

1996

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### Recommended Citation

David L. Forst, *The U.S. International Tax Treatment of Partnerships: A Policy-Based Approach*, 14 BERKELEY J. INT'L LAW. 239 (1996).  
Available at: <http://scholarship.law.berkeley.edu/bjil/vol14/iss2/1>

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# The U.S. International Tax Treatment of Partnerships: A Policy-Based Approach

By  
David L. Forst†

## I. INTRODUCTION

As the use of partnerships as vehicles for international investment has increased, corresponding attention has been given to the U.S. tax issues associated with international partnerships.<sup>1</sup> The resolution of these tax issues, however, can be elusive. Tax treatment is often uncertain because entities that the U.S. treats as partnerships are chameleon-like. Although the distinguishing feature of a partnership (as opposed to a corporation) under U.S. tax law is that its profits and losses are recognized by its individual partners, in the analysis of subtler issues it is often unclear whether a partnership should be viewed as a mere aggregate of its partners or as a separate, stand-alone entity. Uncertain tax treatment also arises in the international context with respect to hybrid entities—the situation where one nation characterizes an entity as a partnership while another nation characterizes it as a corporation.<sup>2</sup> These issues have become more prominent since the IRS issued regulations that permit taxpayers to elect whether most domestic unincorporated business associations and many foreign business associations should be treated for federal tax purposes as corporations or partnerships (or in some cases as branches).<sup>3</sup>

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1. See, e.g. INTERNATIONAL FISCAL ASSOCIATION, INTERNATIONAL TAX PROBLEMS OF PARTNERSHIPS (Kluwer, 1995) [hereinafter INTERNATIONAL FISCAL ASSOCIATION]; Ronald B. Harvey, Michael S. Burke and Susan K. Shapiro, *Uses of Hybrid Entities in the International Arena*, 70 TAX NOTES 215 (1996); Bruce N. Davis and Steven R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 TAX L. REV. 165 (1991).

2. Although the concepts “partnership” and “corporation” often do not exist outside of United States law, most nations’ laws enable investors to conduct business through either a fiscally transparent or a fiscally opaque entity. See generally INTERNATIONAL FISCAL ASSOCIATION, *supra* note 1. For the purposes of this article, the term “partnership” universally refers to an entity in which income and losses are recognized by the individual partners, and the term “corporation” universally refers to an entity which itself recognizes income and losses.

3. See Treas. Reg. §§ 301.7701-1, 301.7701-2 & 301.7701-3. Previously, the classification of most unincorporated domestic business associations and all foreign business associations for federal income tax purposes was determined under complex regulations which evaluated certain characteristics of the associations.

This article attempts to resolve some of the tax issues associated with international partnerships by viewing these issues in the context of U.S. international tax policy. The objectives that underlie the U.S. international tax rules are often obscured by a thicket of complex statutory provisions and Treasury Department regulations and are often diluted by competing goals. Nevertheless, relatively straightforward objectives do exist, and they can be useful in dealing with issues which currently are often addressed through a combination of purely technical analysis and educated guesswork. This article discusses these objectives and international partnerships in the context of the interpretation of bilateral income tax treaties, U.S. foreign tax credit rules, and U.S. anti-deferral rules, most notably Subpart F.

## II.

### OBJECTIVES OF THE U.S. INTERNATIONAL TAX SYSTEM

A fundamental concern of United States income tax policy is the definition of income.<sup>4</sup> Among the competing definitions it appears that the Schanz Haig Simons (SHS) concept, which provides that income is the sum of a person's consumption plus wealth accumulation, has received the most support by tax specialists.<sup>5</sup> It has been questioned, however, whether SHS is the most appropriate definition to apply in the international context,<sup>6</sup> and regardless of which definition is most appropriate, the debate in the United States over international tax policy has not been directly concerned with the definition of income. The debate instead has been primarily concerned with how income (in whatever manner it is defined) should be taxed when it is earned in one state by a resident of another state.

Attempts to resolve this issue have primarily focused on how the taxation of international transactions influences economic concerns, such as the location of American capital and the international competitiveness of American firms.<sup>7</sup> U.S. international tax policy is also scented with the equity-based principles that as a matter of fairness, income should not be taxed fully by both the state in which the taxpayer is a resident (residence state) and the state in which the income is earned (source state) and also that income should not go completely untaxed.<sup>8</sup> A related principle, which is largely based on equity, concerns the fair

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4. See, e.g. Goode, *The Economic Definition of Income*, in *COMPREHENSIVE INCOME TAXATION* 1 (J. Pechman ed. 1977).

5. See *id.* at 7-8.

6. See HUGH AULT & DAVID BRADFORD, *Taxing International Income: An Analysis of the U.S. System and its Economic Premises*, in *TAXATION IN THE GLOBAL ECONOMY* 11, 30-33, 39 (1990) (arguing that SHS is not compatible with such international tax principles as source of income and the distinction between active and passive income, and suggest that the concept of income as a payment of factor services may be more appropriate in the international context, at least with regard to attribution of source).

7. See generally JOINT COMMITTEE ON TAXATION, *DESCRIPTION AND ANALYSIS OF PRESENT LAW TAX RULES RELATING TO INCOME EARNED BY U.S. BUSINESSES FROM FOREIGN OPERATIONS* (July 20, 1995); DEPARTMENT OF THE TREASURY, *INTERNATIONAL TAX REFORM: AN INTERIM REPORT* (Jan. 15, 1993), and discussion at text accompanying note 12-54 *infra*.

8. See discussion of taxpayer equity at text accompanying note 55-69 *infra*.

allocation of taxing claims between the residence state and source state.<sup>9</sup> Simplicity, administrability, revenue raising and consistency with international norms also have been cited as goals of U.S. international tax policy.<sup>10</sup>

Through whatever prism international tax policy is viewed, there is a general international consensus that income earned in a source country by a resident of a different country should not be subject to double taxation, or more precisely, should not be taxed fully by both countries.<sup>11</sup> The elimination of double taxation, therefore, is a good starting point for a discussion of U.S. international tax policy. The issues that spring from the elimination of double taxation, however, concern which tax or taxes should be eliminated or reduced. These issues have been vigorously debated. In one possible solution, the state of residence could have the exclusive right to tax. If this were the case, then the United States, for example, would be able to tax all of the income earned by its residents regardless of where the income was earned, and source states would be required to refrain from taxing income earned within their borders by U.S. residents. Alternatively, the source state could have the exclusive right to taxation. If this were the case, then the United States, for example, would be able to tax all of the income earned within its borders, whether earned by U.S. residents or nonresidents, but could not tax the income earned outside of its borders by U.S. residents.

#### A. *Economic-Based Objectives*

The debate over the allocation of taxing claims has largely been concerned with the economic effect of such an allocation on taxpayers, and by extension on the international economy. If the state of residence had the exclusive right to tax income, then a taxpayer's effective tax rate would not vary regardless of where in the world it earned income. For example, U.S. resident taxpayers would pay tax at U.S. rates and German resident taxpayers would pay tax at German rates on their worldwide income. As a result, tax considerations presumably would not influence where in the world taxpayers chose to invest. It has been argued that this system—labeled “capital export neutrality”—would result in the most efficient worldwide allocation of resources.<sup>12</sup>

Alternatively, if the source state had the exclusive right to tax income, and did not exercise this power discriminatorily, then the income earned by all taxpayers within a particular state would be subject to the same tax rate. For example, all persons who earned income in Singapore, regardless of the countries in which they resided, would be taxed by Singapore at the same rate. It has been

9. See discussion of inter-nation equity at text accompanying note 70-73 *infra*.

10. See DEPARTMENT OF THE TREASURY, INTERNATIONAL TAX REFORM: AN INTERIM REPORT (Jan. 15, 1993), at 116.

11. This consensus is reflected most completely in the international network of bilateral income tax treaties for the avoidance of double taxation. For a discussion of international efforts since the end of the 19th century to eliminate double taxation, see KLAUS VOGEL, KLAUS VOGEL ON DOUBLE TAXATION CONVENTIONS 8-11 (John Marin trans., 1991).

12. For a concise discussion of capital export neutrality, see G.C. HUFBAUER, *A Guide to Law and Policy*, in U.S. TAXATION OF AMERICAN BUSINESS ABROAD 1, 2 (1975).

argued that this system—labeled “capital import neutrality”—would enable all taxpayers who operated in a particular country to compete on an equal tax footing by virtue of being subject to the same overall tax rate on their operations in that country.<sup>13</sup> Thus, while capital export neutrality is generally regarded as fostering efficiency, capital import neutrality is generally regarded as fostering competitiveness.<sup>14</sup> As discussed below, the U.S. international tax system incorporates elements of both capital export neutrality and capital import neutrality.<sup>15</sup>

### 1. Capital Export Neutrality

Capital export neutrality could be implemented most simply and thoroughly if all countries taxed only the worldwide income of their own residents and refrained from taxing income earned within their borders by nonresidents.<sup>16</sup> The earliest modern studies of international tax policy initially endorsed this concept, but quickly discarded it on the grounds that less developed nations were not willing to cede their right to tax income earned within their borders by residents of industrialized countries.<sup>17</sup> At present, countries, whether industrialized or nonindustrialized, give up their right to tax nonresidents only to a limited

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13. For a concise discussion of capital import neutrality, see *id.*

14. These conclusions are not universally supported. See NORMAN B. TURE, *TAXING FOREIGN SOURCE INCOME: THE ECONOMIC AND EQUITY ISSUES* (1976) (arguing that efficiency is better promoted through source-based taxation rather than residence-based taxation, since source-based taxation regimes have less of an effect on pricing). See also KLAUS VOGEL, *The Search for Compatible Tax Systems, in TAX POLICY IN THE TWENTY FIRST CENTURY* 76, 82 (Herbert Stein, ed. 1988) (paraphrasing the German economist, Otto Gandenberger, who argues that in a residence-based tax system, residents of high tax states will be deterred from investing in low tax states because the residents of the low tax states, who earn higher after tax rates of return, will have a competitive advantage). Cf. Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 *TAX NOTES* 581 (Apr. 30, 1990) (arguing that with respect to the taxation of international business income the capital export neutrality/capital import neutrality models are no longer relevant). Although there is not universal agreement as to the validity and relevance of the capital export neutrality and capital import neutrality models, these models have considerably influenced U.S. international tax policy and thus are appropriate to employ for the purposes of this paper.

15. Briefly, the U.S. international tax system incorporates capital export neutrality by allowing U.S. taxpayers to credit their U.S. tax liability with the foreign taxes they paid, and it incorporates capital import neutrality by allowing U.S. shareholders of a foreign corporation to defer their share of the corporation's profits from U.S. tax.

16. Additionally, the shareholder of a company incorporated in a foreign country would be required to currently include the profits of the company, while the source state would be required to refrain from taxing such profits. If this were not the case, then taxpayers could shelter income from residence country taxation simply by forming foreign subsidiaries.

17. In 1921 the Financial Committee of the League of Nations retained four financial experts to prepare a report on double taxation. Their report, which was issued in 1923, advocated exclusive taxation by the state of residence as a means of stimulating international investment. See *Report on Double Taxation, submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp*, League of Nations Doc. E.F.S.73 F.19, at 48-9 (1923) [hereinafter 1923 *League of Nations Report*]. A report issued two years later, however, abandoned this recommendation, and instead proposed a system which closely resembles the U.S. system. The report provided that the state of residence, in principle, could tax the foreign source income of its residents, but the state of source could also tax this income if it arose from a fixed place of business in the source country. To avoid double taxation, it was suggested that the state of residence give the taxpayer some form of relief for the source country tax. See *Report and Resolutions submitted by the Technical Experts on Double Taxation and Tax Evasion to the Financial Committee of the League of Nations*, League of Nations, League of Nations Doc. C.115. M.55. 1925 II, at 32-3 (1925).

extent. For example, a mainstay of bilateral tax treaties is that a country will not tax profits earned within its borders by an enterprise of the treaty partner country if the profits are not attributable to a "permanent establishment."<sup>18</sup> In addition, signatories to bilateral tax treaties have generally agreed to reduce withholding tax rates on such items of income as dividends, interest and royalties remitted to residents of the treaty partner country.<sup>19</sup> Aside from these examples, countries generally have not relinquished the right to tax income earned within their borders, whether such income is earned by residents or nonresidents.

Capital export neutrality has been more practically, but less perfectly, implemented when a state reduces, or "credits", the domestic tax burden of its residents by the amount of tax that its residents pay to foreign governments. The foreign tax credit is the primary means by which the United States implements capital export neutrality.<sup>20</sup> When Congress first enacted the foreign tax credit in 1918, it stated that one of the credit's primary objectives was to achieve the general economic goal of promoting U.S. investment abroad.<sup>21</sup> More recent governmental analyses of the foreign tax credit have viewed it as promoting the more refined economic goal of efficient resource allocation.<sup>22</sup>

The foreign tax credit operates in the U.S. as follows: Suppose a corporation which is a tax resident of the U.S. earns \$100 of income in country A. The income is subject to taxation both in country A, since the income is earned there, and in the U.S., since the U.S. taxes all the income of its residents regardless of where in the world it is earned.<sup>23</sup> Suppose that country A's tax rate is 20%. The firm will pay \$20 in tax to country A and also will be subject to \$35 of U.S. tax. Without a foreign tax credit, the company would pay \$55 in tax on the \$100 of income. The U.S., however, will offset the taxpayer's \$35 U.S. tax burden by the \$20 in tax paid to country A. Thus, the taxpayer's total tax burden on the \$100 of income would be \$35: \$20 paid to country A and \$15 paid to the U.S. Capital export neutrality would be achieved since the taxpayer's effective tax rate on the \$100 is the U.S. rate of 35%. If the entire world consisted of the U.S. and country A, tax considerations should not affect the U.S. taxpayer's decision where to invest.

In a system which sought to achieve full capital export neutrality, a taxpayer would be able to reduce its U.S. tax burden by all of the foreign tax which

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18. See, e.g., Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital, 1992, art. 7, 1 TAX TREATIES (CCH) ¶ 191 [hereinafter OECD MODEL TREATY].

19. See *id.*, arts. 10-12.

20. See I.R.C. §§ 901-08 (1986).

21. In Congressional debate on the foreign tax credit, Rep. Kitchin of the House Ways and Means Committee stated, "[The foreign tax credit] is not only a just provision, but a very wise one. It is wise from the standpoint of the commerce of the United States, the expansion of business of the United States . . . We would discourage men from going out after commerce and business in different countries or residing for such purposes in different countries if we maintained this double taxation." 56 Cong. Rec. (Jan. 8, 1918) (Statement of Rep. Kitchin).

22. See, e.g., DEPARTMENT OF THE TREASURY, INTERNATIONAL TAX REFORM: AN INTERIM REPORT (Jan. 15, 1993), at 122.

23. I.R.C. § 61(a) (1986).

it pays.<sup>24</sup> The U.S. system, however, only permits a taxpayer to credit foreign taxes to the extent of the U.S. tax imposed on its income earned outside of the U.S.<sup>25</sup> An unlimited foreign tax credit could require the U.S. to forego tax revenue on income which a taxpayer earns in the U.S.<sup>26</sup> An unlimited credit also could enable foreign countries to get rich at the expense of the U.S. Treasury by imposing extraordinarily high tax rates on investments by U.S. residents.<sup>27</sup>

The foreign tax credit limitation operates as follows: Suppose a U.S. taxpayer's only foreign source income is \$100 earned in country B, and that country B's tax rate is 50%. The taxpayer will pay \$50 of taxes to country B and will be assessed \$35 in tax by the U.S. If the foreign tax credit were unlimited the taxpayer would be able to completely offset the \$35 of U.S. tax on the \$100 of country B income and also would be able to offset \$15 of additional U.S. tax imposed on unrelated income which the taxpayer earned in the U.S. The foreign tax credit limitation, however, only permits the taxpayer to reduce its U.S. tax burden by \$35 and not by the full \$50. In this case the corporation's worldwide tax burden on the \$100 is \$50: \$50 paid to country B and \$0 paid to the U.S. Capital export neutrality is not achieved because the U.S. taxpayer might prefer to forego investment in country B for investment in the U.S. or a country with a tax rate equal to or lower than the U.S. rate.

A taxpayer, however, may not forego investment in country B if it also earns income in a foreign country with a low tax rate. The U.S. system currently permits a taxpayer to average the foreign tax rates in the various countries in which it earns income.<sup>28</sup> A corporation which earns \$200 in foreign source income (\$100 in country A and \$100 in country B, for example) is entitled to

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24. Note that full capital export neutrality would not be achieved if a taxpayer's U.S. tax burden was not high enough to absorb all of its foreign taxes. Thus, even an unlimited foreign tax credit might not result in full capital export neutrality.

25. I.R.C. § 904(a) (1986).

26. In 1921, three years after it enacted the foreign tax credit, Congress recognized that the foreign tax credit limitation was necessary to protect the U.S. tax base. The House Ways and Means Committee stated, "Where foreign income or profits taxes are imposed at rates higher than those carried by the similar taxes in this country, this credit may wipe out part of our tax properly attributable to income derived from sources within the United States." H. R. REP. NO. 350, 67th Cong., 1st Sess. 13 (1921).

27. The four financial experts retained by the League of Nations, who not coincidentally resided in creditor countries (the United States, Great Britain, the Netherlands and Italy), noted this issue as a concern in the 1923 League of Nations Report. "It is to be doubted whether such creditor countries as the United States, Great Britain and the Netherlands, having regard to their interests abroad, would ever agree permanently to put their exchequers to the mercy of all the unknown increases of taxation of foreign Governments." See 1923 LEAGUE OF NATIONS REPORT, *supra* note 17, at 49. However, nondiscrimination clauses in bilateral tax treaties would prevent source countries from imposing discriminatorily high tax rates on nonresidents. See RICHARD A. MUSGRAVE, *FISCAL SYSTEMS* 252 (1969).

28. See I.R.C. § 904(a) (1986) which provides that the foreign tax credit limitation is calculated on the basis of the taxpayer's total foreign source income ("overall limitation"). Earlier versions of the Internal Revenue Code, by contrast, either permitted or required taxpayers to calculate their foreign tax credit limitation separately for each country from which they derived income ("per country limitation"). The per country limitation was more consistent with the policy goal of efficiency since taxpayers did not have an incentive to derive income from low tax countries to offset excess foreign tax credits accumulated from investment in high tax countries. For a history of the various appearances, disappearances and reappearances of the overall and per country limitations in

claim \$70 in foreign tax credits. If the taxpayer paid \$20 in tax to country A and \$50 in tax to country B it could credit its entire foreign tax burden against its U.S. tax liability. While averaging might enable a taxpayer to reduce its worldwide tax rate, it does not necessarily foster capital export neutrality. If the taxpayer in the above example conducted business only in country B, it might be induced into doing business in country A, another foreign country with a higher tax rate, in order to earn enough lightly taxed foreign source income so that it could credit the entire amount of tax it paid to country B.<sup>29</sup> Thus, taxes might influence the company's decision where to invest. On the other hand, both the U.S. Treasury and Congress have recognized that while averaging might not serve the policy goal of efficiency, it does serve the policy goal of competitiveness by enabling taxpayers to reduce their overall worldwide tax rates.<sup>30</sup>

A taxpayer, however, cannot average foreign taxes imposed on different types, or "baskets," of income. The Internal Revenue Code currently segregates a taxpayer's income into eight specific baskets.<sup>31</sup> If a taxpayer's income does not fall within one of these specific baskets, it is placed in a residual basket and called "general limitation income."<sup>32</sup> To illustrate simply how the complicated world of baskets operates, suppose a taxpayer earns no foreign source income other than \$100 in country B which is taxed by country B at a 50% rate. As discussed above, a taxpayer might be induced to invest in country A, where the tax rate is only 20%, to offset the country B taxes it cannot credit against its U.S. tax liability. A taxpayer, however, can only average foreign tax rates if the underlying foreign source income is of the same type. Thus, if the taxpayer pays foreign tax on \$100 of manufacturing income in country B, it cannot deposit money into a country A bank account and average the country A tax imposed on the resulting interest income. The taxpayer, instead, would be required to earn income in country A that falls within the same basket as the manufacturing income.

Congress has continually justified the segregation of foreign source income into baskets by arguing a nationalistic shade of capital export neutrality. Congress believes that baskets are necessary to prevent taxpayers from making in-

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the Internal Revenue Code, see JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 855 (1986) [hereinafter 1986 BLUE BOOK].

29. See AULT AND BRADFORD, *supra* note 6, at 38 (stating that if U.S. firms accumulate excess credits that they cannot use, then such firms will have a tax incentive to earn income in low tax countries to be able to utilize the excess credits); see also Charles I. Kingson, *The Foreign Tax Credit and Its Critics*, 9 AMER. J. TAX POL'Y 1, 16-19 (1991).

30. See DEPARTMENT OF THE TREASURY, INTERNATIONAL TAX REFORM: AN INTERIM REPORT (Jan. 15, 1993) at 129; JOINT COMMITTEE ON TAXATION, DESCRIPTION AND ANALYSIS OF PRESENT LAW TAX RULES RELATING TO INCOME EARNED BY U.S. BUSINESSES FROM FOREIGN OPERATIONS (July 20, 1995) at 61.

31. The baskets are: passive income, high withholding tax interest, financial services income, shipping income, dividends received by a corporation from each noncontrolled section 902 corporation, U.S. source dividends derived from a domestic international sales corporation (DISC) or former DISC, taxable income attributable to foreign trade income, and certain distributions from a foreign sales corporation (FSC) or former FSC or interest carrying charges derived from a transaction which results in foreign trade income. See I.R.C. § 904(d)(1)(A)-(H) (1986).

32. See I.R.C. § 904(d)(1)(I) (1986).



vestments abroad for ostensibly no purpose other than manipulating the foreign tax credit rules to reduce U.S. tax. In 1962, when Congress created the first basket—passive interest income—it believed that tax considerations alone were responsible for taxpayers moving capital, in the form of loans, overseas. The Senate Finance Committee stated that cross crediting “has served as an artificial inducement to the movement of certain investment income abroad.”<sup>33</sup> The Tax Reform Act of 1986 is largely responsible for the present system of eight specific baskets and one residual basket. The principal justification for the imposition of such complexity, once again, was that low foreign tax rates alone could induce a taxpayer to forego investment in the U.S. for investment in foreign countries. The Joint Committee on Taxation remarked, “U.S. taxpayers with excess foreign tax credits have an incentive at the margin to place new investments abroad rather than in the United States.”<sup>34</sup>

Note, however, that the residual category is a large one and with a few exceptions encompasses all active business income.<sup>35</sup> As a result, at the margin, taxpayers still might have an incentive to deploy capital (which will produce active business income) overseas solely on the basis of tax considerations.<sup>36</sup> Thus, while the foreign tax credit in its simplest form will largely result in capital export neutrality, the foreign tax credit, as applied by the U.S. system, achieves an imperfect form of capital export neutrality. The foreign tax credit limitation, which is motivated by the objective of protecting the U.S. tax base, is largely responsible for compromising capital export neutrality. Other goals, such as the promotion of U.S. competitiveness and the desire to keep U.S. capital invested at home, have also prevented full implementation of capital export neutrality.

## 2. Capital Import Neutrality

Capital import neutrality would be achieved fully if all countries taxed all income earned within their borders, did not subject nonresidents to discriminatory rates, and gave up their right to tax foreign source income earned by their own residents. If this were the case, then all taxpayers would pay the same rate of tax on income earned within a particular country. However, the vast majority of countries’ unwillingness to completely exempt the foreign source income of their residents from tax has prevented worldwide implementation of capital import neutrality.<sup>37</sup> Thus, like capital export neutrality, capital import neutrality has been imperfectly implemented.

A number of industrialized countries incorporate principles of capital import neutrality into their tax systems by including “tax sparing” provisions in

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33. See SENATE FINANCE COMMITTEE, REVENUE ACT OF 1962, S. Rep. No. 1881, 87th Cong., 2nd Sess. (1962), reprinted in 1962-3 C.B. 778. [hereinafter SENATE FINANCE COMMITTEE]

34. See 1986 BLUE BOOK, *supra* note 28, at 862.

35. See *supra*, note 31 and accompanying text.

36. See Kingson, *supra* note 29, at 18, who argues that the “key foreign tax credit category” (general limitation income) does not comport with capital export neutrality.

37. See VOGEL, *supra* note 11, at 2.

bilateral tax treaties with nonindustrialized countries.<sup>38</sup> In a tax sparing arrangement, the industrialized country will agree to forego collecting tax on certain types of profits earned by its residents in the nonindustrialized country. Technically, the industrialized country usually agrees to credit taxes technically imposed, but not collected, by the nonindustrialized country. Thus, the resident of the industrialized country receives a foreign tax credit without having to pay foreign tax.<sup>39</sup> It is not U.S. policy to incorporate tax sparing provisions into its bilateral treaties.<sup>40</sup> The U.S., however, has statutorily adopted a form of tax sparing with respect to profits earned in U.S. possessions, including Puerto Rico and the U.S. Virgin Islands.<sup>41</sup>

Another form of capital import neutrality is the participation exemption. Unlike tax sparing arrangements, participation exemptions usually are part of a country's domestic law.<sup>42</sup> For example, a Dutch corporation that possesses a qualified shareholding in a foreign corporation is exempt from Dutch corporate income tax on dividends remitted by the foreign corporation and is also exempt from Dutch capital gains tax on alienation of the shares in the corporation.<sup>43</sup> The foreign corporation must be subject to a foreign income tax and must be engaged in an entrepreneurial activity that is connected with the business of the Dutch corporation for the participation exemption to apply.<sup>44</sup> The U.S. tax system does not provide for participation exemptions.

Principles of capital import neutrality are incorporated into the U.S. tax system through deferral. A U.S. taxpayer can defer U.S. tax on certain types of income earned in a foreign country if the taxpayer conducts business in the country through a local corporation. For example, if a U.S. corporation directly invests in country A, it will pay \$35 in tax for every \$100 of income earned in country A, even though country A's tax rate is 20%.<sup>45</sup> If a U.S. corporation forms a country A subsidiary, the subsidiary will pay \$20 in tax to country A for every \$100 of profits it earns, and no U.S. tax will be imposed until the subsidiary remits a dividend to the U.S. taxpayer. The Treasury Department has stated that this policy fosters competitiveness. "With unlimited deferral, the most relevant tax liability is the foreign (source country) tax, and U.S. shareholders bear an effective tax burden comparable to that borne by other investors in the source

38. See, e.g., AGREEMENT FOR THE AVOIDANCE OF DOUBLE TAXATION, Dec. 20, 1991, U.K.-Papua N.G., art. 23, reprinted in EUROPEAN TAXATION, vol. C 12.

39. See VOGEL, *supra* note 11, at 1075.

40. One of the primary argument made against tax sparing arrangements is that the U.S. tax system already implements capital import neutrality by enabling U.S. taxpayers to defer U.S. tax on the income of their foreign subsidiaries. For a general exposition of the arguments for and against tax sparing, see JOINT COMMITTEE ON TAXATION, *supra* note 7, at 63-64.

41. See I.R.C. § 936 (1986).

42. See, e.g., CORPORATE INCOME TAX ACT, art. 13, 1969 (Neth.).

43. See *id.*

44. See *id.*

45. As discussed above, the corporation will pay \$20 in tax to country A, and through operation of the foreign tax credit, it will pay an additional \$15 in tax to the U.S.

country. This result is generally consistent with the objective of competitiveness."<sup>46</sup>

Foreign subsidiaries, however, do not fully protect their U.S. parent companies from current imposition of U.S. tax. Since 1937 the U.S., to an increasing degree, has required U.S. shareholders of foreign corporations to currently include the earnings and profits of those corporations into their U.S. gross income.<sup>47</sup> The current inclusion phenomenon accelerated in 1962 when Congress enacted Subpart F. In 1962, President Kennedy sought to end deferral of all income earned in industrialized countries by U.S.-controlled foreign corporations. Congress, however, believed that deferral made U.S. firms competitive with foreign firms and was reluctant to abandon this form of capital import neutrality to such a large extent. In reacting to President Kennedy's proposal, the House Ways and Means Committee stated, "[I]t appeared that to impose the U.S. tax currently on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax."<sup>48</sup> As a result, Congress subjected only certain types of income earned by foreign subsidiaries to current U.S. taxation.<sup>49</sup> Congress believed that ending deferral for these types of income would curb abuse but not hurt competitiveness.<sup>50</sup>

Since 1962, Congress has enacted additional provisions which further eroded the ability of U.S. residents to defer tax on foreign source income by forming foreign subsidiaries.<sup>51</sup> The enactment of these provisions has often been accompanied by legislative history in which Congress, using the jargon of capital import neutrality, stated that it was curbing abuse but not hurting competitiveness. For example, in 1993 when Congress subjected accumulations of foreign subsidiaries' passive earnings to U.S. tax,<sup>52</sup> Congress stated, "[T]he deferral of U.S. tax on accumulated active business profits is not necessary to maintain the competitiveness of business activities conducted by controlled for-

46. See DEPARTMENT OF THE TREASURY, INTERNATIONAL TAX REFORM: AN INTERIM REPORT (Jan. 15, 1993), at 120.

47. The first current inclusion rule, the foreign personal holding company provisions, required U.S. shareholders to currently include income of certain foreign corporations which were primarily used to hold passive investments. The Congressional committee reports, unlike the more recent legislative history on anti-deferral provisions, did not discuss the effect of the rule on competitiveness. Like more recent legislative history, however, the rule was justified as a means of curbing tax avoidance. "This proposal recommends a method of taxation which is a departure from any previously used with respect to corporate income. The committee feels, however, that this innovation is necessary to protect the revenue and prevent further use of one of the most glaring loopholes now existing." Joint Committee on Tax Avoidance (Aug. 5, 1937), reprinted in JACOB STEWART SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 189 (1937).

48. See HOUSE WAYS AND MEANS COMMITTEE, REVENUE ACT OF 1962, H. R. REP. NO. 1447, 87th Cong., 2nd Sess. 461 (1962) [hereinafter HOUSE WAYS AND MEANS COMMITTEE].

49. The income subject to current taxation consisted of Subpart F income and earnings invested in U.S. property. For the current version of the anti-deferral regime which Congress initiated in 1962, see I.R.C. §§ 951-964 (1986).

50. See HOUSE WAYS AND MEANS COMMITTEE, *supra* note 48, at 461-62.

51. See, e.g., the passive foreign investment company ("PFIC") rules at I.R.C. §§ 1291-1297, which were enacted as part of the Tax Reform Act of 1986, P.L. 99-314.

52. See *id.*

eign corporations where such accumulated profits are held in the form of excessive accumulations of passive assets.”<sup>53</sup> Whether the erosion of deferral has or has not hurt U.S. competitiveness abroad, it is clear that the Congressional debate has continually been animated by the principles of capital import neutrality.<sup>54</sup>

### B. Equity-Based Objectives

The policies discussed above all view international taxation as a means of achieving an economic objective, be it efficiency, competitiveness or protection of national resources. International tax policy, however, also can be viewed as a function of equity, fairness or justice. Policies based on equity include the general principles that income should not go untaxed, income should not be taxed twice and national treasuries should fairly divide up taxes collected from international transactions.<sup>55</sup>

Without ascribing particular weights to economics and equity, it is clear that economics and equity have served as dual, and often complimentary, foundations of international tax policy. For example, when the U.S. first enacted the foreign tax credit in 1918, the credit was called both a “wise” provision, because it would facilitate the international expansion of American business, and a “just” provision, because taxpayers would no longer be required to bear two tax burdens.<sup>56</sup> Similarly, the reports on international double taxation which led to the first model income tax treaties were concerned with both the effect of double taxation on the preemption of international investment and the fair allocation of

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53. HOUSE WAYS AND MEANS COMMITTEE, 103d CONG., 1ST SESS., FISCAL YEAR 1994 BUDGET RECONCILIATION RECOMMENDATIONS OF THE COMMITTEE ON WAYS AND MEANS 254 (Comm. Print 1993). Congress has also stated that limiting deferral promotes the efficient worldwide allocation of capital. “It has long been the policy of the United States to impose current tax when a significant purpose of earning income through a foreign corporation is the avoidance of tax. Such a policy serves to limit the role that tax considerations play in the structuring of U.S. persons’ operations and investments. . . . Congress believed that by eliminating the U.S. tax benefits of such transactions, U.S. and foreign investment choices would be placed on a more even footing, thus encouraging more efficient (rather than the more tax-favored) uses of capital.” 1986 BLUE BOOK, *supra* note 28, at 964-65.

54. Another economic based objective of international tax policy is “national neutrality.” Both capital export neutrality and capital import neutrality depend on governments ceding some of their taxing authority for the sake of promoting a worldwide economic objective, whether efficiency or competitiveness. National neutrality, on the other hand, does not require governments to cede their taxing authority and does not seek to promote global objectives. In the parlance of international trade, national neutrality is the equivalent of tax protectionism. Under national neutrality, a taxpayer is taxed on its worldwide income regardless of source and can only deduct, rather than credit, foreign taxes from gross income. Unlike a system based on the foreign tax credit, firms will, at the margin, be deterred from investing in foreign countries because they will be subject to a certain degree of double taxation. National neutrality has not been an influential force in U.S. international tax policy and is not readily applicable to international partnerships.

55. See PEGGY MUSGRAVE, U.S. TAXATION OF FOREIGN INVESTMENT INCOME, 121-33 (1969).

56. See statement of Congressman Kitchin, *supra* note 21.

taxing rights between nations.<sup>57</sup> Commentators also have cited equity as a founding principle of international tax policy.<sup>58</sup>

Although international tax policy has its roots in equity-based principles, equity has more recently been considered as "irrelevant" to contemporary international tax policy, and the more recent literature primarily focuses on economic principles.<sup>59</sup> Furthermore, when equity has been addressed in the more recent literature, its usefulness as a methodology has been questioned. The German commentator Klaus Vogel argues, for example, that equity-based reasoning can never be abbreviated into a single comparison, can produce conflicting evaluations and does not generate a clear cut result, like a logical inference.<sup>60</sup> It is clear that equity has not been as influential as economics in shaping the policy over how double taxation should be eliminated for the individual taxpayer. For example, the term "supernational equity," which provides that all residents of a country should pay the same tax rate on their combined foreign source and domestic source income,<sup>61</sup> does not appear in the international tax literature with nearly the same frequency as its economic counterpart, capital export neutrality. Although equity is not an equal partner with economics with regard to this single, yet undeniably important issue, it would be incorrect to discount it as a factor in all of international tax policy.

### 1. Tax Avoidance

An important equity-based objective of international tax policy which is relevant to international partnerships is the elimination of nontaxation. This issue has been increasingly addressed in bilateral income tax treaties through limitation on benefits, more commonly referred to as anti-treaty shopping, articles.<sup>62</sup> Limitation on benefits articles are necessary to prevent situations where a resident of a particular country attempts to reduce or avoid taxation by obtaining the

57. See 1923 *League of Nations Report*, *supra* note 17, at 3-8.

58. Ault and Bradford, for example, state that the U.S. international tax regime can be understood as "springing from" equity-based principles. AULT & BRADFORD, *supra* note 6, at 27. Hufbauer states that the equitable division of tax revenue between governments was one of the two original goals of international tax policy (the other being the elimination of double taxation). HUFBAUER, *supra* note 12, at 1.

59. Daniel J. Frisch, *Comment to Taxing International Income: An Analysis of the U.S. System and its Premises*, in *TAXATION IN THE GLOBAL ECONOMY* 46, 50 (1990); See also HUFBAUER, *supra* note 12, at 1 (stating that although equitable principles were an original goal of international tax policy, international tax rules were later reinterpreted by economists with a focus on resource flows).

60. Klaus Vogel, *The Search for Compatible Tax Systems*, in *TAX POLICY IN THE 21ST CENTURY* 76, 84 (Herbert Stein, ed. 1988). Cf. AULT & BRADFORD, *supra* note 6, at 29-30 (arguing that equity-based theories are misleading if income is not viewed as an exogenous attribute of the taxpayer but rather than as an aggregation of transactions).

61. See Richard Musgrave, *Criteria for Foreign Tax Credit*, in *TAXATION AND OPERATIONS ABROAD* 87 (1960); See also MUSGRAVE, *supra* note 55, at 122, who uses the term "international equity" to describe a similar concept.

62. For example, the Senate Foreign Relations Committee's report on the U.S./Netherlands Treaty, which has a very strict limitation on benefits article, stated that a "principal purpose of the treaty is to prevent evasion of income taxes of the two countries." SENATE COMMITTEE ON FOREIGN RELATIONS, REPORT ON THE 1992 UNITED STATES/NETHERLANDS INCOME TAX TREATY AND 1993 PROTOCOL, Exec. Rep. 103-19 (1993).

benefits of a treaty between two different countries. There is a concern that such practices, which have no ostensible purpose other than manipulation of the tax system, could erode public confidence in the tax system and hinder the sound administration of the tax laws.<sup>63</sup>

The first U.S. limitation on benefits articles, which was incorporated in the 1962 U.S./Luxembourg treaty, is an illustrative example.<sup>64</sup> The article targets foreign ownership of special Luxembourg holding companies which are exempt from Luxembourg tax. If the provision had not been incorporated in the treaty, a resident of a country that did not have a treaty with the U.S. could have formed a Luxembourg holding company to conduct business in the U.S. It is possible that interest and royalties remitted from the U.S. to the third country resident through the Luxembourg holding company could have been exempt from taxation in the U.S., Luxembourg and the resident country. The U.S. and Luxembourg viewed this result as unacceptable.<sup>65</sup>

In cases where a treaty has not contained a limitation on benefits provision, U.S. courts have stepped in to invalidate sham transactions, citing lack of business purpose. In *Aiken v. Commissioner*,<sup>66</sup> the Tax Court held that interest paid from a U.S. corporation to a Honduran corporation was not exempt from U.S. tax under the U.S./Honduras treaty since an equivalent amount of interest was concurrently paid by the Honduran corporation to a Bahamian corporation. Thus, the interest paid by the U.S. corporation essentially passed through the Honduran corporation to the Bahamian corporation. In denying application of the U.S./Honduras Treaty, the court stated, "tax avoidance . . . standing by itself is not a business purpose which is sufficient to support a transaction for tax purposes."<sup>67</sup>

The OECD Model Treaty does not have a separate limitation on benefits article, but the articles of the Treaty that lower source country withholding tax on dividends, interest and royalties require the recipient to be the "beneficial owner" of the income.<sup>68</sup> The commentaries to these articles elaborate that the reduced treaty rate is not available when an intermediary is interposed between the beneficiary and the payer and provide that states are free to insert more explicit anti-avoidance provisions during bilateral negotiations.<sup>69</sup>

63. See RICHARD A. GORDON, TAX HAVENS AND THEIR USE BY UNITED STATES TAXPAYERS—AN OVERVIEW 158, 159 (1981). Limitation on benefits articles also have been viewed as serving economic and political objectives, including reducing the incentive for U.S. firms to invest abroad and increasing U.S. bargaining power in treaty negotiations. See *id.* at 152, 159.

64. United States-Luxembourg Income Tax Treaty, 1962, art. XV, 2 TAX TREATIES (CCH) para. 5601.

65. See SENATE COMMITTEE ON FOREIGN RELATIONS, REPORT ON THE INCOME TAX CONVENTION BETWEEN LUXEMBOURG AND THE UNITED STATES, 2 TAX TREATIES (CCH) para. 5745.

66. 56 T.C. 925 (1971).

67. *Id.* at 934.

68. See OECD MODEL TREATY, *supra* note 18, arts. 10(2), 11(2) and 12(1).

69. Commentary to the OECD MODEL TREATY, *supra* note 18, art. 10, para. 12.

## 2. *Inter-Nation Equity*

Another international tax issue with a foundation in equity is the effect of the allocation of taxing claims on national treasuries.<sup>70</sup> The capital export neutrality/capital import neutrality/national neutrality debate discussed above primarily concerned the effect of the allocation of taxing claims on individual taxpayers and, by extension, the global economy. When viewed from the perspective of national treasuries, the issues are more parochial. A recurring conflict in this area, for example, occurs between industrialized and non-industrialized countries. Less industrialized countries, which view foreign investment as a more important source of revenue than industrialized countries, are less willing to relinquish their right to impose source-based taxation.<sup>71</sup> For example, model treaties that reflect the views of nonindustrialized countries are less generous in offering permanent establishment protection than model treaties that reflect the views of industrialized countries.<sup>72</sup> Similarly, the nonindustrialized countries are less willing to lower withholding rates on investment income than industrialized countries.<sup>73</sup>

## C. *Other Objectives*

Other policies, such as the facilitation of world trade and the stimulation of worldwide economic growth, have been cited as objectives of international tax policy. Like most of the policies discussed above, these economic-based objectives spring from the general international consensus to eliminate double taxation, and were cited prominently in earlier analyses of international tax policy.<sup>74</sup> These policies, however, do not resolve the issue of how to eliminate double taxation. The neutrality principles, by contrast, seek to achieve more specific economic-based objectives, such as efficiency or competitiveness, and offer specific prescriptions for the elimination of double taxation.

The Treasury Department has also stated that simplicity and administrability are objectives of U.S. international tax policy.<sup>75</sup> A casual glance at the international provisions of the Internal Revenue Code and accompanying Treasury

70. See MUSGRAVE, *supra* note 55, at 130; See also Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151, 1157 (1981).

71. See Richard L. Doernberg, *The U.S.-India Income Tax Treaty: Breaking New Ground in Taxing Services Income from Licensing Technology*, 44 TAX LAW. 735, 738-39 (1991). For an early example of this conflict, see *supra* note 27.

72. Compare art. 5(3)(a) of the United Nations Model Treaty which provides that a building site, construction or installation project shall constitute a permanent establishment only if it lasts for more than 6 months with art. 5(3) of the U.S. Model Treaty which provides that a building site, construction or installation project constitutes a permanent establishment only if it lasts for more than 12 months. United Nations Double Taxation Convention Between Developed and Developing Countries, 1980, 1 TAX TREATIES (CCH) para. 206. [hereinafter U.N. Model Treaty], and United States Model Income Tax Convention, 1996, 1 TAX TREATIES (CCH) para. 214 (Sept. 20, 1996) [hereinafter U.S. Model Treaty].

73. See generally Doernberg, *supra* note 71.

74. See Mitchell B. Carroll, *The Development of International Tax Law: Franco-American Treaty on Double Taxation—Draft Convention on Allocation of Business Income*, 29 J. INT'L L. 586-87 (1935); and the first congressional debate on the foreign tax credit, *supra* note 21.

75. See *supra* note 10.

Regulations dispels any notion that these objectives have been even remotely achieved.<sup>76</sup>

### III.

#### APPLICATION OF INTERNATIONAL TAX POLICY OBJECTIVES TO INTERNATIONAL PARTNERSHIPS

The international tax policies discussed in the preceding section often have not been taken into account when a U.S. taxpayer conducts business in a foreign country through a partnership. Partnerships, because of their dual nature as aggregates and entities and because of their susceptibility to being characterized by different countries as either fiscally transparent or fiscally opaque, often raise issues in the international context to which there is no readily apparent resolution. However, a firm understanding of U.S. international tax policy objectives and an analysis of international partnership issues in the context of such objectives can clarify and provide a principled justification for the resolution of partnership issues.

#### A. *Income Tax Treaties*

##### 1. *General Issues in the Treatment of Partners and Partnerships*

The application of bilateral income tax treaties to partners and partnerships can be confusing and inconsistent. Confusion can arise because treaty analysis requires careful navigation through technical treaty language. Inconsistency can arise because the language addressing partners and partnerships can differ from treaty to treaty.<sup>77</sup> Furthermore, as discussed below, a new U.S. policy towards partners and partnerships appears to be evolving. The 1996 U.S. Model Treaty, which is intended to provide a "basic explanation" of U.S. treaty policy,<sup>78</sup> is a good starting point for discussion of this issue.

The U.S. Model Treaty provides that in general the Treaty shall apply only to persons who are residents of one or both of the Contracting States.<sup>79</sup> Thus, application of the U.S. Model Treaty to a particular enterprise requires the enterprise to be classified as both a "person" and as a "resident." The U.S. Model Treaty provides that the term "person" includes a partnership.<sup>80</sup> The U.S. Model Treaty provides in relevant part that the term "resident of a Contracting State" means any person who, under the laws of that state, is liable to tax therein

76. See James S. Eustice, *Commentary to Toward a New Tax Treaty Policy for a New Decade*, 9 AM. J. TAX POL'Y 101, 102 (1991) ("The United States has exercised undeniable leadership, if that is the word, in drafting complex, microregulatory, anti-abuse driven statutory provisions in the international arena that are second to none.")

77. For a history of the variances in U.S. treaty policy towards partners and partnerships, see COMMITTEE ON TAXATION OF INTERNATIONAL TRANSACTIONS OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, U.S. TAX TREATMENT OF PARTNERSHIPS AND PARTNERS UNDER U.S. INCOME TAX TREATIES, 95 TNT 154-22 [hereinafter, NEW YORK CITY BAR REPORT].

78. U.S. Model Treaty, *supra* note 72, preamble.

79. *Id.* at art. 1(1).

80. *Id.* at art. 3(1)(a).



by reason of his domicile, residence, citizenship or similar criterion.<sup>81</sup> Thus, it appears that a partnership would not be considered a resident of a Contracting State, and thus not be entitled to treaty benefits since a partnership itself is not liable to tax. However, in determining whether a particular partner is entitled to treaty benefits the U.S. Model Treaty states:

[A]n item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.<sup>82</sup>

Thus, income derived through an entity that either Contracting State considers a partnership is considered derived by a resident, and thus it is accorded treaty benefits, but only to the extent that the income is treated by the *partner's* state as the income of a resident. An example provided in the technical explanation to this provision provides that if a U.S. corporation distributes a dividend to an entity that is treated as fiscally transparent in the other state, the dividend will be considered to be derived by a resident of that state to the extent that the taxation law of that State treats the residents of that State as deriving the income for tax purposes.<sup>83</sup>

The U.S. Model Treaty is an improvement over the previous Model Treaty, issued in 1981, which provided that in the case of income derived or paid by a partnership, the term "resident of a Contracting State" applies only to the extent that the income derived by the partnership is subject to tax in that State as the income of a resident either in its hands or in the hands of its partners and beneficiaries.<sup>84</sup> Thus, it appears that under the previous Model Treaty a partnership was entitled to benefits to the extent that its partners were subject to taxation on the basis of their residence. This wording is curious since partnerships were entitled to treaty benefits even though under U.S. principles partnerships do not pay tax.<sup>85</sup> The present U.S. Model Treaty corrects the inconsistency by treating a partner as a resident of a contracting state, and thus as entitled to treaty bene-

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81. *Id.* at art. 4(1).

82. *Id.* at art. 4(1)(d).

83. *Id.* at technical explanation to art. 4(1). Thus, presumably dividend income remitted by a U.S. corporation to a country X entity that was treated by country X as a partnership would be entitled to the reduced withholding rate under the U.S./Country X Treaty to the extent such dividend income was allocable to partners who were tax residents of country X and country X tax law treated such income as income of the country X resident partners. Partners who were residents of country Y would not be entitled to the benefits of the U.S./Country X treaty, but presumably would be entitled to the benefits of the U.S./Country Y treaty to the extent that country Y law viewed the country X entity as a partnership and treated such income as income of the country Y resident partners. If country Y viewed the entity receiving the dividends as a corporation, and thus the country Y resident partners' allocable share of the dividend income was not treated under country Y law as income of a resident (but instead was treated as income of the entity), then the U.S./Country Y income tax treaty presumably would not apply.

84. UNITED STATES DEPT. OF THE TREASURY MODEL INCOME TAX TREATY, June 16, 1981, 1 TAX TREATIES (CCH) para. 211 (withdrawn in 1992) [hereinafter PREVIOUS U.S. MODEL TREATY].

85. See also the discussion of this issue in the New York City Bar Report. The Report questions whether entitlement to treaty benefits should be determined at the partnership level since it is often difficult to determine the country of a partnership's residency and treaty benefits might be denied in cases where one country views the entity at issue as a partnership and the other country

fits, only to the extent that the items of income derived through a partnership are treated by the partner's state as income of a resident.<sup>86</sup>

Because income derived through a partnership is treated as income of a resident only to the extent the income is so treated by the partner's country of residence, the U.S. Model Treaty essentially states that *foreign* entity characterization rules govern.<sup>87</sup> The Model Treaty thus marks a trend in U.S. policy on the issue, since recently proposed U.S. withholding tax regulations instruct U.S. withholding agents to look to the characterization of an entity under foreign law in determining whether to apply the U.S. statutory withholding tax rate or a reduced treaty rate on a payment to a foreign person.<sup>88</sup> This approach, as discussed below, is also consistent with U.S. international tax policy.

As a general matter, U.S. bilateral income tax treaties (which as of the date of publication all predate the U.S. Model Treaty) are not as explicit as the U.S. Model Treaty in stating whether U.S. or foreign law should be consulted in determining the classification of an entity for the purpose of determining whether a particular item of income should be treated as income of a resident. U.S. bilateral treaties are generally consistent with the old Model Treaty in providing that a partnership (however determined) is entitled to treaty benefits to the extent that its income is attributable to partners who are tax residents of such country.

For example, the Treasury Department's Technical Explanation to the U.S./Italy Treaty provides that a domestic partnership which earns income in Italy and is comprised of two U.S. partners and two partners from a third country will be considered as a U.S. resident to the extent of the income attributable to the U.S. partners. The Technical Explanation goes on to state that, "[t]reaty benefits, such as reduced withholding rates on dividends and interest, need not be extended by Italy to income passed through the partnership to the nonresident partners."<sup>89</sup> Thus, under the Technical Explanation only the U.S. resident partners of a domestic partnership which derives Italian source income will be entitled to the benefits of the U.S./Italy Treaty. The Technical Explanation does not address how non-U.S. partners should be treated. Presumably, if a non-resident partner's country of residence has a treaty with Italy and the nonresident part-

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views the entity at issue as a corporation. NEW YORK CITY BAR REPORT, *supra* note 77, at sections V.A & B.

86. See *supra* text accompanying note 82.

87. See *supra* note 83, discussing the inapplicability of treaty benefits where country Y treats the entity at issue as a corporation.

88. See *infra* text accompanying note 115.

89. TREASURY DEPARTMENT TECHNICAL EXPLANATION TO THE U.S./ITALY INCOME TAX TREATY (1984), 2 TAX TREATIES (CCH) para. 4850. The technical explanations to other treaties use slightly different language to convey the same concept. For example, the Technical Explanation to the U.S./Spain Treaty provides, "if a resident of Spain and a resident of a third state form a partnership, and the partnership derives dividends from the United States, the limitation on U.S. withholding taxes . . . applies only to the share of dividends attributable to the partner resident in Spain." TREASURY DEPARTMENT TECHNICAL EXPLANATION TO THE U.S.-SPAIN TREATY (1990), 3 TAX TREATIES (CCH) para. 8425.

ner's country views the entity as fiscally transparent, then that treaty should apply.

An alternative approach has appeared in U.S. income tax treaties with countries which view partnerships as pure conduits. The U.S./Netherlands Treaty, for example, does not include a partnership in its definition of the term "person" and does not incorporate special language about partnerships in its definition of the term "resident."<sup>90</sup> Apparently the Treaty drafters believed that in cases where both countries view partnerships as pure conduits it was more or less self-evident that treaty entitlement should be determined by looking through to the partners. The Technical Explanation to the U.S./Netherlands Treaty provides, "a partnership would not be considered a resident of a treaty country under this article. Only the residence and the income of its partners would be relevant under the proposed treaty."<sup>91</sup> Like the Technical Explanation to the U.S./Italy Treaty, this language suggests that a partner who is a resident of a third country would not be entitled to the benefits of the U.S./Netherlands Treaty.<sup>92</sup>

The treatment of partners and partnerships in the OECD Model Treaty is deliberately unclear. Like the U.S. Model, the OECD Model provides that the treaty applies to persons who are residents of one or both of the Contracting States.<sup>93</sup> Unlike the U.S. Model, which includes a partnership in its definition of "person," the OECD Model ambiguously provides that the term "person" includes an individual, a company and "any other body of persons."<sup>94</sup> The Commentary to the OECD Model justifies this ambiguity by stating that the domestic laws of the OECD Member countries differ in their tax treatment of partnerships and that these differences can have disparate effects on the application of the convention to partnerships.<sup>95</sup> The Commentary states that if a partnership is treated as a taxable unit, it is reasonable to entitle the partnership to invoke the Convention. The Commentary does not suggest how to deal with

90. U.S./NETHERLANDS INCOME TAX TREATY (1992), 2 TAX TREATIES (CCH) para. 6103.

91. TREASURY DEPARTMENT TECHNICAL EXPLANATION TO THE U.S./NETHERLANDS INCOME TAX TREATY (1992), 2 TAX TREATIES (CCH) para. 6121.

92. Note also that with respect to limited liability companies that are treated as partnerships for U.S. tax purposes, the U.S. Treasury has stated that treaty benefits are available only to the extent that the income derived by such limited liability companies is subject to tax in the hands of its members. See TREASURY DEPARTMENT TECHNICAL EXPLANATION TO THE U.S./FRANCE INCOME TAX TREATY (1994), 2 TAX TREATIES (CCH) para. 3058 ("Subparagraph 2(b)(iv) [of the Treaty] further clarifies that the definition of 'resident of a contracting state' includes a partnership or similar pass-through entity . . . but only to the extent that the income derived by such entity is subject to tax in the hands of its partners . . . . A U.S. limited liability company, for example would be a 'similar pass-through entity' for this purpose."). The technical explanation to the U.S. Model Treaty provides that U.S. limited liability companies that are treated as partnerships for U.S. tax purposes are treated as "fiscally transparent entities" for the purposes of the Treaty. See TECHNICAL EXPLANATION to art. 4(1).

93. OECD MODEL TREATY, *supra* note 18, art. 1.

94. *Id.* at art. 3(1)(a).

95. *Commentary to OECD MODEL TREATY*, *supra* note 69, at art. 1, para. 2-6.

partnerships that are treated as fiscally transparent.<sup>96</sup> The Commentary concludes by stating, "The opinions of OECD Member countries differ too much and . . . it is extremely difficult to find a uniform solution which would be acceptable to all or even to the great majority of Member countries. The Convention does not, therefore, contain any special provisions relating to partnerships."<sup>97</sup>

The Commentary to the OECD Model Treaty reflects the difficulty of drafting a uniform rule when the characterization of an entity as a partnership or as a corporation varies from country to country. Suppose that a domestic partnership composed entirely of U.S. resident partners is viewed as a fiscally opaque entity under the laws of a foreign country. Under U.S. principles, treaty benefits should flow through the partnership to the U.S. resident partners: if the partnership receives dividends from an Italian corporation, for example, U.S. principles would entitle the partners to invoke the U.S./Italy treaty and be entitled to the lower, treaty-mandated withholding tax rate. However, if Italy applies its internal laws and treats the entity as a corporation, it could conclude that because the entity is not subject to U.S. residence-based taxation, it is not a "resident of a contracting state," and thus neither the entity nor its partner/shareholders is entitled to treaty benefits.

Various commentators have offered solutions to this issue. Richard Lowengard has argued that the nature of an entity for treaty purposes should be determined according to the laws of the entity's residence.<sup>98</sup> Accordingly, in determining whether U.S./Italy treaty should apply in the above example, Italy, despite its characterization of the entity as a corporation, should respect U.S. characterization of the entity as a partnership and extend treaty benefits to the individual partners, at least to the extent that they are U.S. residents. The American Law Institute also suggested this as a possible solution.<sup>99</sup> A report prepared by the New York City Bar Association similarly advocated that where a partnership is treated as fiscally transparent by the other contracting state, the U.S. should look to the residence of the partners in determining entitlement to treaty benefits, and where a partnership is treated as a taxable entity by the other contracting state, the U.S. should extend treaty benefits to the entity itself.<sup>100</sup> As discussed above, the present U.S. Model Treaty provides that the law of a partner's country of residence should be consulted to determine whether a particular item of income attributable to such partner is considered as income of a resident.<sup>101</sup>

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96. But see the Commentary to the 1963 OECD DRAFT CONVENTION (suggesting that if a partnership is treated as a conduit, application of treaty benefits should be determined by looking through the partnership to the residence of the partners). See *id.* at art. 3, para. 6.

97. See *id.* at art. 1, para. 6.

98. Richard O. Loengard, *Tax Treaties, Partnerships and Partners: Exploration of a Relationship*, 29 TAX LAW. 31, 49-50 (1971).

99. AMERICAN LAW INSTITUTE, INTERNATIONAL ASPECTS OF U.S. INCOME TAXATION II 245-46 (1992).

100. NEW YORK CITY BAR REPORT, *supra*, note 77.

101. See *supra* text accompanying note 82-83.

Another approach, which conflicts with current U.S. policy, would create the fiction that partnerships are taxpaying entities for treaty purposes. Accordingly, a partnership would be treated as a resident of a Contracting State and would be entitled to treaty benefits (assuming that a treaty's definition of "person" includes a partnership). The partnership's treaty benefits, like its income, would flow through to the individual partners. Thus, in the above example, Italy would be required to treat the entity as a resident of the U.S. and extend treaty benefits to the entity. Treaty benefits would flow through to the individual partners, whether or not they were U.S. residents. This approach could be abused if residents of a particular country use a domestic partnership to obtain the benefits of a treaty between the U.S. and a third country.<sup>102</sup> This form of abuse could be cured through a limitation of benefits article, or alternatively, but less efficiently, through the courts of the aggrieved country.<sup>103</sup>

A different approach to the treatment of partners and partnerships would view treaty entitlement in the context of international tax policy. Under this approach treaty entitlement would be conditioned on the fulfillment of a policy objective rather than a successful performance of the technical gymnastics necessary to interpret current treaties. The results reached by this approach, while not necessarily inconsistent with the results reached by many of the approaches discussed above, would be integrated with the economic and equity-based principles underlying international tax policy. This approach is best illustrated by analyzing treaties' business profits and withholding tax articles.

## 2. *Business Profits*

The business profits article of a bilateral income tax treaty requires the source state to refrain from taxing the business profits of a resident of the other Contracting State if the profits are not attributable to a permanent establishment in the source state.<sup>104</sup> As discussed in section II, *supra*, implementation of the simplest and purest form of capital export neutrality would require all countries to tax the worldwide income of their own residents but refrain from taxing income earned within their borders by nonresidents. The business profits article, by requiring the source state to relinquish its right to tax nonresidents, applies this form of capital export neutrality to a limited extent. If the business profits

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102. See *supra* discussion of limitation on benefits articles at text accompanying notes 62-65.

103. The Swiss Bundesgericht reached such a result in 1987. In the case at issue, four West German resident individuals were the sole partners in a Swiss partnership which owned all the shares in a Swiss corporation, which in turn owned stock in a Portuguese corporation. The partners sought application of the Portugal/Switzerland Treaty which provides for a reduced withholding tax rate on dividends remitted by a Portuguese company of which at least 25% of the stock is held by a Swiss company. Despite the fact that this provision technically applied to the Swiss corporation, the Portuguese government withheld dividends at the higher, nontreaty rate. The Swiss Bundesgericht agreed with the Portuguese government's action. It held that that Switzerland and Portugal would probably not have agreed to limit their withholding tax rates on dividends in a case where neither the Swiss entity seeking treaty benefits nor its shareholders was subject to Swiss tax. The Court also stated that it would be exceptional to assume that a person, who is a resident of a third state, is also a resident of Switzerland merely because he is a partner in a Swiss partnership. See Boekhorst, *The Abuse of Tax Treaties*, 29 *EUROPEAN TAXATION* 339 (1989).

104. See *supra* text accompanying note 18.

article is viewed as an instrument of capital export neutrality, then it could be fairly stated that treaty partners have made mutual commitments to refrain from taxing income which is subject to residence-based taxation and not derived in the source country through a permanent establishment. By viewing the business profits article in this manner, the technicalities of who earns or is the beneficial owner of the income become less important. The more important issue is whether one of the Contracting States subjects the income at issue to residence-based taxation. If this is the case, then regardless of who is viewed as earning or beneficially owning the income, the source country should be obligated to apply the business profits article.

For example, suppose an Italian partnership composed entirely of Italian resident partners earns U.S. source income which is not attributable to a permanent establishment in the U.S.<sup>105</sup> Regardless of whether the U.S. views the Italian entity as a partnership or a corporation, the partners, by virtue of their residence in Italy, presumably would be subject to Italian residence-based tax on the U.S. source income. Accordingly, the U.S. effectively connected income should receive protection under the business profits article of the U.S./Italy Treaty. *See* Example A. This result would be consistent with capital export neutrality since the U.S. source income would be taxed only by Italy (the residence country) and at Italian tax rates. The Italian partners should be tax indifferent as to whether they earn the income at issue in the U.S. or in Italy.

This approach also can be applied to partnerships which are composed of partners resident in different states. Suppose an Italian partnership has one Italian-resident partner and one Japanese-resident partner. If the partnership earns U.S. effectively connected income which is not attributable to a permanent establishment in the U.S., the Italian partner, by virtue of her residence in Italy, presumably would be subject to Italian residence-based tax on her share of the income. Thus, the Italian partner should be able to invoke the business profits article of the U.S./Italy Treaty. The Japanese partner, however, should not receive the benefits of the U.S./Italy Treaty because she presumably would not be subject to Italian residence-based tax on her share of the income. If the Japanese partner is subject to Japanese residence-based tax on her share of the income, then she should be able to invoke the business profits article of the U.S./Japan Treaty.<sup>106</sup> *See* Example B. If a partner in the Italian partnership were a resident of a country which did not have a treaty with the U.S. (Hong Kong, e.g.), then

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105. Absent treaty protection, effectively connected income earned by a nonresident alien individual or a foreign corporation engaged in a U.S. trade or business is subject to U.S. tax. *See* I.R.C. § 871(b) (1986) (for nonresident alien individuals) and § 882(a) (1986) (for foreign corporations).

106. If Japan views the Italian entity as a corporation, and the Japanese partner accordingly is not subject to residence-based taxation on the U.S. effectively connected income, then under this approach, the U.S./Japan Treaty should not apply. *See* Example C. This situation would be more common where the intermediate entity is formed in a tax haven country. For example, if a Japanese individual invested in a Cayman Islands corporation which conducted business in the U.S., the U.S./Japan Treaty should not apply if the Cayman Islands viewed the entity as fiscally transparent and Japan viewed the entity as fiscally opaque.

that partner should not receive any treaty protection, and should be taxed by the U.S. on her share of the U.S. effectively connected income.<sup>107</sup>

What about the situation where Italy treats the entity as a corporation and the U.S. treats the same entity as a partnership? In this case, profits earned in the U.S. would be subject to residence-based taxation in Italy, and thus the U.S./Italy Treaty should apply even if under U.S. law the corporation would not be subject to tax. Subject to any applicable limitation on benefits article, the U.S./Italy Treaty should apply regardless of the residency of the corporation's shareholders. See Example D. Again, this result would be consistent with capital export neutrality because profits earned in the U.S. which are not attributable to a U.S. permanent establishment will be subject to Italian residence-based taxation, at Italian corporate rates. The Italian corporation should be tax indifferent as to whether it earns the profits at issue in the U.S. or in Italy.

The same principles should apply in an outbound situation. Suppose a U.S. partner holds an interest in an Italian entity which the U.S. and Italy view as a partnership and which earns income in Japan. In this case, the U.S. partner would not be subject to Italian residence-based tax on the Japanese source income, and thus should not be able to apply the business profits article of the Japan/Italy Treaty. The U.S. partner, however, would be subject to U.S. residence-based tax on the income, and thus should be able to invoke the business profits article of the U.S./Japan Treaty. Italian resident partners would be subject to Italian residence-based tax on the Italian source income, and thus should be able to invoke the business profits article of the Japan/Italy Treaty. See Example E. Both the U.S. and Italian partners should be tax indifferent as to whether they earn the income at issue in Japan due to the application of their countries' respective income tax treaties with Japan.

### 3. *Dividends, Interest and Royalties*

In bilateral income tax treaties, the source country usually agrees to reduce or eliminate withholding tax on remittances of dividends, interest and royalties to a resident of the treaty partner country.<sup>108</sup> Dividends paid by a subsidiary which is a resident of the source country to a parent corporation incorporated in the residence country, and which owns a certain amount of stock in the subsidiary, are often subject to an even lower rate of withholding than the regular treaty rate.<sup>109</sup> Treaties have characterized these concessions by the source country as a means of reducing double taxation and facilitating international investment.<sup>110</sup>

107. But see AMERICAN LAW INSTITUTE, *supra* note 99, at 145-46 which provides that the permanent establishment exemption is intended to avoid administrative and compliance burdens in cases where the level of economic penetration in the source jurisdiction is not substantial, and that a look-through rule could defeat such an objective.

108. See, e.g. OECD MODEL TREATY, *supra* note 18, arts. 10(2)(b), 11(2) and 12(1), which provide for withholding rates on dividends, interest and royalties at 15, 10 and 0 percent, respectively.

109. See OECD MODEL TREATY, *supra* note 18, art. 10(2)(a) (requiring ownership of at least 10% of the subsidiary's voting stock).

110. See *Commentary to OECD MODEL TREATY*, *supra* note 69, art. 10, paras. 9-10.

The source country's concessions also can be viewed as a means of implementing capital export neutrality, since reduced withholding tax rates are an example of the source country relinquishing its right to tax income earned within its borders by nonresidents.<sup>111</sup> If the reduction or elimination of withholding taxes is viewed as an instrument of capital export neutrality, then like the analysis of the business profits article, *supra*, the important issue is not how partners and partnerships are treated under technical treaty language, but instead whether one of the contracting states subjects the income at issue to residence-based taxation. The U.S. Model Treaty and recently-proposed U.S. withholding tax regulations would produce results that are consistent with this principle.<sup>112</sup>

Suppose, for example, that an Italian partnership consisting entirely of non-corporate partners who are Italian residents receives dividends from a U.S. source. Regardless of whether U.S. law views the entity as a partnership or corporation, the dividend income received by the Italian partners would be subject to Italian residence-based taxation. Accordingly, a result consistent with capital export neutrality would require the amount of U.S. withholding tax to be determined in accordance with the U.S./Italy Treaty. See Example A. The dividends would be subject to Italian residence-based taxation at non-corporate rates. Thus, even if the partnership's wholly-owned subsidiary remitted the dividends, the U.S. should tax the dividend income at the reduced treaty rate for nonincorporated shareholders.<sup>113</sup>

If the Italian partnership earned U.S. source dividends and had a Japanese non-corporate partner, the Japanese partner would not be subject to Italian residence-based taxation on her share of the dividend income, but (assuming that Japan viewed the entity as fiscally transparent) presumably would be subject to Japanese residence-based taxation on the income. Accordingly, the withholding rate in the U.S./Japan Treaty, rather than the withholding rate in the U.S./Italy Treaty, should apply with respect to the Japanese partner's share of the dividend income.<sup>114</sup> See Example B. Again, this result is consistent with capital export neutrality since the income at issue is subject to Japanese residence-based taxation. This result is also equitable to the source state since the U.S. would reduce its source-based taxation on income which is subject to Japanese residence-based taxation at the rate agreed to by the U.S. and Japan.

111. Note that Frisch, who questions the continued relevance of the capital export neutrality/capital import neutrality models with regard to the taxation of international business income, nevertheless believes that capital export neutrality is the correct policy to apply to international portfolio investment. "From the point of view of worldwide efficiency, there would seem to be no reason for tax rules to distort the decisions of portfolio investors . . . . Thus, the best tax regime would seem to be one that taxed investors the same whether they chose the foreign or domestic security. In short the CEN [capital export neutrality] approach can be resuscitated as a solid basis for taxation of income from portfolio investments. Frisch, *supra* note 14, at 587.

112. See Prop. Treas. Reg. §§ 1.1441-1 & 1.1441-6 (Apr. 22, 1996), further discussed *infra*.

113. Even if U.S. law viewed the Italian partnership as a corporation, the dividend income would be subject to Italian tax at Italian noncorporate rates. Thus, it would be consistent with the analysis for the noncorporate withholding rate to apply. Accord Loengard, *supra* note 98, at 51-52.

114. See the discussion at *supra* note 106, stating that the U.S./Japan Treaty should not apply in cases where Japan does not treat the entity as fiscally transparent. See also Example C.



If the Italian entity were treated by Italy as a corporation, then regardless of U.S. treatment, the dividends presumably would be subject to Italian residence-based, corporate taxation. Accordingly, subject to a limitation of benefits article, the U.S./Italy Treaty should apply. *See* Example D. This result is consistent with recently proposed withholding tax regulations which provide that in determining whether to apply an income tax treaty, U.S. withholding agents should look to the principles of the foreign country to determine whether the entity or the persons holding an interest in that entity are required to include the amounts at issue in income.<sup>115</sup> In addition, because the Italian entity is subject to Italian corporate taxation, the reduced corporate withholding rate under the U.S./Italy Treaty should apply if the Italian entity holds the requisite amount of stock in the U.S. entity remitting the dividend.

An interesting scenario arises where the Italian corporation has a shareholder who is a resident of a non-treaty country, and the Italian corporation is viewed by the non-treaty country as fiscally transparent. In this case, the non-treaty shareholder's distributive share of the U.S. source dividend would be subject to residence-based taxation both in Italy and in the non-treaty country. Since the income at issue would be subject to residence-based taxation in two countries, a policy consistent with capital export neutrality would permit either country's arrangement with the U.S. to apply. *See* Example F. In this case, the U.S./Italy arrangement is more favorable, and thus it presumably would be applied. The proposed withholding tax regulations permit the U.S. withholding agent to decide which arrangement to apply,<sup>116</sup> and thus they are consistent with capital export neutrality to the extent that the U.S. withholding agent applies the arrangement most favorable to the taxpayers at issue.

The same principles should apply in an outbound situation. If a U.S. corporation receives an Italian source dividend, then regardless of whether Italy views the entity as a corporation or a partnership, the entity will be subject to residence-based taxation in the U.S. Thus, subject to any limitation on benefits article, the U.S./Italy Treaty should apply. *See* Example G. If the U.S. corporation holds the requisite amount of stock in the Italian entity remitting the dividend, then the reduced corporate dividend withholding rate under the U.S./Italy Treaty should apply.<sup>117</sup> Similarly, if a U.S. partnership receives an Italian source dividend, the U.S./Italy Treaty should apply only with respect to the amount of the dividend income allocated to the partnership's U.S. resident partners. *See* Example H.

115. *See* Prop. Treas. Reg. §§ 1.1441-1(c)(6)(ii)(B) & 1.1441-6(b)(4)(v), Example 1 (Apr. 22, 1996).

116. *See* Prop. Treas. Reg. § 1.1441-6(b)(4)(v), Example 2.

117. Even if Italian law viewed the U.S. entity as a partnership, the dividend income would be subject to U.S. tax at U.S. corporate rates. Thus, it would be consistent with the analysis for the corporate withholding rate to apply. *Cf. supra* note 113.

### B. Foreign Tax Credit

As discussed above, the general objective of the U.S. foreign tax credit rules is to promote the efficient worldwide allocation of capital without sacrificing tax revenue collected from U.S. source income. In general, this policy results in a U.S. resident taxpayer being subject to the greater of the U.S. tax rate or the foreign tax rate on an item of foreign source income. Application of this policy can become obscured, however, when a U.S. resident taxpayer conducts business in a foreign country through an entity which at least one of the countries views as a partnership.

If the U.S. views an entity as a partnership for tax purposes, then the U.S. resident partners will be subject to a single level of tax on their allocable share of the partnership's income. In this case, the policy underlying the foreign tax credit suggests that the U.S. resident partners should be able to credit the foreign taxes which they might pay in their individual capacities and any foreign taxes which might be paid by the partnership as an entity. If a domestic corporation is viewed by a foreign country as a partnership, then the income earned by the entity will be subject to tax at the shareholder/partner level in the foreign country and to U.S. tax at the corporate level and at the shareholder level if and to the extent that dividends are paid. This dichotomy raises issues as to whether the corporation or the shareholders should be able to credit the foreign tax and to what extent the credit should apply. If the U.S. views a foreign entity as a corporation and the foreign country views the entity as a partnership, U.S. policy suggests that U.S. shareholders should receive a foreign tax credit when dividends are remitted, but not earlier.

#### 1. *Entity, Whether U.S. or Foreign, Treated By Both the U.S. and the Foreign Country as a Partnership*

If a U.S. resident invests in an entity which is treated by both the U.S. and the foreign country as a partnership, then for both U.S. and foreign tax purposes the entity's income will be viewed as flowing through to the U.S. partner. The U.S. partner will pay tax in the foreign country on her proportionate share of the partnership's income and will be eligible to credit her foreign tax liability against her U.S. tax burden.<sup>118</sup> This result is consistent with the policy underlying the foreign tax credit. Example 1.1 assumes that the partner's share of the partnership's income is \$100, and the partner pays foreign tax at a 20% rate and U.S. tax at a 40% individual rate. Under the U.S. partnership and foreign tax credit limitation rules, the partner could credit the entire \$20 of foreign tax against the \$40 it pays in U.S. tax.<sup>119</sup> Accordingly, the U.S. partner's total tax burden on the \$100 would be \$40, which is the greater of the U.S. tax rate or the foreign tax rate. The partner should be tax neutral as to whether the partnership invests in the U.S. or the foreign country.

118. See I.R.C. §§ 702(a)(6) (1986) & 901(b)(5) (1986).

119. See *id.*

Example 1.2 assumes the same facts as Example 1.1, except that the partner pays foreign tax at a 50% rate. In this case the partner would pay \$50 of foreign tax and could credit \$40 of the foreign tax against her U.S. tax burden. Accordingly, the U.S. partner's total tax burden on the \$100 would be \$50, which again is consistent with U.S. policy to tax an item of foreign source income at the greater of the U.S. rate or the foreign rate.

## 2. *Entity Treated by the U.S. as a Partnership and the Foreign Country as a Corporation*

If a U.S. resident taxpayer invests abroad through an entity which is treated by the U.S. as a partnership and by the foreign country as a corporation, then it would be consistent with U.S. tax principles if the U.S. partners were able to credit both the entity level of tax and the partner/shareholder level of tax imposed by the foreign country. In this situation U.S. law follows U.S. tax policy. In *Arundel Corporation v. United States*,<sup>120</sup> two Maryland corporations formed a joint venture which conducted business in Puerto Rico. The U.S. treated the joint venture as a partnership, and accordingly imposed a single level of tax on the joint venturers in their individual capacities. Puerto Rico viewed the joint venture as a corporation, and accordingly taxed both the joint venture itself and the joint venturers on distributions. The issue was whether the U.S. joint venturers could claim a direct foreign tax credit for the foreign tax imposed at the joint venture level.<sup>121</sup>

The court stated that notwithstanding Puerto Rican concepts, U.S. law must determine whether the joint venturers were the taxpayers of the joint venture-level tax. The court stated that under U.S. principles the Puerto Rican tax was imposed in two separate levies on the joint venturers—one levy nominally imposed on the entity, and another levy imposed upon the respective distributive shares of the joint venturers—and that the individual joint venturers actually were subject to and paid both levies. Thus, the court held that the joint venturers could claim a direct foreign tax credit for the entity level tax.

By enabling the joint venturers to credit both levels of foreign tax, *Arundel* produces a result which is consistent with the principles underlying the foreign tax credit. Example 2.1 assumes that an entity is treated by the U.S. as a partnership and by the foreign country as a corporation. It also assumes foreign tax rates of 10% at both the entity and partner/shareholder levels, and a U.S. tax rate of 40% at the partner/shareholder level. Under *Arundel*, the partner/shareholder pays \$19 of foreign tax on \$100 of income (\$10 of tax at the corporation level and \$9 of tax on the \$90 remaining for distribution to the partners/shareholders, for a 19% effective rate). The partner/shareholder pays \$40 of U.S. tax, against which it can credit the full \$19 of foreign taxes. Thus, the partner's/shareholder's total tax burden is \$40: \$19 of foreign tax and \$21 of U.S. tax. The partner's worldwide effective tax rate on the \$100 of income is the U.S. rate of

120. 102 F. Supp. 1019 (Cl. Ct. 1959).

121. The Service conceded that the joint venturers could claim a direct foreign tax credit with respect to the shareholder/partner level of foreign tax. *Id.* at 1022.

40% which is consistent with the capital export neutrality objective of the foreign tax credit.

Example 2.2 assumes foreign tax rates of both 30% at the corporate and partner/shareholder levels. Under *Arundel*, the partner pays \$51 of foreign tax on \$100 of income (for a 51% effective rate). The partner pays \$40 of U.S. tax against which it can only credit \$40 of the foreign taxes. Thus, the partner's total tax burden is \$51: \$51 of foreign tax and \$0 of U.S. tax. The partner's worldwide effective tax rate on the \$100 is the foreign rate of 51% which is consistent with U.S. policy neither to credit foreign taxes paid in excess of the U.S. rate, nor to produce double taxation.

If *Arundel* had held that the joint venturers were not able to credit the entity level tax, the result would have been inconsistent with U.S. tax principles. Example 2.3 again assumes foreign tax rates of 10% at both the corporate and partner/shareholder levels. In this case the partner pays \$19 of Puerto Rican tax on \$100 of income but can only credit the \$9 of partner/shareholder level tax against \$40 of U.S. tax. Thus, the partner's total tax burden is \$50: \$19 of foreign tax and \$31 of U.S. tax. The partner's worldwide effective tax rate on the \$100 of income is 50%, which is in excess of the U.S. rate of 40%. Under normal U.S. tax rules, the partner's worldwide effective rate should be 40% since the effective foreign rate is below 40%. Thus, this treatment would produce a result that is inconsistent with U.S. principles.

The same result holds if the combined effective foreign tax rate is higher than the U.S. rate. Like Example 2.2, Example 2.4 assumes foreign tax rates of 30% at both the corporate and partner/shareholder levels. The partner pays \$51 of foreign tax on \$100 of income, but can only credit the \$21 of partner/shareholder level tax. The partner is assessed \$40 of U.S. tax. Thus, the partner's total tax burden is \$70: \$51 of foreign tax and \$19 of U.S. tax. The partner's worldwide effective tax rate on the \$100 is 70%, which exceeds the foreign effective rate of 51%. Under normal U.S. tax rules, the partner's worldwide effective rate should not exceed the foreign rate. Thus, this treatment would result in double taxation.

### 3. *Domestic Corporation Treated by the Foreign Country as a Partnership*

The tax treatment of individual shareholders of domestic corporations that are viewed by foreign countries as partnerships is problematic. When a domestic corporation is treated by a foreign country as a partnership, foreign tax is imposed on the shareholders/partners, and U.S. tax is imposed on the entity itself, and again on the shareholders when the corporation distributes its profits as dividends. In Rev. Rul. 72-197,<sup>122</sup> the Service ruled that the individual shareholders, and not the corporation, were entitled to credits for the proportionate share of foreign taxes they paid. While the ruling is correct as a matter of statu-

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122. 1972-1 C.B. 215.

tory interpretation,<sup>123</sup> it raises a number of issues with respect to U.S. international tax policy.

The discussion of these issues will be informed by a base case example. Example 3.1 assumes that a domestic corporation earns \$100 of U.S. source income, the U.S. corporate tax rate is 35% and the U.S. individual tax rate is 40%. In this case, the corporation pays \$35 of tax on the \$100 of income, and the shareholder pays \$26 in tax on the \$65 that remains for distribution. The shareholder receives \$39 net after tax, for an effective combined corporate/shareholder rate of 61%. Since the general purpose of the foreign tax credit is to make a U.S. person tax-indifferent as to where he invests (up to a level of foreign tax equaling the U.S. rate), a U.S. shareholder who is treated by a foreign country as a partner should receive the same after tax return if the corporation earns \$100 of U.S. source or foreign source income.

Example 3.2(a) makes the same assumptions as Example 3.1 except that the corporation earns \$100 of foreign source income, and the shareholder must pay foreign tax on the income at a 40% individual rate. The first issue that arises is the source of the dividend income which the U.S. shareholder receives. Because the corporation is domestic, the dividends remitted by the corporation will be U.S. source income.<sup>124</sup> The foreign tax credit limitation, however, conditions the utilization of foreign tax credits on the receipt of foreign source income. Thus, the shareholder would not be able to apply her foreign tax credits against the U.S. tax imposed on the dividend income. The shareholder would not be able to use the foreign tax credits at all if she had no foreign source income.<sup>125</sup> This is incongruous with U.S. policy which seeks to promote tax indifference as to the worldwide location of investments. The example produces a particularly absurd result because the shareholder's inability to utilize her foreign tax credits would result in a higher worldwide tax burden than the amount of income earned. The corporation would pay \$35 in uncreditable U.S. tax on the \$100 of foreign source income. The shareholder would pay \$26 in uncreditable U.S. tax on the \$65 that remained for distribution and \$40 in foreign tax on the \$100 of foreign source income. The total tax burden would be \$101. Thus, a rule consistent with U.S. policy would grant the shareholder some sort of look-through treatment so that the source of the income does not change from foreign to domestic when it passes through the corporation.

A second issue concerns the amount of foreign source income that the shareholder should be considered as earning. The amount which the corporation remits to the shareholder as a dividend is net of U.S. tax, while the amount on which the U.S. shareholder pays foreign tax is gross of U.S. tax. This disparity could cause the shareholder to pay too much combined U.S. and foreign tax.

123. I.R.C. § 901(b)(1) (1986) provides that U.S. citizens and domestic corporations are allowed to credit the amount of any income, war profits, and excess profits taxes, paid or accrued during the taxable year to any foreign country of possession of the United States. Since the facts of the ruling provided that a U.S. shareholder paid the foreign tax, the ruling is consistent with § 901(b)(1) for the U.S. shareholder to receive the credit.

124. See I.R.C. § 861(a)(2)(A) (1986).

125. See discussion of foreign tax credit limitation at text accompanying notes 28-36.

Example 3.2(b) makes the same assumptions as Example 3.2(a) except that the \$65 remitted as a dividend to the shareholder is considered as foreign source income. In this case the taxpayer's foreign tax credit limitation is \$26. To complete the example, the taxpayer could credit the entire \$26 in U.S. tax on the \$65 of dividend income, but she would still be out of pocket an additional \$14 in foreign tax. Thus, the total tax paid on the \$100 of foreign source income would be \$35 of U.S. corporate tax, \$40 of foreign individual tax, and \$0 of U.S. individual tax, for an effective worldwide tax rate of 75%.

A result more consistent with capital export neutrality would, for purposes of calculating the foreign tax credit limitation, consider the shareholder, in her individual capacity, as earning the full \$100 of foreign source income and paying U.S. tax on the \$100 at her individual tax rate. In this case, as described in Example 3.2(c), the shareholder would receive \$40 of usable foreign tax credits. The shareholder could credit the entire \$26 of U.S. tax imposed on the dividend remittance and be able to apply the additional \$14 of usable credits against other U.S. tax. Thus, the total tax paid on the \$100 of foreign source income would be \$35 of U.S. corporate tax, \$40 of foreign individual tax, \$0 of U.S. individual tax, and \$14 in unutilized U.S. credits. Accordingly, the combined corporate/shareholder rate on \$100 of foreign source income would be 61%, which is equal to the combined corporate/shareholder rate if the corporation earned \$100 of U.S. source income.<sup>126</sup> If the foreign tax rate imposed on the shareholder is higher than 40%, then, consistent with the foreign tax credit limitation rules, the shareholder would not be able to credit the foreign tax imposed in excess of the 40% rate.

An additional issue concerns timing. Suppose a corporation earns \$100 of U.S. source income in year 1, but does not remit a dividend to the shareholder in that year. In this case, the corporation would pay \$35 of U.S. tax in year 1 and the shareholder would pay \$0 of U.S. tax in year 1. Accordingly, the total tax paid in year 1 would be \$35. If the corporation earned \$100 of foreign source income in year 1 and did not remit a dividend to the shareholder in that year, it would pay \$35 of U.S. tax in year 1 and the shareholder would pay \$40 of foreign tax in year 1. If the shareholder could not credit the foreign tax in year 1, the total tax paid in that year would be \$75, as opposed to a total tax burden of \$35 if the \$100 of income were U.S. source.

To achieve a result that is consistent with capital export neutrality, the shareholder should be considered, for foreign tax credit limitation purposes, as earning the \$100 of foreign source income and paying U.S. tax on the income in year 1. If this were the case, then the shareholder's year 1 tax burden on the

126. This result produces a \$5 loss for the U.S. Treasury since the taxpayer receives \$40 of useable foreign tax credits on \$100 of foreign source income, but the Treasury collects only \$35 in tax on the \$100. If the taxpayer paid U.S. tax at a 30% rate, then the Treasury would gain \$5 since it would collect \$35 in tax but only be required to grant \$30 of useable foreign tax credits. If all shareholders, regardless of their individual rates, received \$35 in useable foreign tax credits, then the effect on the Treasury would be neutral, but the decision as to whether the corporation should directly invest in a foreign country would not be tax neutral unless all of the corporation's shareholders paid U.S. tax at a 35% rate.

\$100 of foreign source income (assuming the corporation does not remit a dividend to the shareholder) would be \$35. The corporation would pay \$35 of U.S. tax, the shareholder would pay \$40 of foreign tax, and the shareholder would receive \$40 in usable foreign tax credits which the shareholder could use to offset its U.S. tax on other income.

A final issue concerns the treatment of an actual dividend remitted by the corporation. Since the treatment described in the above example achieves a result which is consistent with capital export neutrality, the shareholder would receive a tax benefit from the corporation's foreign investment if the actual dividend income were considered as foreign source income. Accordingly, the actual dividend should be considered as U.S. source income. Since the amount of a taxpayer's foreign tax credit limitation is dependent only on the amount of foreign source income earned and not on the amount of U.S. source income earned, it is immaterial whether the dividend income and the U.S. taxes paid on the dividend are included in the taxpayer's foreign tax credit limitation calculation.

#### 4. *Foreign Entity Treated by the U.S. as a Corporation and the Foreign Country as a Partnership*

As discussed in section II, when a U.S. person invests in a foreign entity which the U.S. views as a corporation, the predominant policy consideration is capital import neutrality, which is achieved by deferral of U.S. tax on the foreign source income earned by the entity. When a foreign entity is treated by both the U.S. and the foreign country as a corporation, deferral is achieved since the U.S. shareholder is only subject to U.S. tax in the year the entity remits a dividend (assuming the entity does not earn Subpart F income or other income subject to an anti-deferral regime), while the entity is subject to foreign tax in the year it earns income. When the entity is treated by the foreign country as a partnership, the U.S. shareholder also is only subject to U.S. tax in the year in which the entity remits a dividend. However, in this case the U.S. shareholder, in her individual capacity, could be subject to foreign tax in the year in which income is earned.

There are two possible U.S. tax treatments of the above situation. If the shareholder is directly liable for the foreign tax, she could receive a foreign tax credit under section 901 and, assuming she has sufficient foreign source income, immediately credit the foreign tax against U.S. tax imposed on other income. Alternatively, the shareholder could receive a deemed-paid credit under section 902 and credit the foreign tax when the entity remits a dividend. The latter approach is most consistent with U.S. policy objectives.

The direct liability of the U.S. shareholder to foreign tax does not in and of itself violate capital import neutrality. Capital import neutrality can be achieved if either the entity or the individual owner of the entity pays source country tax as long as residence country tax is eliminated, or in the less-perfect case of the U.S., deferred. A section 901 foreign tax credit, which could immediately eliminate or reduce the shareholder's foreign tax liability, does not further any capital import neutrality objective. Regardless of whether the shareholder receives the

section 901 credit, she still would be able to defer U.S. tax on the foreign source income since the U.S. views the entity as a corporation. Thus, the section 901 credit enables the shareholder to receive a potential double benefit—the immediate reduction or elimination of the foreign tax cost and the deferral of U.S. tax.

A section 902 credit is more consistent with U.S. policy. In this case, the taxpayer defers U.S. tax on the foreign source income until the corporation's profits are repatriated as a dividend. When dividends are repatriated, the section 902 credit operates to reduce or eliminate double taxation.<sup>127</sup> Thus, if the entity were located in a low-tax jurisdiction, the entity's business would be able to operate competitively at the source country's low tax rate until profits were repatriated to the U.S. This approach also has been approved by the Seventh Circuit, although the court's reasoning was not based on the furtherance of policy objectives.<sup>128</sup>

### C. Deferral

As discussed above, the ostensible purpose of the U.S. anti-deferral rules is to promote the efficient allocation of capital by preventing U.S. taxpayers from using foreign corporations as a means of sheltering lightly taxed foreign source income from U.S. tax without a sufficient business purpose.<sup>129</sup> The effect of the U.S. anti-deferral rules, most notably Subpart F,<sup>130</sup> is the acquisition by foreign corporations of some of the characteristics of partnerships. A controlled foreign corporation which earns Subpart F income is deemed to remit such income to its U.S. shareholders in the year in which such income is earned.<sup>131</sup> The tax effect of a foreign corporation earning Subpart F income is analogous to a partnership earning the income; in both cases the income flows through to the U.S. shareholder.

#### 1. Flow Through of Losses

Controlled foreign corporations that earn Subpart F income, however, are partnership-like only in a limited sense since their Subpart F losses do not flow through to their U.S. shareholders. If anti-deferral provisions do indeed eliminate taxes as a motivation for the location of capital, it would seem necessary for

127. Note, however, that U.S. corporate taxpayers are only eligible to receive the § 902 credit if they own, directly or indirectly, at least 10 percent of the foreign corporation's voting stock. The § 902 credit also is not available with respect to foreign taxes paid by fourth- and lower-tier subsidiaries. See I.R.C. § 902(a), (b) (1986).

128. *Abbott Laboratories International Co. v. United States*, 267 F.2d 940 (7th Cir. 1959), *aff'd per curiam* 160 F. Supp. 321 (N.D. Ill. 1958). In a hybrid situation, the court held that the taxpayer should receive a deemed paid foreign tax credit and not a direct foreign tax credit. The court stated that the taxpayer should not be able to reduce taxes on income other than the income on which the foreign tax was paid. The court also noted that the taxpayer controlled the timing of distributions by the foreign corporation, at which time a credit could be claimed. The court implied that a § 901 credit might be available where a taxpayer is not eligible for a § 902 credit and has no control over the distributions made by the foreign entity.

129. See text accompanying notes 48-50.

130. See *id.*

131. See I.R.C. § 951(a) (1986).



a controlled foreign corporation's Subpart F losses as well as its Subpart F income to flow through to its U.S. shareholders. For example, one category of Subpart F income, foreign base company sales income, can arise if a controlled foreign corporation purchases a product, which is not manufactured in its country of incorporation, from related party and sells the product outside of its country of incorporation. If a subsidiary incorporated in country A (which taxes income at a 20% rate) purchases products manufactured in the U.S. by its wholly-owned U.S. parent corporation and sells the product to a customer in country B (which taxes income at a 50% rate), the country A subsidiary's profit on the sale would be Subpart F income. Before the enactment of Subpart F, Congress evidently believed that the U.S. taxpayers were using country A subsidiaries to make sales into country B so that the sales income would be subject to country A's 20% tax rate rather than country B's 50% tax rate. Congress apparently presumed that the application of Subpart F would eliminate the U.S. taxpayer's tax incentive for using the country A subsidiary to make sales to customers in country B.<sup>132</sup>

Subpart F, however, may have replaced the tax incentive with a tax disincentive, since Subpart F losses cannot flow through to the U.S. taxpayer. If a U.S. taxpayer has non-tax reasons for selling its products in country B through a country A subsidiary, Subpart F could, at the margin, negate the non-tax reasons rather than be a tax-neutralizing factor, as it apparently was intended to do. In this respect it would be more advantageous for tax purposes if the U.S. taxpayer formed a partnership or branch in country A since the partnership's or branch's losses could flow through to the U.S. taxpayer.

Although a controlled foreign corporation's Subpart F losses cannot flow through to its U.S. shareholders, these losses can, to a limited extent, offset the controlled foreign corporation's Subpart F income earned in subsequent years.<sup>133</sup> The losses also can offset certain related controlled foreign corporations' Subpart F income earned in the same year.<sup>134</sup> The rules regarding losses, however, can conflict with the efficiency objective of anti-deferral. If a Subpart F loss cannot reduce Subpart F income earned in the same taxable year, the U.S. shareholder loses the benefit of the loss in that year. This timing disadvantage is not cured if the loss can be used to offset Subpart F income earned in subsequent years. Furthermore, even if Subpart F income and losses could be netted without restriction in the same taxable year, a net loss could not flow through to the U.S. shareholder.

Thus, if tax neutrality and efficiency are the objectives of Subpart F, the netting of Subpart F income and losses at the level of the foreign corporation is not a substitute for the flow-through of Subpart F losses to the U.S. shareholder.

132. Note, however, that the combination of the U.S. foreign tax credit limitation and Subpart F results in the sales income being subject to the U.S. tax rate, which for corporations is currently 35%. This rate is still lower than the 50% tax rate that would be imposed if a country B subsidiary were used, albeit the U.S. parent could defer U.S. tax on the subsidiary's sales income.

133. See I.R.C. § 952(c) (1986).

134. See *id.*

Treating foreign corporations as quasi-partnerships for the purposes of Subpart F promotes quasi-efficiency. A more consistent policy would disregard the corporate status of foreign corporations to the extent of their Subpart F income and losses, or any of their other income and losses which are subject to an anti-deferral provision. Instead, controlled foreign corporations should be treated as pure conduits to the extent of such income and losses.

## 2. *Brown Group and Related Issues*

The treatment of partnerships in the context of deferral has most recently been concerned not with the effect of the policies underlying deferral, but rather with the implementation of that policy, whatever its effect might be. As part of the Tax Reform Act of 1986 Congress changed a Subpart F provision because it believed that the pre-1987 version precluded Subpart F from applying to a controlled foreign corporation which conducted business outside of its country of incorporation through a partnership.<sup>135</sup> This issue has recently made a serpentine journey through the court system.

The issue, briefly, is this. Suppose a U.S. corporation has a wholly-owned country B subsidiary, and the country B subsidiary is a partner in a country A partnership. Suppose also that the country A partnership purchases products which are not manufactured in country A and sells the products to the U.S. parent. If the country A partnership were a corporation, then under both current and pre-1987 law, such a corporation would be considered as making the sale to a "related party" (the U.S. parent), and consequently Subpart F would apply. However, under pre-1986 law, the U.S. parent would not be considered as related to a country A partnership. Congress believed that this precluded Subpart F from applying. The 1986 Blue Book states that Congress considered the pre-1987 rule as "without logical support" because a controlled foreign corporation could "avoid [Subpart F] treatment" merely by operating in a third country through a partnership rather than a corporation.<sup>136</sup> Thus, in Congress' view a tax irony existed; it was possible for a controlled foreign corporation to avoid assuming partnership characteristics if it conducted business in a third country through a partnership.

The Service has disagreed with Congress' view, and is of the opinion that the separate legal existence of partnerships should be disregarded in this context, and thus controlled foreign corporations operating in third countries through partnerships should be subject to Subpart F. In Rev. Rul. 89-72,<sup>137</sup> which was issued after the Tax Reform Act of 1986, the Service ruled that a controlled

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135. Before the effective date of the Tax Reform Act of 1986, P.L. 99-514, a partnership in which a controlled foreign corporation held an interest was not considered a "related person" with respect to the controlled foreign corporation. See I.R.C. § 954(d)(3) (1986). Since the effective date of the Tax Reform Act of 1986, a partnership in which a controlled foreign corporation has an interest is considered a "related person" with respect to the controlled foreign corporation if the partnership is controlled by the same person or persons which control the controlled foreign corporation. See I.R.C. § 954(d)(3)(B) (1986).

136. 1986 BLUE BOOK, *supra* note 28, at 989.

137. 1989-1 C.B. 257.

foreign corporation which held only a 25% interest in a third country partnership (as opposed to the 50% interest necessary for Subpart F to apply under the revised law) was subject to Subpart F to the extent of its distributive share of the partnership's income. The Service stated that, at least for the purposes of Subpart F, a controlled foreign corporation should be considered to directly realize the income earned by a partnership in which it has an interest.<sup>138</sup> Thus, the Service apparently considered the 1986 change in the tax law as irrelevant. The dispositive issue was not whether a partnership should be considered as "related party" under the relevant Subpart F provisions, but rather whether a partner should be viewed as stepping into the shoes of its partnership in order to convert the partnership's earnings into Subpart F income.

The same issue was examined by the Eighth Circuit and twice by the Tax Court in *Brown Group v. Commissioner*.<sup>139</sup> Unlike Rev. Rul. 89-72, *Brown Group* involved Subpart F law before it was changed by the Tax Reform Act of 1986. In its first decision on the case the Tax Court held that Rev. Rul. 89-72 was incorrect and applied an entity theory of partnerships. The court surveyed prior cases and rulings on the aggregate/entity distinction in partnership law and concluded that the proper level for characterization of the income at issue was at the entity, or partnership level. Without mentioning Congress' interpretation of pre-1986 law, the implication of the first *Brown Group* decision was consistent with this interpretation. Since the court held that income earned by a partnership retains its character as non-Subpart F income when passed through its partners, Subpart F could be avoided if controlled foreign corporations invest in third countries through partnerships.

In a rare event, the full Tax Court reheard the case and reversed the prior decision. At its core the second Tax Court decision was motivated by the majority's desire to effectuate the policy underlying Subpart F. The majority opinion stated, "The facts seem ripe for the application of Subpart F. A contrary result would lead to just the type of siphoning of profits that Congress was concerned with when it subjected foreign base company sales income to the conduit treatment of subpart F."<sup>140</sup> With this policy objective paramount, the majority attempted to justify its holding on three grounds. Two of the grounds were generous, technical interpretations of Subchapter K<sup>141</sup> and Subpart F<sup>142</sup> provi-

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138. The Service based its ruling on Treas. Reg. § 1.702-1(a)(8)(ii) which provides, "Each partner must also take into account separately his distributive share of any partnership item which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately."

139. 77 F.3d 217 (8th Cir. 1996), *rev'g*, 104 T.C. 105 (1995) (en banc), *vacating*, 102 T.C. 616 (1994). The issue was also examined in *MCA, Inc. v. United States*, 685 F.2d 1099 (9th Cir. 1982), *rev'g*, 502 F. Supp. 838 (C.D. Cal. 1980), discussed *infra* note 145.

140. 104 T.C. at 115-16.

141. Like the Service in Rev. Rul. 89-72, the majority opinion stated that pursuant to Treas. Reg. § 1.702-1(a)(8)(ii) a controlled foreign corporation should be considered as if it directly realized the income earned by a partnership in which it has an interest if such income would be subject to Subpart F if earned directly by the controlled foreign corporation. 104 T.C. at 112-14.

142. The majority opinion stated that I.R.C. § 954(d)(1) applied to the facts at issue. Section 954(d)(1) provides in relevant part that Subpart F income includes "income . . . derived in connection with . . . the purchase of personal property from any person on behalf of a related person . . ."

sions. These interpretations were criticized in detail by concurring opinions.<sup>143</sup> The third ground was the aggregate theory of partnerships, providing that the partners should be viewed as if they directly earned the income at issue. The dissenting opinion, authored by the same judge who issued the first *Brown Group* decision, took issue with the majority's aggregate approach.<sup>144</sup>

The Eighth Circuit reversed the Tax Court, agreeing with the dissenting Tax Court judges that the income earned by the partnership should be characterized at the partnership, or entity, level and should retain its character when distributed to the individual partners.<sup>145</sup> The Eighth Circuit believed that the pre-1987 version of the Subpart F provision created a "loophole" which the taxpayer exploited, but believed that Congress closed the loophole when it broadened the definition of "related person" to include partnerships in which controlled foreign corporations held interests.<sup>146</sup> The Eighth Circuit also noted that partnership anti-abuse regulations, which are effective for transactions occurring on or after December 30, 1994, enable the Service to recast partnership income under Subpart F.<sup>147</sup> Accordingly, this issue is not likely to arise in future transactions.

Although *Brown Group*, Rev. Rul. 89-72 and Congress' modification of Subpart F in 1986 do not involve a broader debate over the policy underlying Subpart F and involve an issue which likely is of historic importance, the issue is instructive in that it reveals the lengths to which all three branches of government will resort to implement tax policy, however well (or poorly) thought-out it might be. Recently-issued partnership anti-abuse regulations, which were discussed by the Eighth Circuit in *Brown Group*, have also accorded tax policy great weight. The regulations permit the Service to treat a partnership as an aggregate (but not an entity) to carry out the purpose of *any* provision of the

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The majority believed that the term "in connection with" implied that the controlled foreign corporation's distributive share of the partnership's profits was connected to the purchases made by the U.S. shareholder, a party related to the controlled foreign corporation. 104 T.C. at 119-20.

143. With respect to the section 702 argument, concurring opinions noted that the application of Treas. Reg. § 1.702-1(a)(8)(ii) is premised on the partner at issue having a tax liability. Because the partner at issue, a Cayman Islands corporation, was not subject to tax, it was argued that Treas. Reg. § 1.702-1(a)(8)(ii) did not apply. 104 T.C. at 121-23 (Ruwe, concurring) and 104 T.C. at 130 (Chiechi, concurring). With respect to the section 954(d)(1) argument, a concurring opinion stated that the majority's broad interpretation of the term, "in connection with" was tenable only in conjunction with application of the aggregate theory of partnerships. 104 T.C. 130-31 (Chiechi, concurring).

144. The dissenting opinion surveyed the caselaw on the aggregate/entity distinction and concluded that in nearly every case courts have concluded that an item of income should be characterized at the entity or partnership level. The dissent also noted that regulations issued in late 1994, which permit the Service to treat partnerships as aggregates to carry out the purpose of any provision of the Internal Revenue Code, applied to transactions occurring after the date of the transaction at issue. 104 T.C. at 131-40 (Jacobs, concurring).

145. The Ninth Circuit is also of this view. In *MCA, Inc.*, *supra* note 139, the Ninth Circuit stated that the (pre-1987) statute was written to apply to Subpart F income received from controlled corporations and not controlled partnerships. 685 F.2d at 1104. The court acknowledged that that language of the statute could result in deferral of tax on income which Congress intended to tax currently, but that the remedy for such an unjustified loophole was legislation and not judicial improvisation. *See id.*

146. 77 F.3d at 221.

147. *Id.* at 222.

Internal Revenue Code or the regulations thereunder unless (1) the Code or regulations prescribe the treatment of a partnership as an entity, and (2) that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.<sup>148</sup>

This regulation, with its emphasis on policy, could cause a great deal of mischief. Taxpayers could credibly ask the Service to apply the regulation against statutory provisions or other regulations which frustrate tax policy in their treatment of partnerships. For example, under the Internal Revenue Code, one category of Subpart F income, foreign personal holding company income, includes the excess of gains over losses from the sale or exchange of property which is an interest in a partnership.<sup>149</sup> Thus, a controlled foreign corporation's gain from its sale of a partnership interest is immediately taxable to the controlled foreign corporation's U.S. shareholders. Recently issued Treasury Regulations mimic the statute's characterization of partnerships as entities and do not, as some commentators had advocated, treat partnerships as aggregates to the extent that they are engaged in an active trade or business.<sup>150</sup>

The foreign personal holding company rules' strict treatment of partnerships as entities can be contrary to the policy underlying Subpart F. The foreign personal holding company rules simultaneously seek to eliminate deferral for U.S. taxpayers who use foreign corporations to hold passive investments but not to impinge on the competitiveness of U.S. taxpayers conducting active international operations. When Congress enacted the foreign personal holding company rules in 1962, both the House Ways and Means and the Senate Finance Committee reports stated:

[The] committee, while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same foreign countries, nevertheless sees no need to maintain the deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely receiving investment income. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated.<sup>151</sup>

If a U.S. shareholder can demonstrate that an investment by its controlled foreign corporation in a partnership is not a "portfolio type" of investment, but rather an active business investment, then the controlled foreign corporation's gain from the sale of its partnership interest would not be portfolio income. It would be contrary to the purpose of the foreign personal holding company risks if the shareholder were required to currently include such gain. In this case the shareholder could credibly ask the Service to invoke Treas. Reg. § 1.701-2(e) to override the foreign personal holding company rules. Yet a caveat in Treas. Reg. § 1.701-2(e) provides that a partnership cannot be treated as an aggregate if

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148. Treas. Reg. § 1.701-2(e), 60 Fed. Reg. 32 (Jan. 3, 1995) (emphasis added).

149. I.R.C. § 954(c)(1)(B)(ii) (1996).

150. See Treas. Reg. § 1.954-2(e)(B) (1996). Commentators have expressed the view that a look-through rule should apply. See NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT ON SECTION 956A (Aug. 1, 1995).

151. SENATE FINANCE COMMITTEE, *supra* note 33, at 789; HOUSE WAYS AND MEANS COMMITTEE, *supra* note 48, at 466.

(1) the Code or regulations prescribe the treatment of a partnership as an entity, and (2) treatment and final tax results, taking into account all the relevant facts and circumstances, is clearly contemplated by the provision. This would provide the Service with a counter argument. It is unclear, however, how the caveat should ultimately be interpreted.

What if a controlled foreign corporation's investment in a partnership is a "portfolio type of investment," but a taxpayer can prove that current inclusion of gain from the sale of the interest would hurt its international competitiveness? According to the legislative history, Congress apparently believed that current inclusion of portfolio investment income and the impingement of a U.S. taxpayer's international competitiveness were mutually exclusive. But if a taxpayer can demonstrate otherwise, it could argue, not unreasonably, that current inclusion would frustrate U.S. tax policy not to interfere with competitiveness. In this case, the shareholder also could ask the Service to invoke Treas. Reg. § 1.701-2(e) to override the foreign personal holding company rules.

#### IV. CONCLUSION

This article has attempted to demonstrate that international tax policy can serve as a useful guidepost in analyzing issues associated with international partnerships. When international partnership issues are analyzed from a purely technical perspective, it is often difficult or impossible to arrive at resolutions of these issues. Furthermore, it often appears that resolutions are lurched at rather than comfortably reached. The drafters of the OECD Model Treaty, for example, did not even offer a recommendation for the treatment of partnerships and instead threw up their hands. When policy enters the mix, however, both to assist the technical analysis of partnership issues and to inform partnership rules, solutions become firmer and more readily apparent. Firmer solutions to partnership issues will, if anything, become more in demand as the partnership form of conducting international business proliferates.

Policy-aided solutions, however, are only as reliable as the policy which underlies them. As this article has briefly discussed, the weight and complexity of U.S. international tax rules has often obscured and resulted in contradictory U.S. policy objectives. It is perhaps for this reason that policy has not been accorded greater weight in the analysis of partnership issues. Reforms of the international tax rules which result in more coherence and clarity would only benefit the analysis and resolution of partnership issues.

**Example A**



**U.S./ITALY TREATY APPLIES ACROSS THE BOARD**  
 (Non corporate rate for dividend withholding)

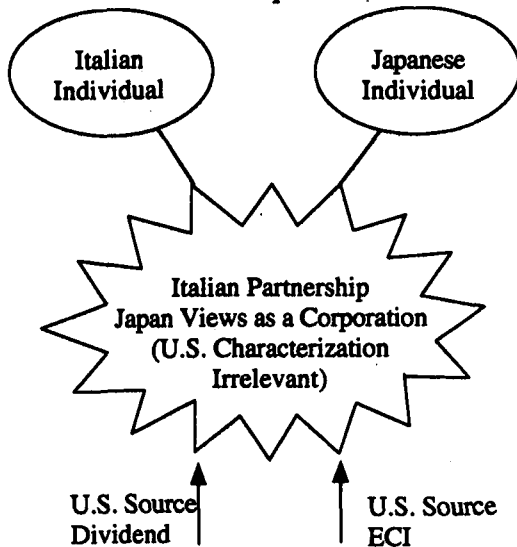
**Example B**



**U.S./ITALY TREATY APPLIES WITH RESPECT  
 TO ITALIAN INDIVIDUAL'S SHARE OF INCOME**

**U.S./JAPAN TREATY APPLIES WITH RESPECT  
 TO JAPANESE INDIVIDUAL'S SHARE OF INCOME**

**Example C**



**U.S./ITALY TREATY APPLIES WITH RESPECT  
 TO ITALIAN INDIVIDUAL'S SHARE OF INCOME**

**NO TREATY APPLIES WITH RESPECT  
 TO JAPANESE INDIVIDUAL'S SHARE OF INCOME**



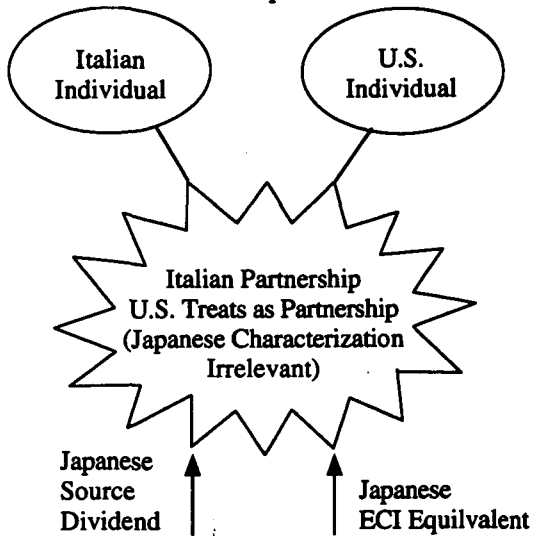
***Example D***



**U.S./ITALY TREATY APPLIES ACROSS THE BOARD  
(SUBJECT TO LIMITATION ON BENEFITS ARTICLE)**

**(Reduced corporate dividend withholding rate should apply if  
requisite interest held in U.S. company remitting dividends.)**

**Example E**



**ITALY/JAPAN TREATY APPLIES WITH RESPECT  
TO ITALIAN INDIVIDUAL'S SHARE OF INCOME**

**U.S./JAPAN TREATY APPLIES WITH RESPECT  
TO U.S. INDIVIDUAL'S SHARE OF INCOME**

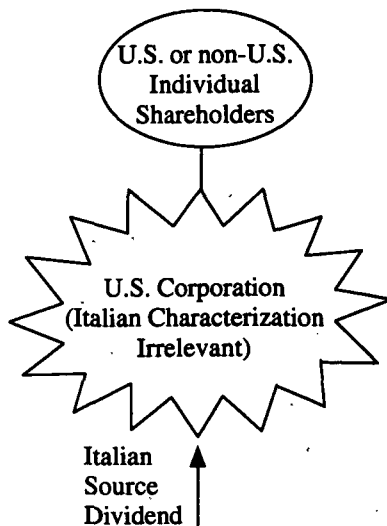
**Example F**



**U.S./ITALY TREATY APPLIES WITH RESPECT  
TO ITALIAN INDIVIDUAL'S SHARE OF INCOME**

**BEST RESULT, EITHER U.S./ITALY ARRANGEMENT  
OR U.S./NON-TREATY COUNTRY ARRANGEMENT,  
APPLIES WITH RESPECT TO NON-TREATY  
INDIVIDUAL'S SHARE OF INCOME**

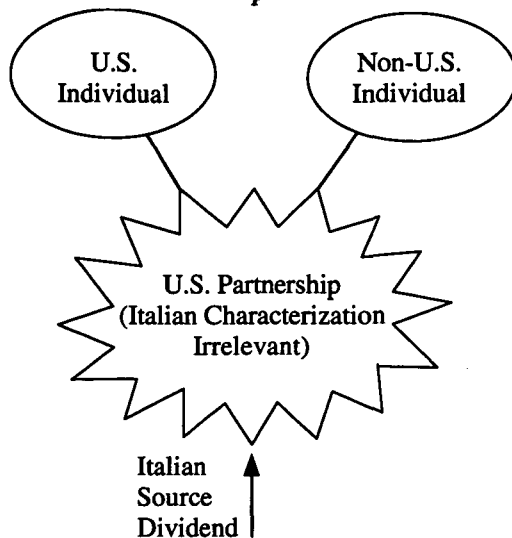
***Example G***



**U.S./ITALY TREATY APPLIES ACROSS THE BOARD  
 (SUBJECT TO LIMITATION ON BENEFITS ARTICLE)**

**(Reduced corporate dividend withholding rate should apply  
 if U.S. corporation holds requisite interest in Italian company  
 remitting dividends.)**

**Example H**



**U.S./ITALY TREATY APPLIES WITH RESPECT  
TO U.S. INDIVIDUAL'S SHARE OF INCOME**

**ITALY/NON-U.S. ARRANGEMENT APPLIES WITH  
RESPECT TO NON-U.S. INDIVIDUAL'S  
SHARE OF INCOME**

**Example I**

U.S./ITALY TREATY APPLIES WITH RESPECT  
TO ITALIAN INDIVIDUAL'S SHARE OF INCOME

BEST RESULT, EITHER U.S./ITALY ARRANGEMENT  
OR U.S./NON-TREATY COUNTRY ARRANGEMENT,  
APPLIES WITH RESPECT TO NON-TREATY  
INDIVIDUAL'S SHARE OF INCOME

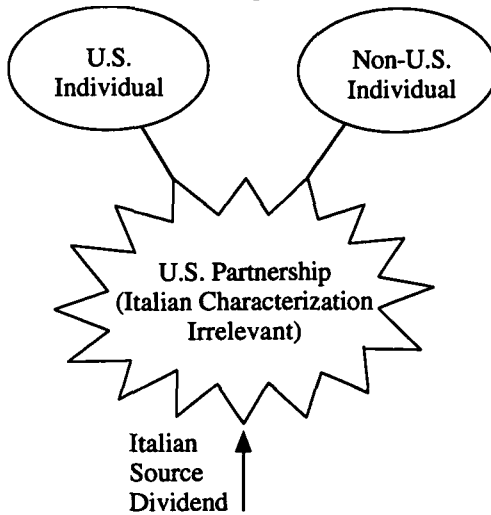
**Example J**



**U.S./ITALY TREATY APPLIES ACROSS THE BOARD  
(SUBJECT TO LIMITATION ON BENEFITS ARTICLE)**

**(Reduced corporate dividend withholding rate should apply  
if U.S. corporation holds requisite interest in Italian company  
remitting dividends.)**

**Example K**



U.S./ITALY TREATY APPLIES WITH RESPECT  
TO U.S. INDIVIDUAL'S SHARE OF INCOME

ITALY/NON-U.S. ARRANGEMENT APPLIES WITH  
RESPECT TO NON-U.S. INDIVIDUAL'S  
SHARE OF INCOME

**Example 1.1**

(Assumes entity treated by both U.S. and foreign country as a partnership; 40% U.S. tax rate; 20% foreign tax rate.)

Income	100	
Total foreign tax	(20)	
Nominal U.S. tax		(40)
U.S. FTC		20
Total U.S. tax	(20)	
Cash to taxpayer	60	
Foreign tax rate	20%	
U.S. tax rate	20%	
Effective worldwide tax rate	40%	

**Example 1.2**

(Same as Example 1.1, but foreign tax rate is 50%.)

Income	100	
Total foreign tax	(50)	
Nominal U.S. tax		(40)



U.S. FTC	40
Total U.S. tax	<u>0</u>
Cash to taxpayer	50
Foreign tax rate	50%
U.S. tax rate	0%
Effective worldwide tax rate	50%

### ***Example 2.1***

(U.S. treats entity as partnership; foreign country treats entity as corporation;  
 10% foreign entity and shareholder level tax rates; 40% U.S. partner level tax.)

Income	100	
Foreign entity tax		(10)
Cash available for distribution		90
Foreign S/H tax		(9)
Total foreign tax	(19)	
Cash after foreign tax	81	
Nominal U.S. tax		(40)
U.S. FTC		19
Total U.S. tax	(21)	
Cash to S/H	60	
Foreign tax rate	19%	
U.S. tax rate	21%	
Effective worldwide tax rate	40%	

### ***Example 2.2***

(Same as Example 2.1 except foreign entity and shareholder rates are 30%.)

Income	100	
Foreign entity tax		(30)
Cash available for distribution		70
Foreign S/H tax		(21)
Total foreign tax	(51)	
Cash after foreign tax	49	
Nominal U.S. tax		40
U.S. FTC		(40)
Total U.S. tax	<u>0</u>	
Cash to S/H	49	
Foreign tax rate	51%	
U.S. tax rate	0%	
Effective worldwide tax rate	51%	

**Example 2.3**

(Same as Example 2.1, but no U.S. foreign tax credit for foreign entity level tax.)

Income	100	
Foreign entity tax		(10)
Cash available for distribution		90
Foreign S/H tax		(9)
Total foreign tax	(19)	
Cash after foreign tax	81	
Nominal U.S. tax		(40)
U.S. FTC		9
Total U.S. tax	(31)	
Cash to S/H	50	
Foreign tax rate	19%	
U.S. tax rate	31%	
Effective worldwide tax rate	50%	

**Example 2.4**

(same as Example 2.2, but no U.S. foreign tax credit for foreign entity level tax.)

Income	100	
Foreign entity tax		(30)
Cash available for distribution		70
Foreign S/H tax		(21)
Total foreign tax	(51)	
Cash after foreign tax	49	
Nominal U.S. tax		(40)
U.S. FTC		21
Total U.S. tax	(19)	
Cash to S/H	30	
Foreign tax rate	51%	
U.S. tax rate	19%	
Effective worldwide tax rate	70%	

**Example 3.1**

(Base Case: U.S. corporation; U.S. corporate tax rate 35%, U.S. shareholder tax rate 40%.)

Income	100	
U.S. corp. tax		(35)

Cash available for distribution	65
U.S. S/H tax	(26)
Total U.S. tax	(61)
Cash to S/H	39
Effective U.S. tax rate	61%

**Example 3.2(a)**

(U.S. treats entity as corporation; foreign country treats entity as partnership; U.S. corp. tax rate is 35%, U.S. individual tax rate is 40%, foreign individual tax rate 40%, dividend remitted by entity is U.S. source, NO U.S. FTC.)

Income	100	
Foreign entity tax	(40)	
Cash available after foreign tax	60	
U.S. corp. tax		(35)
Cash available for distribution		65
U.S. S/H tax		(26)
Nominal U.S. tax		(61)
U.S. FTC		0
Total U.S. tax	(61)	
Cash to S/H	(1)	
Foreign tax rate	40%	
U.S. tax rate	61%	
Effective worldwide tax rate	101%	

**Example 3.2(b)**

(Same as Example 3.2(a) except U.S. after-corporate-tax amount is foreign source income.)

Income	100	
Foreign entity tax	(40)	
Cash available after foreign tax	60	
U.S. corp. tax		(35)
Cash available for distribution		65
U.S. S/H tax		(26)
Nominal U.S. tax		(61)
U.S. FTC		26
Total U.S. tax	(35)	

Cash to S/H	25
Foreign tax rate	40%
U.S. tax rate	35%
Effective worldwide tax rate	75%

**Example 3.2(c)**

(Same as Example 3.2(a) except, entire 100 of income is foreign source to U.S. shareholder.)

Income	100	
Foreign entity tax	(40)	
Cash available after foreign tax	60	
U.S. corp. tax		(35)
Cash available for distribution		65
U.S. S/H tax		(26)
Nominal U.S. tax	(61)	
U.S. FTC	26	
Total U.S. tax	(35)	
Extra FTCS	(14)	
Cash to S/H	25	
Final Economic Result (assuming other US taxable income)	39	
Foreign tax rate	40%	
U.S. tax rate	21%	
Effective worldwide tax rate	61%	