Emory Law Journal

Volume 60
Issue 2 *The 2010 Randolph W. Thrower Symposium — The New New Deal: From De-Regulation to Re-Regulation*

Article 6

2010

The Difficulties with the Subpart F System of International Taxation: How the Schering-Plough Decision Indicates that the Status Quo Is Unclear and Unwise

Daniel Soleimani

THE DIFFICULTIES WITH THE SUBPART F SYSTEM OF INTERNATIONAL TAXATION: HOW THE *SCHERING-PLOUGH* DECISION INDICATES THAT THE STATUS QUO IS UNCLEAR AND UNWISE

ABSTRACT

Complicated subpart F rules govern the taxation of transactions between a U.S. parent company and its foreign subsidiaries. The difficulty with interpreting the subpart F rules and applying them to complex derivative transactions has been the subject of extensive tax literature. Few of the proposed solutions have been simple enough to implement quickly and efficiently without wholesale changes to the subpart F system. This Comment focuses on the inconsistent tax treatment of economically equivalent transactions that currently exists under subpart F and the incentives that this system creates for U.S. companies to engage in expensive tax-planning strategies to avoid subpart F taxation. These tax-planning strategies—used to achieve an economically identical result—cost both the government and U.S. companies unnecessary money.

This Comment uses the Schering-Plough Corp. v. United States *decision to highlight the difficulties in properly complying with subpart F and the lengths to which a taxpayer must go to avoid subpart F. It explores the reasons why the subpart F system was created the way that it was, as well as the competing theories on international taxation that led to the subpart F system. This Comment then proposes that economically equivalent transactions should be taxed the same, either by using the transfer pricing rules—currently used to govern asset sales between a parent and its foreign subsidiary—more extensively in governing cash loans and loans of property between a parent and its foreign subsidiary, or alternatively, by treating asset sales between a foreign subsidiary and its domestic parent as a repatriating event—the same way that a loan between a foreign subsidiary and its domestic parent is currently treated—and taxing the entire transaction under subpart F. Either option would give greater consistency to transactions governed by subpart F and would be relatively simple to implement within the political process.*

INTRODUCTION 505
I. THE *SCHERING-PLOUGH* CASE 507
II. THE HISTORY AND ENACTMENT OF SUBPART F 512
A. How Subpart F Became the Law 512
B. The Current Subpart F Rules 514
III. THE DIFFERENCE BETWEEN AN INTERNATIONAL TAX SYSTEM BASED ON CAPITAL IMPORT NEUTRALITY AND ONE BASED ON CAPITAL EXPORT NEUTRALITY 518
IV. DIFFICULTIES AND PROPOSED SOLUTIONS TO THE CURRENT SUBPART F SYSTEM 521
A. The Debate over the Treatment of Hybrid Entities Under Subpart F 521
B. Proposed Academic Solutions to Subpart F 523
1. Benefits and Drawbacks of Implementing Uncontrolled CEN 523
2. Benefits and Drawbacks of Implementing Uncontrolled CIN 525
V. POSSIBLE REMEDIES TO THE ARBITRARY CLASSIFICATION OF ASSETS BY THE COURT IN THE *SCHERING-PLOUGH* DECISION 527
A. The Schering-Plough *Transaction: Was It a Sale or a Loan? Why We Need a Better Way to Tell the Difference* 528
B. Using Theories of Global Taxation to Remedy the Arbitrary Categorizations of Income Taxed by Subpart F 530
VI. PROPOSED CHANGES TO SUBPART F: TAXING ECONOMICALLY IDENTICAL TRANSACTIONS THE SAME 531
A. First Proposal 532
B. Second Proposal 533
CONCLUSION 534

INTRODUCTION

> *Permitting a taxpayer to control the economic destiny of a transaction with labels would . . . exalt form over substance, thereby perverting the intention of the tax code.*[1]

Currently, under subpart F of the Internal Revenue Code,[2] most forms of income earned by a foreign subsidiary of a domestic company[3] are not taxed until the income is repatriated[4] to the United States. Once the income is repatriated to the domestic parent, the amount of money that has been earned abroad is then usually subject to subpart F taxation. Subpart F provides detailed rules and regulations describing when income earned by a foreign subsidiary is subject to U.S. taxation.[5]

In 1991, the multinational drug corporation Schering-Plough was faced with a "ballooning" balance sheet as its cash reserves and debt were rising to high levels.[6] Schering-Plough's cash was tied up in its foreign Irish and Swiss subsidiaries, while its domestic parent accumulated the debt.[7] Schering-Plough wanted to get the cash from its foreign subsidiaries to pay down its domestic debt and slow the ballooning of its balance sheet, but also wanted to avoid the significant subpart F taxation that would accompany the simple transfer of these funds from foreign subsidiary to parent.[8]

In an effort to avoid subpart F taxation while still getting lump sum payments from its subsidiaries, Schering-Plough enlisted the help of Merrill Lynch to design a transfer method with the sole goal of deferring taxation.[9] The transfer method consisted of two waves of contracts, the first in 1991 and the second in 1992.[10] Each wave was essentially the same: notional principal contracts[11] based on a large amount of money that would provide Schering-

---

1 Schering-Plough Corp. v. United States, 651 F. Supp. 2d 219, 242 (D.N.J. 2009).

2 I.R.C. §§ 951–965 (2006).

3 This income is generally referred to as *active income*. *See, e.g.*, Stephen E. Shay, *Exploring Alternatives to Subpart F*, TAXES, Mar. 2004, at 29, 30.

4 *Repatriation* is the transfer of income earned in a foreign country back into the home country, which for the purposes of this Comment will be the United States.

5 *See generally* I.R.C. §§ 951–965.

6 *Schering-Plough Corp.*, 651 F. Supp. 2d at 226.

7 *Id.* at 225–26.

8 *Id.* at 227–28.

9 *Id.* at 226. Schering-Plough paid Merrill Lynch $2.2 million for its services in connection with the 1991 swap and $2 million for its work on the 1992 swap. *Id.* at 230–32.

10 *Id.* at 229–32.

11 *See infra* notes 24–25 and accompanying text.

Plough with a right to receive a stream of income over twenty years.[12] Schering-Plough then sold this interest in income to one of its subsidiaries.[13] That way, Schering-Plough hoped to amortize the lump sum from the subsidiary over the lifetime of the contract, rather than paying taxes on the lump sum all at once.[14]

The Internal Revenue Service (IRS) challenged this arrangement, claiming that the transactions were actually loans between Schering-Plough and its foreign subsidiaries.[15] The U.S. District Court of New Jersey agreed with the IRS and held that the transactions were loans, which subjected Schering-Plough to a $473 million tax liability.[16] The court's analysis in recategorizing the notional principal contracts as loans was extremely complex and detailed, and it is unclear which factors the court used to determine whether the transaction was a loan. The court's analysis highlights the difficulties that exist with the current subpart F system, and the loopholes and tax-planning strategies available as a result of these rules.[17]

To fully appreciate the issues in *Schering-Plough*, an analysis of the two competing theories on international taxation, Capital Import Neutrality (CIN) and Capital Export Neutrality (CEN), is necessary. CIN is an international tax system predicated on the assumption that all businesses in the same country should be taxed at the same rate.[18] If all countries had identical rates of taxation for income earned within their borders, then CIN would be achieved.[19] On the other hand, CEN is achieved when a country taxes only its residents on their worldwide income.[20] Moving toward a system of CEN lessens the problem of categorizing a specific asset for tax purposes because wherever a taxpayer chooses to do business, it would be taxed at the same rate.[21] CEN would eliminate the role that taxes play on where an investor does business and would make efficiency the driving force behind investment.[22]

---

12 *Schering-Plough Corp.*, 651 F. Supp. 2d at 222.

13 *Id.*

14 *Id.*

15 *Id.* at 234.

16 *Id.* at 221, 272.

17 *See infra* note 109 and accompanying text.

18 *See infra* note 123 and accompanying text.

19 *See infra* note 123 and accompanying text.

20 Tsilly Dagan, *National Interests in the International Tax Game*, 18 VA. TAX REV. 363, 367 (1998).

21 *See infra* note 115 and accompanying text.

22 *See infra* note 121 and accompanying text.

Additionally, to repair the difficulties with subpart F it is important that transactions between a domestic parent and a foreign subsidiary should be treated consistently. There is no reason that the sale of an asset between a parent and its subsidiary should not trigger subpart F income while a loan between the two does. Consistent treatment of these transactions can be achieved by using the transfer pricing rules that currently regulate asset sales between a parent and subsidiary to also regulate loans. Alternatively, if transfer pricing rules are deemed ineffective then asset sales between a subsidiary and parent should be deemed repatriating events under subpart F in the same way that loans are currently treated. This Comment does not endorse which of these two solutions would be more effective but advocates that treating economically identical transactions consistently is imperative, and that one of the two solutions must be adopted to ensure consistent treatment.

Part I of this Comment examines the details and rationale of the *Schering-Plough* decision. Part II tracks the development of the subpart F system, and describes the details of the subpart F system as it exists today and the various forms of income that are covered under subpart F. Part III explores the competing theories of international taxation and the arguments that proponents of each system use to advocate their positions. Part IV examines the problems and inconsistencies in the current subpart F system and several academics' suggestions on how to better the system.

Part V uses the *Schering-Plough* case to illustrate how arbitrary some of the distinctions in subpart F are and discusses how moving toward an international tax theory of CEN would lead to more efficient investment decisions. Part VI proposes that the taxation of cash loans from a foreign subsidiary to its domestic parent should be consistent with the taxation of asset sales and property loans between the two. It suggests that one of two alternate theories should be adopted, which will lead to consistent tax treatment of economically identical transactions.

I. THE *SCHERING-PLOUGH* CASE

In 1991, Schering-Plough entered into a notional principal contract with the Dutch bank ABN, in which $650 million was the principal amount that the parties used to make payments to each other based upon different interest rates.[23] A notional principal contract is a transaction in which periodic

[23] Schering-Plough Corp. v. United States, 651 F. Supp. 2d 219, 228–29 (D.N.J. 2009).

payments are made with respect to a notional amount which itself never actually changes hands.[24] Typically, the periodic transfer payments are based on different interest rates, and the only cash that exchanges hands is the net payment of the difference between the two interest rates.[25]

The contract worked in the following way: Schering-Plough agreed to make payments every six months to ABN based on the London Interbank Offered Rate (LIBOR), and ABN agreed to pay Schering-Plough every six months based on the federal funds rate.[26] After netting these payments, it becomes apparent that the only payment actually made was the net difference between the two rates.[27] ABN then entered into a mirror swap with Merrill Lynch, which was based on the same $650 million notional principal amount, but in this transaction ABN made payments based on the LIBOR rate and Merrill made payments to ABN based on the federal funds rate.[28]

Following these transactions, in 1991, Schering-Plough sold its right to receive income from years six through twenty on the notional principal contract to its foreign subsidiary, Scherico, for $202.4 million.[29] Once Schering-Plough assigned its right to receive income, the biyearly payments to ABN were no longer netted.[30] Thus, Schering-Plough was obligated to make full payments to ABN, and ABN to Scherico.[31] In 1992, Schering-Plough entered into almost the same notional principal contract with ABN, but this time with a notional principal amount of $950 million.[32] It again assigned the right to receive income from years six through twenty on the contract to

---

24 Alvin C. Warren, Jr., *US Income Taxation of New Financial Products*, 88 J. PUB. ECON. 899, 905 (2004).

25 *Id.*

26 *Schering-Plough Corp.*, 651 F. Supp. 2d at 231.

27 *See id.*

28 *Id.* at 229. The length of the agreement was for the same term as the original agreement, and payments were to be made on the same payment dates. *Id.* The purpose of ABN entering into the mirror transaction was to insulate itself from any volatility in the interest rates. *Id.* at 230. The benefit that ABN received from this entire transaction was ten basis points (one-tenth of one percent of the overall transaction) of yearly compensation from Merrill Lynch. *Id.* at 229.

29 *Id.* at 230. The court considered the $202.4 million amount a fair value because Schering-Plough initially assigned its right to receive income on $60 million of the notional principal amount to Banco di Roma, to establish an arms-length pricing agreement that it would later use in its assignment to Scherico. *Id.* The bank paid Schering-Plough $26.4 million for the assignment. *Id.* In the 1991 swap, Schering-Plough also assigned its right to receive income on $100 million of the notional principal amount to another subsidiary for an additional $44 million lump sum payment. *Id.*

30 *Id.* at 229.

31 *Id.*

32 *Id.* at 231. There was still an initial agreement to net payments, and ABN entered into the same mirror transaction with Merrill Lynch as it did in the 1991 transaction. *Id.*

Scherico, but this time, because the notional amount was larger, the lump sum payment Schering-Plough received was $444 million.[33]

By entering into these notional principal contracts with ABN, Schering-Plough solved the problem of its ballooning balance sheet by receiving large lump sum cash payments from its foreign subsidiaries, which it could use to pay off debt, thereby reducing the accumulating cash and debt that was on its balance sheet. By assigning the right to receive income to its foreign subsidiaries, Schering-Plough believed it would able to amortize the taxes on the transactions over the life of the notional principal contract and thus not pay subpart F taxes on the lump sum payments it received.[34] Instead of paying tax on the entire $690.4 million lump sum in one year, Schering-Plough hoped to pay a portion of the tax each year over the life of the contract.[35]

Schering-Plough relied on the authority of IRS Notice 89-21, issued on February 7, 1989, to come to the conclusion that it was justified in sidestepping subpart F taxation.[36] The Notice provides guidance concerning income tax treatment of lump sum payments received in connection with notional principal contracts.[37] It announces that "lump-sum payments . . . with respect to notional principal contracts . . . [that require future payments must be] taken into account over the life of the contract . . . ."[38] Thus, under this Notice, Schering-Plough believed that it would be able to amortize the income it received over the life of the notional principal contract and defer significant tax liability.[39] Notice 89-21, however, also states that "[n]o inference should be drawn . . . as to the proper treatment of transactions that are not properly characterized as notional principal contracts, for instance, . . . transactions . . . [that] are in substance . . . loans."[40]

The district court ruled that Schering-Plough's transactions were entered into exclusively for tax purposes and thus were in substance loans, even though in form, the transactions were the sale of future income as part of a notional

33 *Id.* at 232. For the 1992 swap, Schering-Plough entered into the same type of arms-length pricing agreement as it had in the 1991 swap, but this time with Rabobank Nederland. *Id.* at 231. The assignment was based on $25 million of the notional amount, and Schering-Plough was paid $12 million. *Id.*

34 Complaint at 2–4, Schering-Plough Corp. v. United States, 651 F. Supp. 2d 219 (D.N.J. 2009) (No. 05-2575), 2005 WL 1474762.

35 *Id.* at 3.

36 I.R.S. Notice 89-21, 1989-1 C.B. 651.

37 *Id.*

38 *Id.* at 652.

39 Complaint, *supra* note 34, at 2.

40 I.R.S. Notice 89-21, 1989-1 C.B. 651, 652.

principal contract.[41] The court focused on the subjective intent of Schering-Plough to structure these transactions simply to avoid taxes, and the court concluded that Schering-Plough was taking out a loan from its subsidiaries.[42] The court's speculation that these transactions were entered into exclusively to avoid subpart F taxation was further fueled by the fact that Schering-Plough determined the amount of money it needed and then worked backwards to find the proper notional amount that would produce the desired lump sum payments from Scherico.[43]

When a court finds that a certain type of transaction creates a tax result that is inconsistent with the form of the transaction, it has the authority to reclassify the transaction in accordance with its substance.[44] This is known as the substance-over-form doctrine.[45] In *Schering-Plough Corp.*, the court employed stricter scrutiny to analyze the substance of the swaps because Schering-Plough and its subsidiaries were related parties.[46] The court articulated that to analyze the economic substance of the transaction the "determinative fact is the intention as it existed at the time of the transaction,"[47] and relied on evidence that Schering-Plough officials considered the transactions as though they were loans and that ABN was paid for its participation in the transaction.[48] Additionally, the court focused on the fact that ABN had no significant risk in these swap transactions and that the probability of Schering-Plough defaulting on payment was almost zero.[49]

The court rejected Schering-Plough's substantive argument that the company had precisely followed Notice 89-21, which specifically governs notional principal contracts in which a lump sum is paid for the right to receive

41 The court agreed with the government's contention that these transactions were in actuality loans, with the lump sum payments by Scherico to Schering-Plough representing the principal loaned and assignment of future income streams representing the repayment of the principal plus interest. Schering-Plough Corp. v. United States, 651 F. Supp. 2d 219, 272 (D.N.J. 2009).

42 *Id.* The court focused on the objective test of the economic realities of this transaction and relied on the substance-over-form doctrine to classify these transactions as loans. *Id.* at 223.

43 The court determined that there was no other practical reason for Schering-Plough to enter into these transactions other than to avoid taxes. *Id.* at 266–70.

44 *See id.* at 243.

45 *Id.*

46 *See id.* at 246.

47 *Id.* (quoting Saigh v. Comm'r, 36 T.C. 395, 420 (1961)) (internal quotation marks omitted).

48 *Id.* at 262.

49 *Id.* at 264.

future payments.[50] Schering-Plough argued that a change the IRS made to Notice 89-21 in 1993 provided further proof that the taxes should be amortized.[51] In 1993, regulations were adopted which treated lump sum payments from notional principal contracts as loans, making them taxable in the year received.[52] These regulations were changed only for transactions "entered into on or after December 13, 1993"[53] and should not have applied to either the 1991 or 1992 Schering-Plough transactions.[54] Schering-Plough also argued that it was denied consistent treatment with other similarly situated taxpayers who were afforded the benefit of Notice 89-21.[55]

Congress has set up detailed rules about how repatriated income should be taxed, and the IRS supplemented those rules with Notice 89-21. Schering-Plough followed Notice 89-21, which was applied to other similarly situated taxpayers who entered into this type of transaction before 1993, so why did it lose the case? The answer is the court's conclusion, after a detailed analysis regarding each aspect of the transactions, that the substance-over-form doctrine applied.

However, taxpayers routinely structure transactions that may offer a variety of benefits; the point at which one transaction becomes a different one is extremely difficult to determine.[56] If courts draw a line at this case, then under what circumstance is Notice 89-21 a useful or relevant tool, and why did the IRS issue this ruling? To begin to answer these questions, a more detailed analysis of the history and difficulties with the subpart F international taxation regime is required.

---

50 *Id.* at 272. Schering-Plough argued that it should have been able to rely on Notice 89-21 because it was an "administrative pronouncement on which taxpayers could rely." Complaint, *supra* note 34, at 2 (internal quotation marks omitted).

51 *Schering-Plough Corp.*, 651 F. Supp. 2d at 236.

52 *See id.*

53 Treas. Reg. § 1.446-3(j) (1994).

54 *Id.*

55 Lee A. Sheppard, *Looking Through Derivatives to Find Substance*, TAX ANALYSTS, Dec. 14, 2009, at 1141. The IRS issued a Field Service Advice Memoranda (FSA) to a competitor of Schering-Plough in 1997, which declared that the same type of assignment of future income streams in exchange for a lump sum payment on a notional principal contract was governed by Notice 89-21, even though the assignment could be properly characterized as a loan. *Id.* at 1144. The IRS advised the taxpayer that the lump sum payment should be amortized. I.R.S. Field Serv. Adv. Mem. TL-N-3454-94 (Aug. 29, 1997). Although an FSA does not have precedential value and cannot be relied on by taxpayers, it does prove that taxpayers similarly situated to Schering-Plough were given the benefit of Notice 89-21.

56 *See generally* Warren, *supra* note 11 (discussing the difficulty with characterizing certain derivative transactions).

II. THE HISTORY AND ENACTMENT OF SUBPART F

Between 1913 and 1950, U.S. corporations were not taxed on the income of their foreign subsidiaries until the income was repatriated to the United States.[57] This system created a strong incentive for U.S. corporations to shift operations, especially income-generating activities, to foreign countries with low tax rates, thereby gaining the benefit of tax deferral on the foreign-earned income.[58] Section A of this Part examines the reasons why it was necessary to enact subpart F legislation. Section B then explains the detailed provisions of subpart F and how they functionally operate.

A. How Subpart F Became the Law

Prior to subpart F, the most common technique that U.S. corporations used to take advantage of tax deferral was setting up foreign corporations in countries with low taxes (tax havens) to hold passive assets.[59] Congress initially responded to this problem by enacting the Foreign Personal Holding Company regime in 1937.[60] This regime, which was the first step in ending tax deferral on foreign-held passive assets, operated by taxing U.S. owners on certain passive income earned by foreign corporations in the same year it was earned by the foreign corporation.[61] The regime had major gaps because it did not reach foreign subsidiaries owned by publicly held U.S. companies, or foreign subsidiaries that earned less than 60% of their income through passive activities.[62] It only affected a small group of foreign subsidiaries, leaving the previous deferral regime largely unchanged.[63] Additionally, U.S. corporations began establishing foreign base companies, an arrangement through which a

57 Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, 79 TEX. L. REV. 1525, 1527 (2001). The reason for this is that under long-standing U.S. international tax policy, foreign-chartered corporations are treated as foreign persons and the distinct legal identity of foreign subsidiaries are honored, making foreign earnings of foreign persons non-taxable. MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL TAXATION 217 (2003).

58 Engel, *supra* note 57, at 1527. Though these earnings will eventually be taxed upon repatriation, the deferral benefits corporations because of the time value of money. *Id.*

59 *Id.* at 1532–33. *Passive assets* are stocks, bonds, and other securities held outside of the United States. *Id.* The income produced by them was not subject to U.S. tax and only subject to a usually small tax in the foreign country in which they were held. *Id.* at 1532.

60 *Id.* at 1533.

61 *Id.*

62 *Id.* at 1533–34.

63 *Id.* Requirements existed prescribing that the foreign subsidiary be owned by five or fewer U.S. individuals, and at least 60% of the foreign subsidiary's gross income initially had to come from certain passive categories. Revenue Act of 1937, Pub. L. No. 75-377, § 201, 50 Stat. 813, 818 (codified as amended at I.R.C. §§ 551–558 (2006)).

U.S. multinational would divert income from a high-tax jurisdiction to a low-tax jurisdiction by making deductible payments offshore to a foreign company in the low-tax jurisdiction.[64] Passive income could then be reinvested into foreign activities without triggering U.S. taxation.[65]

For example, consider a U.S. multinational corporation with a U.S. subsidiary and a foreign subsidiary. The U.S. subsidiary conducts operations in the United States that yield $700 of income. The foreign subsidiary, which is located in a low-tax jurisdiction, acts as a financing entity providing loans to the U.S. subsidiary. As part of the loan agreement, the U.S. subsidiary owes the foreign subsidiary $600 of interest. The interest is deductible to the U.S. subsidiary, and the $600 is taxed at the lower rates of the foreign subsidiary's country. This transaction also reduces the U.S. multinational's domestic tax obligation to $100, instead of the $700 obligation that would have existed without the loan arrangement.[66]

Congress did not address this tax structure again until 1961, when the U.S. tax base began to decline and the United States was running a large deficit.[67] The Kennedy Administration proposed a virtual elimination of deferral for U.S.-owned foreign corporations, thereby taxing both domestic and foreign investments at the same rate.[68] The Kennedy Administration frowned upon the diversion of business income through tax havens and sought to prevent American companies from avoiding global taxation by diverting income from foreign subsidiaries in countries with high tax rates to foreign countries with low tax rates.[69] The 1961 Kennedy proposal aimed to achieve these goals by eliminating deferral for income earned by U.S. subsidiaries in developed countries, and eliminating deferral for U.S. subsidiaries operating in developing countries if the income was generated through profit shifting.[70] Due to the ease with which passive income could be transferred abroad and

---

[64] William J. Gibbons, *Tax Effects of Basing International Business Abroad*, 69 HARV. L. REV. 1206, 1206–08 (1955).

[65] *Id.* at 1214–16. This arrangement specifically involved a U.S. multinational owning the stock of a foreign subsidiary located in a tax haven (base country with a low tax rate), and the base company owning additional foreign subsidiaries, which operated active businesses outside of the tax haven. *Id.* The foreign subsidiaries would give passive income to the base company, who could reinvest this income without being taxed by the United States because the money was never repatriated. *Id.*

[66] Engel, *supra* note 57, at 1535–36.

[67] *Id.* at 1538.

[68] *Id.* U.S. economic growth was also sluggish at this time, growing at approximately 2% and being significantly outpaced by its rivals. *Id.*

[69] *Id.* at 1539.

[70] *Id.* For a comparison to the transaction in the *Schering-Plough* case, see *supra* note 41.

allowed to grow without any U.S. taxation, the tax base would have faced significant decline if the deferral rules were not adjusted in some way.[71]

B. The Current Subpart F Rules

The leading congressional goal in enacting the subpart F legislation was to eliminate the tax-haven device that multinationals were using to accumulate passive income abroad.[72] Most active business income was left untouched by subpart F, and deferral continued for these activities.[73] Subpart F purported to end deferral on passive income by taxing income earned by controlled foreign corporations (CFCs) on what is known as subpart F income.[74] A CFC is defined in I.R.C. § 957(a) as

> any foreign corporation if more than 50 percent of (1) the total combined voting power of all classes of stock . . . entitled to vote, or (2) the total value of the stock of such corporation, is owned . . . by United States shareholders on any day during the taxable year of such foreign corporation.[75]

The most significant element of subpart F income is "foreign base company income," which includes three major categories.[76] The first of these categories was, and continues to be "foreign personal holding company income,"[77] which consists of income from liquid passive assets.[78] This income includes the

---

71 GRAETZ, *supra* note 57, at 219.

72 JOSEPH ISENBERGH, INTERNATIONAL TAXATION 174 (2000). The House Ways and Means Committee's report offers four motivations behind the subpart F regime: (1) to prevent U.S. taxpayers from taking advantage of foreign tax systems to avoid taxation by the United States "on what could ordinarily expected to be U.S. income"; (2) to reach income retained abroad that was not used in the taxpayer's trade or business and not invested in an underdeveloped nation; (3) to prevent the repatriation of income to the United States in such ways that it would not be subject to U.S. taxation; and (4) to prevent taxpayers from using foreign tax systems to divert sales profits from goods manufactured by related parties either in the United States or abroad. H.R. REP. NO. 87-1447, at 58 (1962).

73 ISENBERGH, *supra* note 72, at 172. Foreign base company sales income, as well as foreign base company services income, is active income that is covered by subpart F, but these are exceptions rather than the rule. *Id.* at 175.

74 *Id.* at 172–73.

75 I.R.C. § 957(a) (2006). Many U.S. corporations have structured their control over their foreign subsidiaries to avoid triggering the statutory CFC definition while still maintaining constructive control over the foreign subsidiary. Regulations under § 957 have addressed this issue, making clear that formal ownership agreements will be set aside if the original domestic parent has actually retained a majority interest in the foreign subsidiary. GRAETZ, *supra* note 57, at 232.

76 I.R.C. § 954(a). There is an additional category of "foreign base company oil income" that is listed in the statute, but it is not utilized often nor is it significant for this discussion.

77 *Id.* § 954(c)(1).

78 Engel, *supra* note 57, at 1542.

"portion of the gross income which consists of . . . [d]ividends, interest, royalties, rents, and annuities," as well as the sale or exchange of property that creates this form of income.[79] This passive income was an easy target for Congress because American businesses had no reasons to defer taxation on this income—passive income created no competitive business concerns.[80] Eliminating deferral on these types of income removed the incentive to move passive income abroad, where the income was previously allowed to grow without being subjected to U.S. tax.[81] The desired effect was to bolster the U.S. tax rolls without placing American businesses at a comparative disadvantage with their foreign competitors.

The second major category of income covered by subpart F is "foreign base company sales income," which is income arising from passing sales through a low-tax foreign subsidiary with no real relation to those sales.[82] This income covers the active income from purchases and sales if the purchase or sale is between two related parties (usually a domestic corporation and its foreign subsidiary), and the purchase or sale lacks an economic nexus to the CFC's country of incorporation.[83] The purpose for creating this income category was to prevent U.S. corporations from obtaining lower tax rates on sales income by having subsidiaries located in low-tax jurisdictions sell products manufactured in a higher tax jurisdiction.[84]

For example, a U.S. corporation manufactures widgets in the United States and then sends the widgets over to its CFC in Switzerland, which is a low-tax jurisdiction. The CFC in Switzerland then sells these widgets to customers in Europe and Asia. Under the pre-subpart F rules, the income from these sales would only be taxed under the lower Swiss rates. Subpart F changed this rule to encompass the income from the sale of the widgets by the Swiss CFC.[85]

---

79 ISENBERGH, *supra* note 72, at 175.

80 Engel, *supra* note 57, at 1542. This effectively evened the playing field between foreign subsidiaries owned by U.S. multinationals and foreign subsidiaries that were owned by closely held U.S. persons. Foreign subsidiaries owned by closely held U.S. persons were already covered under the Foreign Personal Holding Company regime. *Id.*

81 *Id.* at 1544.

82 *See* I.R.C. § 954(d)(1); ISENBERGH, *supra* note 72, at 176.

83 Engel, *supra* note 57, at 1544.

84 H.R. REP. NO. 87-1447, at 62 (1962). If the subsidiary in a low-tax jurisdiction adds any substantial value to the product when it is received from the high-tax jurisdiction, then there is no foreign base company sales income. Simply packaging or labeling the product, or even minor assembly, does not count as substantial. Production costs (direct labor plus factory costs) must account for 20% or more of the goods sold to count as substantial. Treas. Reg. § 1.954-3(a)(4)(iii) (as amended in 2008).

85 *See* Engel, *supra* note 57, at 1544–45.

However, this rule only applies if the CFC purchases from a related party, the CFC does not produce the property in its country, and the property is not ultimately going to be consumed or disposed of in the CFC's country.[86]

The final category of income initially covered by subpart F is "foreign base company services income," which includes the same rules for triggering subpart F taxation as the foreign base company sales income.[87] Income derived from the performance of "technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services"[88] falls under subpart F if the services are performed for or on behalf of a related party and are done outside the CFC's country of incorporation.[89]

In addition to eliminating deferral for the above classes of CFC income, subpart F also created deemed-dividend rules intended to prevent CFCs from repatriating profits back to the United States without paying subpart F taxation.[90] These rules prevented CFCs from making loans to U.S. shareholders that would essentially be tax-free repatriation of income back to the United States.[91] Any purchase by a CFC of U.S. property, U.S. corporation stock, or U.S. intangibles would trigger these deemed-dividend rules and thus be subject to subpart F taxation.[92] The *Schering-Plough* case is a good example of the deemed-dividend rules.[93] The district court found that the subsidiaries loaned Schering-Plough $690 million dollars, and Schering-Plough owed subpart F taxation on $690 million dollars when the loan was made.[94]

The subpart F rules have created a framework that taxes a U.S. parent corporation on income earned passively through a CFC, or upon repatriation of funds earned by the CFC.[95] The deemed-dividend rules include an "obligation

---

86 I.R.C. § 954(d)(1).

87 Engel, *supra* note 57, at 1546. Services must involve a related party and have no economic nexus to the country of incorporation to trigger subpart F income. *Id.*

88 I.R.C. § 954(e)(1).

89 ISENBERGH, *supra* note 72, at 177. If the services are performed in the CFC's country of incorporation, then subpart F is not triggered. *Id.*

90 Engel, *supra* note 57, at 1546–47.

91 *Id.* at 1547.

92 *Id.* The deemed-dividend rules are subject to exceptions including the purchase of U.S. bonds, U.S. money, U.S. bank accounts, and unrelated U.S. stocks and bonds. The purpose of these exceptions is that these are normal transactions and the intention is not to keep the funds in the United States indefinitely. *Id.*

93 *See* Schering-Plough Corp. v. United States, 651 F. Supp. 2d 219, 222 (D.N.J. 2009).

94 *Id.* at 272.

95 I.R.C. §§ 951–964 (2006).

of a U.S. person,"[96] which includes a loan made from a subsidiary to a parent. Loans are considered to be repatriating events, and the entire amount loaned from a subsidiary to a parent triggers subpart F taxation for the parent.[97] If a subsidiary lends expensive tools to its parent, the transaction would only trigger subpart F to the extent of the interest the parent pays to "borrow" the tools from the subsidiary.[98] If a parent sells an asset to a subsidiary, then this would not trigger subpart F taxation at all.[99] The difference in the way a loan of money, a loan of property, and an asset sale are treated under subpart F is critical to the outcome in the *Schering-Plough* case and is revisited later in this Comment.[100]

The American business community argued against these rules because they believed the system would put them at a comparative disadvantage in relation to their foreign rivals.[101] The end result of the business community's resistance to the Kennedy proposals was the enactment of the subpart F regime.[102] The subpart F regime was a compromise between the two sides and reflected the different approaches that each took to international taxation.[103] The American business community favored Capital Import Neutrality, which preserves deferral and ensures that the business community remains competitive with its foreign rivals, while the Kennedy Administration favored Capital Export Neutrality, which eliminates deferral altogether because of the incentive it creates to move capital overseas.[104]

---

96 *Id.* § 956(c)(1)(C).

97 Lowell D. Yoder, *Short-Term CFC Loans May Avoid Code Sec. 956*, INT'L TAX J., Jan.–Feb. 2008, at 3, 3.

98 *See* I.R.C. § 956(c)(2)(C).

99 *Id.* This exemption can include the "stock or obligations of a domestic corporation" that is not related to the subsidiary. *Id.* § 956(c)(2)(F).

100 *See infra* Part V.A.

101 *See* Engel, *supra* note 57, at 1540. If the Kennedy reforms had passed, U.S. businesses would have been taxed if they continued to use tax havens, while their foreign counterparts would not. Passing the initial Kennedy proposals would have made the United States the only nation to disallow deferral on tax-haven income, and foreign countries would still have been able to use this device without paying additional taxes to their domestic governments, thus placing them at a competitive advantage. *Id.*

102 *See id.* at 1541. Subpart F refers to the additional sections of the Code, §§ 951–964.

103 GRAETZ, *supra* note 57, at 225.

104 *Id.*

III. THE DIFFERENCES BETWEEN AN INTERNATIONAL TAX SYSTEM BASED ON CAPITAL IMPORT NEUTRALITY AND ONE BASED ON CAPITAL EXPORT NEUTRALITY

Ideally, the most efficient international tax system would eliminate the role that taxes play on the decisions by investors as to which countries to invest in or borrow from. A fully neutral international tax system would mean that each country would tax its residents on their worldwide income at the same rate.[105] Therefore, nonresidents doing business in a country would not be taxed by that country but would instead be taxed by their country of residence at the same uniform rate.[106] The place where the income is earned would be immaterial.[107]

The current global tax regime, in which different countries have different rates of taxes that apply to different types of income, does not encourage the most efficient investment and allocation of resources.[108] Companies engage in tax-planning strategies, which lead to investments that yield the greatest tax benefits and not necessarily the most efficient investment decisions.[109] For example, when a foreign subsidiary wants to sell its widgets to a U.S.-based person or company, it must be conscious of the fact that it will subject its domestic parent to subpart F taxation. If the foreign subsidiary sells its widgets to a foreign person or company, the same sale does not trigger subpart F taxation for the domestic parent. Thus, the foreign subsidiary will sell the widgets to a foreign entity for a lower price, so long as the difference in price is less than the subpart F tax ramifications that a sale to a U.S. entity would produce. This is an economically inefficient result that is dictated by a convoluted global tax system.

Unfortunately, the idealized international tax system is unattainable because of the many differences that exist in countries' methods of taxation and the impracticality of obtaining international cooperation for the goal of global welfare.[110] Instead, efforts to move closer to global tax efficiency have

---

105 Dagan, *supra* note 20, at 364.

106 *Id.*

107 *Id.*

108 *See id.* at 364–65.

109 *See* Shay, *supra* note 3, at 29–30.

110 Dagan, *supra* note 20, at 365. Professor Dagan advances the argument that this cooperation is not feasible because countries are rational actors looking to maximize their own well-being, and the long-term success that a current tax policy will have on their own country is more important than the priority of global long-term welfare. *Id.*

centered around two major ideas: Capital Export Neutrality and Capital Import Neutrality.[111]

The goal of CEN is to prevent tax considerations from interfering with an investor's decision on where to invest.[112] The rationale of CEN is that the location in which an investor chooses to do business should be chosen with an eye toward efficiency rather than tax consequences.[113] Achieving global efficiency would in turn lead to greater national welfare.[114] CEN is achieved when the income tax imposed by the country in which the investor resides (country of residence) and the income tax imposed by the country where the investor does business (host country) equals the tax imposed on domestic investments in the country of residence.[115] This formula ensures that an investor has the same profits from investing whether at home or abroad.[116] The achievement of CEN would occur if every country taxed only its residents on their worldwide income.[117]

Today, most countries tax the income earned within their borders, so to obtain CEN a system of foreign tax credits would need to be implemented.[118] If a foreign country has a higher rate of tax than the domestic company's country of residence, the income earned by the company in that foreign country would be subject to a higher rate of tax.[119] To even out this disparity, the country of residence would need to provide the company with domestic tax credits equal to the difference between the two countries' taxes.[120]

The only way that a system of CEN could fully be achieved is if there is no ceiling on the amount of tax credits that the company's country of residence is willing to provide.[121] This would ensure that investors are only taxed at their country of residence's tax rate, regardless of whether they earned income at

---

111 *See id.*; Robert J. Peroni, *Deferral of U.S. Tax on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle with Subpart F?*, 79 TEX. L. REV. 1609, 1609 (2001).

112 Dagan, *supra* note 20, at 367–68.

113 *See* Peroni, *supra* note 111, at 1613.

114 Dagan, *supra* note 20, at 367–68. As global welfare increases as a result of this increased efficiency, national welfare should increase correspondingly. *Id.*

115 *Id.*

116 *Id.* at 368. This assumes the same before-tax return in each country. *Id.*

117 *Id.* Critics of CEN argue that this would lead to a competitive disadvantage for investors if their country of residence's tax rate were higher than the domestic tax rates of their competitors. Their competitors would have a significant advantage because of the lower tax rates to which they are subject. *Id.*

118 *Id.*

119 *Id.* at 369.

120 *Id.*

121 *Id.*

home or overseas.[122] Take as an example a U.S. multinational that has an Italian subsidiary and the Italian subsidiary earns income from the Italian market. If Italy has a 35% corporate tax rate and the United States has a 25% corporate tax rate, then if the Italian subsidiary earns $1,000,000 of income in Italy, it will pay $350,000 in taxes to Italy. The Italian subsidiary would have only paid $250,000 in taxes based on the U.S. corporate rate. So to compensate for this disparity and to ensure that tax consequences are not dictating where business is being done, the United States would need to provide $100,000 in tax credits to the U.S. multinational to reduce its overall tax burden.

CIN, on the other hand, is predicated on the fact that the total tax on the investment returns in a country should be the same, regardless of the investor's country of residence.[123] Any business operating in a country would be subject to the same rate of taxation.[124] Without CIN, countries with low tax rates are able to attract more investment than countries with high tax rates, even when such investment would be otherwise less efficient.[125]

CIN could be reached if all countries had an identical rate of taxation on all income produced within their borders, regardless of investors' residency status, and if countries exempted residents from tax on the income that they produced abroad.[126] For example, if a U.S. multinational has a foreign subsidiary located in a low-tax jurisdiction, its income would be subject to the low rate and, at least initially, would avoid U.S. rates of taxation. Once the income has repatriated, it would be subject to U.S. taxation. This affords the multinational deferral on the income earned by the subsidiary and provides an incentive to have passive income held in low-tax jurisdictions to reduce the multinational's tax liability. By adopting CIN, a country allows its resident investors to compete more effectively with foreign competitors because earned foreign income is only subject to foreign countries' tax rates and not to any additional domestic tax.[127]

[122] *Id.* at 368–69. For true CEN to be achieved, there should be no maximum amount of foreign tax credits given to an investor. If the foreign tax rate is higher, then the country of residence should subsidize the difference in taxes to ensure that the total level of taxes equals the level in the country of residence. *Id.* at 369.

[123] *Id.* at 370.

[124] *Id.*

[125] *Id.* at 371. This serves as a prime example of taxes driving investment strategy rather than the most efficient investment option.

[126] *Id.*

[127] *See id.* Commentators have criticized CIN because it provides an incentive for investors to move investments to countries with low tax rates. Thus, tax considerations are a major factor for investors deciding

IV. DIFFICULTIES AND PROPOSED SOLUTIONS TO THE CURRENT SUBPART F SYSTEM

It is difficult to create a complex and nuanced international tax system that balances a careful compromise between global tax neutrality and keeping American businesses competitive with their rivals. Essentially, subpart F tries to strike this balance by distinguishing the good deferral of active business income, which keeps American companies competitive abroad, from the bad deferral of passive income from tax havens.[128]

Subpart F's approach to striking this balance was to establish a series of detailed rules to separate the good deferral from the bad.[129] When rigid objective rules are used to solve such a complex and detailed problem, strong incentives are created for corporations to use tax-planning strategies that structure transactions to avoid the anti-deferral rules.[130] Section A describes one of the biggest loopholes in the current subpart F system: hybrid entities. Section B then explains the competing policies on international taxation that are guiding proponents on each side of the debate.

A. The Debate over the Treatment of Hybrid Entities Under Subpart F

Major issues with subpart F are highlighted by the ongoing dispute over how subpart F should treat hybrid branches that arose after the check-the-box regulations issued by the Treasury Department in 1996.[131] These regulations allow a foreign entity to qualify as a corporation for foreign tax purposes and a branch for U.S. tax purposes.[132] The hybrid branch structure involves three different entities, all of which are owned by a U.S. corporation: (1) a foreign holding company, (2) a foreign active company, and (3) a foreign hybrid

where to locate their investments because they may receive an economic return lower than what they would receive in their home country—as long as the tax reduction makes the investment worthwhile. Peroni, *supra* note 111, at 1613–14.

128 GRAETZ, *supra* note 57, at 226.

129 *Id.*

130 An example of this is the convoluted transaction that Schering-Plough entered into with ABN to sell future income from notional principal contracts to its foreign subsidiary in exchange for a lump sum cash payment. *See* Complaint, *supra* note 34, at 3. This transaction technically followed the letter of Notice 89-21 and, according to the letter of the law, should have been exempt from subpart F taxation. Schering-Plough paid Merrill Lynch millions of dollars to plan this tax strategy to comply with the complicated objective Code regulations, while still accomplishing its desired result of repatriating income without it being subject to subpart F taxation.

131 *See* Treas. Reg. §§ 301.7701-2(a), 301.7701-3(a) (1996); Engel, *supra* note 57, at 1552.

132 Engel, *supra* note 57, at 1552. Branch status generally makes the foreign entity disregarded for U.S. tax purposes. *Id.*

entity.[133] The first two companies are located in the same high-tax-rate country while the foreign holding company forms the hybrid entity in a tax-haven country.[134] A debtor–creditor relationship is then established with the foreign holding company paying interest to the hybrid branch.[135] This structure allows interest payments that are sent to the hybrid to avoid subpart F taxation because the hybrid branch is not recognized for U.S. tax purposes and the payment is a direct payment from a foreign holding company and active company in the same country.[136]

An example of how this would work would be if the foreign holding company and active company are each located in the high-tax jurisdiction of Germany and the holding company that creates the hybrid entity is located in the low-tax jurisdiction of Switzerland. Each of the three companies is owned by a U.S. company. The active company in Germany has earned $500 of income from its business. The hybrid entity enters into a loan agreement with the active company, under which the active company must pay $500 in interest to the hybrid. The interest payment to the hybrid shifts the $500 of income earned by the active company to Switzerland. The United States would look at the interest payment as moving from the active company to the holding company (which set up the hybrid) in Germany, because the hybrid entity is disregarded as a branch. This would avoid subpart F taxation because the active and holding companies are both located in Germany and they are related parties.[137]

In 1998, the IRS proposed anti-hybrid regulations aimed at stopping this practice by recognizing the hybrid branch for U.S. tax purposes.[138] These regulations faced strong challenges from those who argued that this hybrid system merely avoided foreign tax and was outside the intended scope of subpart F.[139] Critics also argued that the hybrid structure was a necessary mechanism that allowed U.S. companies to compete on a level playing field

[133] *Id.* at 1553.
[134] *Id.*
[135] *Id.*
[136] *Id.* This type of transaction avoids subpart F taxation because of the same-country exception for sales to related parties with regard to foreign personal holding company income. *Id.*
[137] *See id.* at 1553–54.
[138] Prop. Treas. Reg. § 1.954-9T(a)(4), 63 Fed. Reg. 14,669, 14,673 (Mar. 26, 1998). Under the proposed regulations, the hybrid branch would be treated as a corporation for subpart F purposes, and the interest payments the hybrid received would be subpart F income because they fall outside the same country exception. *See id.*
[139] Engel, *supra* note 57, at 1554.

with foreign competitors who were able to exploit this tax-haven structure.[140] Without the hybrid structure, U.S. businesses would be subject to higher rates of taxation than their foreign competitors that were still able to utilize hybrids.[141] Referring back to the above example, the German active company would now have the $500 of income subject to subpart F taxation, while foreign multinationals would still be able to use the hybrid structure to keep the $500 safe from domestic taxes. This difference would place U.S. companies at a comparative disadvantage. This concern was not shared by the IRS, who argued that subpart F was created to prevent companies from avoiding a worldwide tax.[142]

The debate over the anti-hybrid regulations pitted the same parties against one another as in the initial debate regarding subpart F.[143] The disagreement was still over what the preferred policy behind international taxation should be: CEN or CIN.[144] The anti-hybrid regulation debate proved how far the Treasury Department was willing to go to support the policy of CEN, even when the U.S. tax base was not immediately threatened.[145] The Treasury Department reiterated that CEN was its guiding principle in international taxation when it released a report on the current effectiveness of subpart F in 2000.[146] In the report, the Treasury Department expressed its clear preference for CEN and advocated a position that would reduce deferral greatly.[147]

B. Proposed Academic Solutions to Subpart F

1. Benefits and Drawbacks of Implementing Uncontrolled CEN

There are those who would take the Treasury Department's proposals even further, by outright eliminating all deferral on earnings from foreign

140 *Id.* at 1555.
141 *Id.*
142 *Id.*
143 *See id.*
144 *Id.*
145 *Id.*
146 *See* OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY 23–54 (2000) (stating that capital export neutrality is likely the best policy for promoting economic welfare).
147 *See id.* at 23–54, 83 (arguing that an anti-deferral regime is necessary to prevent the use of tax-avoidance techniques). The only recognition that the Treasury Department gives to the goal of simplicity in the tax system is the concept that getting rid of deferral would be easier than the current system. *Id.* at 84.

subsidiaries.[148] Robert J. Peroni, a professor at the University of Texas School of Law, argues that the deferral principle, which allows U.S. parent companies to avoid taxation from most foreign subsidiary active income until repatriation, undercuts fairness in the tax system and encourages U.S. companies to shift income to low-tax overseas jurisdictions.[149] He argues that the complicated subpart F system that exists today makes deferral elective for a well-advised taxpayer and points to the check-the-box hybrid system as proof.[150] He concludes from this information that deferral should be completely eliminated for CFC income.[151] Professor Peroni discounts the idea that the repeal of deferral would reduce American competitiveness abroad because if firms face the same tax rate in any location in which they operate, then "their pretax return on their marginal investment will be equal."[152]

The American business community thoroughly disagrees with both the reduction and elimination of the current system of deferral.[153] U.S. multinationals issued a report which compared the subpart F rules that are applied to U.S. corporations with other countries' systems of international taxation.[154] The report shows that, in nearly every respect, the CFC regimes of other similarly situated countries are less strict than that of the United States.[155] As U.S. companies have continued to focus on foreign markets to remain competitive in this global economy, and as income from foreign subsidiaries has increased at a faster rate than domestic sales, the more stringent subpart F rules place American businesses on unequal footing with their foreign

148 *See* Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 988 (1997).

149 *Id.* at 986–87.

150 *Id.* at 987–88.

151 *Id.* at 988.

152 *Id.* at 988–99. The argument is that pretax return is the true measure of productivity of capital and that regardless of what foreign competitors are doing, it is more efficient for U.S. firms to move capital back into the United States if they are earning a lower rate of pretax return in the low-tax foreign country. *Id.* at 989.

153 *See* NAT'L FOREIGN TRADE COUNCIL, THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY 46 (2001) (stating that U.S. trade and business interests believed that the abolition of deferral would erode the competitive position of U.S. companies abroad).

154 *See id.* at 67–92. The countries used for comparison were Canada, France, Germany, Japan, the Netherlands, and the United Kingdom. *Id.* at 67.

155 *See id.* at 67–92. The report indicates that the foreign countries' regimes were all adopted after subpart F and therefore reflected a study of the impact of subpart F as well as ways to refine the system. *Id.* at 68. The United States is the only country that currently taxes active financial-services income from both related and unrelated parties. *Id.* at 89 tbl.4–1a. The United States is also the only major country to tax active business royalty payments from a subsidiary in another country. *Id.* at 90 tbl.4–1b.

competitors.[156] The report urges that adoption of CEN is unwise because of the increased global competition that U.S. multinationals face, and the fact that no other country has adopted an international taxation system consistent with CEN.[157] The business community argues that moving international tax policy toward CIN, by limiting the scope of subpart F to include only passive income, would simplify U.S. tax rules and would be more in line with those of foreign companies.[158]

2. *Benefits and Drawbacks of Implementing Uncontrolled CIN*

On the other hand, David Rosenbloom, a professor at New York University School of Law, suggests that keeping American multinationals competitive should be the guiding principle behind any subpart F reform.[159] He finds fault with taxing domestic base company income while most foreign base company income is not covered by subpart F.[160] He argues that in a globalized world, it should not matter where the income is earned, and that, when a U.S. company buys from or sells to a related party and the good's manufacture or its sale occurs in the United States, that income should be exempt from taxation.[161] He states that it is "competitiveness on which any 'reform' of subpart F must rest," and, because other countries allow their multinationals to place income into low-tax jurisdictions without taxing the income, the United States should also do this to keep its companies competitive.[162]

By exempting income made by foreign base companies abroad as well as domestic base income earned in the United States, American business would be more competitive globally, and there would be an increased incentive for companies to invest domestically.[163] For example, if the United States affords a multinational deferral on a portion of its income that is assigned a specific economic function earned in Malaysia, then that same income assigned the

---

[156] *Id.* at 97. This competitive imbalance hurts business more than in the 1960s because of the increasingly globalized market and percentage of business sales that come from foreign subsidiaries. *See id.* at 95.

[157] *Id.* at 126–27.

[158] *Id.* at 127.

[159] H. David Rosenbloom, *Thinking About Subpart F: The Domestic Base Company,* TAXES, Mar. 2004, at 153, 155.

[160] *Id.* This income is taxed if the sale involves a related party and lacks an economic nexus to the CFC's country of incorporation. I.R.C. § 954(d)(1) (2006).

[161] Rosenbloom, *supra* note 159, at 155–56. Rosenbloom acknowledges that this system would be the equivalent of an across-the-board corporate tax cut. *Id.* at 155.

[162] *Id.* at 155–56.

[163] *Id.* at 156.

same economic function in the United States should also get deferral.[164] The income is earned in the same fashion, so it should not matter whether the income is earned at home or abroad.[165]

The problem with this proposal is that it encourages U.S. businesses to earn income abroad in countries with low tax rates. Income would be earned abroad in the country with the lowest possible tax rate and then sent back to the United States with no tax consequences. This proposal would reduce the amount of money that the government receives in taxes and would encourage U.S. companies to move operations abroad, theoretically cutting American workforces.

A second proposal would wholly eliminate U.S. tax upon repatriation.[166] This proposal would remove any U.S. tax motivation for leaving deferred income overseas[167] and would essentially function as a tax exemption on CFC income that is not covered by subpart F.[168] This proposal trusts that the tax CFCs face in their home countries is sufficient, and no additional U.S. tax upon repatriation is required.[169] As a result of the proposal, U.S. multinationals would structure their transactions so that CFCs in countries with low tax rates generate as much taxable income as possible. After the income is taxed in the low-tax jurisdiction, the U.S. multinational would have a strong incentive to transfer this money back to the United States.[170]

As the goal of global tax neutrality becomes more viable, this system will become increasingly feasible since foreign tax rates will be an effective substitute for the existing U.S. tax system.[171] Additionally, the United States collects less than one billion dollars a year on nonpassive subpart F income,[172] so the ramifications for adopting a proposal like this would not greatly affect

---

164 *See id.* at 154 (arguing that there is no reason for U.S. policymakers to favor foreign activities over U.S. activities).

165 *Id.*

166 Engel, *supra* note 57, at 1603.

167 *Id.*

168 *Id.* Foreign base company sales and service income rules are forms of active income for which the policy would provide tax exemption. I.R.C. § 954(d)(1), (e)(1) (2006).

169 Engel, *supra* note 57, at 1603.

170 *Id.* Under this proposed system, there is no need for U.S. multinationals to keep non-subpart F income in low-tax jurisdictions to gain the benefit of deferral. *Id.* Therefore, as soon as income earned by foreign subsidiaries is needed by the domestic parent, it is sent back to the United States. *See id.* This system would make the issue in the *Schering-Plough* case moot because Schering-Plough would have been able to get the money from its foreign subsidiaries without structuring a complicated and expensive arrangement.

171 Rosenbloom, *supra* note 159, at 153.

172 *Id.*

the amount of taxable income that the government receives, while the benefits of increased investment in the United States could be significant.[173]

This proposal is severely limited by the incongruities between the current U.S. tax system and one based on global tax neutrality. It is also unlikely that foreign tax rates will ever be an effective substitute for domestic rates because there is an incentive for foreign countries to lower their tax rates in an effort to attract foreign capital into their country.[174] Thus, wholly eliminating the tax on repatriation would encourage American businesses to earn as much money as they could abroad in the country with the lowest tax rate, and foreign countries to compete for the lowest tax rate in an effort to attract capital.

V. POSSIBLE REMEDIES TO THE ARBITRARY CLASSIFICATION OF ASSETS BY THE COURT IN THE *SCHERING-PLOUGH* DECISION

Under current subpart F rules, the proceeds of a loan from a CFC to a parent company are taxable to the parent immediately upon receipt of the funds.[175] The reason for this is that a loan from subsidiary to parent is considered a constructive dividend and thus a repatriating event.[176]

The congressional purpose for taxing these loans was to capture income that would otherwise not be taxable under subpart F, because a loan from a domestic to parent is effectively repatriation of income from a subsidiary to a parent.[177] Section A of this Part analyzes the difficulty in determining whether the transaction engaged in by Schering-Plough was an assignment of future income or a loan. Section B determines whether CIN or CEN would prove more effective in eliminating different taxation for economically equivalent transactions.

---

173 Adoption of this proposal would also save companies a great deal in avoiding tax-planning strategies to repatriate income and avoid taxation.

174 *See* Rosanne Altshuler & Harry Grubert, *The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies*, 7 FLA. TAX REV. 153, 167 (2005) (suggesting that high-tax host countries have reacted to increasing tax sensitivity in investment by easing transfer pricing and thin capitalization rules to attract foreign capital). This phenomenon of foreign countries attempting to have the lowest tax rate in an effort to gain foreign investment is often referred to as a “race to the bottom.” NAT’L FOREIGN TRADE COUNCIL, *supra* note 153, at 67–68.

175 I.R.C. § 956(c)(1)(C) (2006).

176 *E.g.*, *id.*; Yoder, *supra* note 97, at 3.

177 H.R. REP. NO. 87-1447, at 58 (1962).

A. *The Schering-Plough Transaction: Was It a Sale or a Loan? Why We Need a Better Way to Tell the Difference*

Subpart F taxes U.S. shareholders on the amount of "United States property held (directly or indirectly) by the controlled foreign corporation,"[178] and defines U.S. property, in part, as "an obligation of a United States person."[179] The regulations define an obligation as "any bond, note, debenture . . . whether or not issued at a discount and whether or not bearing interest . . ."[180] U.S. property does not include the purchase by a CFC of stock or debt obligations from unrelated domestic corporations.[181]

It follows from these provisions that the sale of an unrelated domestic company's asset from a parent to a CFC would be taxed in the way that most asset sales are taxed—amount realized minus adjusted basis[182]—and would not be included as subpart F income. This analysis shows that a loan from a CFC to a parent would be taxable under subpart F, while the sale of an asset would not be.[183] When a CFC makes a loan to a parent, it is assumed that the money from the loan will not be paid back.[184] Therefore, the loan is treated as a repatriating event, and the entire sum of the loan is immediately taxable to the parent under subpart F.[185] On the other hand, the sale of an asset from a parent to a CFC is not covered under subpart F,[186] presumably because the sale price the CFC is paying for the asset is fair. If a parent takes out a legitimate loan from its CFC that it intends to pay back, then why are these transfer pricing rules insufficient to police the legitimacy of loans as well as sales?

---

178 I.R.C. § 956(a)(1)(A).

179 *Id.* § 956(c)(1)(C). These deemed-dividend rules also include the selling of parent company stock to a CFC. *Id.* § 956(c)(1)(B).

180 Temp. Treas. Reg. § 1.956-2T(d)(2) (as amended in 2008).

181 *E.g.*, I.R.C. § 956(c)(2)(F); Lowell D. Yoder & Sandra P. McGill, *Treatment of CFC Loans to U.S. Affiliates: The Sword and Sickle of Subpart F*, 26 TAX MGM'T INT'L J. 454, 457 (1997). Originally, under § 956, a loan from a CFC to a parent, whose term was less than a year, did not trigger the deemed-dividend rules. *Id.* at 459. Regulations in 1993 changed the rule so that the loan would trigger subpart F if not paid in three months. *Id.* at 468.

182 *See* I.R.C. § 1001(a).

183 *Compare id.* § 956(c)(1)(C) (stating that an obligation of a U.S. person is taxable under subpart F), *with id.* § 956(c)(2)(C) (stating that the stock or debt obligations of a domestic corporation that is neither a U.S. shareholder of a CFC, nor a domestic corporation, is exempt from subpart F taxation).

184 Kimberly S. Blanchard, *Guidance Needed for CFC Lending Transactions*, 126 TAX NOTES 201, 205 (2010).

185 *See, e.g.*, I.R.C. § 956(c)(1)(C); Yoder, *supra* note 97, at 3.

186 *See* I.R.C. § 482. These sales between parent and CFC are governed by the transfer pricing rules under § 482 of the Code. *See id.*

The arbitrary distinction between a loan and a sale renders the *Schering-Plough* opinion disconcerting. The difference between the assignment of future income streams that Schering-Plough sought to participate in with its CFC, and the loan that the court found the transaction to be, is a factual determination.

Given the failure of the *Schering-Plough* court to announce which elements it considered essential to the distinction between a sale and loan, how are courts to draw the line in the future? The court did not articulate a balancing test or the factor that made this transaction a loan, but instead relied heavily on the amorphous substance-over-form doctrine.[187] In substance, there is little difference between the gain realized from an asset and interest paid on a loan, yet one transaction is taxed at a higher rate under subpart F. Both transactions need to be policed, but currently asset sales are policed using the transfer pricing rules, while loans are presumed to be unfair transactions and deemed repatriating events when they occur, even if the loan is legitimate.

The difficult and subjective analysis in which a court must engage to determine which of several economically identical transactions a company has entered suggests a need for clearer and more objective rules that give meaningful distinction between transactions that are to be taxed differently. Additionally, it is important to give taxpayers predictability and stability in the law. Schering-Plough relied on Revenue Notice 89-21, which was the governing principle on notional principal contracts at the time of the transaction, yet still lost the case.[188] This further suggests that the arbitrary distinctions that still exist with regard to which transactions fall under subpart F need to be made clearer and more meaningful. The goal of a tax system should not be to encourage a company to engage in expensive tax-planning strategies.[189] Nor should it force companies to synthetically create a transaction wholly for tax purposes that is economically identical to the transaction it would have otherwise engaged in had it not been for the unnecessary distinction created by the law.

---

[187] Schering-Plough Corp. v. United States, 651 F. Supp. 2d 219, 246 (D.N.J. 2009).

[188] *Id.* at 222, 272.

[189] *See* Reuven S. Avi-Yonah et al., *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497, 498–515 (2009) (discussing the reward for aggressive tax planning and proposing a formulary apportionment tax system which would tax U.S. multinational corporations on a fraction of their worldwide incomes).

B. Using Theories of Global Taxation to Remedy the Arbitrary Categorizations of Income Taxed by Subpart F

If a major goal of international tax policy should be to treat economically identical transactions in a consistent manner, then the United States needs an overarching theoretical policy to reach this result. In thinking about better alternatives to having a court make the difficult decision of categorizing a transaction as a sale or loan, it is useful to refer back to the discussion of CIN and CEN.[190] A CEN system would lessen the problem of categorizing a specific asset for tax purposes because, wherever a taxpayer chooses to do business, it would be theoretically taxed at the same rate.[191]

A business would have no incentive to construct a transaction to elude the complicated repatriation rules if its earnings abroad were taxed at the same rate as its domestic earnings. There would, in fact, be no need for the subpart F rules regarding repatriation because the incentive to earn income in low-tax jurisdictions would no longer exist, and taxpayers would engage in tax-planning strategies less frequently. The CEN approach would lead taxpayers toward the most efficient forms of investment rather than those that would produce the most tax savings, as well as provide taxpayers with a simple and predictable administrative framework on how their investments would be taxed.[192] Moving toward CEN would also increase domestic investment by eliminating any tax advantage from investing abroad.[193]

Moving toward CEN would also reduce the vigorous debate over the treatment of hybrid entities under subpart F to merely an academic distinction.[194] By having all of a company's earnings taxed at the same rate abroad as they are taxed domestically, the complicated hybrid entity transactions designed to exploit lower tax rates in foreign countries would no longer yield any benefit to American companies. The elimination of the hybrid-entity loophole, by moving closer to an international tax system based on CEN, would greatly reduce expensive and complicated tax-planning strategies in which U.S. corporations engage.

CIN would be less helpful in ending the difficult types of asset distinction that occurred in *Schering-Plough*. By subjecting companies only to foreign tax

---

190 *See supra* notes 105–27 and accompanying text.
191 *See supra* text accompanying notes 115–16.
192 See *supra* text accompanying notes 113–16.
193 Peroni, *supra* note 113, at 1613.
194 *See supra* notes 131–47 and accompanying text.

rates, CIN would continue to create an incentive for businesses to earn a significant amount of their income in countries with low tax rates.[195] The policy of CIN would also strengthen the need for the subpart F repatriation laws because companies would continue to attempt to avoid U.S. taxation on the income that they earn in the low-tax jurisdictions.

The transaction that Schering-Plough entered would not be changed by this rule. Loopholes in the tax system would continue to be exploited, and tax-planning strategies would continue to be routinely utilized. The hybrid branch debate would continue as American companies would inevitably seek the foreign country with the lowest tax rate to gain the greatest possible tax advantage. Although countries have varying tax rates and CIN is a useful tool to keep American businesses competitive with foreign competitors who could be taxed at a lower rate abroad,[196] this policy does not move the United States any closer to treating economically identical transactions the same. It does not solve the difficult distinction between loans and asset sales that the court faced in categorizing the transaction in *Schering-Plough*.

VI. PROPOSED CHANGES TO SUBPART F: TAXING ECONOMICALLY IDENTICAL TRANSACTIONS THE SAME

In analyzing the Schering-Plough transaction on a microeconomic level, it is helpful to refer back to the way in which loans and asset sales are treated under subpart F.[197] When a foreign subsidiary lends money to a domestic parent, this is deemed a repatriating event and requires no further investigation of the transaction's fairness.[198] This tax treatment of a cash loan is different from the treatment of a loan of property from a foreign subsidiary to a domestic parent.[199] A loan of property—chair-making equipment, for example—is not deemed a repatriating event for the domestic parent, and subpart F is only triggered to the extent of the interest that the domestic parent pays to its subsidiary to loan the chairs.[200] When a domestic parent sells an

---

[195] *See supra* note 127.

[196] Most foreign countries' policies on repatriation are more lenient than that of the United States. *See supra* note 155.

[197] *See supra* note 92.

[198] *See supra* notes 95–96 and accompanying text.

[199] *Compare* I.R.C. § 956(c)(1)(C) (2006) (stating that an obligation of a U.S. person is taxable under subpart F), *with id.* § 956(c)(2)(C) (stating that an obligation arising from the sale or processing of property is exempt from subpart F taxation).

[200] *Id.* § 956(c)(2)(C).

asset to its foreign subsidiary, the transaction is not deemed a repatriation and does not trigger subpart F at all.[201]

Subpart F draws a distinction among the loaning of money, the loaning of the chair-making equipment, and the sale of an asset between a subsidiary and parent. For example, if a domestic parent loans chair-making equipment from its foreign subsidiary and then sells the equipment for a large profit to a third party, this may not trigger subpart F taxation to the parent.[202] But if cash loans between parent and subsidiary are repatriating events because of the difficulty in policing repayment to a subsidiary, then why is there not the same concern that chairs loaned to the parent company will not be given back to the subsidiary or that the sale price a subsidiary pays for an asset is too low? Subpart F draws a distinction where no distinction should exist. The fact that there is an artificial line distinguishing the tax treatment of these three transactions is not sound tax policy and allows for manipulation.

A. First Proposal

Transfer pricing rules should be used to police loans between a parent and its subsidiary. Under current tax law, when a parent sells an asset to a subsidiary, it is not taxed under subpart F but instead is policed by the transfer pricing rules in the Code.[203] If the transfer pricing rules are effective in policing the asset sales between parent and subsidiary, then these same rules should be used to police loans between parent and subsidiary. Rather than automatically categorizing cash loans between parent and subsidiary as repatriating events, transfer pricing rules should be used to analyze the legitimacy of the loan.

If the loan is, in fact, a true loan and there is no actual value transfer, then the loan should be treated consistently with asset sales. For example, if a foreign subsidiary loans its domestic parent $300 million, the transfer pricing rules should be used to determine whether the loan is actually a loan that the parent will repay. If it is deemed to be a loan, then the only amount that would trigger subpart F income to the parent would be the interest payments made to

[201] This asset sale is governed by § 1001(a) and subject to the complicated transfer pricing rules in § 482. *See id.* §§ 482, 1001(c).

[202] Complicated and conflicting regulations exist when property is loaned from subsidiary to parent including the "guarantee" and "asset pledge" rules. *See* Blanchard, *supra* note 184, at 202–04 (describing the complicated regulations involved when assets from a foreign subsidiary are used as collateral for a domestic parent's debt obligation).

[203] *See* I.R.C. § 482.

the subsidiary. The amount of interest is the amount that the parent pays to rent the money from its subsidiary and is the only amount of actual value that is being transferred. Therefore, that amount should be subject to subpart F taxation when it is made.

Transfer pricing rules could also be used to police property loans between subsidiary and parent, thereby eliminating the need for the confusing regulations that exist to determine when a parent would have subpart F income from these loans. Attempting to determine whether the agreed-to sale price of an asset between a subsidiary and its parent is fair is a more difficult task than determining whether a loan between a subsidiary and its parent should be respected.

For example, if a subsidiary sells equipment to its parent, it is a difficult task to determine whether the parent paid the equipment's fair market value, especially if the parent resold the equipment a year later for a profit.[204] If the transaction is, in fact, deemed to be a legitimate loan under the transfer pricing rules, then the only amount that should be subject to subpart F taxation is the interest that the parent owes the subsidiary on the loan.[205] Applying the transfer pricing rules to these three types of transactions between subsidiary and parent would go a long way in ensuring consistent tax treatment for these transactions, and it would eliminate disputes like the one that occurred in *Schering-Plough*.[206]

B. Second Proposal

Alternatively, if the transfer pricing rules are deemed to be ineffective in determining whether an asset sale between subsidiary and parent is legitimate, then subpart F must be amended to encompass these asset sales.[207] In this circumstance, asset sales and property loans between parent and subsidiary should be treated in the same way that cash loans are currently treated.[208] All three transactions should automatically be considered repatriating events, and

---

[204] This transaction would be governed by the transfer pricing rules in § 482. *See id.*

[205] This is the way that property loans are currently taxed under subpart F. *See id.* § 956(c)(1)(C).

[206] If the transaction that Schering-Plough entered into with its foreign subsidiaries was governed by the transfer pricing rules, then there would be no need to engage in a substance-over-form analysis or attempt to categorize the transaction. All that would be necessary would be a determination on whether the agreement was fair under the transfer pricing rules.

[207] Section 956(c) of the Code could broaden the definition of U.S. property to include any type of loan between subsidiary and parent, as well as asset sales between subsidiary and parent.

[208] *Id.* § 956(c)(1)(C).

subpart F should immediately be triggered. This approach provides the added benefit of bypassing complicated inquiries into the validity of a given transaction.[209]

For example, if a domestic parent sold its foreign subsidiary stock of an unrelated U.S. company, the entire amount of the transaction would immediately subject the parent to subpart F taxation.[210] There would be no need to examine the transfer pricing rules to analyze the transaction. This immediate invocation of subpart F for transactions between a subsidiary and parent would prevent courts from undertaking the difficult factual inquiry in *Schering-Plough* because the difficulties in policing transactions between subsidiary and parent would necessitate that they are always repatriating events.[211] Multinational taxpayers would have clear guidance on what the law is and would no longer need to enter into expensive tax-planning strategies in dealings with their subsidiaries because they would be taxed under subpart F, no matter how the transaction is structured.[212]

CONCLUSION

The *Schering-Plough* opinion illustrates the difficulties with courts categorizing complex financial transactions for the purposes of subpart F. These categories can mean a difference of hundreds of millions of dollars in tax liability and encourage companies to engage in expensive tax-planning strategies to structure economically identical transactions in a way that avoids subpart F taxation. To resolve these issues and inconsistencies, the subpart F rules must be more consistent and predictable, treating like transactions alike and discouraging the artificial construction of transactions simply for the purpose of avoiding taxation. By moving toward an international tax system

---

[209] The entire substance-over-form analysis used by the *Schering-Plough* court would be unnecessary. *See supra* note 42.

[210] Under the current rules, this transaction would be governed by the transfer pricing rules of § 482. If the domestic parent sold the subsidiary stock of itself, this would trigger subpart F taxation under § 956(c)(1)(B).

[211] As such, dealings between a parent and its subsidiaries will be governed by § 956(a)(1)(A).

[212] *See supra* note 189.

based on CEN and treating identical transactions the same by using one of the two proposals presented, the United States can move closer to a tax system in which efficiency is the driving force behind investment decisions.

DANIEL SOLEIMANI*

* Articles Editor, *Emory Law Journal*; J.D. Candidate, Emory University School of Law (2011); B.A., University at Buffalo (2007). I thank my advisor, Professor Howard E. Abrams, for providing me with insight and encouragement. I would also like to thank my colleagues on the *Emory Law Journal* for all their excellent ideas which greatly enhanced this paper.