audit.<sup>27</sup>

Just the same as in the domestic context, CTB for foreign entities increases fairness and neutrality between sophisticated and unsophisticated taxpayers. Considering that “the resources required to make entity classification determinations [were] generally much greater with respect to foreign entities than domestic entities,”<sup>28</sup> the inequality of opportunity under the *Kintner* regime was exaggerated in the foreign context.<sup>29</sup> The CTB regulations, though, remove the cost

of achieving elective classification, thereby allowing sophisticated and unsophisticated taxpayers to realize their desired tax classification on an equal basis.

The ease of achieving a desired entity classification under CTB also minimizes the tax distortions of business decisions. The *Kintner* regulations encouraged foreign entities to tailor their legal form and organizational documents to attain a specific U.S. tax classification. Occasionally, given the different types of business entities available under the laws of the foreign country, the ideal form for conducting the business and the ideal form for arriving at the desired U.S. tax classification were not the same. Also, foreign investors might resist some classification-based organizational decisions, thus forcing the U.S. investors either to make concessions to the foreign investors to gain consent or eschew foreign investment altogether.<sup>30</sup> The CTB regulations eliminate the need to stray from the optimal business structure because U.S. tax classification no longer turns on the contents of the organizational documents or, unless an entity is a per se corporation, on the legal form adopted in the foreign jurisdiction.<sup>31</sup>

## C. Concern Over Use of Hybrid Entities

As stated in Notice 95-14, one of the primary concerns over extending CTB to foreign entities was the increased opportunity for inconsistent treatment of a single entity by two taxing authorities, for example when U.S. law classifies an entity as a partnership or disregarded entity while a foreign country classifies the same entity as a corporation.<sup>32</sup> This is known as a hybrid entity. The reverse situation — when the U.S. classifies as a corporation and the foreign country classifies as a partnership or disregarded entity — is referred to as a reverse hybrid entity.<sup>33</sup>

From the beginning, officials expressed their apprehension that CTB would cause an increase in the prevalence of hybrid entities. Speaking to American Bar Association members in early 1995, then-IRS Associate Chief Counsel (International) Robert Culbertson stated his belief that extension of CTB to foreign

<sup>24</sup>See Rev. Rul. 73-254, 1973-1 C.B. 613 (“It is the local Law of the foreign jurisdiction that must be applied in determining the legal relationships of the members of the organization among themselves and with the public at large, as well as the interests of the members of the organization in its assets.”).

<sup>25</sup>See NYSBA comment, *supra* note 5, at Section V.B.1 (asserting that the costs associated with determining an entity’s classification were generally significantly higher in the foreign context than in the domestic context).

<sup>26</sup>*Id.* at Section V.B.1-2.

<sup>27</sup>*Id.* (suspecting that the IRS has no greater fluency in foreign law than taxpayers, and noting that the IRS typically does not retain foreign counsel); Charles H. Gustafson et al., *Taxation of International Transactions*, 972-973 (3rd ed. 2006) (pointing out that in addition to money, the elective regime saves time and effort); “Council Supports Extension of Check-the-Box Proposal to Foreign Entities, Says There Is No Need for ‘International Consistency,’” *Doc 95-7024, 95 TNI 146-23* (June 28, 1995) (remarking also that a change in foreign law may cause a change in U.S. classification under *Kintner*).

<sup>28</sup>NYSBA comment, *supra* note 5, at Section V.B.1.

<sup>29</sup>It is worth questioning whether fewer unsophisticated taxpayers operate abroad, and thus the impact of CTB in leveling the playing field may be overstated. *Id.* (“The Committee’s perception is that U.S. taxpayers seeking to organize foreign entities and foreign taxpayers seeking to do business in the United States

(Footnote continued in next column.)

generally are not the types of small businesses that cannot afford the resources needed to cope with the complexity of the current system.”).

<sup>30</sup>*Id.* at Section V.B.2 (noting that much depends on the bargaining power of the U.S. investors); Rod Garcia et al., “LLCs, or How the Government Got to Check-the-Box Classification,” *Tax Notes*, May 29, 1995, p. 1139 (suggesting that many foreign investors simply do not understand why U.S. investors are altering business arrangements for tax considerations).

<sup>31</sup>NYSBA comment, *supra* note 5, at Section V.B.2.

<sup>32</sup>Notice 95-14, 1995-1 C.B. 297.

<sup>33</sup>For simplicity, this article will use the term “hybrid” or “hybrid entity” to refer generally to both hybrid and reverse hybrid structures.

entities would exacerbate the hybrid problem.<sup>34</sup> It is easy to understand Culbertson's rationale — if your classification as a partnership or corporation for U.S. tax purposes is purely elective, then so long as you establish a foreign corporation that is not a per se corporation for U.S. purposes, you can achieve flow-through tax treatment in the U.S., and thus create a hybrid entity, simply by checking the box.

At least three distinct arguments were put forward to allay fears of an explosion of hybrid entities. First, proponents of extending CTB to foreign entities contended that CTB was merely a simplification of an already elective classification system and thus would not affect the incidence of hybrid abuse.<sup>35</sup> The New York State Bar Association Tax Section, in their 1995 endorsement of the CTB proposal, said that “the Committee does not believe that the overall potential for abuse would be materially enhanced by the ‘check the box’ system given the degree of electivity associated with current law, particularly in tax-motivated transactions.”<sup>36</sup> Similarly, according to then-IRS Associate Chief Counsel (International) Christine Halphen in 1996, Treasury also believed that the use of hybrids would neither increase nor decrease as a result of CTB.<sup>37</sup> Second, advocates maintained that the advantages of CTB would outweigh any incremental increase in hybrid abuse.<sup>38</sup> In other words, the simplicity, efficiency, fairness, and mitigation of the distortionary effects of tax planning engendered by CTB justified any attendant increase in the risk of hybrid abuse.<sup>39</sup> Third, supporters argued that there were more appropriate methods for curbing hybrid abuse than denying foreign entities the ability to check the box.<sup>40</sup> Realizing that a simple blanket rule requiring an entity's U.S. tax classification to match its foreign tax classification would cede primary classification authority to foreign jurisdictions, champions of this view instead preferred to curb abuse

<sup>34</sup>“ABA Members Comment on Rev. Proc. 95-10 and Foreign Entity Classification,” 95 *TaxDay* Item M.1 (CCH, Feb. 1, 1995).

<sup>35</sup>NYSBA comment, *supra* note 5, at Section V.B.4; “Exchanges of Information Become Key Issue in Treaty Negotiations,” 96 *TaxDay* Item M.7 (CCH, May 14, 1996) (hereinafter “Treaty Negotiations”).

<sup>36</sup>NYSBA comment, *supra* note 5, at Section V.B.4.

<sup>37</sup>*See* Treaty Negotiations, *supra* note 35, (explaining that Treasury was surprised to hear concern from treaty partners over the potential increase in hybrid entities). *But see* “International Tax Developments Discussed by Treasury, IRS Officials,” 97 *TaxDay* Item M.1 (CCH, May 13, 1997) (stating that then-IRS Associate Chief Counsel (International) Michael Danilack believed CTB promoted the use of hybrid entities); “Treasury's Lubick Defends Hybrid Branch Notice and Revenue-Raising Proposals,” 98 *TaxDay* Item M.1 (CCH, Mar. 17, 1998) (stating that then-Treasury Assistant Secretary Donald Lubick believed CTB prompted the creation of hybrid entities).

<sup>38</sup>NYSBA comment, *supra* note 5, at V.B.4.

<sup>39</sup>*See* Section II.B of this article for a more detailed account of the perceived benefits of extending CTB to foreign entities.

<sup>40</sup>NYSBA comment, *supra* note 5, at Section V.B.4.b.ii.

through the reform of rules governing the categories of transactions that hybrids were perceived as abusing.<sup>41</sup> Whether or not any or all of these arguments were persuasive, Treasury's final CTB regulations covered both domestic and foreign entities, though they warned:

Treasury and the IRS will continue to monitor carefully the uses of partnerships in the international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties.<sup>42</sup>

### III. Exploitation of Hybrid Entities

Cross-border tax arbitrage can generally be described as a taxpayer's purposeful use of two countries' conflicting treatment of a single transaction or entity with the effect of the reduction of that taxpayer's overall tax burden compared with the situation in which the same transaction or entity existed exclusively within one or the other jurisdiction.<sup>43</sup> Arbitrage presents one of the primary tax planning opportunities in cross-border transactions and is considered disquieting because it causes inefficient economic distortions by incentivizing a tax-advantageous international transaction over the same intranational transaction. More specifically, it is believed that arbitrage causes the use of international transactions at the expense of domestic ones, promotes transactions with the countries in which the benefit of arbitrage is the greatest, shifts resources from businesses with no opportunity for arbitrage toward businesses with the opportunity for arbitrage, and is unlikely to be constrained by traditional market forces.<sup>44</sup> Entity classification is considered “an active (and highly contested) source of arbitrage.”<sup>45</sup> This section will endeavor to explain two of the more typical areas in which hybrid entities are used as vehicles for tax arbitrage: subpart F and the foreign tax credit.

#### A. Subpart F

Subpart F is an anti-deferral regime aimed at neutralizing the tax deferral benefit of operating abroad through a subsidiary.<sup>46</sup> A branch operation is considered simply an extension of the U.S. taxpayer, thus under the U.S. principle of worldwide taxation of citizens and residents, a foreign branch's profits will be taxed

<sup>41</sup>*Id.*

<sup>42</sup>T.D. 8697, 1997-1 C.B. 215.

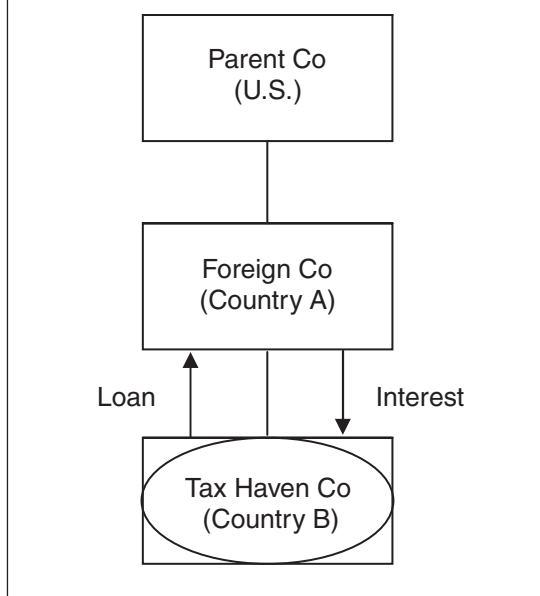
<sup>43</sup>*See, e.g.,* Diane M. Ring, “One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage,” 44 *B.C. L. Rev.* 79, 85-86 (2002) (acknowledging that various definitions of arbitrage exist, and attempting to conflate them all into a single working definition).

<sup>44</sup>*Id.* at 109.

<sup>45</sup>*Id.* at 96.

<sup>46</sup>*See generally* IRC sections 951-965.

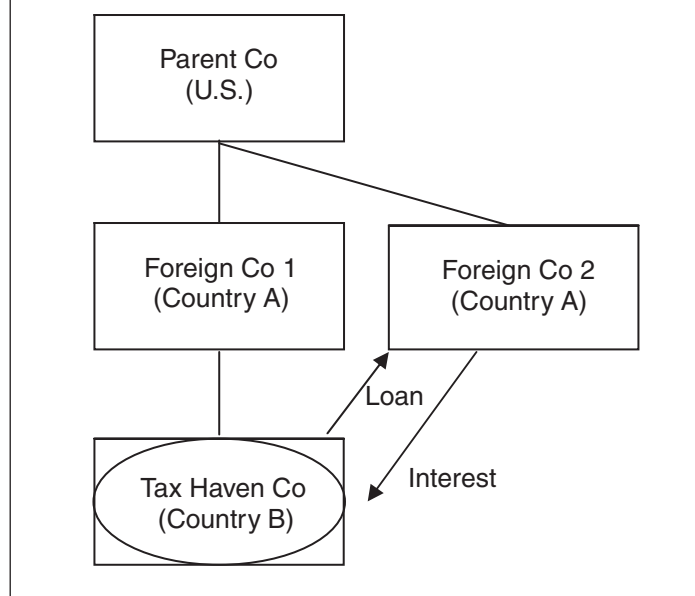
Figure 1. Subpart F Disregarded Loan



currently to the U.S. taxpayer. On the other hand, a foreign subsidiary organized under the corporate laws of another country is respected as an entirely separate legal entity from its owner. Because the U.S. has no jurisdiction to tax the foreign-source income of a foreign corporation on the basis of citizenship/residence or territoriality, the profits of a subsidiary generally will not be subject to tax in the U.S. until they are repatriated. So long as the foreign jurisdiction's tax rate is lower than the tax rate in the U.S., a U.S. taxpayer operating through a subsidiary can thus benefit from the deferral of U.S. tax on foreign income, while a foreign branch or a taxpayer operating exclusively within the U.S. cannot.

Subpart F, however, attempts to reduce the benefit of deferral by currently taxing the U.S. shareholders of controlled foreign corporations operating in low-tax jurisdictions on specific types of income earned by the subsidiary — generally passive, mobile income.<sup>47</sup> Hybrid entities, though, can create unintended consequences. Among the most fundamental uses of a hybrid entity in subpart F tax planning is earnings stripping through a disregarded loan, illustrated in Figure 1. In this situation, the U.S. views Tax Haven Co as a disregarded entity, not distinct from Foreign Co, for tax purposes. As such, from the U.S. perspective, the loan and the interest payments (which would normally constitute subpart F income) are also disregarded, because they occur within a single entity. Country A, however, views Tax Haven Co as a corporation. As a result, Foreign Co will be able to deduct the interest paid to Tax Haven Co as a business expense, thereby reducing its Country A tax burden without any corresponding subpart F inclusion in the U.S.

Figure 2. Same-Country Exception



and minimal or no tax on the interest received by Tax Haven Co in tax haven Country B.

Taxpayers can reach a similar result by use of a “same-country exception” from subpart F inclusion for the receipt of interest by an entity organized in the same country as the related entity paying the interest.<sup>48</sup> In this situation, illustrated in Figure 2, Tax Haven Co is once again disregarded for U.S. tax purposes and viewed as a corporation for Country A tax purposes. From a U.S. perspective, therefore, Foreign Co 2's interest payments are going to Foreign Co 1 and are thus within the same-country exception and not subject to subpart F inclusion by Parent Co. Once again, Foreign Co 2 will be able to deduct the interest payments in Country A, and the receipt of interest by Tax Haven Co will be subject to minimal or no tax in Country B.<sup>49</sup> Statutory attempts to curb this abuse are discussed below in Section IV.C.

## B. Foreign Tax Credit

The foreign tax credit is designed to mitigate the effects of double taxation of foreign income. For example, when a U.S. company is operating in a foreign country, that foreign country has jurisdiction to tax

<sup>47</sup>This is, admittedly, a gross simplification of the mechanics of subpart F. For a more in-depth look at subpart F, see Gustafson et al., *supra* note 27, at ch. 6.

<sup>48</sup>IRC section 954(c)(3).

<sup>49</sup>For a good overview of several other subpart F planning techniques using hybrid entities, see Philip R. West, “Re-Thinking Check-the-Box: Subpart F,” 83 *Taxes* 29 (2005), available at <http://www.steptoec.com/assets/attachments/1245.pdf>.

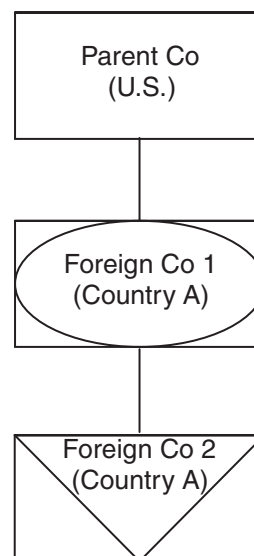
profits earned in that country on the basis of territoriality, while the U.S. maintains jurisdiction to tax those same foreign earnings on the basis of the principle of worldwide taxation of citizens and residents. The foreign tax credit allows the U.S. taxpayer to credit the payment of some foreign income taxes against their U.S. tax liability.<sup>50</sup> The rationale for such a credit is that absent the credit, tax consequences would distort a taxpayer's business decision to operate domestically or abroad, in violation of the principle of capital export neutrality.<sup>51</sup>

A fundamental principle of the foreign tax credit is that the entity that bears the legal liability for the foreign tax, and not necessarily the entity that remits the tax, is the entity eligible to claim the credit.<sup>52</sup> For example, when a foreign entity is required by law to withhold and remit taxes on interest income being paid to a nonresident, the legal liability for such tax typically remains with the recipient of the interest payment, rather than the withholding agent.<sup>53</sup> For this purpose, the taxpayer on whom legal liability is placed is determined regarding foreign law, while U.S. principles govern the determination of who earned the income for purposes of assessing U.S. income taxes. In the withholding example above, if the nonresident is an American corporation, U.S. tax principles would be used to conclude that the American corporation earned the interest, creating U.S. income and a corresponding U.S. income tax obligation. If the American corporation were legally liable for the tax under the foreign law, it would be eligible to claim a credit against its U.S. taxes for the amounts withheld.

Once again, hybrid entities have been used to produce unintended results. One such use is illustrated in Figure 3.<sup>54</sup> In this situation, Foreign Co 1 is a hybrid entity (a disregarded entity from the U.S. perspective and a corporation from the perspective of Country A), and Foreign Co 2 is a reverse hybrid entity (a corporation from the U.S. perspective and a partnership or disregarded entity from the perspective of Country A). If income is earned by Foreign Co 2, U.S. tax principles are used to determine that the income is in fact properly attributable to Foreign Co 2 because it is a corporation, rather than a flow-through entity, in the U.S. view. Foreign law, however, places legal liability for the foreign income tax on Foreign Co 1 because from the foreign perspective, Foreign Co 2 is a flow-through entity and the income tax is considered owed by Foreign

Co 1. But, because the U.S. disregards the separate existence of Foreign Co 1, legal liability is considered to flow through to Parent Co. As a result, Parent Co is eligible to claim a foreign tax credit even though Parent Co did not have any corresponding income inclusion. Statutory attempts to curb this credit and income splitting are discussed below in Section IV.C.

**Figure 3. Foreign Tax Credit Splitting**



## IV. Extending CTB to Foreign Entities

As discussed in Section II.C, there were at least three distinct arguments put forth to justify the extension of the CTB regime to foreign entities in light of the concern over hybrids. First, because CTB was merely a simplification of the existing, de facto elective entity classification regime, the prevalence of hybrid entities would neither increase nor decrease upon allowing foreign entities to elect their U.S. tax classification. Second, the benefits of CTB would offset the negative effects of any incremental increase in the use of hybrids. Finally, hybrid entity abuse is more appropriately curtailed through means other than the denial of CTB.

### A. Increased Use of Hybrids

Evidence, both statistical and anecdotal, points to increased hybrid entity usage following CTB. Notice 98-11, addressing the use of hybrid entities as a means for avoiding subpart F, said that the CTB regulations “have facilitated the creation of the hybrid branches used in these arrangements.”<sup>55</sup> Speaking on the topic

<sup>50</sup>This is a simplification of the operation of the foreign tax credit. For a more detailed account, see Gustafson et al., *supra* note 27, at chs. 5 and 7.

<sup>51</sup>The principle of capital export neutrality states, generally, that a taxpayer's choice between investing at home or abroad should not be affected by domestic tax policy. *Id.* at 17-18.

<sup>52</sup>Treas. reg. section 1.901-2(f).

<sup>53</sup>See Treas. reg. section 1.901-2(f)(2)(ii), Ex. 1.

<sup>54</sup>This factual scenario is based on CCA 200920051.

<sup>55</sup>Notice 98-11, 1998-1 C.B. 433.

of subpart F reform, the Joint Committee on Taxation echoed the sentiment of Notice 98-11, recognizing that in addition to some benefits of simplification, CTB has also produced “unintended tax-avoidance opportunities” by way of hybrid entity use. Acknowledging the significant degree of electivity inherent in the pre-CTB classification regime, the JCT said that “the expressly elective approach of the current regulations has removed some frictions that may have acted as a brake on some of the tax planning involving the classification of entities.”<sup>56</sup> Concurring with both the JCT’s findings and its friction metaphor, the ABA Task Force on International Tax Reform stated that “the check-the-box classification rules materially reduce transactional friction and consequently put greater pressure on structural infirmities in the tax rules.”<sup>57</sup> Finally, the U.S. Treasury, in a report on subpart F, agreed that CTB had caused an increase in the use of hybrid entities.<sup>58</sup>

On the statistical side, it is difficult to quantify and track the number of hybrids. It is possible, however, to quantify and track the U.S. tax classification elections of foreign entities. Since CTB’s implementation in 1997, the IRS Statistics of Income Division reports that roughly 83,000 new entities have filed a classification election and 55,000 existing entities have filed an election to change their classification. In the aggregate, foreign entities elected not to be treated as an entity separate from its owners in 69 percent of the cases.<sup>59</sup> While the limitations of the available data militate against definitive conclusions on the use of hybrids, Heather Field, a law professor at the University of California, Hastings, believes it is fair to infer that something has made a flow-through election particularly attractive for foreign entities, and says “that level of attractiveness may be suspicious.”<sup>60</sup>

## B. Purported Benefits of CTB Not Realized

The benefits advertised by proponents of extending CTB to foreign entities have not borne out as antic-

pated. Complexity and inefficiency have not been reduced so much as they have been redirected. The actual classification of a foreign entity is undoubtedly simpler as a result of CTB. But the increased ability to achieve a hybrid entity and the tax planning opportunities created as a result of CTB have necessitated the issuance of many intricate rules to attempt to quash abusive transactions.<sup>61</sup> Thus, in place of incurring the significant administrative costs of determining the correct entity classification under the *Kintner* regulations, the IRS is incurring significant administrative costs in detecting and preventing the abuses spawned by the CTB regulations.<sup>62</sup> Similarly, taxpayers have replaced the cost of achieving a desired classification under the *Kintner* regulations with the cost of resources expended on planning opportunities, assessing the tax consequences of the available classification alternatives, and, in the event of a hybrid, maintenance of separate U.S. and foreign tax accounting records.<sup>63</sup>

Taking full advantage of the planning opportunities presented by CTB and hybrids, however, requires that taxpayers are well-advised, and being well-advised requires that taxpayers spend considerable money.<sup>64</sup> The net result is that in spite of the claim that CTB would enhance fairness and neutrality between sophisticated and unsophisticated taxpayers, those who can afford to be well-advised will continue to have a substantial advantage over those who cannot, just as was the case under the *Kintner* regulations. Advocates also asserted that CTB would minimize the tax distortions of business decisions that existed under *Kintner* by eliminating the need to compromise the business deal to achieve a specific tax classification for the entity. Certainly, the flexibility CTB provides in realizing a desired tax classification has lessened this type of organizational distortion. That same flexibility, however, may encourage tax distortions of transactional decisions. In other words, now that a hybrid or a flow-through entity can

<sup>56</sup>JCT, “Options to Improve Tax Compliance and Reform Tax Expenditures,” JCS-02-05, 182-185 (Jan. 27, 2005).

<sup>57</sup>ABA, “Report of the Task Force on International Tax Reform,” 59 *Tax Law.* 649, 739 (2006) (hereinafter “ABA report”).

<sup>58</sup>Office of Tax Policy, U.S. Department of the Treasury, “The Deferral of Income Earned Through U.S. Controlled Foreign Corporations,” 68 (2000). Note also that domestic entity classification elections since 1997 have been overwhelmingly in favor of the corporate form. See Heather M. Field, “Checking In on ‘Check-the-Box,’” 42 *Loy. L.A. L. Rev.* 451, 526, Figure 2 (2009). This is likely a reflection of the fact that under the default rules, an entity eligible to make an election is treated as a flow-through entity, even without making an affirmative election. *Id.* at footnote 119.

<sup>59</sup>Melissa Costa and Nuria E. McGrath, *Statistics of Income Studies on International Income and Taxes*, in 30 No. 1, SOI Bulletin, 172, 187 (2010), available at <http://www.irs.gov/pub/irs-soi/10sumbul.pdf>.

<sup>60</sup>Field, *supra* note 58, at footnote 205.

<sup>61</sup>Some of these attempts are addressed in Section IV.C of this article.

<sup>62</sup>See ABA report, *supra* note 57, at 742 (“The principal reason given for elective classification is to reduce the administrative cost and burden that was entailed in applying the corporate resemblance tests. Yet, the check-the-box elective classification rules impose substantial complexity and administrative burden”); Thomas R. May, “Warning: Hybrid Entities — Proceed With Caution,” *Tax Notes*, Jan. 24, 2000, p. 533 (“One must wonder how long Treasury will be content to expend all the time and effort they had hoped to save on entity classification issues through the issuance of the CTB regulations combating hybrid entity planning that the CTB regulations helped facilitate (if not propagate).”).

<sup>63</sup>See ABA report, *supra* note 57, at 742 (mentioning also that late and mistaken elections necessitate additional costs); Field, *supra* note 58, at 486 (noting that planning opportunities can cause a waste of resources).

<sup>64</sup>Field, *supra* note 58, at 481.

be easily achieved, routine transactions may be redirected to take advantage of the tax benefits offered by the hybrid or flow-through entity.

### C. Attempts to Curb Hybrid Abuse Unsuccessful

Hybrid entity abuse, according to advocates of extending CTB to foreign entities, is more appropriately addressed through transaction-specific rules than through the denial of the ability to check the box. This section explores several rules addressing the use of hybrids within the frameworks of subpart F and the foreign tax credit.

#### 1. Subpart F

In January 1998, one year after issuance of the CTB regulations, Treasury issued Notice 98-11 in response to taxpayers' use of hybrid entity planning to sidestep subpart F. The notice announced Treasury and the IRS's intention to issue regulations to prevent the use of hybrids "contrary to the policies and rules of subpart F."<sup>65</sup> Temporary and proposed regulations followed in March.<sup>66</sup> The business community received the notice and regulations with an "immediate and furious" uproar,<sup>67</sup> and by July, Treasury had issued Notice 98-35 withdrawing the regulations and Notice 98-11.<sup>68</sup>

This tacit blessing of subpart F planning using hybrids turned into outright endorsement in 2006 with the passage of section 954(c)(6), which was inspired by the outcome of the Notice 98-11 argument.<sup>69</sup> Section 954(c)(6) is a look-through rule that exempts from subpart F inclusion dividend, interest, rent, and royalty income earned from a related CFC, to the extent that payment is allocable to non-subpart F income of the related corporation.<sup>70</sup> For example, if two CFCs that are organized in different countries and wholly owned by the same U.S. shareholder execute a loan agreement, the interest received by the lending corporation would not be subject to subpart F inclusion by the U.S.

shareholder to the extent the interest payment is allocable to non-subpart F income of the corporation paying the interest. This was presented as an extension of the same-country exception of section 954(c)(3),<sup>71</sup> which already lent itself to subpart F planning using hybrids (discussed above in Section III.A).

#### 2. Foreign Tax Credit

The IRS has continuously tried to stop the type of foreign tax credit and foreign income splitting discussed above in Section III.B through efforts to compel "matching" — that is, requiring that the credits go to only the taxpayer who reports the associated foreign income. In *Guardian Industries v. United States*, the IRS argued that the subsidiaries of a foreign group filing a consolidated return under a hybrid Luxembourg holding company (disregarded by the U.S. but a corporation in Luxembourg), were jointly and severally liable for the foreign taxes, and thus, under Treas. reg. section 1.901-2(f)(3),<sup>72</sup> each subsidiary was liable for its proportionate share of the foreign tax.<sup>73</sup> Accordingly, the IRS argued, foreign law did not place legal liability for the entirety of the consolidated group's foreign taxes on the hybrid Luxembourg holding company, and therefore legal liability, and the attendant foreign tax credits, for that entire amount did not flow up to the holding company's U.S. owner. The Federal Circuit affirmed the Court of Federal Claims and held against the IRS, saying that under Luxembourg consolidated return law, the Luxembourg holding company bore the legal liability for the consolidated group's foreign taxes.<sup>74</sup> As a result, the U.S. parent of the Luxembourg holding company was entitled to the foreign tax credits of the foreign consolidated group without concurrent inclusion of the associated foreign income.

In the time between the *Guardian* case at the Court of Federal Claims and its appeal to the Federal Circuit, the IRS promulgated proposed regulations under section 1.901-2(f) in an attempt to compel matching. The proposed regulations essentially said that legal liability for the foreign tax is placed on the taxpayer who takes into account the related foreign income and not necessarily the person who faces collection of the tax.<sup>75</sup> This rule is consistent with the IRS's stance in *Guardian*. These regulations, however, have yet to be finalized

<sup>65</sup>Notice 98-11, 1998-1 C.B. 433.

<sup>66</sup>T.D. 8767, 1998-1 C.B. 875; REG-104537-97, 1998-1 C.B. 892.

<sup>67</sup>David R. Sicular, "The New Look-Through Rule: W(h)ither Subpart F?" *Tax Notes Int'l*, May 7, 2007, p. 589, *Doc 2007-8611*, or 2007 *WTD 92-23* (explaining that the attack on Notice 98-11 proceeded on three fronts: that Treasury lacked the authority to promulgate such regulations; that the notice was not, as claimed, restorative of subpart F's original policy aims; and that the notice would negatively affect the economy).

<sup>68</sup>Notice 98-35, 1998-2 C.B. 34.

<sup>69</sup>See Philip D. Morrison, "The Obama Check-the-Box Proposal — Notice 98-11 Redux," *Insights & Commentary* (BNA), July 24, 2009, available at [http://www.bna.com/tm/insights\\_morrison22.htm](http://www.bna.com/tm/insights_morrison22.htm) ("The enactment of section 954(c)(6) was motivated in large part by the resolution of the debate over Notice 98-11 and the conclusion that that conclusion should be more widely available.").

<sup>70</sup>IRC section 954(c)(6).

<sup>71</sup>See Cadwalader, Wickersham & Taft LLP, "The Obama Administration's Fiscal Year 2010 Revenue Proposals," May 29, 2009, available at [http://www.cadwalader.com/assets/client\\_friend/052009\\_The\\_Obama\\_Administration\\_Fiscal\\_Year.pdf](http://www.cadwalader.com/assets/client_friend/052009_The_Obama_Administration_Fiscal_Year.pdf) (explaining that section 954(c)(6) acted to codify many of the planning opportunities that CTB had created).

<sup>72</sup>Treas. reg. section 1.901-2(f)(3) (apportioning legal liability for taxes pro rata based on the attributable shares of taxable income when foreign law makes two taxpayers jointly and severally liable for a tax).

<sup>73</sup>477 F.3d 1368, 1371 (Fed. Cir. 2007).

<sup>74</sup>*Id.* at 1373.

<sup>75</sup>Prop. Treas. reg. section 1.901-2(f).

after nearly five years, because a matching principle “has proven difficult to condense into administrable, mechanical rules.”<sup>76</sup>

The most recent effort to end splitting is new IRC section 909. Entering into force on January 1, 2011, section 909 represents an about-face on how the IRS has attempted to quash the splitting of foreign tax credits and foreign income. In *Guardian* and the proposed regulations, the IRS tried to push the legal liability for foreign taxes down to the level where the foreign income is being generated. Section 909, on the other hand, essentially allows the foreign tax liability to flow up to a U.S. entity, but it suspends the availability of a foreign tax credit until that entity accounts for the “related income.”<sup>77</sup> This rule only applies to enumerated “splitting events.”<sup>78</sup> First among these listed splitting events is a transaction involving a reverse hybrid (a corporation in the U.S. but disregarded in the foreign jurisdiction), whereby foreign law would have legal liability flow up to the reverse hybrid’s parent while the U.S. would see the foreign income as accruing at the reverse hybrid level.<sup>79</sup> Section 909 also applies retroactively to foreign taxes paid by a foreign corporation in pre-2011 splitting events that have not yet had a related income inclusion at the U.S. level.<sup>80</sup> The IRS, however, limited section 909’s retroactivity to taxes after January 1, 1997,<sup>81</sup> perhaps not coincidentally, the date that the CTB regulations came into effect. This fact may implicitly signal the IRS’s recognition that much foreign tax credit planning began, in earnest, after the promulgation of the CTB regulations.<sup>82</sup>

<sup>76</sup>Rebecca Rosenberg, “New Foreign Tax Credit Anti-Splitting Rule,” *Tax Notes*, Nov. 8, 2010, p. 701, *Doc 2010-21599*, or *2010 TNT 217-9*.

<sup>77</sup>IRC section 909; John D. Bates, “Nature Abhors a Splitter: The Splitter and Indirect FTC Rules,” *Tax Notes Int’l*, Feb. 14, 2011, p. 517, *Doc 2011-1606*, or *2011 WTD 30-11*.

<sup>78</sup>Notice 2010-92, 2010-2 C.B. 916 (listing four distinct splitting events: reverse hybrid structures, some foreign consolidated groups, group relief and loss-sharing regimes, and hybrid instruments).

<sup>79</sup>*Id.*

<sup>80</sup>*Id.*

<sup>81</sup>*Id.*

<sup>82</sup>See Kristen A. Parillo, “Treasury, IRS Officials Address FTC Splitter Notice, Sunsetting Regs,” *Doc 2010-26227* or *2010 WTD 237-4* (citing a Treasury Office of International Tax Counsel attorney-adviser explaining why the 2007 cutoff date recommended by practitioners was rejected); Lee A. Sheppard, “IRS Provides Answers for Foreign Tax Credit Splitter Rule,” *Tax Notes Int’l*, Nov. 15, 2010, p. 467, *Doc 2010-24142*, or *2010 WTD*

Section 909’s rule suspending foreign taxes until the related income is taken into account in the U.S., however, has been subject to significant criticism. The chief concern lies in the ability to identify a foreign tax’s related income.<sup>83</sup> The IRC does not provide a helpful definition of related income, and differences in U.S. and foreign tax laws and tax bases will cause additional difficulty.<sup>84</sup> As a result, section 909 is generally viewed as a rule that adds significant complexity to the foreign tax credit.<sup>85</sup> Furthermore, the passage of section 909 has not caused the revocation of the existing final regulations on legal liability under section 1.901-2(f) or, for that matter, the proposed regulations under section 1.901-2(f).<sup>86</sup> Therefore, section 909 is not replacing prior rules, it is acting “as an additional sieve through which foreign income taxes must pass before becoming creditable.”<sup>87</sup>

## VI. Conclusion

This article analyzed the use of hybrid entities under the CTB system as a means of investigating the policy rationale behind the decision to extend CTB to foreign entities. Without a more all-encompassing examination of CTB as a whole, it is difficult, and perhaps imprudent, to draw any overarching conclusions about the wisdom of allowing foreign entities to check the box. What can be asserted without argument, however, is that CTB facilitates the creation of hybrid entities, that hybrid entities present significant opportunities for cross-border tax arbitrage, that the benefits of CTB do not conclusively outweigh the effects of increased hybrid use, and that the results of statutory attempts to regulate hybrid entities have been mixed, at best. While these points alone may not justify a reexamination of the CTB rules, they certainly do not support the conclusion that reconsideration is unnecessary. ◆

*218-1* (indicating that a 1997 cutoff date was considered because CTB “cause[d] most of the problems”).

<sup>83</sup>See generally Rosenberg, *supra* note 76 (describing identifying the related income as “one of the more difficult tasks facing the IRS in interpreting the statute”).

<sup>84</sup>Bates, *supra* note 77, at footnote 3; Rosenberg, *supra* note 76, at 703.

<sup>85</sup>See generally Philip D. Morrison, “Section 909 — Part 2,” *Insights & Commentary* (BNA), Feb. 1, 2011, available at <http://www.bnatax.com/insightsdetail.aspx?id=2147485814> (recognizing that the IRS is forced to choose between complexity and fairness).

<sup>86</sup>Bates, *supra* note 77, at 793 (describing section 909 as an “overlay” on the existing foreign tax credit rules).

<sup>87</sup>*Id.*

(Footnote continued in next column.)