NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON THE MANAGEMENT AND CONTROL PROVISION OF THE "INTERNATIONAL TAX COMPETITIVENESS ACT OF 2011"

January 31, 2011

Report No. 1232

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This report[1] comments on a legislative proposal originally introduced in March 2009 by each of Senator Carl Levin and Rep. Lloyd Doggett, reintroduced in May 2010 by Rep. Doggett in his "International Tax Competitiveness Act of 2010" and introduced for a third time in January 2011 by Rep. Doggett in his "International Tax Competitiveness Act of 2011."[2] All three versions of the proposal are identical. It would generally treat certain foreign corporations that are managed and controlled in the United States as domestic corporations.

The report first introduces the proposal and summarizes our recommendations. It then outlines the proposal and discusses in detail how it applies to industrial or service corporations versus incorporated investment funds, expanding on our recommendations in each case.

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1 This report was prepared by an ad hoc committee consisting of Peter Blessing, David Miller, Andrew Needham, Erika Nijenhuis, Yaron Reich, Diana Wollman and Jim Brown, who was the principal drafter. Additional helpful comments were provided by David Borisky, Samuel Dimon, Elliot Pisem, Michael Schler, John Schrier, David Sicular, Eric Sloan and Eric Solomon. Significant research assistance was provided by Revital Bar Or, Meredith Levy, Kamela Nelan and D.J. Stauber. Opinions expressed in the report are those of the Tax Section of the New York State Bar Association, and do not represent those of the New York State Bar Association unless and until they have been adopted by the Association's House of Delegates or its Executive Committee.

2 The most recent version of the proposal, the "International Tax Competitiveness Act of 2011" [hereinafter the International Tax Competitiveness Act of 2011] was introduced as H.R. 62 in the 112th Congress. This legislative proposal is available at http://thomas.loc.gov/cgi-bin/query/z?c112:H.R.62:. The May 2010 version of the proposal, the "International Tax Competitiveness Act of 2010," was introduced as H.R. 5328 in the 11th Congress with five co-sponsors. The text of this bill can be found at http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.5328:. Sen. Levin originally made this proposal in the Senate in the "Stop Tax Haven Abuse Act" [hereinafter the Stop Tax Haven Abuse Act], introduced as S. 506, in March 2009, which had five-co-sponsors. This proposal is available at http://thomas.loc.gov/cgi-bin/query/z?c111:S.506:. The Stop Tax Haven Abuse Act was also introduced by Rep. Doggett as H.R. 1265, with 64 co-sponsors, in March 2009. This proposal, as introduced in the House of Representatives, is available at http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.1265:. Senator Levin's March 2, 2009 floor statement introducing the Stop Tax Haven Abuse Act [hereinafter the Levin Floor Statement] is at http://levin.senate.gov/newsroom/release.cfm?id=308945 (part I) and http://levin.senate.gov/newsroom/release. cfm?id=308946 (part II). Although a bill with the same name was proposed by Sen. Levin in the Senate in 2007 (S. 681) and by Rep. Doggett in the House of Representatives (H.R. 2136), the 2007 version of the Stop Tax Haven Abuse Act did not contain the management and control proposal that is the subject of this report.

I. Introduction and Summary of Recommendations

Each of these three bills would enact a new Section 7701(p),[3] which would change the rule for determining the residency for U.S. federal tax purposes of a foreign-organized corporation. Under current law, corporate residency generally is determined by reference to where the corporation is organized.[4] Proposed Section 7701(p) would treat any foreign-organized corporation that is large or publicly traded as a foreign corporation for U.S. federal tax purposes only if the corporation is managed to a material extent outside of the United States.

The proposal seems generally to be intended to impede the ability of certain corporations to achieve nonresidency status where motivated by U.S. tax considerations.[5] The premises of the proposal seem to be that (i) nonresident corporations may enjoy reduced U.S. taxes on income from their U.S. business activities[6] and avoid U.S. taxes on their worldwide

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[3] Under the 2011 version of the proposal, current Section 7701(p) would be redesignated as Section 7701(q) and the new provision would be inserted as Section 7701(p). All section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[4] Section 7701(a)(4), (a)(5). For a discussion of the history of this rule, see David Tillinghast, *A Matter of Definition: "Foreign" and "Domestic" Taxpayers*, 2 INT'L TAX & BUS. LAW 239 (1984). A 1920 ruling from the Bureau of Internal Revenue interpreted the original purpose of this corporate residency rule as follows:

> As to whether [a corporation] is a domestic or foreign corporation, the meaning of the text of the Revenue Act of 1918, defining the terms 'domestic' and 'foreign' as applied to corporations must be ascertained, gathering the legislative intent from the Act as a whole. It is fundamental that a corporation is a creature of the law and can exist only by virtue of the law which creates it. Such a corporation must of necessity be domestic to the country under whose laws it is created.
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> It is the opinion of this office that Congress intended to treat as domestic all corporations which owe their existence to and enjoy their franchises under the laws of the United States, of the respective States, the Territories of Alaska and Hawaii, and the District of Columbia. It is difficult to conceive any other case than the one in hand in which a corporation can claim to be organized under the laws of the United States and at the same time be not organized *in* the United States. It is not believed that Congress had in mind any such exceptional case. Accordingly, the expression 'created or organized in the United States' will be construed to include corporations created or organized under the laws of the United States. The phrase 'in the United States' is believed to have been used in the two sentences defining domestic and foreign corporations chiefly for the purpose of providing for those associations which are not organized under any incorporation laws but by private contract and yet fall within the definition of corporations as used in the Revenue Act.

O.D. 66, 1 C.B. 19.

[5] For multinational businesses, the place of the parent's incorporation may have relatively little non-U.S. tax consequence in comparison with the U.S. tax consequence, for example, in terms of access to capital markets or legal institutions. See, e.g., Michael Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 551-63 (2004-2005)

[6] Expatriation in combination with measures such as earnings stripping and intangible asset migration could have as an effect the reduction in a corporation's U.S. taxes. See NYSBA Tax Section, *Report on Section 367(d)*,

passive investment income and their business income earned in non-U.S. jurisdictions, (ii) certain instances of corporations organized outside the United States but with management resident in the United States have been driven by U.S. tax considerations, and (iii) at least some corporations that would have fit that pattern would instead be established as domestic corporations if the proposal were adopted.

The main target of proposed Section 7701(p) appears to be industrial or service corporations that are U.S.-managed but organized outside the U.S., particularly in tax haven jurisdictions. In addition, proposed Section 7701(p) separately targets U.S.-managed investment entities—for example, hedge funds, securitization vehicles and other pooled investment funds with U.S. sponsors—that are classified under current law as foreign corporations; proposed Section 7701(p) does this by treating trading or investing in stock, securities and commodities by foreign investors in the same manner as other business activities, which would be a major reversal of current U.S. tax policy since under current law this trading activity is not treated as a trade or business triggering net-based income taxation to foreign persons.[7]

For purposes of this report, we refer to the aspects of proposed Section 7701(p) that would affect U.S.-managed investment entities as the "Funds-Specific Proposal," and the aspects that would affect all other types of foreign-organized corporations as the "General U.S.-Managed Proposal". We have analyzed these two proposals separately for two reasons. First, we suspect each is motivated, at least in part, by different concerns. Second, if enacted, each would likely result in very different behavioral responses by affected taxpayers and investors and therefore would likely produce very different costs relative to the amount of tax revenue generated or other tax policies advanced.

General U.S.-Managed Proposal

The decision to change the rules for determining corporate residency clearly rests with Congress. As to the General U.S.-Managed Proposal, however, we recommend that Congress wait and decide that issue in connection with its resolution of the broader issues of international tax reform intended to be taken up in the relatively near future, since the merits of any change in the residency rules will vary depending what other reforms are adopted. We also recommend special consideration be given to the likely administrative burden that would result (for the government and taxpayers) from adopting any residency rule that is less clear than the bright-line rule under current law. If Congress decides to adopt a version of the General U.S.-Managed Proposal to deter U.S.-tax motivated decisions to organize a corporation offshore, we recommend that a bright-line exception be adopted to avoid covering corporations whose incorporation was not likely tax motivated (for example, the exception might exclude foreign-organized corporations that have been operating with foreign-situs management for a certain period, such as five years). We also have a number of other more technical comments on the specific draft of the proposal.

Funds-Specific Proposal

Report No. 1222, TA Doc. 2010-22245 (Oct. 12, 2010); NYSBA Tax Section, *Report on Certain Issues Under Section 7874*, Report No. 1211 TA Doc. 2010-9861 (May 3, 2010) [hereinafter NYSBA 2010 7874 Report].

[7] Section 864(b).

As to the Funds-Specific Proposal, we urge Congress to carefully consider, before adopting any version of that proposal, the potential effect of doing so on both the flow of foreign investment into the United States and the U.S.-based investment advisory industry. We strongly recommend that any decision regarding the taxation of inbound foreign portfolio investment be applied uniformly to all foreign investors. In particular, if Congress believes that the foreign investors should continue to be protected from net-based income taxation on income from trading in stocks, securities and commodities, then we recommend that the Funds-Specific Proposal not be adopted in its current form and that the General U.S.-Managed Proposal, if it were to be adopted, be modified so that it would disregard such trading activity if it is not treated as a U.S. trade or business under current law. Conversely, if the Funds-Specific Proposal would reflect a determination by Congress that foreign investors should no longer enjoy this protection from net-based income taxation from their trading activity, then we would recommend that the protection under current law be repealed for all foreign investors and not only those that are foreign-organized corporations.

II. Summary of Proposed Section 7701(p)

General Rule. Proposed Code Section 7701(p) would treat a foreign-organized corporation as a domestic[8] corporation for purposes of chapter 1 of the Code (and thus subject to regular U.S. income taxation on its worldwide income) if it meets two requirements:

- First, management and control of the corporation occurs, directly or indirectly, primarily in the United States (the "Management Test"), and
- Second, either

  (1) the stock of the corporation is regularly traded on an established securities market (the "Trading Test"), or

  (2) the aggregate gross assets of the corporation (or any predecessor), including assets under management for investors, whether held directly or indirectly, at any time during the current or a past year are at least $50,000,000 (the "Asset Test").

Exceptions to the General Rule. There would be two exceptions to the general rule:

(1) a corporation that would be subject to domestication under the rule by reason of meeting the Asset Test in a prior year (i.e., would not currently meet the Trading Test and would not be subject to the rule if prior years were disregarded) and that would not expect to meet the Asset Test in the future (again, disregarding prior years) would be able to avoid being treated as a domestic corporation under the rule if granted a waiver by the IRS, and

(2) a controlled foreign corporation (a "CFC") otherwise subject to the rule by reason of the Asset Test would not be domesticated under the rule if it is a member of an affiliated

[8] "Domestic" means created or organized in the United States or under the law of the United States or of any State. Section 7701(a)(4). In this report, "U.S. corporation" means "domestic corporation" as so defined.

group (under Section 1504 but disregarding Section 1504(b)(3)) with a U.S.-organized domestic parent that has substantial assets (other than cash, cash equivalents and stock of foreign subsidiaries) held for use in the active conduct of a U.S. trade or business.

The Two Ways of Satisfying the Management Test. Proposed Section 7701(p) would direct the issuance of regulations defining the Management Test. This section would specifically state that the regulations would provide that the Management Test would be met by a corporation if either:

(1) "substantially all of the executive officers and senior management of the corporation who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policy of the corporation are located primarily in the United States," and so treating other individuals (including officers and employees of other corporations in the same chain) if they such exercise day-to-day responsibility (the "Officer Test"), or

(2) "the assets of the corporation (directly or indirectly) consist primarily of assets being managed on behalf of investors," and "decisions about how to invest the assets are made in the United States" (the "Investor Test").

The Funds-Specific Proposal. The aspects of proposed Section 7701(p) that would impact investment funds and that we are calling the Funds-Specific Proposal are (i) the Investor Test version of the Management Test and (ii) the aspect of the Asset Test that takes into account "assets under management for investors." (This is discussed in more detail below in Section IV.) The remainder of the proposal is what we refer to as the General U.S.-Managed Proposal.

Effective Date. All four versions of the proposal would make the new section effective for tax years beginning on or after the date that is two years after the date of enactment.

III. Discussion of the General U.S.-Managed Proposal

A. Overview

The General U.S.-Managed Proposal, in contrast to the Funds-Specific Proposal, picks up and continues a longstanding debate about how corporate residency should be defined and its relationship to broader tax reform. By enacting Section 7874 in 2004, Congress weighed in on a discrete aspect of that debate. The General U.S.-Managed Proposal reintroduces the full range of issues previously raised.

In particular, the General U.S.-Managed Proposal expands on a 2005 proposal made by the staff of the Joint Committee on Taxation (the "JCT 2005 Anti-Inversion Proposal") as part of its report on "Options to Improve Tax Compliance and Reform Tax Expenditures" (the "JCT 2005 Tax Expenditures Report").[9] The JCT 2005 Anti-Inversion Proposal would treat a

[9] Staff of the Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05, TA Doc. 2005-1714 (Jan. 27, 2005) [hereinafter JCT 2005 Tax Expenditures Report and JCT 2005 Anti-Inversion Proposal].

foreign-organized corporation as a U.S. corporation if it is publicly traded and is primarily "managed and controlled" in the United States.[10] A report on tax reform prepared by a Presidential panel in 2005 (the "2005 Bush Tax Reform Report") also recommended extending U.S. residency to foreign-organized corporations primarily managed and controlled in the United States.[11]

The standard for "managed and controlled" in the JCT 2005 Anti-Inversion Proposal is virtually identical to the Officer Test,[12] both of which are intended to be more robust than the "management and controlled" standard commonly used in many foreign jurisdictions.[13] The JCT Anti-Inversion Proposal did not contain anything similar to the Investor Test. The 2005 Bush Tax Reform Report provides little detail on how its proposed "management and control" standard would be applied.

Whether the General U.S.-Managed Proposal should be adopted, in its current or a modified form, is for Congress to decide based on the proposal's likely costs as compared to what it is likely to achieve. Because the intended objectives of the proposal are not entirely clear, we have suggested how it might be tailored to fit more closely to its different possible objectives and described what we view as its likely costs if implemented, including in those different forms. Finally, we have also described our technical concerns with the proposal as written.

B. Purpose of the General U.S.-Managed Proposal.

The precise scope of foreign organized corporations targeted by the General U.S.-Managed Proposal is unclear.

In Senator Levin's introduction to the Stop Tax Haven Abuse Act, he suggested that its target might be limited to shell corporations organized in tax havens to avoid U.S. taxation:[14]

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10 In addition, under the JCT 2005 Anti-Inversion Proposal, U.S.-managed foreign corporations that are not publicly traded would not be treated as domestic. Id. at 179-80.

11 The report stated that "the residency test would ensure that businesses whose day-to-day operations are managed in the United States cannot avoid taxes simply by receiving mail and holding a few board meetings each year in an island resort." The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System,* Nov. 2005, at 135 [hereinafter 2005 Bush Tax Reform Panel].

12 The proposal is described as follows:

> Under the proposal, a company's residence is based on the location of its primary place of management and control. A corporation's primary place of management and control is where the executive officers and senior management of the corporation exercise day-to-day responsibility for the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries).
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> In determining which individuals are considered executive officers and senior management employees, the decision-making activities of all executive officers and senior management employees are taken into account.

JCT 2005 Tax Expenditures Report, supra note 9, at 180.

13 Id.

14 The Levin Floor Statement, supra note 2.

> Section 103 of the bill is a new addition to the Stop Tax Haven Abuse Act designed to address the Ugland House problem. It focuses on the situation where a corporation is incorporated in a tax haven as a mere shell operation with little or no physical presence or employees in the jurisdiction. The shell entity pretends it is operating in the tax haven, even though its key personnel and decisionmakers are in the United States. The objective of this set up is to enable the owners of the shell entity to take advantage of all of the benefits provided by U.S. legal, educational, financial, and commercial systems, and at the same time avoid paying U.S. taxes.[15]

Consistent with this objective, both this proposal and the JCT 2005 Anti-Inversion Proposal appear to be intended to reinforce Section 7874, which was enacted in 2004 to prevent a domestic corporation from "inverting" itself into a foreign corporation to reduce its U.S. tax liability without materially changing its operations or beneficial ownership.[16] In the same floor statement, Senator Levin stated:

> This new section relies on the same principles regarding the true location of ownership and control of a company that underlie the corporate inversion rules adopted in the American Jobs Creation Act of 2005. Those inversion rules, however, do not address the fact that some entities directly incorporate in foreign countries and manage their businesses activities from the United States. Section 103 seeks to level the playing field and ensure that entities which incorporate directly in another country are subject to a similar management and control test. Section 103 is also similar in concept to the substantial presence test in the income tax treaty between the United States and the Netherlands, which looks to the primary place of management and control to determine corporate residency.[17]

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15 The "Ugland House problem" is a reference to the findings of the 2008 GAO report described in Part IV.B.1 of this report.

16 The House Committee Report underlying Section 7874 states that "[u]nder present law, a U.S. corporation may reincorporate in a foreign jurisdiction and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. . . . [T]he post-inversion structure enables the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations." H.R. Rep. No. 108-548, pt. 1, 108th Cong., 2d Sess. (2004). The transmittal letter to a previous NYSBA report on inversions states that "some of the recent publicly announced outbound transactions . . . involve largely formalistic restructurings and are initiated to reduce U.S. tax." NYSBA Transmittal Letter to Report No. 1014 to Senators Max Baucus and Charles E. Grassley, May 24, 2002. The report states that "[t]he inverted corporation typically is a 'shell' corporation, which inverted corporation, although in substance operationally headquartered in the U.S., achieves foreign status merely by filing organizing papers in a tax haven and then typically claims 'residency' in a separate U.S. tax treaty jurisdiction through what can be seen as minimal contacts with that jurisdiction." NYSBA Tax Section, *Report on Outbound Inversion Transactions*, Report No. 1014, TA Doc. 2002-13085 (May 24, 2002) at 25 [hereinafter NYSBA 2002 Inversion Report].

17 The Levin Floor Statement, supra note 2. The JCT 2005 Tax Expenditures Report argues that the principles of Section 7874 should extend to corporations that previously escaped its reach on the basis of being

It is less clear how much more, beyond targeting these identified situations, the General U.S.-Managed Proposal and the JCT 2005 Anti-Inversion Proposal are intended to do. The JCT 2005 Tax Expenditures Report stated that "[d]etermining corporate residency based on the location of the corporation's management activities would be a more meaningful standard."[18] This statement may indicate an intention to revise the residence test to achieve other objectives beyond preventing the use of "shell" tax-haven-organized entities and other inversion activities from eroding the U.S. tax base.[19]

C. Background

(1) Corporations Affected by the Proposal.

A broad range of different types of foreign-organized corporations with U.S.-based management potentially would be affected by the General U.S.-Managed Proposal. Some examples include: (1) U.S.-managed corporations that "inverted" from U.S.-organized to foreign-organized corporations but are not treated as domestic under Section 7874 because either they are grandfathered from its application or do not meet the conditions for coverage by the provision,[20] (2) U.S.-managed start up businesses that were organized offshore in order to maximize their flexibility for future international tax planning and to avoid U.S. tax on their non-U.S.-source income, (3) multinational corporations that have long been (directly or through subsidiaries) in a foreign business and always have been organized outside of the United States (and in fact perhaps originated as and continue to be operated as predominantly foreign businesses) but that have migrated significant management functions to the United States, including perhaps by reason of U.S. individuals assuming key leadership positions, (4) multinational businesses that have long been (directly or through subsidiaries) in a foreign business and always have been organized outside of the United States (and in fact perhaps originated as and continue to be predominantly foreign business) but were acquired by U.S. investors (perhaps one or more private equity funds and perhaps in a going private transaction) through a newly formed foreign-organized corporation and that hired U.S.-based management in connection with that acquisition, (5) foreign-organized corporations that (directly or through subsidiaries) have always had exclusively or mostly foreign operations, that were strategically acquired by a U.S. purchaser (perhaps a U.S.-organized multinational business) and that hired U.S.-based management in connection with that acquisition. The place of organization of any of these business might be in a high-tax jurisdiction (including one with special tax rules favorable to "headquarter" companies), a low-tax jurisdiction or a jurisdiction considered a "tax haven." In addition, the business operations of these businesses may be predominantly outside or inside of

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grandfathered, newly formed or foreign acquired because these corporations, by retaining their status as foreign corporations even though they "fail to establish substantial presence overseas and effectively manage their business from within the United States . . . [achieve] tax results similar to those achieved by pre-existing companies via inversion." JCT 2005 Tax Expenditures Report, supra note 9 at 179.

[18] JCT 2005 Tax Expenditures Report, supra note 9 at 179. "Revising the general U.S. corporate residency rules to test for primary place of management and control would present a comprehensive response to the problem identified and addressed by Congress in 2004." Id. at 197.

[19] Senator Levin's explanation that basing residency on place of management "seeks to level the playing field" among multinationals with U.S. management raises the question of whether Senator Levin views place of management as an appropriate criterion generally (that should be applied to all corporations) or whether this is intended as an anti-abuse type rule to target U.S.-managed expatriated corporations.

[20] See infra note 40 and accompanying text.

the United States, and the corporations may have predominantly U.S. or foreign ownership either now or historically (or some combination).

(2) Consequence of Corporate Residency.

U.S. corporations are subject to U.S. net-based taxation on their worldwide income.[21] Importantly, however, they are generally able to credit their foreign taxes against their U.S. tax liability on their foreign-source income, subject to certain limitations.[22] In addition, they are generally able to defer recognizing income from their foreign corporate subsidiaries until it is distributed as a dividend (or otherwise realized on a sale). Subpart F of the Code limits this ability to defer, however, by generally requiring each 10-percent shareholder of a foreign corporation meeting a U.S.-ownership test to currently recognize its share of certain of its passive and other income.[23]

By contrast, foreign corporations are subject to (1) U.S. net-based taxation only on income effectively connected with a U.S. trade or business[24] and (2) U.S. gross-based taxation on any U.S.-sourced fixed or determinable income that is not effectively connected to a U.S. trade or business.[25] Significantly, however, foreign corporations may be able to reduce their net U.S. trade or business income subject to tax through earnings-stripping and development or movement of intangibles offshore, subject to certain limitations.[26] For certain multinationals, therefore, having a non-U.S. parent corporation rather than a U.S. parent corporation may materially reduce the group's aggregate U.S. tax liability.

(3) Context of the Proposal within Other Residency Tests and Potential Reforms.

(a) *Other Examples of Management and Controlled Standards.*

Both the Levin Floor Statement and the JCT 2005 Tax Expenditures Report refer to the U.S.-Netherlands tax treaty protocol, ratified by the Senate in 2004 ("Dutch Protocol"), as

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21 Section 11 (establishing rates of tax on corporate taxable income "from whatever source derived") and Section 61 (defining gross income).

22 Sections 901-04. A deduction is available in lieu of a credit. Section 164(a)(3).

23 Subpart F (Sections 951 to 964) is in Subchapter N of Chapter 1 of the Code.

24 Under Section 882(a), income of a foreign corporation that is effectively connected to a U.S. trade or business, net of deductions, is taxed at the regular corporate tax rates in Section 11. Section 864(b) defines "U.S. trade or business" and Section 864(c) defines "effectively connected income." For residents of a country that has a tax treaty with the United States, net-based taxation generally applies to income attributable to a U.S. permanent establishment. See, e.g., 2006 U.S. Model Income Tax Convention, arts. 5(1), 5(2), & 7, Nov. 15, 2006.

25 Section 881 imposes a flat 30 percent tax, without allowances for deductions or credits, on foreign corporation's "fixed or determinable annual or periodical gains, profits, and income" (generally, investment-type income, such as dividends and interest) that is not effectively connected with a U.S. trade or business. With respect to certain categories of income, in particular dividends and interest, this tax is usually reduced for residents of countries that have tax treaties with the United States. See, e.g., 2006 U.S. Model Income Tax Convention, arts. 10 & 11, Nov. 15, 2006.

26 For example, as to earnings stripping of interest, see Section 163(j) for these limitations, and as to transfer pricing, see Section 482.

an example of a robust "management and control" standard for determining residency,[27] contrasting it with similar but more formalistic standards used in other jurisdictions, which are described below.[28] Since 2004, the standard included in the Dutch protocol has been included in various other treaties and the 2006 U.S. Model Income Tax Treaty.[29]

The Limitation on Benefits article of the Dutch Protocol states that a publicly traded corporation is a qualified person, and thus eligible for treaty benefits, only if it has substantial presence in the country of which it is a resident. Substantial presence can be satisfied either by meeting a stock trading test or if the "primary place of management and control" of the company is in its country of residence. The management and control of a company is where both "executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries) in that state than in any other state," and where "the staffs conduct more of the day-to-day activities necessary for preparing and making those decisions in that state than in any other state." The first part of this test looks not only at executive officers and senior management of the company but also executive officers of direct or indirect subsidiaries if they perform the policy-making functions that are normally the responsibility of the board of the parent company. In addition, officers and management are considered only to the extent they are actually responsible for making company decisions, disregarding any special voting or other arrangements.[30]

Many other jurisdictions base corporate residency at least in part on some version of a management and control test; albeit one that is less robust than the General U.S. Managed Proposal. Under UK tax law, a company is a resident of the United Kingdom if either it is incorporated in the UK or its "central management and control of its business" is in the UK.[31] This has been interpreted by the UK courts and taxing authorities as a facts and circumstances test that generally favors the location where the board of directors meets, though not always. For

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[27] Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 26(8)(e)(iii), Dec. 18, 1992, amended Mar. 8, 2004 [hereinafter "Dutch Protocol"].

[28] See supra notes 31 through 36 and accompanying text.

[29] Treaties between the U.S. and other countries generally use the place of incorporation or place of management to determine a corporation's residency. See, e.g., U.S.-UK Income and Capital Gains Convention, art. 4(1), Jul. 24, 2001, as amended (defining residence by reference to either place of incorporation or place of management); U.S.-Canada Income and Capital Gains Convention, art. 4(1), Sept. 26, 1980, as amended (same); U.S.-Ireland Income and Capital Gains Convention, art. 4(1), Jul. 28, 1997, as amended (same); U.S.-Italy Income Tax Convention, art. 4(1), Apr. 17, 1984, as amended (same). 2006 U.S. Model Income Tax Convention, art. 22(2)(c)(i)(B), Nov. 15, 2006; see, e.g., U.S.-New Zealand Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 16(6)(d), Jul. 23, 1982, amended Dec. 1, 2008 (adopting the Dutch Protocol's management and control test); see also Treasury Department, *Report to the Congress on Earning Stripping, Transfer Pricing and U.S. Income Tax Treaties*, TA Doc. 2007-26269, 2007 TNT 230-17 (Nov. 28, 2007) [hereinafter Treasury 2007 Report]. The 2008 OECD Model Income and Capital Tax Convention defines residence as place of management, with a tie-breaker rule that favors the "place of effective management." OECD Model Tax Convention, arts. 4(1), 4(3), Jul. 17, 2008. The Commentary explains that this is "the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made." OECD Commentaries on the Articles of the Model Tax Convention, art. 4(3), paragraph 24, Jul. 17, 2008. This place is determined by examining "all relevant facts and circumstances," but the test has generally been interpreted as meaning the place where the board of directors meets.

[30] Dutch Protocol, art. 26(8)(e)(iii).

[31] Finance Act 1988, section 66(1).

instance, in the seminal case interpreting the management and control test, a company was held to be a resident of the UK because the court found that it was through the directors' meetings in the UK that the control of the company was exercised, even though the company's head office, shareholder meetings and business operations were all outside of the UK.[32] According to British tax authorities, the test looks to the highest level of control of a company, though the exercise of control can be in the form of passive oversight.[33] British courts have looked to the location of board of directors to determine residency even when the directors are acting based on the advice of non-director advisors who are located elsewhere.[34] Despite the fact that the management and control test frequently results in residence where the board of directors meets, the UK taxing authorities have emphasized that this factor is not necessarily dispositive.[35] British case law is frequently relied upon in the application of the management and control tests of other jurisdictions, including, for example, Australia, Israel and Ireland.[36]

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[32] De Beers Consolidated Mines Ltd. v. Howe, 5 T.C. 198 (1906).

[33] Statement of Practice SP 1/90, available at http://www.hmrc.gov.uk/manuals/intmanual/INTM120140.htm.

[34] For instance, in Wood v. Holden, [2006] STC 443, the Court of Appeal determined residency as outside the UK even though the directors were implementing a scheme recommended by their UK-based accountants. In the case of a parent-subsidiary structure, the location of the parent's management and control may be the deciding factor if the subsidiary directors defer to decisions made by the parent company. See Bullock v. Unit Construction Company, [1959] 3 All ER 831, HL(E).

[35] SP 1/90.

[36] Under Australian tax law, a company is a resident if it is incorporated in Australia or both carries on business and has its "central management and control" in Australia. Income Tax Assessment Act of 1936, section 6(1)(b). The first prong, the carrying on of business in Australia, has been interpreted by the Australian Taxation Office as either where the company's major operational activities take place or, for investment companies, where the investment decisions are made. Australian Taxation Office, Taxation Ruling 2004/15, available at http://law.ato.gov.au/atolaw/view.htm?locid=TXR. Corporations whose sole activity is managing investment assets are still considered to "carry on business." Id. As in the UK, the place of management and control has been interpreted as the place where high-level decision-making occurs, which is generally the location where the majority of board meetings occurs. The test looks at those individuals who actually manage and control the company, not those who have the mere legal right to do so but do not exercise this right (although the delegation of decision-making powers to others does not necessarily shift the application of the test to those other individuals). Id. The tax authorities also look for facts indicating an artificial or contrived outcome, such as situations where there is no business reason for the location of the meeting. Id. Central management and control can exist in more than one country for Australian tax purposes. Id.

In Israel, a company is considered a resident if either it is registered as a domestic corporation in Israel or the control of its business and its management is exercised in Israel. Income Tax Ordinance of 1961, section 1, S.H. 120. This test looks primarily to the place where major strategic decisions are made and business policies are determined, and to a lesser extent, to the location of the day-to-day management of the company's business. Circular 4/2002 (Mar. 3, 2002), available at http://www.finance.gov.il/taxes/mainpage.htm. In practice, this is generally the place where the board of directors meets, though the tax authorities have indicated that this will not always be the case. Id. There is some uncertainty among practitioners as to whether the "management and control" test has one prong or two, i.e., whether "management" and "control" are separate elements that both need to be satisfied.

Irish tax law deems a company a resident of Ireland if either the company is incorporated in Ireland (after 1999) or, if foreign-incorporated, the company's "central management and control" is in Ireland. Taxes Consolidation Act of 1997, Sections 23A(2) and 82. Relying on UK common law, Irish practitioners have interpreted this test as looking to the location of those individuals who exercise control over the key commercial decisions of the company. These individuals will usually be the directors of the company.

Other countries have similar management and control tests. A company is an Italian resident if either its "legal seat" (as indicated in its articles of incorporation) is in Italy or the company's place of effective management or main business purpose is in Italy. Testo Unico in Materia di Imposte Sui Redditi, Article 73(3). The place of

(b) *Relationship of the Proposal to Treasury Recommendations, Section 7874 and Tax Reform*

The General U.S.-Managed Proposal deviates from the approach recommended by the Treasury Department in a 2002 report on inversions ("Treasury 2002 Inversion Report").[37] The Treasury 2002 Inversion Report suggested reforming the substantive tax rules applicable to multinationals so that their business activities would be taxed more similarly based more on where those activities are conducted and less on the parent company's residency status. It specifically suggested (1) adopting an immediate stopgap rule to limit the effectiveness of what it perceived as the most egregious inversion transactions, (2) strengthening rules that are intended to prevent the erosion of the U.S. tax base with respect to U.S.-source business income[38] and (3) reforming the rules applicable to the taxation of U.S. multinational corporations on their foreign-source income, which the report stated are "unique [among the international tax rules of most jurisdictions] in their breadth of reach and degree of complexity."[39]

Partially implementing the recommendations made in the Treasury 2002 Inversion Report, Section 7874 generally applies only if (1) a domestic corporation becomes a subsidiary of or transfers substantially all of its assets to a foreign-organized corporation after March 4, 2003, (2) there is 80 percent overlap between the shareholders of the inverted domestic corporation before the transaction and the new foreign-organized corporation and (3) the new foreign-organized corporation (after looking through its chain of subsidiaries with 50 percent ownership) does not have substantial business activities in its country of organization.[40] Section 7874 thus grandfathers corporations that inverted prior to its effective date and does not apply to newly formed corporations or foreign-organized corporations that acquire a domestic corporation or its business in a sale transaction. In connection with enacting Section 7874, Congress directed the Treasury Department to conduct a study of the impact of that section on inversion activity and, based on those findings, recommend to Congress how to improve the legislation. This report has not been submitted.[41]

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effective management is the location where the company's directors manage the company; the main business purpose is the company's activities or the purpose indicated in its articles of association. In Germany, a company is a resident if either its legal seat or its place of management is located in Germany, with "place of management" defined as the location where the persons who have final authority make decisions about the management of the business. Canada also has a management and control test for residency of foreign corporations, which is interpreted as the place where essential decisions are made by directors acting independently and not pursuant to instructions from others.

37 Office of Tax Policy, Dep't of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications*, May 2002, TA Doc. 2002-12218 [hereinafter Treasury 2002 Inversion Report].

38 "A prompt and thoroughly-reasoned response [to inversions] is needed to address the U.S. tax advantages that are available to foreign-based companies through the ability to reduce the U.S. corporate-level tax on income from U.S. operations." Id. at 2.

39 The report continues, "[b]oth the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy. A comprehensive reexamination of the U.S. international tax rules and the economic assumptions underlying them is needed." Id. at 2-3.

40 Like the General U.S.-Managed Proposal, Section 7874 applies to private corporations (a Senate proposal to limit it to publicly traded corporations was rejected).

41 In November 2007, the Treasury Department submitted a report on the related topics of earnings stripping, transfer pricing and treaties, which were also commissioned as part of the Jobs Act. This report indicates that more

The last suggestion of the Treasury 2002 Inversion Report, regarding tax reform, was a response to those who, prior to the enactment of Section 7874, defended allowing inversions on the basis that these transactions enabled corporations to change their tax residency to achieve a more "territorial"-type measure of tax on their non-U.S. income and thereby compete more effectively with corporations resident in other jurisdictions that similarly tax non-resident income.[42] Acknowledging this argument, the legislative history of Section 7874 stated that "corporate inversion transactions are a symptom of larger problems with our current uncompetitive system for taxing U.S.-based global businesses and are also indicative of the unfair advantages that our tax laws convey to foreign ownership."[43] The JCT 2005 Tax Expenditures Report proposed addressing this issue by taking the further step of recommending a dividend exemption system for the repatriation of foreign business income.[44] It did not address, however, how the JCT Anti-Inversion Proposal would fit with this more fundamental proposed change.

The second recommendation made in the Treasury 2002 Inversion Report, namely better protecting the tax base of U.S. business income and reforming the substantive tax rules applicable to multinationals, has begun to be implemented, though incrementally. In November 2007, the Treasury Department submitted a report on preventing base erosion, which Congress had commissioned (along with the report on inversions yet to be submitted) when Section 7874 was enacted.[45] Some steps have been taken. For example, the Treasury Department has

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time is needed to study the effectiveness of Section 7874. Treasury 2007 Report, supra note 29, at 1. Temporary Treasury Regulations discussing whether a foreign corporation would be treated as a "surrogate foreign corporation" for purposes of Section 7874 were published in the Federal Register on June 12, 2009. Guidance under Section 7874 Regarding Surrogate Foreign Corporations, 74 Fed. Reg. 27,920 (Jun. 12, 2009). Notice 2009-78, issued in the fall of 2009, announced the intention to issue regulations that would clarify what stock of a foreign corporation was to be included when applying the ownership condition of Section 7874(a)(2)(B)(ii). Notice 2009-78, 2009-40 I.R.B. 452. See NYSBA 2010 7874 Report, supra note 6.

42 The report continues, "[b]oth the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. business and the U.S. economy. . . . We should look to the experience of other countries and the choices that they have made in designing international tax systems. Consideration should be given to fundamental reform of the U.S. international tax rules, including the merits of the exemption-based tax system of some of our major trading partners." Treasury 2002 Inversion Report, supra note 37, at 29. One of the report's bases for this conclusion is the capital import neutrality argument, which is that a U.S. multinational should bear the same tax when competing in a foreign market as its local competitors face. Id. at 27-28. In contrast, capital export neutrality, which is the economic justification of the current system of U.S. taxation of worldwide income, with credits for foreign taxes paid, argues that a U.S. multinational should face the same tax burden on a new investment whether made in the U.S. or abroad. See Staff of the Joint Committee of Taxation, *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses*, JCX-22-06, TA Doc. 2006-12053 (Jun. 21, 2006) at 3. However, the "competitive" argument for territoriality is controversial. Reuven S. Avi-Yonah, *For Haven's Sake: Reflections on Inversion Transactions*, TAX NOTES, Jun. 17, 2002, TA Doc. 2002-14379, 2002 TNT 117-47, at 1795 (calling the competitiveness argument an "excuse" and discussing several counterarguments).

43 H.R. Rep. No. 108-548, pt. 1, 108th Cong., 2d Sess. (2004).

44 JCT 2005 Tax Expenditures Report, supra note 9, at 186-97.

45 Treasury 2007 Report, supra note 29. In addition, there are other base erosion rules that are under consideration. For example, legislation was proposed in January 2011 by Representative Lloyd Doggett, that would limit treaty withholding rates based on the residency of the parent company. H.R. 64, 112th Cong., Section 1. In addition, H.R. 4849 was passed by the House of Representatives on March 24, 2010 which would, under certain circumstances, limit treaty withholding rates if made to a party related to the U.S. payor if the payment was deductible by the U.S. payor. H.R. 4849, 11th Cong., Section 301. See also NYSBA Tax Section, *Comments on the*

provided regulatory guidance governing intercompany services and cost-sharing arrangements,[46] many income tax treaties have been modernized[47] and enforcement efforts have increased.[48]

Some but little overall progress has been made on the third recommendation, reform of the substantive tax rules applicable to multinationals.[49] There is broad consensus that

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Proposed Denial of Treaty Benefits for Certain Related-Party Deductible Payments, Report No. 1213, TA Doc. 2010-11544 (May 22, 2010) (explaining that this same proposal has been made in previous pieces of legislation). Finally, a proposal to revise Section 163(j) to "limit the deductibility of interest paid by an expatriated entity to related persons" was made in President Obama's 2010 and 2011 Revenue Proposals. Treasury Department, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, available at http://www.treasury.gov/resource-center/tax-policy/Pages/Greenbook.aspx. See also Treasury Department, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*, available at http://www.treasury.gov/resource-center/tax-policy/Pages/Greenbook.aspx ("The proposal would revise section 163(j) to tighten the limitation on the deductibility of interest paid by an expatriated entity to related persons").

[46] Temp. Treas. Reg. § 1.482-4T(g). Temp. Treas. Reg. § 1.482-7T. Treas. Reg. § 1.482-9.

[47] E.g., U.S.-New Zealand Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Jul. 23, 1982, amended Dec. 1, 2008; U.S.-France Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital, Aug. 31, 1994, amended Dec. 8, 2004 and Jan. 13, 2009.

[48] The Internal Revenue Service has announced its intention to partner with other countries with which the U.S. has entered into an income tax treaty to conduct joint audits of multinational corporations. *See* Doug Shulman, Commissioner, Internal Revenue Service, Prepared Remarks at the 23rd Annual Institute on Current Issues in International Taxation (Dec. 9, 2010).

[49] For example, the American Jobs Creation Act of 2004, Pub. L. No. 108-357 ("2004 Jobs Act"), Sections 401 and 404, modified the rules relating to foreign tax credits and interest allocations. The foreign tax credit modification increased taxpayers' ability to "cross-credit," i.e., average high and low foreign taxes to increase the ceiling limitation on the use of the foreign tax credits. Under revised Section 904(d), the limitation is applied separately to two categories, passive income and other income, whereas previously there were nine categories. This change simplified the rules and benefited multinational companies that receive income from both high-tax and low-tax jurisdictions, since it is now easier to average the tax rates and increase the ceiling of the limitation. This amendment was enacted because "Congress believed that reducing the number of foreign tax credit baskets to two would greatly simplify the Code and undo much of the complexity created by the Tax Reform Act of 1986. The Congress believed that simplifying these rules would reduce double taxation, make U.S. businesses more competitive, and create jobs in the United States." Staff of the Joint Committee on Taxation, *General Explanation of the Tax Legislation Enacted in the 108th Congress*, JCS 5-05, at 273 (May 2005) [hereinafter JCT Explanation of 2004 Jobs Act]. The 2004 Jobs Act also modified the rules in Section 864 for interest expense allocations for purposes of calculating the foreign tax credit. In general, members of an affiliated group, other than certain foreign corporate members, are treated as a single taxpayer and the allocation of interest expense is made on the basis of the location of assets. The 2004 Jobs Act provided an election that, when effective, would permit taxpayers to allocate U.S. interest expense on a worldwide affiliated group basis. Section 864(f). The reason for making this change was that "Congress believed that [the prior law] unduly limited . . . a taxpayer's ability to claim foreign tax credits and left it excessively exposed to double taxation of foreign-source income. The Congress observed that the United States was the only country to impose what it considered to be harsh and anti-competitive interest expense allocation rules on its businesses and workers." JCT Explanation of 2004 Jobs Act, at 265. The effective date of this change has been pushed back several times since the initial effective date set forth in the 2004 Jobs Act, which was December 31, 2008. In 2008, the Pub. L. No 110-289 amended Section 864(f) so that elections could be made for taxable years beginning after December 31, 2010. In 2009, this date was changed to December 31, 2017 by Pub. L. No. 111-92. And in 2010, this date was changed again to December 31, 2020. Further amendments were made to the foreign tax credit rules by Pub. L. No. 111-226. New Section 909 deals with foreign tax credits taken by a taxpayer which is related to the person or entity which takes the income into account. Under this new rule, the foreign tax credit generally cannot be taken until the year in which the related party recognizes the income for U.S. federal income tax purposes. This law also adds Section 901(m) which denies applicability of the foreign tax credit from certain foreign taxes paid in a covered asset acquisition. Finally, Section 904(d)(6) was added to the Code, requiring separate application of the foreign tax credit with respect to any item of income that would be U.S. source

the substantive rules applicable to multinationals should be reformed without regard to whether or how our current residency rules are changed.

A report prepared by the American Bar Association Tax Section on international tax reform (the "ABA Tax Reform Report") described the substantive tax rules applicable to U.S. resident multinational corporations as allowing them "to structure foreign operations to erode the foreign tax base, defer U.S. tax, and achieve a materially lower effective tax rate than in the United States."[50] In summarizing the aggregate effect of current law, the ABA Tax Reform Report quoted the following text from the JCT 2005 Tax Expenditures Report:

> The present-law system thus creates a sort of paradox of defects: on the one hand, the system allows tax results so favorable to taxpayers in many instances as to call into question whether it adequately serves the purpose of promoting capital export neutrality or raising revenue; on the other hand, even as it allows these results, the system arguably imposes on taxpayers a greater degree of complexity and distortion of economic decision making than that faced by taxpayers based in countries with exemption systems, arguably impairing capital import neutrality in some cases.[51]

While these substantive tax rules are often faulted as being over-burdensome and ineffective, there is not a consensus on how they should be changed. Each of the Treasury 2002 Inversion Report, the JCT 2005 Tax Expenditures Report and the 2005 Bush Tax Reform Report generally favored reforms intended largely to limit U.S. taxation of U.S.-resident multinationals to their U.S. business income and repatriated foreign business income, but leave in place much of Subpart F to tax on a current basis U.S.-based multinationals on their worldwide passive income and income from related-party cross-border transactions earned in low-tax jurisdictions.[52] The ABA Tax Reform Report was critical of these proposals, in particular on the grounds that they failed to address the taxation of cross-border business income in a comprehensive way.[53]

Importantly, however, all these proposals would make residency status—regardless of how determined—less important to the taxation of multinationals than it is under

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income but for a treaty provision treating such item as foreign source income. See NYSBA Tax Section, *Report on Issues under Section 909*, Report. No. 1223, TA Doc. 2010-24059 (Nov. 8, 2010).

50 American Bar Association, Tax Section, *Report of the Task Force on International Tax Reform,* 59(3) TAX LAW. 649, 705 (2007) [hereinafter ABA Tax Reform Report]. Using as illustrations standard international tax planning strategies, the ABA Tax Reform Report outlines how these substantive tax rules encourage the reduction of foreign taxes below the U.S. effective rate, the use of transfer pricing to shift additional income to foreign corporations subject to low effective foreign tax rates, the deferral of U.S. tax on foreign income subject to a low effective foreign income tax rate, the acceleration of repatriation of foreign taxes to cross-credit excess foreign tax against U.S. tax on low-taxed foreign income in the same foreign tax credit limitation category and the repatriation of low-taxed income when excess foreign taxes are available to offset U.S. tax. Id. at 705-717.

51 JCT 2005 Tax Expenditures Report, supra note 9, at 189.

52 Both the JCT and the Bush reform proposals recommended retaining the current subpart F rules to tax currently passive income and income shifted to low tax jurisdictions through inter company transactions. JCT 2005 Tax Expenditures Report, supra note 9, at 189; 2005 Bush Tax Reform Panel, supra note 11, at 134.

53 ABA Tax Reform Report, supra note 50, at 734-35.

current law. This is because all of these proposals would tax business income more similarly regardless of residency determinations. The General U.S.-Managed Proposal pointedly raises the question of whether, in the absence of tax reform, a broadly applicable residency rule based on management and control would be an incremental improvement to our current system or aggravate the problems that have already been identified with that system.

D. The Merits of Adopting the General U.S.-Managed Proposal.

Assessing the merits of the General U.S.-Managed Proposal requires, we believe, consideration of two questions: (1) would using place of management as a basis for residence taxation advance one or more tax policy goals, such as preserving the U.S. tax base or taxing similarly situated persons similarly, and (2) if so, what economic distortions and administrative burdens (including by reason of its ambiguity) would likely result as compared to the amount of tax revenue raised and any other tax policy goals advanced by the proposal's enactment.

1. Arguments for the General U.S.-Managed Proposal.

The two main arguments for adopting the General U.S.-Managed Proposal are that it (1) reduces the potential for U.S. tax-motivated formation of foreign corporations, including in the context of corporate inversions, and thus reinforces Section 7874, and secondarily (2) provides what its proponents refer to as a more "meaningful" residency test than does current law. We discuss these arguments below.

(a) *Discourage U.S. Tax-Motivated Formation of Foreign Corporations*

As described above, the genesis of the General U.S.-Managed Proposal was the concern about the effect of mobility of U.S. companies on the U.S. corporate income tax base (due to expatriations and corporation formations motivated by U.S. tax savings) and the resulting negative effect of those corporate expatriations on perceptions of the fairness and effectiveness of the U.S. tax system on the part of the U.S. taxpayer public. A phenomenon often noted was the tendency of management to remain in the United States. The hypothesis underlying the General U.S.-Managed Proposal is that the attractiveness of such moves would be diminished if management were forced to relocate in order to escape the U.S. tax net.

Accordingly, the General U.S.-Managed Proposal seems most appropriate for situations in which the choice of place of organization of an entity is primarily U.S. tax-motivated. We recognize however that a residence rule based upon a corporation's subjective motives would be unworkable and unadministrable and therefore that a bright-line test would be needed for a residence rule to operate properly. To attempt to craft such a bright-line test in light of a goal of impacting only U.S.-tax motivated organizational decisions, we have considered broad classes of transactions that could be considered to fall on one side of the "tax-motivated" line or the other.

For example, in situations in which an existing U.S. entity chooses to expatriate, it arguably may be fair to assume that the primary motivation is reduction of U.S. tax liability. Congress made the determination that in cases described in Section 7874 (and 80 percent or more continuing ownership), the expatriation should be made tax-neutral from a U.S. income tax standpoint (which has had the result, to our knowledge, of no company determining to expatriate for non-tax purposes while retaining status as a domestic corporation for tax purposes). Thus, the General U.S.-Managed Proposal may be justifiable for situations in which a U.S. entity has expatriated prior to the effective date of Section 7874. The General U.S.-Managed Proposal similarly may be justified for situations in which an entity would be subject to Section 7874 but for the fact that, for example, it conducts a business in the jurisdiction to which it expatriates (at least if the business is disproportionately small), as the conduct of such a business may not be inconsistent with a primary U.S. tax motivation if management remained in the United States.

Similarly, arguably a primary U.S. tax motivation also may be assumed in the case of a start-up enterprise with U.S. management that nevertheless is organized legally as an entity outside of the United States. The General U.S.-Managed Proposal could be appropriate in such a situation.

Finally, a primary U.S. tax motivation may be present where a U.S.-managed company is formed outside the United States with the primary objective of making acquisitions, including acquisitions of one or more U.S. target companies or businesses.

In other cases, however, the foreign organization of an entity does not seem primarily U.S. tax motivated. For example, a multinational company that was organized years ago for the conduct directly or through subsidiaries of a business outside of the United States may have since that time hired or located part or even most of its senior management from within the United States. In such a case, the choice of location of the foreign corporation typically would not have been motivated by U.S. tax consequences. Similarly, if such an entity determines to make an acquisition in the United States and in that connection hires or locates senior management in the United States, a U.S. tax motivation for the organization of the entity abroad is absent.

Adoption of the General U.S.-Managed Proposal would affect these non-U.S. tax motivated situations as well. We have serious reservations as to whether the merits of an approach that would apply beyond the U.S.-tax motivated cases would outweigh the negative aspects of doing so, as discussed below. Accordingly, if a management situs residence test is considered necessary to deal with situations such as the classes of transactions that might be deemed primarily U.S.-tax motivated, we nevertheless would exclude cases in which a foreign-organized corporation has been operating with foreign-situs management for, for example, five years.

(b) *Management Situs Test Applied More Broadly*

As indicated above, the JCT 2005 Tax Expenditures Report indicated that a managed and controlled test would be a more “meaningful” test than the current place of incorporation test. It is not clear, however, what the JCT staff had in mind by “meaningful.” Certainly, the situs of senior management decisions is a physical phenomenon, as opposed to the set of laws under which a corporation is organized. That, however, does not necessarily answer the question as to which is more meaningful, which would require a comparison of the legal and commercial impact of both where management decisions are made and where the corporation is organized. A “managed and controlled” residency test clearly requires more than the simple election of a place of organization that would govern under a place-of-organization test. However, that alone does not answer which test would result in a test that is more meaningful in any other policy sense (such as causing economically similar businesses to be taxed similarly).[54]

Significantly, the General U.S.-Managed Proposal would not test the residence of a *domestic* corporation based on the situs of management, but rather would continue to look to its place of incorporation. Thus, the proposal is not across the board principle-based, or based on substance or the notion that economically similar enterprises should be treated similarly, but rather seems simply intended to extend U.S. residence-based taxing jurisdiction to those non-U.S. corporations that choose to have U.S. management.

Exercising U.S. taxing jurisdiction over a larger universe of foreign-organized corporations than under current law would be, in a very general sense, consistent with the exercise of jurisdiction by a number of other countries, including, for example, the other common law countries, China, France, Germany and Israel. However, among the countries that have adopted this general approach, there is a great deal of variation in the extent to which the focus is on high-level strategic decisions, in the nature of actions of a board of directors, on the one hand, and the day-to-day high-level decisions of senior management generally, on the other hand. For example, in the case of the United Kingdom, from which the test in the rest of the common law countries derived, a managed and controlled test was adopted judicially to permit taxing jurisdiction over a UK-organized and managed corporation conducting business wholly abroad, since at that time the United Kingdom lacked a statutory right to tax such corporations based on their place of organization.[55] Further, the test was adopted at a time when businesses were much simpler and the board of directors played a much greater role in the key decision-making of a company.

We recognize that U.S. management creates a nexus to the United States and for that reason presumably would create jurisdiction for residence-based taxation of the income from a business so managed.[56] On the other hand, any categorization of a multinational as resident in a particular jurisdiction (including under either current law or a proposal like the General U.S.-Managed Proposal) is necessarily very arbitrary since a multinational, as the term indicates, has

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54 Similarly taxing similar businesses means that avoiding the tax would require a business to become dissimilar to how it would be in the absence of the tax. If the cost of doing that is generally high, a business would not do that in the absence of an ever higher tax. Based on the assumption that the cost of doing that is high, similarly taxing similar businesses is thought generally to minimize economic distortions. See, e.g., David Weisbach, *Line Drawing, Doctrine and Efficiency in the Tax Law,* 84 CORNELL L. REV. 1627 (1997).

55 John F. Avery Jones CBE, "*Corporate Residence in Common Law: the Origins and Current Issues*" in *Residence of Companies under Tax Treaties and EC Law, EC and International Law Series* – Volume 5, Series Editor Guglielmo Maisto (IBFD 2009).

56 Professor Avi-Yonah reasons that place of management likely correlates with "business realities" because "even in this age of teleconferencing, there is a distinct business advantage in locating the principal officers of a corporation in one location where they can meet and run the corporation on a daily basis." Avi-Yonah, supra note 42, at 1797.

foreign and domestic characteristics.[57] In particular, we are skeptical that place of management correlates with any non-superficial economic similarity among these corporations.[58]

Accordingly, adoption of the General U.S.-Managed Proposal rather than a narrower proposal tailored to U.S.-tax motivated situations may mean only that more U.S.-managed corporations would be taxed similarly while other economically similar but foreign-managed corporations would continue to be taxed very differently, in which case adopting the General U.S.-Managed Proposal might do little beyond discouraging the use of U.S.-based management.

For these reasons, we believe that taxing business income more similarly (by implementing other tax reforms) without regard to place of management is more likely to result in similarly taxing economically similar businesses and thus better achieve the tax policy aim of minimizing economic distortions.

2. Consideration of Economic Cost.

The objectives of the General U.S.-Managed Proposal, and the likelihood that those objectives would be achieved, should be weighed against the economic costs of adopting it. The principal advantages of the current residency rule are that it (1) contains no ambiguity and (2) allows multinationals with a foreign-organized parent corporation to locate senior management in the United States without the concern of causing the foreign parent company to be taxed by the U.S. as a resident entity.

Changing current law in this regard will create uncertainties for businesses and the government. It may be argued that the ambiguity created by the General U.S.-Managed Proposal should not be a basis for rejecting it, given all the other existing ambiguous tax rules. However, at least under current law, residency affects tax liability more fundamentally than other ambiguous rules. This will both add to the administrative burden of complying and enforcing the rule and likely cause its own economic distortions, as taxpayers adjust their behavior and location of operations to fit more clearly on one side of the rule. It also has the disadvantage of potentially rewarding taxpayers willing to take more aggressive positions than their competitors.

Certain countries that have a managed and controlled concept have dealt with these issues in part by adopting a simplifying assumption, in particular, focusing on the actions of the board of directors as long as the board is not merely a figurehead. Such a rule, however, while more easily administrable, does have the disadvantage of making the managed and controlled test more manipulable, and seems anachronistic given the complexities of today's business models.

We also understand that few if any countries that have adopted a management situs residence test tax worldwide income of a business enterprise, including income that has been earned abroad in a business managed and controlled abroad.

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[57] Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 26 BROOKLYN J. INT'L L. 1357, 1422 (2001).

[58] Id. at 1425.

Some of the ambiguities and tensions contained in the proposal, and how they might be reduced, are discussed below in our technical comments on the draft bill language.

A separate issue is the effect of a management situs test on the location of senior management in the United States. We are not economists and so can offer no technical analysis of the economic costs associated with the potential movement of senior jobs out of the United States. As observers we would think that the residence of senior management of a foreign holding company in a country is of substantial value to that country as compared with the absence of that management.

3. Likely Taxpayer Responses to the General U.S.-Managed Proposal.

How taxpayers would likely respond to the enactment of the General U.S.-Managed Proposal would depend significantly on whether and, if so, how the substantive rules applicable to multinationals are also changed. Before the Levin and Doggett proposals were introduced, the proposals made to adopt a "management and control" residency standard were accompanied by other reform proposals that would materially diminish the differences in tax treatment between corporations classified as U.S. as opposed to foreign.[59] Neither the Stop Tax Haven Abuse Act nor the International Tax Competitiveness Act of 2011, however, include a larger reform proposal.

If adopted in the absence of broader tax reform, the General U.S.-Managed Proposal would likely affect different U.S.-managed multinationals differently. Multinationals that are not in the expatriated category presumably would be more willing to relocate or replace their U.S. managers with foreign managers to maintain foreign status. Expatriated entities would be more willing to make a substantial effort to maintain foreign status, though some would view that cost as too high and choose to incur the avoidance and compliance costs now commonly borne by U.S. resident multinationals to minimize their tax burden (which may include allocating resources inefficiently in order to defer U.S. taxation of offshore income). We would expect start-ups of U.S. entrepreneurs to be formed as U.S. entities, given the remoteness of future tax savings and the difficulty U.S. entrepreneurs would have in avoiding U.S. management.

The likely taxpayer responses of existing multinational entities suggest that adopting the General U.S.-Managed Proposal would likely result in material new economic costs in addition to the costs associated with a much more complicated legal framework. This does not mean that the General U.S.-Managed Proposal should necessarily be rejected. Nevertheless, there would seem to be a serious question as to whether the incremental tax revenue, if any, that would result under an across-the-board management situs residence test, like the General U.S.-Managed Proposal, is worth the associated costs.

If there is fundamental tax reform, the General U.S.-Managed Proposal would become less significant (i.e., have less of an effect on tax revenue and avoidance costs) to the extent that those reforms diminish the significance of domestic versus foreign residence in determining the extent to which domestic and foreign income, respectively, of the entity are

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[59] JCT Anti-Inversion Proposal, in JCT 2005 Tax Expenditures Report, supra note 9; 2005 Bush Tax Reform Panel, supra note 11.

subject to U.S. tax. For example, if a territorial system were adopted domestically, the domestic or foreign residence of a corporation would have much less significance for the U.S. taxation of business income (though the differences for passive income likely would remain).

E. Specific Comments on Proposed Section 7701(p).

If proposed Section 7701(p) is enacted, it would be helpful if the rules used to determine residency were as unambiguous as possible, given the importance of residency status to substantive taxation. In this respect we have the following suggestions.

1. Limitation to Certain Types of Transactions.

As discussed above, we believe that the General U.S.-Managed Proposal, if adopted, should be limited to situations likely to involve a U.S. tax motivation. To accomplish this, we would exclude from those situations cases in which a foreign-organized corporation has been operating with foreign-situs management for a period of years, e.g., five years.

2. Management Test Generally.

The operative provision redefining "domestic corporation" (proposed Section 7701(p)(1)) looks to where "management and control of the corporation occurs." By contrast, the provision directing the issuance of regulations to determine this (what we describe above as the "Officer Test") looks to the "location" of individuals who exercise key responsibilities, asking whether "substantially all" of them are "located primarily within the United States" and apparently without regard to where they carry out those responsibilities.[60] The following clarifications would be helpful:

- Assuming that the test is supposed to be based on "location" of key individuals (and not on where they carry out their responsibilities), it would be clearer if "location" were restated as the location of the individual's primary office (and, if none, then the individual's residence for U.S. tax purposes).

- Using the standard "primarily" in addition to "substantially all" seems unnecessarily ambiguous. If location of an individual's primary office (or if none, the individual's residence) is substituted for the individual's location, each key individual generally would have one such location (instead of possibly multiple locations) and collectively as a group they could be tested against the "substantially all" standard. The concept of "primarily" could then be deleted from the provision authorizing prescribing regulations. It would also be helpful to provide some indication of the meaning of "substantially all" for this purpose.

- Senior management and executive officers include others exercising policy-level responsibilities (including officers and employees of other corporations in the same chain) for the corporation being tested. To the extent that shareholders exercise such responsibilities, we believe that they should be taken into account. If consultants

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[60] The Dutch Protocol looks to where the activities take place instead of the location of the key individuals. See supra note 30 and accompanying text.

(including consultants of shareholders) exercise such responsibilities, they might also appropriately be considered. If Congress decides that investment funds should not be subject to the Management Test (and provides that trading stocks and securities is generally not covered by that test), special consideration will need to be given to how the test should apply to a fund with an investment in an operating company located overseas if any management decisions with respect to the company is made on the fund's behalf in the United States.

- Many operating businesses, including businesses located outside of the United States, are organized as partnerships but utilize corporate shell partners (blocker corporations) formed overseas to protect U.S. investors from liability, including tax liability. For example, this structure protects U.S. tax-exempt investors from recognizing unrelated business taxable income ("UBTI") (which would otherwise be recognized if such investors were direct partners in a partnership that uses leverage) and allows other U.S. taxable investors to defer their share of the corporation's income. It would be helpful for the Management Test to clarify whether it is intended to cover these types of corporations by reason of U.S. management activities at the partnership level.

3. Carving the Funds-Specific Proposal Out of the Management Test.

As discussed below, if the General U.S.-Managed Proposal is adopted but not the Funds-Specific Proposal, then the General U.S.-Managed Proposal should be changed to clarify that trading activities that are not treated as a U.S. trade or business under Section 864(b)(2) are disregarded in applying the Management Test. In addition, so that investment funds are not otherwise covered by the General U.S.-Managed Proposal, the Management Test should be changed to clarify that "decisions involving strategic, financial and operational policy of the corporation" do not include those decisions or policies relating to activities carried on by funds that, while not described in Section 864(b)(2), are nevertheless necessary for the fund to carry on activities so described. These include, for example, decisions about policies related to fund marketing and investor-relations activities and accounting, valuation, financing of assets and/or activities covered by Section 864(b)(2).

In addition, consideration should be given to the situation where a foreign-incorporated fund engages in activity not covered by Section 864(b)(2) and the decisions about the strategic, financial and operational policies relating to such activity are made in the United States. Should the application of the General U.S.-Managed Proposal to the fund as a whole depend on the size of that activity relative to the activities covered by Section 864(b)(2), as measured by relative size of assets or income related to the activity? Alternatively, should that activity simply be isolated and deemed to be carried on within a U.S. corporation (in a manner analogous to how taxable mortgage pools are taxed when part of larger entities) so that the trading activity is not subject to U.S. corporate taxation? In answering either of these questions, should it matter whether the activity is a U.S. trade or business? (Note that, if it is a U.S. trade or business, then the income from it would be fully subject to U.S. corporate (and perhaps branch profits) taxation whether or not the U.S.-Managed Proposal is applied to the fund, and therefore the principle consequences of treating the fund as a U.S. corporation would be to cause the income and gains from the fund's investing and trading activity to become subject to U.S. corporate taxation.)

4. Trading Test.

We assume that regulations will clarify that under the Trading Test, "regularly" and "established securities market" have the same meaning as used in other places in the Code, which generally means that "market" does not have to be a government-sponsored exchange but must be a known place where quotes are readily available, and "regularly" requires actual trades as a percentage of outstanding shares within specified periods (like quarters or years). If something different is intended (for example, mere listing on an exchange satisfies the test), then it should be clarified.

5. Asset Test.

We have considered whether the proposal should apply to private companies and believe that generally no distinction should be drawn based on whether a company has accessed the capital markets. We note that although an exception for nonpublic entities was included in the Senate version of Section 7874, no exception was included in the final provision. If, as we recommend above, the General U.S.-Managed Proposal is made applicable only to situations considered likely to involve U.S. tax motivation, then we do not believe an asset-based threshold is appropriate. We note that having such a threshold can only increase the possibility of problems for taxpayers crossing the threshold, as described below.

If the Asset Test is retained, then, given the importance of residency, it will be important to know exactly how to value the "gross assets" under the Asset Test, and the test raises a number of questions.

- Must fair market value be used or can book value be used?

- The test is tripped if the $50 million threshold is met "at any time during the taxable year or any preceding taxable year." This makes the test very impractical to apply since even book value is not usually determined daily. Consideration should be given to making it a quarterly test.

- Are only assets treated as owned for tax purposes considered or are other net-leveraged positions grossed up, for example if a book method is used for valuation?

- More clarity would be helpful on the meaning of "held directly or indirectly" in the context of chains of entities, including lower-tier minority investments. What level of ownership will require looking through lower-tier entities?

6. IRS Waiver Exception.

The Asset Test looks to all prior years of a corporation to determine if its gross assets exceeded the $50 million threshold, and if they did, generally the Asset Test would be met. However, by receiving an IRS waiver, the corporation will not be treated as domestic if it is not publicly traded and it has, and expects to continue to have, less than $50 million of gross assets.

It would be helpful to clarify what conditions, if any, must be met to obtain this waiver. If the only condition is certifying as to "reasonable expectation" of having less than $50 million of gross assets, then consideration might be given to making this exception affirmatively available (for example, by filing a certification as to reasonable expectation) rather than making it subject to an IRS waiver.

7. <u>CFC Exception</u>.

The General U.S.-Managed Proposal would not apply to a CFC that would be part of an affiliated group if the residency of its members were disregarded and if the group has a U.S.-organized parent (or a parent treated as domestic under Section 7874) with substantial business assets (other than cash and stock of foreign subsidiaries) used in an active U.S. business. This exception raises a number of questions.

- It would be helpful to clarify that the U.S. parent does not need to directly conduct the U.S. active business but simply needs to hold stock of a U.S.-organized subsidiary that does so or is part of a chain of U.S.-organized corporations, one of which does so.

- It is unclear why this exception is limited to foreign-organized corporations that if U.S.-organized, would be part of an affiliated group headed by a U.S. parent. For example, the exception would not cover CFCs that are held through a partnership and 100 percent indirectly owned by the U.S. parent; this seems to be an oversight. Similarly the exception would appear not to be available if the CFC is below a U.S. consolidated group (with a U.S. parent) and that group is owned by a foreign parent. Further, the exception would not apply to a CFC owned (even wholly owned) by one or more U.S. individuals described in Section 951(b). As to less than 80 percent-owned CFCs, perhaps it is thought that in the absence of a high degree of ownership (like 80 percent) by a U.S. corporation (which would ultimately pay U.S. tax on the deferred income from the CFC), U.S. residence based taxation of the CFC's income should apply.

- It is unclear why, to fit within this exception, the parent corporation must be a domestic corporation without regard to proposed Section 7701(p), i.e., must be U.S. organized or treated as U.S. organized under Section 7874.

8. <u>Movement of Assets Into and Out of the U.S.</u>

A change in status of a company under proposed Section 7701(p) from a foreign corporation to a domestic corporation would presumably be a reorganization under Section 368(a)(1)(F). Under Section 362, the transaction would result in importation into the U.S. tax net of any built-in gains (even if they had been economically accreted over many years). On the other hand, under Section 362(e)(1), if there is a net built-in loss in assets, then the basis of the domestic transferee in each "loss" asset is treated as its fair market value, even though the transferee succeeds to the built-in gain in each gain asset. In the case of a U.S. shareholder owning stock representing 10 percent or more of the voting power of the corporation, the shareholder would have to include as dividend income its share of the corporation's "all E&P amount." Treas. Reg. §1.367(b)-3(b)(3). (Further, upon a reverse change in status from a domestic corporation to a foreign corporation, gains generally would be triggered into income under Section 367(a).) A taxpayer that is aware that its residence is about to change would presumably plan for the change and attempt to avoid to the extent possible consequences of this sort. Under proposed Section 7701(p), however, unanticipated changes may occur due to changes in value of a private company or simply because upon an audit or other controversy it is determined that the corporation's determination of its management situs was incorrect.

9. Limitation of Proposed Section 7701(p)'s Scope.

As proposed, the provision would apply only for Chapter 1 "Normal Taxes and Surtaxes" and any other provision of the Code relating to Chapter 1. It would be helpful to clarify what Code provisions outside of Chapter 1 are treated as "related" for this purpose. For example, presumably it would include provisions relating to withholding and consolidated returns but not gift and estate tax provisions. What about employment taxation?

10. Treaty Issues.

We presume that proposed Section 7701(p) is not intended to override U.S. income tax treaties, but that should be clarified in order to avoid confusion under the "last in time" rule. For example, the tie-breaker rule of the U.S.-Canada income tax treaty looks to the place of organization of an entity in the case of an entity organized in only one jurisdiction. The Congressional Reports accompanying the legislation should clarify, if this is the intent, that the provision is not intended to override treaty provisions.

IV. Funds-Specific Proposal.

A. Overview.

As described above, under the General U.S.-Managed and Funds-Specific Proposals, a foreign-organized corporation with either stock regularly traded on an established securities market or aggregate gross assets in the current or any preceding taxable year of $50 million or more generally would be treated as a U.S. corporation if the management and control of the corporation occurs, directly or indirectly, primarily within the United States. The Funds-Specific Proposal additionally would provide that for this purpose (1) the assets of the corporation would include "assets under management for investors, whether held directly or indirectly" and (2) management and control of the corporation would be treated as occurring primarily within the United States "if the assets of such corporation (directly or indirectly) consist primarily of assets being managed on behalf of investors, and decisions about how to invest the assets are made in the United States."

Our discussion of the Funds-Specific Proposal begins with a description of Senator Levin's 2009 introduction of it, which contains the only articulation of its possible purpose. There Senator Levin indicated that its purpose is to tax U.S.-managed corporations the same as U.S.-organized corporations regardless of the type of the investment or business activity conducted by them. We question, however, whether the promotion of that purpose is being motivated at least in part by a misunderstanding of why taxpayers typically use the kinds of funds targeted by the proposals and how that use is consistent with longstanding U.S. tax policy. Therefore, after describing the proposals stated purpose, we provide significant background on the types of funds covered by the proposals, their U.S. tax treatment under current law and the tax policies underlying that treatment. Finally, to help policy makers evaluate the merits of the Funds-Specific Proposal, we describe the proposal's likely effect on these funds' investors and managers and the tax policies that would be likely strengthened or undermined by that effect.

The specific question of whether foreign-organized incorporated funds with U.S.-based managers should be taxed like U.S. corporations — along with the other policy questions implicitly raised by the proposal — are for Congress to answer. However, if Congress takes up these questions, we urge that it carefully consider the desirability of (1) taxing foreign investors' income from U.S.-managed portfolio investments differently depending on whether the investment is held through an offshore incorporated fund instead of either directly or through a partnership and (2) reversing decades of U.S. tax policy intended to encourage foreign investment in the United States by imposing net income taxation on foreign investors' income from U.S.-managed portfolio investments. We also believe that implementing any of these possible changes to U.S. tax policy through the adoption of the Funds-Specific Proposal would require significant revisions to the proposal as currently drafted, and in that regard, we have a number of technical comments on it.

B. *Stated Purpose of Funds-Specific Proposal*

Senator Levin has indicated that the purpose of the Funds-Specific Proposal is to tax U.S.-managed corporations the same as U.S.-organized corporations regardless of the type of investment or business activity conducted by them. The rationale for this seems to be based on the belief that the favorable tax treatment available under current law to foreign-organized incorporated funds is, insofar as it applies to those that are U.S. managed, unfair to U.S.-organized corporations and not justified by the investment activities of those funds.

More specifically, Senator Levin introduced proposed Section 7701(p) by describing it as "designed to address the Ugland House problem," which he described as "the situation where a corporation is incorporated in a tax haven as a mere shell operation with little or no physical presence or employees in the jurisdiction" and "pretends" that it is operating in the tax haven although its key personnel and decision makers are in the United States.[61] Senator Levin seems to particularly object to these shell entities availing themselves of U.S. legal, educational, financial and commercial institutions and their professionals while avoiding liability for U.S. taxes.

Senator Levin's statement specifically refers to hedge funds as examples of the business arrangements considered abusive:

> Section 103 is intended to stop, in particular, the outrageous tax dodging that now goes on by too many hedge funds and investment management businesses that structure themselves to appear to be foreign entities, even though their key decisionmakers—the folks who exercise control of the company, its assets and investment decisions—live and work right here in the

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[61] Levin Floor Statement, supra note 2. See supra notes 14 through 17 and accompanying text. The International Tax Competitiveness Act of 2011, in contrast, was not issued with an accompanying press release, introduction or similar statement.

> United States. Too many hedge funds establish a structure of offshore entities, often including master and feeder funds that make it appear as if the hedge fund's assets and investment decisions are offshore, when, in fact, the funds are being managed and controlled by investment experts located in the United States. It is unacceptable that such companies utilize U.S. offices, personnel, laws and markets to make their money, but then stiff Uncle Sam and offload their tax burdens onto competitors who play by the rules.[62]

The GAO report on Ugland House, cited by Senator Levin's introductory statement, indicates that other common types of investment vehicles with their registered address at Ugland House include private equity funds and securitization vehicles. Consistent with Senator Levin's characterization of the entities registered there, the Funds-Specific Proposal would also squarely cover many types of securitization vehicles and "blocker" entities commonly used in private equity investment structures.

C. Background.

Funds effected by the Funds-Specific Proposal are commonly used in investment structures that function in a manner entirely constantly with longstanding U.S. tax policy.

1. Types of Funds Affected by the Proposal.

Senator Levin's statement introducing the Funds-Specific Proposal suggests that its target is U.S.-managed offshore hedge funds. Given its broad scope, however, many types of U.S.-managed investment vehicles would also be potentially affected by it, in particular private equity funds and structured finance vehicles.

(a) *Common Key Features of Affected Funds.*

While the different types of funds affected by the Funds-Specific Proposal operate differently in many respects (for example, invest in different asset classes and provide investors different rights), in key respects they are very similar. In particular, they generally function like pooled investment accounts that share expenses and income and are managed externally by an investment advisor rather than internally by employees. For the reasons discussed below, many of these funds are foreign organized and classified as corporations for U.S. tax purposes, and those with U.S.-based advisors are thus potentially covered by the Funds-Specific Proposal. However, U.S. taxable and foreign investors do not invest in incorporated (as opposed to other) funds for the purpose of reducing the amount of U.S. tax borne on their investment income, since investing through incorporated funds usually either has no effect on or increases the total U.S. tax borne by them.

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62 Levin Floor Statement, supra note 2.

(b) *Hedge Funds.*

The term "hedge fund" generally refers to a lightly regulated pooled investment vehicle that trades in liquid assets. Because these funds are lightly regulated, they are usually offered only to wealthy individuals and institutions. They might invest in a wide range of different types of assets, but most funds invest mainly in publicly traded stocks, securities and/or commodities. Being lightly regulated, they are generally considered riskier than mutual funds, which are typical heavily regulated and offered principally to retail investors.

While the investors in a hedge fund typically "own" the fund, in the sense that they provide all of its capital and are entitled to all the investment return on that capital net of the fund's expenses (including compensation to the advisor), the fund's investment advisor typically "sponsors" the fund, in the sense that the advisor usually organizes the fund, establishes its terms (including the investors' rights and obligations) and manages it, in particular its investment program. The fund pays the sponsor for these services, though sometimes the sponsor's fees are collected directly from the fund's investors. The compensation to the advisor is usually paid annually and measured by reference to the fund's net assets plus an additional amount based on the fund's positive investment performance (which might be received in the form of a fee or equity of the fund that entitles the advisor or an affiliate to share directly in the fund's profits).[63]

A hedge fund's advisor is usually a separate entity that is not owned by the fund or its investors (though the advisor and/or its owners may invest in the fund). Sometimes the advisor contracts with the fund to provide all of the services necessary for the fund to function (like shareholder-servicing, accounting, legal and custody), which it may sub-contract out to affiliates or third parties, and sometimes the fund contracts directly with others for these services, who may or may not be affiliated with the advisor. One or more brokers hired directly by the fund usually provide all brokerage services for portfolio trading, and the fund may hire an affiliated or unaffiliated broker dealer to distribute its interests. Many funds hire a "prime" broker to provide all (or many) services other than advisory, legal and accounting services.

Within certain limits, a fund's investment advisor usually controls all of the fund's activities, including the management of its assets and selection of its other service providers. The rights of a fund's investors are generally established by the fund's organizational documents, which are usually drafted at the direction of the fund's advisor, and the law of its place of organization, which the advisor usually selects. Even these rights, however, often are very limited and relate to terms like the ability of the advisor to change the fund's investment program (which can be drafted very broadly), shareholder reporting, sponsor conflicts, maximum advisor compensation and investor liquidity (i.e., when and how an investor is permitted either to redeem or sell its interest in the fund, which can be subject to further limitations in the case of unusual market conditions and the investor's share of the fund's illiquid investments). Many

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[63] In general, a hedge fund pays its advisor an annual fee calculated as a percentage (often 1 to 3 percent) of its net assets. In addition, the fund may pay its advisor or an affiliate of its advisor a percentage (often 20 percent) of its annual income and gains. See Jerald David August & Lawrence Cohen, *Hedge Fund— Structure, Regulation, and Tax Implications: Part I. Structure and Regulation*, BUS. ENTITIES, Jul.–Aug. 2006, at 14, 18. In the past, advisors of hedge funds organized as non-U.S. corporations were able to defer their compensation, but Section 457A of the Code was passed in order to end such deferral. Veena K. Murthy, *New Laws Target Foreign Entities and Related U.S. Service Providers*, BUS. ENTITIES, Jan.–Feb. 2009, at 27, 30.

times, however, fund investors may contract separately with the fund and its investment advisor to obtain special rights, including, for example, with respect to the liquidity of its investment, investment reports, restrictions on types of investments and fee reductions.

Hedge funds are typically organized as either U.S. partnerships (including limited liability companies taxed as partnerships) or offshore corporations (or some other foreign-organized entity classified as a corporation for U.S. tax purposes). The form of organization usually depends on the tax characteristics of their investors. Funds offered to U.S. taxable investors are usually organized as U.S. partnerships to provide them with pass-through tax treatment. Funds offered to U.S. tax-exempt and foreign investors are usually organized as offshore corporations to allow the U.S. tax-exempt investors to avoid recognizing UBTI on the fund's debt-financed income and to allow the foreign investors to avoid U.S. tax reporting. Hedge funds commonly incur substantial amounts of debt.

Funds organized as corporations or limited companies generally have a board that is initially selected by the advisor (though a majority of its members are typically unaffiliated with the advisor). The board is usually either self-perpetuating or approved by investors, though sometimes board candidates are limited to those proposed by the advisor. Funds organized as limited partnerships generally have a general partner that formally selects and is an affiliate of the advisor. Investors often have very limited or no ability to terminate the advisor, the board, the general partner or the fund. However, so that the advisor and/or general partner can avoid having to include the fund within its consolidated financial statements, sponsors often allow investors some rights to terminate the advisor and/or general partner.

Funds that offer investors redemption rights generally provide fewer rights allowing investors to terminate the advisor. The rationale for this is that, if an investor is dissatisfied with the performance of the fund or its advisor, the investor can redeem its interest, since redeeming from the fund is functionally like terminating the advisor as to the investor's investment. Most hedge funds are not traded on an exchange (since trading usually subjects funds to unwanted regulation and reporting), but those that are traded usually provide investors more rights to terminate the fund, advisor and/or board (or general partner). Some of those termination rights are required by the exchange where the fund is traded.

To achieve greater economies of scale, funds organized as domestic partnerships and offshore corporations with the same manager and investment objectives sometimes pool their investments in an underlying fund organized as a partnership in what is commonly called a "master-feeder" structure, with the two upper-tier funds "feeding" into a common "master" fund. In some master-feeder structures, the feeder funds may make direct investments that are unique to it. In addition, sometimes investors are also permitted to invest directly in the master fund.

Funds may also participate in so-called "fund of fund" structures. In these structures, upper-tier hedge funds, which are classified as either partnerships or foreign corporations, invest some or all of their assets in other funds, which are also classified as either partnerships or foreign corporations. Each lower-tier fund would typical have a different investment strategy or manager, allowing the upper-tier funds to obtain diversification and/or specialized management through their investment in the lower-tier funds. Usually, upper-tier funds invest in lower-tier funds with the same tax classification (e.g., upper-tier funds classified as partnerships would invest in lower-tier funds classified as partnerships so that they achieve full flow-through treatment on their investment).

(c) *Private Equity Funds and "Blockers."*

Like hedge funds, private equity funds are usually lightly regulated and have external investment advisors that "sponsor" (and thus generally control) the fund and set its terms for investors, though many investors may negotiate special terms with the fund and its sponsor. While most hedge funds invest mostly in liquid stocks and securities and provide investors with some opportunities to redeem all or part of their interest periodically, private equity funds invest mostly in the equity securities of private businesses that are usually organized as corporations. Depending on the fund's investment objective, these businesses may be targeted by industry, geography and/or size.

While many hedge funds grow and shrink as investors purchase and redeem their shares and have a perpetual life, private equity funds are usually organized as closed pools of committed capital with a limited investment period. Usually, investors agree to fund their contributions of capital to the fund upon request from the fund's sponsor at anytime over a specified investment period, and they are not entitled to receive distributions from the fund except as investments are realized, when the proceeds are distributed to all investors pro rata to their capital contributed in respect of the investment, subject to the fund sponsor receiving a portion of the proceeds representing a percentage of any gain.

The sponsor is usually compensated for its management services based on a fixed percentage of the fund's committed capital through the investment period (and then based on invested capital) plus a percentage of net gains from investments as they are realized. Hedge funds typically have more service providers (like prime brokers) than private equity funds, though both often hire distributors or placement agents to market themselves.

Most private equity funds are organized as entities taxed as partnerships. Many large funds are subdivided into separate entities designed for different types of investors, usually based on their tax characteristics, though even then those sub-funds are usually taxed as partnership. They are separated into sub-funds to facilitate tax and regulatory planning for portfolio investments made by the funds as a group. Private equity funds usually do not incur debt directly to make their investments, though many have credit lines to enable them to borrow to make investments before they receive funds by investors. They therefore typically do not recognize UBTI (or contain special provisions intended to protect exempt investors from recognizing UBTI). The other reason that private equity funds have been traditionally organized as partnerships is to allow their sponsor to receive their performance-based compensation in the form of profits allocation that retains the tax character of the tax items realized by the fund from its investments.

Private equity funds frequently use "blocker" entities for investors and to make portfolio investments. These entities are typically organized offshore and elect to be classified as corporations for U.S. tax purposes. They are formed to hold interest in the private equity fund itself or are held by the fund and hold underlying investments. They are intended to "block" the income and other tax attributes of their assets from their owners (either the private equity fund or its investors).

For example, in cases where some fund investors desire not to invest in a partnership, the fund sponsor would usually organize a blocker for those investors. Those investors would contribute their capital to the blocker, which would then invest those contributions in the main private equity fund organized as a partnership (with the sponsor's incentive compensation being paid as a profits allocation from the partnership). Similarly, in cases in which fund investors desire not to recognize directly the income of an investment in a particular portfolio company, the fund might form a blocker and either invest through that blocker or allow its investors to make their indirect investment in that portfolio company through the blocker. A classic example of this would be where the fund makes an investment in a foreign business that is otherwise treated as a partnership for U.S. tax purposes. Since income from such investment would be UBTI to the fund's U.S. tax-exempt investors, it would typically either make the investment through a blocker or allow its investors to do so.

These blocker corporations would typically be controlled by the fund's sponsor, with its shareholders having rights that are limited consistent with their rights in the fund itself. In the case where the sponsor is located in the United States, the blocker would often be covered by the Funds-Specific Proposal, assuming that it meets the proposal's Asset Test.

(d) *Structured Finance Vehicles.*

The term "structured finance vehicle" generally refers to any type of entity that issues asset-backed securities. Like hedge funds and private equity funds, those that are not publicly offered are also usually lightly regulated, though some structured finance vehicles have widely held traded interests and are regulated. Also, unlike private equity and hedge funds, structured finance vehicles typically own a fixed (or largely fixed) pool of assets, usually consisting of financial instruments (like mortgages, credit card or other type of consumer or business receivables, other forms of debt or other types of rights to defined payment streams).

A structured finance vehicle often issues to its investors different classes of interest that entitles them to different payment rights. Those rights might relate, for example, to payments on different parts of the underlying assets or different priorities to all payments on all of the underlying assets. Usually, investors are either told exactly what assets will be held by the vehicle or that it will hold assets only meeting a strict set of criteria (based, for example, on credit, maturity or size). For U.S. tax purposes, the senior classes of interest in the vehicle would typically be treated as debt while the most junior classes would be treated as equity, though all of the classes sharing in the economics of the underlying assets might be denominated as debt.

The sponsor of the vehicle might be the seller of the assets to it or a financial intermediary that arranges for the purchase of those assets and confirms their quality. Often the sponsor or an affiliate purchases the vehicle's most junior class of interest issued. Either the sponsor or another agent would typically manage the asset, including enforcing the vehicle's rights against its counterparties on the underlying assets, and would receive an asset-based fee and perhaps also performance-based compensation. Investors in the vehicle usually have very few rights with respect to the management of the entity or even replacement of its managers.

Structured finance vehicles that are not offered to retail U.S. investors are usually organized offshore and classified for U.S. tax purposes as a corporation. They elect corporate classification for the same reason as other funds, in particular to protect U.S. tax-exempt investors from UBTI and foreign investors from U.S. tax reporting.

2. Tax Policy Rationale for the Favorable Treatment of Offshore Funds.

Under current law, foreign investors generally are not subject to U.S. tax on capital gains or interest realized with respect to their stocks and securities.[64] They generally are subject to tax on U.S.-source dividends, gains from U.S. real estate-related investments and certain other categories of U.S.-source income.[65] While the rules for taxing investors vary from country to country, these U.S. rules are broadly similar to how most developed countries tax foreign investors on their income from portfolio investments.

Foreign persons are generally subject to U.S. net-based income taxation on their income effectively connected with a U.S. trade or business[66] (except as provided by treaty).[67] Trading (as opposed to investing) in stocks, securities or commodities is treated as a "trade or business" under the common law,[68] but for purposes of taxing foreign persons, trading in stocks securities or commodities have long been statutorily treated as not a U.S. trade or business.

More specifically, Section 864(b)(2) (the "Trading Safe Harbor") generally protects foreigners (other than dealers) trading in stocks, securities or commodities in the United States (either directly or through a U.S.-resident agent) from being treated as engaged in a U.S. business by reason of such trading.[69] This rule thus allows U.S.-based money managers to trade

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[64] Capital gains earned by foreign investors generally are treated as foreign-sourced and therefore not subject to U.S. tax. Under Section 865(a)(2), income from the sale of personal property by a nonresident is considered foreign-source income. Individuals are considered nonresidents for this purpose if they are not U.S. citizens, resident aliens with no tax home in another country, or nonresident aliens with a tax home in the United States. Section 865(g)(1). Interest and other types of "fixed or determinable annual or periodical" ("FDAP") income is generally subject to U.S. withholding tax. Section 871 (imposing a flat 30 percent tax, without allowances for deductions or credits, on nonresident alien's FDAP income from sources within the United States); Section 881 (same, for income of foreign corporations); Section 1441 (imposing a withholding obligation on payments made by U.S. payors to nonresident aliens of FDAP); Section 1442 (imposing the same withholding obligation for payments to foreign corporations). However, under the "portfolio interest" and other exemptions, interest paid to an unrelated investor generally is exempt from such tax. Sections 871(h) and 881(c)

[65] Sections 871, 881 and 897.

[66] Sections 871(b) and 882(a). In addition, a foreign corporation's income so connected may be subject to a branch profits tax. Section 884.

[67] Section 894. Very generally, most treaties allow business income to be taxed only if attributable to a fixed base or permanent establishment.

[68] See, e.g., Higgins v. Commissioner, 312 U.S. 212, 218 (1941) and Cont'l Trading, Inc. v Commissioner, 265 F. 2d 40, 43 (9th Cir. 1959) ("Since [Higgins] it is fair to say that it is settled law that the mere management of investments and the collection of rents, interest, and dividends is insufficient to constitute the carrying on of a trade or business.").

[69] In general, for dealers to rely on the Trading Safeharbor, the trades must be through an independent agent, and the dealer must not have an office through which the trades are effected or directed. Section 864(b)(2)(C). In addition, for commodities transactions to fit under the Trading Safeharbor, the commodities must be of a kind customarily dealt in on an organized commodity exchange and the transactions must be of a kind customarily consummated at such a place. Section 864(b)(2)(B)(i), (B)(iii) and (C).

stocks, securities and commodities on behalf of foreign investors, including corporate investors and offshore funds sponsored by U.S.-based managers, without causing the income and gain from such trading to become subject to net-based U.S. income taxation to the foreign investors.[70] The Trading Safe Harbor developed to facilitate foreign investment into the United States.

The first version of this Trading Safe Harbor was enacted as part of the Revenue Act of 1936 (the "1936 Act").[71] Under the 1936 Act, foreign persons were subject to net-based taxation on their U.S. source income if they were engaged in a U.S. trade or business or had an office or place of business with in the United States; however, a U.S. trade or business did not include "the effecting of transactions in the United States in stocks, securities, or commodities through a resident broker, commission agent, or custodian."[72] While the legislative history of this initial version of the Trading Safe Harbor was sparse,[73] it has been suggested that the provision was based on concepts contained in contemporary tax treaties.[74]

After its enactment, the provision came to be interpreted narrowly, resulting in significant litigation and confusion.[75] By the 1960s, there was a concern that the provision's narrow scope and ambiguity deterred foreign investment into the United States.[76] To remedy that deficiency, Congress expanded the Trading Safe Harbor in 1966 to what is essentially its current form.[77] The immediate purpose of the revised provision was to encourage foreigners to

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70 A lot has been written about the history and scope of the Trading Safeharbor. For a comprehensive article on recent issues raised under the Trading Safeharbor in the funds context, see David Sicular and Emma Sobol, *Selected Current Effectively Connected Income Issues for Investment Funds*, 56 TAX LAWYER 719 (2002-03).

71 49 Stat. 1648, 1714, 1717.

72 Section 211(b) of the 1936 Act. The "office or place of business" criterion for net-based taxation was removed by the Revenue Act of 1942. Section 160, 56 Stat. 798, 860-61.

73 The House Report states that this exception was created because of the administrative difficulties that inhered in trying to collect tax on capital gains earned by nonresident aliens. H.R. Rep. No. 2475, 74th Cong., 2d Sess. 9, 21 (1936). The Senate Report just said that the changes were intended to clarify the meaning of "engaged in trade or business in the United States." S. Rep. No. 2156, 74th Cong., 2d Sess. 21-22 (1936).

74 A 1936 report prepared by the American Bar Association states that, prior to 1936, the tax law read "carrying on or doing business in the United States" very broadly, and because it essentially encompassed "every conceivable activity of a foreign corporation, including transactions on the stock and commodity exchanges, it was considered expedient in the bill, when under consideration by the Senate Committee on Finance, to insert a specific definition modeled after the essentially similar provision in the Franco-American treaty, which states that the foregoing phrase 'does not include the effecting of transactions in the United States in stocks, securities or commodities through a resident broker, commission agent or custodian.'" International Double Taxation—ABA Report, 14 TAX MAG. 611, 612 (1936).

75 "The law in this area before 1966 was chaotic, with the line between trading as a business and trading as an investment being drawn case by case according to the frequency of trades and the average length of holdings. As early as 1936, the tax laws provided that engaging in business 'does not include effecting of transactions in the United States in stocks, securities, or commodities through a resident broker, commission agent or custodian.' This exclusion was construed quite narrowly, however, and was not, for example, extended to taxpayers trading in securities through agents residing in the United States. The resulting distinctions made in the cases bordered on the talmudic. Extensive trading for the taxpayer's own account somehow also fell outside the umbrella of this provision." Joseph Isenbergh, *The "Trade or Business" of Foreign Taxpayers in the United States*, 61 TAXES 972, 981 (1983).

76 The Fowler Task Force Report (April 27, 1964) ("[r]evision of U.S. taxation of foreign investors is one of the most immediate and productive ways to increase the flow of foreign capital into this country"). This report was commissioned by President Kennedy in 1963 to recommend ways to reduce the balance of payments deficit. S. Rep. No. 89-1707 at 9-10.

77 The Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539, 1544, § 102(d).

invest in U.S. dollar denominated assets in order to reduce a U.S. balance of payments deficit then existing under the system for fixing the currency-exchange rates that was in place at that time.[78] It was thought that, by removing prior law ambiguity, the Trading Safe Harbor would encourage foreign investment in the United States.[79]

This new version of the Trading Safe Harbor, which remains largely intact today, provides two means for concluding that trading will not be treated as a U.S. trade or business. The first, which is sometimes referred to the "independent agent Safe Harbor," covers trading "through a resident broker, commission agent, custodian, or other independent agent" so long as the taxpayer at no time during the year has an office or other fixed place of business in the United States through which or by the direction of which the transactions were effected. The second alternative for fitting under the Trading Safe Harbor allows taxpayers to trade for their own account, whether while present in the United States or through employees, brokers, custodians, or other agents, but only if the taxpayer is not a dealer and (prior to 1997) maintained a principal office outside of the United States.

Because the independent agent Safe Harbor precludes having a U.S. office that effects or directs the trades, most U.S.-managed offshore funds have traditionally relied on the second means of fitting under the Trading Safe Harbor, which allows U.S.-based trading for one's own account through resident agents whether or not they are independent. Before 1997, this second means of relying on the Trading Safe Harbor (as indicated above) also required maintaining a "principal office" outside of the United States, but this requirement was easily met because the location of an entity's "principal office" was formalistically determined based on where certain administrative functions occurred and did not depend on the location of management or where investment decisions were made.[80] Offshore funds sponsored by U.S. advisors hired offshore administrators to perform these functions even though all investment decisions were made in the United States.

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[78] "In his balance-of-payments message of February 10, 1965, the President proposed a series of measures designed to reinforce the program to correct the balance-of-payments deficit of the United States. Among the proposals made by the President is one to remove the tax deterrents to foreign investment in U.S. corporate securities so as to improve our balance of payments by encouraging an increase in such investment." Explanation by the Department of the Treasury of the Act to Remove Tax Barriers to Foreign Investment in the United States, inserted in the Congressional Record on March 8, 1965, by Chairman Wilbur D. Mills, reprinted in Staff of House Committee on Ways & Means, Legislative History of H.R. 13103, 89th Cong., Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 90th Cong., 1st Sess., Section 3, at 59, 61 (1967).

[79] "There is some confusion as to whether the amount of activity in an investment account, or the granting of a discretionary power to a U.S. banker, broker, or adviser, will place a nonresident alien outside of this exception for security transactions so that he is engaged in trade or business in the United States. This uncertainty may deter investment in the United States and is undesirable as a matter of tax policy." Id. at 62. The House Report stated that "[a]lso, the confusion regarding the status of a foreign investor who has granted discretionary authority to a U.S. agent may have acted to deter some foreign investment in the United States." H.R. Rep. No. 89-1450, 89th Cong., 2d Sess., at 12-13 (1966).

[80] Under Treas. Reg. § 1.864-2(c)(2)(iii), a foreign corporation's principal office was not considered to be in the United States (even if most or all of its investment activities were carried on in the United States) if all or a substantial portion of ten functions were performed by the corporation from an office outside the United States. These functions were colloquially known as the "ten commandments."

In 1997, the Trading Safe Harbor was liberalized to remove the "principal office" requirement.[81] Recognizing that this requirement had little substantive meaning, Congress eliminated the rule rather than trying to strengthen it by making it more "meaningful" and less formalistic. It did so to "facilitate the foreign investment in U.S. markets that the safe harbor was designed to promote."[82] Now, offshore funds sponsored by U.S. advisors typically do not perform any administrative or other operational functions offshore. Today, with the "principal office" requirement removed, the second means of relying on the Trading Safe Harbor ("trading for one's own account") essentially subsumes the first (the "independent agent" Safe Harbor) except in the case of dealers.

Regulations generally provide that the Trading Safe Harbor is available to foreign partners of a partnership if the partnership's activities fit within the scope of the Trading Safe Harbor.[83] Accordingly, the Trading Safe Harbor is now routinely relied on by investment advisors organizing pooled investment funds. These funds are typically organized as either partnerships, which rely on the Trading Safe Harbor to protect their foreign partners from net-based U.S. taxation by reason of the partnership's activities, or as foreign-organized corporations, which rely on it in determining their own U.S. tax treatment. In the common master-feeder structure, where foreign investors invest in an offshore incorporated fund that invests all of its asset into a master fund classified as a partnership, the Trading Safe Harbor protects the feeder fund from net-based U.S. taxation on its share of the master fund's income as long as the master fund's activities fall within the Safe Harbor.

3. Reasons for Organizing Investment Funds Offshore.

In the case of most offshore funds, U.S. tax is only one reason for organizing the fund offshore. In particular, U.S. and foreign securities laws significantly affect the decision of where to organize funds.

Most U.S.-managed funds offered to both U.S. and foreign investors are organized outside of the United States so that they are not required to take account of foreign investors under applicable exemptions from U.S. securities laws. For example, in general, funds offered to U.S. investors are regulated under the Investment Company Act of 1940, as amended (the "1940 Act"), unless the fund is exempt from regulation by reason of the number of investors in the fund[84] or unless the fund is offered only to large and sophisticated investors.[85] However, if the fund is organized offshore, foreign investors are generally ignored in determining the availability of these exemptions.[86]

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81 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 987, § 1162 (eliminating the requirement that the principal office be outside the United States).

82 H.R. Rep. No. 105-148, 105th Cong., 1st Sess., at 542 (1997).

83 Treas. Reg. § 1.864-2(c)(2)(ii).

84 Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(1) (2006) ("Investment company" does not include "[a]ny issuer whose outstanding securities . . . are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.").

85 Id. at § 80a-3(c)(7)(A) ("Investment company" does not include issuers if all of the issuer's outstanding securities are owned by "qualified purchasers.").

86 Touche Remnant & Co., SEC No-Action Letter (Aug. 27, 1984), and Goodwin, Procter & Hoar, SEC No-Action Letter (Feb. 28, 1997).

In addition, some funds are organized in a particular foreign jurisdiction to subject the fund to regulation in that jurisdiction, especially when doing so facilitates an offering to a targeted investor class or is required under applicable foreign securities laws. Common jurisdictions for organizing funds offered to European investors, particularly retail investors, are Luxembourg and Ireland.[87] Finally, some investors may prefer to invest in funds organized in bank secrecy jurisdictions to avoid disclosure of their assets and income.[88]

Tax considerations may also interact with U.S. regulatory issues when deciding whether to organize a fund offshore or in the United States, especially if the fund is offered to both foreign and U.S. investors. In particular, a U.S.-organized fund's income will be subject to regular U.S. corporate income taxation unless the fund can be structured to qualify to be taxed as a partnership, mutual fund or other "pass-through" vehicle.[89] For many foreign investors, as discussed below, partnership classification is undesirable because it subjects them to U.S. tax reporting and direct U.S. taxation on any active business income. A fund required to be registered under the 1940 Act (because, for example, it is U.S.-organized, widely offered and holds mostly investment securities) cannot be taxed as a partnership unless its interests are treated as not traded on an established securities market or secondary equivalent thereof (including by reason of redemptions of the fund interests by investors, which would preclude many funds from being taxed as partnerships if they were required to be registered under the 1940 Act, because, for example, of their offering and U.S. status).[90] To be taxed on a pass-through basis, those funds investing primarily in stocks or securities generally must qualify as mutual funds, which would significantly limit the type of activity the fund is permitted to conduct.[91] For foreign investors, however, even such pass-through treatment can be disadvantageous as compared to how they would have been taxed if they were to invest directly or through a partnership or offshore corporation. That is because dividends paid from mutual funds to its foreign shareholders are generally subject to withholding tax even if those dividends attributable to income that would be exempt in the foreign investor's hands if earned directly.[92] To avoid these complications, most funds targeted to foreign investors are organized offshore.

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[87] See, e.g., as to investment funds in Luxembourg: http://www.ey.com/Publication/vwLUAssets/invest-funds-luxembourg-2008-print/$FILE/Investment%20Funds%202008.pdf; as to investment funds in Ireland: http://www.ey.com/Publication/vwLUAssets/Investment_funds_in_Ireland_2008/$FILE/investment_funds_ireland_2008.pdf; Appendix A: http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/CCCTB_for_financial_institutions_appendix_a_en.pdf.

[88] See, e.g., Staff of Permanent Subcommittee on Investigations of the S. Comm. on Homeland Security and Governmental Affairs, 110th Cong., Tax Haven Banks and U.S. Tax Compliance 41-96 (2008).

[89] See supra notes 115 and accompanying text.

[90] Publicly traded partnerships are generally taxed as regular corporations unless they both meet an qualifying income test and are not required to be registered under the 1940 Act. Section 7704(c).

[91] Under Section 851, these funds must meet a income and asset diversification test and under Section 852 must annually distribute substantially all of their income (other than net capital gain).

[92] Section 871(k) partially and temporarily alleviates this problem by generally exempting from withholding tax dividends attributable to short-term gains and interest; however, this provision is scheduled to sunset at the end of 2011 and does not apply to other types of income that would be exempt from U.S. tax if earned directly, like foreign-source dividend income or periodic and nonperiodic payments on notional principal contracts.

4. Tax Reasons for Offshore Funds to Elect Corporate Status.

The regulatory reasons for choosing to organize a fund offshore generally do not compel the fund to be classified for U.S. tax purposes as either a partnership or corporation,[93] though some types of these entities are per se corporations for U.S. tax purposes.[94] By contrast, funds organized offshore usually elect corporate status solely for U.S. tax reasons, typically to accommodate their foreign and U.S. tax-exempt investors.[95]

Foreign investors often prefer to invest in funds organized as foreign corporations so that they will not be subject to either U.S. tax reporting that applies to partnership investments or any direct U.S. tax liability, in particular in the event that the fund recognizes income treated as effectively connected with a U.S. business because it is not within the Trading Safe Harbor.[96] Many foreign investors prefer not to file U.S. tax returns, for a variety of reasons, including the inconvenience of doing so, the cost of hiring U.S. tax return preparers, and the unknowns that come with subjecting themselves to an unfamiliar taxing jurisdiction. They may also prefer not to have the fact that they are making a particular investment made known to their home taxing jurisdiction by reason, for example, of an exchange of information between the United States and that jurisdiction. Some, we are told, would not invest in a fund that would subject them to U.S. partnership reporting if other comparable funds were available that did not involve such reporting.

Importantly, structuring an offshore fund as a foreign corporation generally does not reduce the amount of U.S. tax that is imposed on a foreign investor's share of the fund's income and may in fact increase it. Most funds operate in a manner intended to fit within the Trading Safe Harbor. If a fund's operations were to give rise to U.S. net income tax, however, that tax would be payable at the fund level, if the fund were classified as a foreign corporation, and at the foreign partner level, if fund were classified as a partnership.[97] Similarly, when withholding tax applies to income of the fund, it generally applies regardless of whether the fund is organized as a foreign corporation or partnership and is generally not at a lower rate by reason of the fund being a foreign corporation instead of a partnership.[98] A fund's foreign corporate

93 As discussed immediately above, there are tax reasons for organizing funds offshore, for example, because of the tax consequence of being required to be registered under the 1940 Act by reason of being U.S. organized.

94 For example, a société anonyme organized in Luxembourg is a per se corporation for U.S. tax purposes and a common form of organization for retail funds, especially since they can be structured as "cell" entities (which refers to a type of juridical entity able to be divided into sub-funds, each with different assets and liabilities that are insulated from those of each other sub-fund within the entity).

95 As suggested above, some funds may be organized offshore and elect corporate status solely for tax reasons.

96 Domestic partnerships are required to file partnership returns for each taxable year. Treas. Reg. § 1.6031(a)-1(a)(1). In addition, domestic partnerships must provide Schedules K-1 to its partners with the same information. Section 6031(b). Foreign partnerships are under similar filing obligations if they have income that is effectively connected with the conduct of a U.S. trade or business or if they have gross income derived from sources within the U.S. Treas. Reg. § 1.6031(a)-1(b).

97 Technically, the foreign partnership would be required to withhold tax on the income, but as a legal matter the partner would be treated as earning the income and liable for the tax.

98 The only exception to this would be in the case of funds eligible for treaty benefits, to the extent any of their investors would not be entitled to such benefits, which would generally only apply in the case of those funds organized in treaty jurisdictions that negotiated for such benefits. Very generally, those benefits are comparable to those received by U.S. mutual funds under the same treaty and are available only if the fund satisfies certain other

status thus establishes that the fund (instead of the fund's foreign investors) is liable for the tax but does not reduce the amount of tax imposed. In fact, by investing through a foreign corporation, a foreign investor generally cannot claim that its share of the fund's income is eligible for tax relief under a tax treaty even if such relief would have been available had the income been earned directly or through a partnership,[99] and in that respect, investing through a foreign corporation (instead of directly or through a partnership) often increases the total U.S. tax borne in respect of an investment.

Also relying on the Trading Safe Harbor, many U.S. tax-exempt entities choose to invest through incorporated offshore funds (including those feeding into partnership masters) -- instead of either partnerships or separate accounts -- to protect themselves from being subject to unrelated business income tax ("UBIT") on income and gain from investments acquired or carried with acquisition indebtedness.[100] Although less significant, the fund's corporate classification also protects U.S. tax-exempt investors from direct taxation on other forms of UBTI recognized by the fund (for example, income from an operating business), placing liability for tax on that income on the fund itself, provided the income is effectively connected with a U.S. trade or business or otherwise U.S.-source. Investing through a foreign blocker corporation is both widely used by exempt investors and understood by the government as a strategy for investing without causing the exempt investor to become subject to UBIT.[101] To eliminate the reason for such structuring and encourage tax-exempts to invest through partnerships instead of offshore corporations,[102] Representative Levin circulated a draft bill earlier this year that would generally treat partners with limited liability in a partnership as not subject to the acquisition indebtedness rules with respect to the partnership's securities and commodities whether or not those assets are debt-financed in the partnership's hands.[103]

Compliant U.S. fund investors generally cannot reduce their U.S. tax liability by structuring their investments through an incorporated offshore fund and, because of the tax disadvantages of investing in incorporated funds, usually invest through one or more partnerships when able to do so. In most cases, an incorporated offshore fund is treated as a

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conditions establishing its connection with that jurisdiction, such as a certain percentage of its shareholders being treaty residents.

[99] In the case of some treaties, this relief might be available if the fund is treated as transparent in the investor's home jurisdiction.

[100] Exempt entities are generally not subject to tax on income from securities and commodities trading unless it is debt-financed. See Sections 512(b)(5) & 514(b)(1). Therefore, a U.S. tax-exempt entity holding stock of a corporation will not recognize UBTI with respect to that stock, so long as it is not debt financed, without regard to whether the corporation recognizes such income. Since foreign corporations are not subject to tax on their trading income (other than FDAP), investing through a foreign corporation avoids all tax on debt-financed income except in the case of FDAP.

[101] See the discussion in Section IV.C.1.c, above.

[102] The debt-financed UBTI rules are very controversial and are widely viewed as not well supported by any tax policy. See, e.g., Suzanne Ross McDowell, *Taxation of Unrelated Debt-Financed Income*, 34 EXEMPT ORG. TAX REV. 197, TA Doc. 2002-2660 (Nov. 2001); William H. Weigel, *Unrelated Debt-Financed Income: A Retrospective (and a Modest Proposal)*, 50 TAX LAW. 625 (1997).

[103] This bill was circulated as part of the 111th Congress, 1st Session. A similar bill, H.R. 3501, was proposed by Rep. Levin in September 2007. Note too, however, that a circulated Senate Finance Committee bill from the 110th Congress, 2nd Session, proposed a look-through rule to treat as UBTI income from energy speculation. See Tax Analysts, *Wyden-Grassley Staff Discussion Draft Oil Speculation Tax Proposal*, TA Docs. 2008-16856 & 2008-16857 (Jul. 31, 2008).

passive foreign investment company ("PFIC").[104] In general, the PFIC rules effectively treat any gain and extraordinary distributions from the investment as ordinary income earned over the life of the investment, with interest charges added to the tax that is deferred and attributed to periods prior to the year it is due, which is generally when the associated income is recognized under regular principles. In lieu of this treatment, a U.S. taxable investor in a PFIC can elect to include its share of the PFIC's income and net capital gain on an annual basis (provided that the PFIC is willing and able to provide that information), but is then taxed on those earnings, even if no cash is distributed, and cannot deduct losses or utilize tax credits of the PFIC. Consequently, U.S. taxable investors in a hedge fund or private equity fund usually choose to invest through one or more partnerships rather than an offshore corporation. Securitization vehicles are more commonly structured to be classified as foreign corporations, with U.S. taxable investors in the PFIC's equity accepting the disadvantages of the vehicle's PFIC status.

D. Merits of Adopting Funds-Specific Proposal.

Adopting the Funds-Specific Proposal would fundamentally change U.S. policy governing the taxation of investment funds. As with the General U.S.-Managed Proposal, the merits of doing that depend on what objectives could be reasonably expected to be achieved and at what cost.

1. Effect on Foreign Investors and Their Investment Decisions.

At its core, the Funds-Specific Proposal asks whether the tax policies underlying the Trading Safe Harbor, which is intended to ensure that U.S. tax considerations do not deter foreign investors from hiring U.S. managers and investing in the United States, should be reversed. Since the arguments for continuing or repealing the Trading Safe Harbor apply uniformly to all foreign investors, we strongly recommend that any change to the Trading Safe Harbor apply uniformly to all foreign investors and not only to incorporated funds. Moreover, we recommend that Congress carefully consider the likely consequences of repealing the Trading Safe Harbor before reaching a decision that doing so is appropriate.

(a) *The Reason for Applying Trade or Business Determinations Uniformly to All Foreign Investors.*

Under current law, the Trading Safe Harbor treats trading and investing by foreign investors in the same manner regardless of whether that activity is conducted inside or outside of the United States, and regardless of whether it is conducted directly though a managed account or indirectly through funds classified for U.S. tax purposes as partnerships or foreign corporations. In all cases, the activity generally is not treated as a U.S. trade or business and therefore is not subject to net income-based taxation.

The rationale for this treatment is that foreign investors' trading activity should not be taxed in a manner that discourages them from investing into the United States or hiring U.S. managers. This rationale applies to equally to all types of foreign investors regardless of whether incorporated. This rationale also applies equally to all foreign investors regardless of whether they invest directly, through a partnership or through an incorporated fund. Investing

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[104] Sections 1291-98.

through an incorporated fund generally will not reduce amount of tax due in respect of the investment activity. The principal tax differences among those three avenues for investment is whether the foreign investor is required to provide U.S. tax forms and is potentially directly liable to file a U.S. tax return. Whether avoiding that information reporting is of concern as a policy matter should be addressed after answering the more fundamental policy question of whether the Trading Safe Harbor should be preserved because it encourages foreign investors to invest in the United States.

The stated reason for adopting the Funds-Specific Proposal also applies equally to all types of foreign investors. In essence, this reason is that U.S. net-based taxation should apply to the trading income of U.S.-managed incorporated funds because they “utilize U.S. offices, personnel, laws and markets to make their money.” If that argument is accepted, then other foreign investors that similarly utilize U.S. management should be similarly taxed.

Finally, preserving or repealing the Trading Safe Harbor for all investors—regardless of whether incorporated—parallels the treatment of any activity classified as a U.S. trade or business. More specifically, the classification of such activity as a trade or business does not change depending on whether it is conducted by a foreign incorporated entity or other type of foreign person. In all cases, it is subject to net income-based taxation.

In addition to these broad tax policies, there are other reasons to have consistent rules for all foreign investors. Repealing the Trading Safe Harbor only for foreign corporations and not other types of foreign investors invites taxpayers adversely affected by the partial repeal to shift the form of their investment from a foreign corporation to a partnership or to invest in a fund that hires foreign rather than U.S. managers (see the discussion immediately below) or to attempt to invest through a foreign corporation that otherwise escapes the application of the Funds-Specific Proposal (see our technical comments below). To the extent that such restructuring is effective, foreign investment into the United States may continue, but in a manner that gives rise to economic inefficiencies (making that investment less attractive). This result would promote neither any U.S. tax policy nor any larger U.S. interest. If Congress wishes to change the law, it should do so in a way that does not draw arbitrary lines between what are largely economically equivalent forms of investment.

When considering the merits of the Funds-Specific proposal, therefore, the question that should be asked is whether the Trading Safe Harbor should be preserved or repealed for all foreign investors. For this reason, we recommend that, if Congress determines the Trading Safe Harbor should be continued, then the Funds-Specific Proposal not be adopted and that the General U.S.-Managed Proposal, if adopted, be modified so that the Management Test disregards activities covered by the Trading Safe Harbor. Conversely, if the Funds-Specific Proposal reflects a determination by Congress that U.S.-based trading should be treated as a U.S. trade or business, then the Trading Safe Harbor should be repealed for all foreign investors.

(b) *The Reasons for Continuing or Repealing the Trading Safe Harbor.*

The stated purpose of the Trading Safe Harbor mirrors the arguments for repealing it. The “utilization of U.S. offices, personnel, laws and markets” is both what is intended to be encouraged by the Trading Safe Harbor and what Senator Levin points to when arguing that it should be repealed as it applies to foreign-organized corporations.

The argument for repeal thus implies either that the Trading Safe Harbor is unnecessary or ineffective at accomplishing its goal or that its goal is not worthwhile. Therefore, the decision to continue or repeal the Trading Safe Harbor should depend on (1) whether the Trading Safe Harbor positively affects inbound investments and the competitive position of U.S. investment managers and (2) if so, whether those positive effects are worth the lost tax revenue, if any, that would be otherwise be raised from imposing a net income-based tax on U.S.-based trading by foreign investors.

Repealing the Trading Safe Harbor would clearly discourage some foreign investors from hiring U.S.-based investment advisors. Even if foreign investors were assumed to prefer U.S. managers, and to be willing to pay more for that preference, it would be surprising if foreign investors would value this preference more highly than the amount of tax that would be borne from net income-based taxation, since it would seem unlikely that U.S.-based managers could provide risk-adjusted investment returns that are marginally greater than the amount of the new tax.[105] If this is true, then repealing the Trading Safe Harbor would raise little or no tax revenue to the extent that foreign investors could avoid the new tax by using foreign-based investment managers, including U.S. managers who relocate to an office outside the United States where they make decisions about how to invest assets.[106]

Attempting to prevent that result by expanding the proposal to tax all U.S. investments regardless of where managed would likely raise some tax but would certainly discourage inbound investing.[107] That would be an even more radical change to U.S. tax policy and would likely have significant consequences to inbound investment unless other countries with large economies adopt similar policies. For foreigners, the cost of avoiding any significant tax on capital would almost always be less than such tax unless its economic burden is reduced

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[105] The only exception to this result would be in the case of foreign investors able to fully credit the U.S. tax in their home jurisdiction.

[106] Investment advisory services are currently available in many of the financial centers located outside of the United States. See McKinsey & Company, *Sustaining New York's and the U.S.' Global Financial Services Leadership* at 122, http://www.abanet.org/buslaw/committees/CL116000pub/materials/library/NY_Schumer-Bloomberg_REPORT_FINAL.pdf (stating that, while taxes were not as important to global financial service business leaders as litigation, regulation, or talent, "favorable tax treatment did represent a clear centerpiece of the business attraction programs implemented with great success by these financial centers and should not now be overlooked as a policy instrument to enhance competitiveness"). Other financial centers, including the United Kingdom and Hong Kong, have trading safeharbors similar to those of the United States. See, e.g., Kimberly S. Blanchard, *Cross-Border Problems of Investment Funds*, 60 TAX LAW. 583, 619, 625 (2007).

[107] Mihir A. Desai & Dhammika Dharmapala, *Investor Taxation in Open Economies*, available at http://areas.kenan-flagler.unc.edu/Accounting/TaxCenter/taxsym2010/Documents/Dharmapala-Desai.pdf (Aug. 2009); Stephen E. Shay, Statement to Ways and Means Committee, Select Revenue Measures Subcommittee, Hearing On Issues Involving Banking Secrecy Practices And Wealthy American Taxpayers (Mar. 31, 2009), TA Doc. 2009-7177, at 30 (testifying that, if the source taxation of investment income is expanded, "[c]oncerns regarding the flow of capital to the United States would have to be addressed"). Recent and planned tax increases on investment advisors—e.g., Section 457A and "carried interest" tax proposals—effectively tax foreign investors to the extent that these advisors are able to push the economic cost of the tax to their foreign investors by charging higher pre-tax fees. See Section 457A; H.R. 1935, 111th Cong., 1st Sess. (2009).

by credits in their home jurisdiction.[108] Therefore, since foreign capital is highly mobile, it seems likely that attempts to tax it would tend to drive it to other jurisdictions.

We cannot evaluate the extent to which the repeal of the Trading Safe Harbor (without taxing more broadly foreign investments in the United States) would reduce inflows of capital into the United States, but intuitively it seems that doing so would likely have some effect. It is obviously the case that investments in U.S. issuers could continue to be made from abroad without triggering net income-based taxation. After all, the capital markets are much more global and sophisticated than in 1966, when the Trading Safe Harbor was expanded to encourage foreign investment into the United States. However, it is also easy to imagine why a repeal might reduce capital flows into the United States. For example, it likely continues to be easier, at least to some extent, to execute investments in U.S. issuers from inside the United States. It is also possible that U.S. advisors tend to steer capital toward U.S. issuers because, for example, they are more familiar with those issuers.

It appears likely, then, that repealing the Trading Safe Harbor would have at least some, and possibly a large, adverse effect on foreign investment in the United States and U.S.-based managers. We have not identified any potential benefits to repealing the Trading Safe Harbor.

The narrower repeal that would result from adopting Funds-Specific Proposal could be viewed as beneficial insofar as it were to eliminate the talismanic effect of a legal formality—the place of incorporation—while still permitting foreign investment in the United States through a partnership or a foreign-managed fund. However, we do not consider this rationale to be relevant to the taxation of foreign investors because it would not affect foreign investors' U.S. tax liability—whether or not they continued to invest in the United States through those alternative means. Whether determinations of corporate residency should be imbued with more substance seems to us to be more relevant to the taxation of U.S. investors.

2. Effect on U.S. Taxpayers.

We do not think that the effect of adopting the Funds-Specific Proposal on U.S. taxpayers (including funds treated as domestic corporations under the proposal) would advance any tax policy objective applicable to U.S. taxpayers. Prior to the 2009 introduction of the Funds-Specific Proposal, Congressional testimony reflected considerable concern about the use of offshore funds to facilitate tax abuse by U.S. taxpayers.[109] We do not believe, however, that substantive tax treatment of incorporated offshore funds presents the opportunity for such abuse, although reaching that conclusion in the case of tax-exempt investors depends on how one views the policies underlying the UBTI rules for debt-financed income. Rather, we think that any U.S. taxpayers using incorporated offshore funds to facilitate tax abuse are doing so in violation of current law and that the information reporting requirement enacted in March 2010 (after Senator

[108] For similar reasons, other jurisdictions, particular those competing with the United States as financial centers (like the United Kingdom, Hong Kong and Japan), have similar rules intended to encourage securities trading there.

[109] Levin Floor Statement, supra note 2.

Levin first introduced the Funds-Specific Proposal) is a far superior method of curbing that abuse.[110]

(a) *Taxing the Fund to Prevent Avoidance of U.S. Corporate Taxation.*

The General U.S.-Managed Proposal is premised on the conclusion that many U.S.-managed business corporations are improperly avoiding U.S. corporate tax by being organized offshore.[111] It is possible that the Funds-Specific Proposal reflects a similar conclusion about incorporated investment funds managed in the United States. That conclusion, however, fails to consider that very generally U.S.-organized investment funds are permitted to be taxed as pass-throughs on the basis of their investment activities.

The Trading Safe Harbor functions as an alternative means to obtain effective pass-through treatment and is entirely consistent with the principles underlying the basis upon which domestic entities are given pass-through treatment. A domestic operating business is generally permitted to be taxed as a pass-through only if it has a limited number of investors or illiquid interests. A domestic collective investment vehicle is generally permitted to be taxed as a pass-through on the basis of its investment activities even if it has many investors, liquid interests and U.S. managers.

Since the scope of the Trading Safe Harbor is in important respects generally narrower than the scope of trading activities permitted for broadly held domestic corporations to obtain pass-through treatment (for example, mutual funds are permitted to engage in a financing business, which is generally not covered by the Trading Safe Harbor), we do not think that allowing foreign-organized incorporated funds to continue to rely on the Trading Safe Harbor to avoid U.S. net income-based taxation is abusive or inconsistent with U.S. corporate tax policy. In so concluding, we do not mean to suggest that every foreign-incorporated fund could reinvent itself as a domestic pass-through entity, since the Trading Safe Harbor is more flexible in other important respects (for example, it does not require registration under the 1940 Act as does qualification as a mutual fund). Rather, we think that the example of pass-through treatment for many types of U.S.-managed domestically incorporated investment funds indicates that allowing such treatment for incorporated offshore funds does not undermine the corporate income tax.

As noted earlier, our two-tier tax system generally is designed to tax business income no more than twice. To ensure that taxpayers are able to pool their capital in a manner that avoids multi-tier taxation of business income, current law provides clear paths for investment funds to obtain pass-through taxation. Today, depending on their particular situation (and especially on the applicability of U.S. securities laws), investment funds aimed at sophisticated investors typically obtain pass-through treatment either by relying on the entity classification rules or by becoming a foreign corporation and relying on the Trading Safe Harbor.

Very generally, current law limits pass-through treatment for U.S.-organized investment funds to two categories. The first category is a partnership, whether or not U.S.-organized. Partnerships are generally not subject to entity taxation, and impute their income to

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110 See infra note 124and accompanying text.

111 See supra notes 9 through 11 and accompanying text.

their owners. To qualify for pass-through treatment, a partnership must either not be a publicly traded partnership (or "PTP")[112] or meet an investment income test (the "PTP Income Exception").[113] The PTP Income Exception permits a broad range of typical "investment" income from stocks, securities and natural resources. It also permits income from certain derivative financial instruments. For an investment fund with U.S. investors, the principal reason not to use a partnership is, as previously discussed, U.S. securities law restrictions.[114]

The second category is a handful of other types of statutorily defined investment entities ("Statutory Investment Entities")—most commonly, mutual funds, REITs or REMICs—that are permitted to function like pass-throughs (and thereby avoid corporate taxation) provided they meet specified investment asset and/or income tests and actually pass-through their income so that it is taxed currently at their investor level.[115] These Statutory Investment Entities are U.S. organized and generally would be taxed as regular U.S. corporations if they failed to meet these tests because they are sufficiently widely held and provide enough liquidity to investors that they

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112 The definition of PTP includes partnerships with interests that are "traded on an established securities market" or are "readily tradable on a secondary market or the substantial equivalent thereof," but does not include partnerships that have both partnership interests that are privately placed and no more than 100 partners. Section 7704(b); Treas. Reg. § 1.7704-1(h)(1).

113 This income test requires that 90 percent or more of the partnership's gross income is "qualifying income," which generally includes interest, dividends, real property rents, gains from the sale of real property and certain energy related income. This exception is not permitted for PTPs that are registered under the 1940 Act. Sections 7704(c); 7704(c)(3).

114 As discussed elsewhere, if U.S.-organized, many funds would be unable to avoid registration under the 1940 Act, which is very burdensome, and could obtain pass-through treatment only by qualifying as RICs, which is also highly limiting. See supra notes 84 through 86 and accompanying text.

Another type of pass-through domestic entity is an S corporation. Like partnerships, S corporations are generally not subject to entity taxation and impute their income to their owners. However, S corporations are very limited in their number and type of shareholders. Corporations can qualify as S corporations if they have no more than 100 shareholders, all of which must be individuals, estates or trusts. Section 1361. S corporations are typically used for operating businesses rather than investment funds.

115 RICs, which this report refers to as mutual funds, are domestic corporations that are treated as pass-throughs if, among other things, they are registered under the 1940 Act; earn 90 percent of gross income from passive investment sources; hold 50 percent of assets in cash or securities, subject to diversification rules; and distribute 90 percent of the taxable income to shareholders. Sections 851-55. Real estate investment trusts ("REITs") are domestic corporations that are treated as pass-throughs if, among other things, 95 percent of gross income is from passive or real property sources; 75 percent of gross income is from specified real property sources; 75 percent of the REIT's assets consist of real estate assets, cash or government securities, subject to diversification rules; and 95 percent of taxable income is distributed to shareholders. Sections 856, 857. Real estate mortgage investment conduits ("REMICs") are real estate mortgage pools that are exempt from tax if, among other things, their income is allocated among and currently taxed to the interest holders. Sections 860A, 860D(a). Substantially all of a REMIC's assets must be qualified mortgages and permitted investments, and REMICs can have only two classes of ownership interests. Sections 860G(a), 860D(a)(4). Common trust funds are investment vehicles, established by banks for the purpose of combining and investing funds of trusts for which the bank acts as fiduciary, that are treated as pass-throughs with the income taxed to the participants, not the bank. Section 584. In addition, some financial institutions offer "managed accounts," a term used to denote an agency arrangement under which an investment manager manages accounts belonging to multiple investors pursuant to a specified investment strategy. This is collective investment in its purest form, since there is no fund or vehicle, in the sense that a single manager is managing the investment of many investors. Technically, however, the accounts are managed in parallel rather than collectively.

would avoid PTP status, if classified as partnerships, only by meeting the PTP Income Exception.[116]

Importantly, the management of an entity's assets or income generally does not bear on whether the entity can avoid corporate taxation by qualifying to be taxed as a partnership or Statutory Investment Entity.[117] On the contrary, in the case of managed Statutory Investment Entities, centralization of management is cited one of the benefits of investing in them and thus reasons for encouraging their formation by taxing them on a pass-through basis.[118]

Electing foreign corporate status (by organizing offshore) is another way under current law that incorporated entities, including funds, effectively obtain pass-through taxation for income that fits within the Trading Safe Harbor (subject to entity level withholding tax on U.S. dividend income). Doing so exempts the entity's trading income from net income-based entity taxation, subjecting it to U.S. tax only at the investor level and based on the tax rules applicable to the entity's investors.[119] U.S. taxable investors in such a fund are subject to the anti-deferral rules governing the taxation of CFCs and PFICs.[120]

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[116] In general, a U.S.-organized entity that is not a partnership, S corporation or Statutory Investment Entity is classified as a C corporation, and its income is subject to two tiers of tax (when earned and then when distributed). In summary, active businesses can avoid corporate taxation only if sufficiently closely held or illiquid to qualify as an S corporation or partnership that is not a PTP. Widely held and liquid entities can avoid corporate taxation only by meeting the investment income and/or asset tests applicable either under the PTP Income Exception or through qualification as a Statutory Investment Entity.

[117] The only exception to this rule is for "grantor trusts," which are generally disregarded for tax purposes and thus are not subject to corporate taxation. In general, for an entity to qualify as a grantor trust, it cannot be managed (i.e., it must have a fixed pool of assets) and cannot have multiple classes of ownership. Its ownership interests, however, can be publicly traded without affecting the entity's status as a grantor trust. Trusts that do not qualify as grantor trusts (because, for example, they are managed) are subject to the above rules for determining whether they can avoid entity taxation.

[118] H.R. Rep. 83-1337, 83rd Cong., 2d Sess., at 73 (1954) ("This method [of taxing RICs] permits investors to pool their funds through the use of a corporation in order to obtain skilled, diversified investment in corporate securities without having to pay an additional layer of corporate tax."); Statement of J. C. van Eck, Jr., General Revenue Revisions Hearing before the House Ways and Means Committee, 83rd Cong., 1st Sess., pt. 2, at 1470 (Jul. 1953) ("[T]he whole tax concept of regulated investment companies under [the predecessor of Section 851] of the Internal Revenue Code was evidently designed by Congress to avoid additional tax burdens and thus to encourage this channel of investment."); Statement of Rep. Flippo on the Mutual Fund Technical Amendments Act of 1985, House of Representatives, Proceedings and Debates of the 99th Congress, 1st Sess., 131 Cong. Rec. H. 7699 (Sept. 20, 1985) ("The conduit treatment is premised on the notion that mutual funds can and should provide a mechanism by which investors of more modest means may obtain the same professional investment management, the same diversification of risk, and roughly the same tax treatment available to the direct investor who more typically can afford direct investment guidance.").

[119] In the case of U.S. active business income, this path to pass-through treatment facilitates its U.S. taxation since it requires the tax on that income to be collected by the entity; whereas if an alternative means of pass-through treatment were chosen, the tax would have to be collected separately from each investor (except to the extent tax withholding applied).

[120] U.S. shareholders are taxed currently on Subpart F income of a CFC (whether or not such income is distributed to the shareholder), which is defined as a foreign corporation that is more than 50 percent owned by U.S. shareholders. Sections 957(a), 952. U.S. shareholders of PFICs, which are foreign corporations that receive predominantly passive foreign source income or hold mainly passive investment assets, are subject to special tax rules, under which either the amounts received by the shareholders as distributions or from the sale of shares are allocated to previous years and included in income (with interest), or the shareholders may elect to be taxed currently on their share of the earnings of a "qualified electing fund." Sections 1291, 1293 & 1297.

While the Trading Safe Harbor excepts certain trading income from net income-based U.S. taxation, it defines the category of that income more narrowly in important respects than the category of income that can be earned by a widely held and liquid domestic entity without causing the entity to be subject to corporate tax. For example, income from real estate and energy assets is treated as investment-related under the PTP Income Exception (and some of it would meet the income tests for certain Statutory Investment Entities), but such income would not qualify for the Trading Safe Harbor. In other regards, the Trading Safe Harbor is more flexible than the rules applicable to Statutory Investment Entities. For example, it permits funds to trade in commodities and commodity-linked derivatives, while mutual funds generally cannot do so and PTPs can do so only if certain conditions are met. Moreover, the Trading Safe Harbor does not have diversification or distribution requirements.

Notwithstanding these technical differences, the limited scope of the Trading Safe Harbor is consistent with the boundaries of the U.S. tax base intended to cover active business income as such income is defined for purposes of taxing domestic entities and investors. The Trading Safe Harbor does not protect foreign investors from U.S. net-based income taxation on their U.S. active business income, though earning such does not affect a foreign investor's ability to be protected from such tax on investment and trading income that is not part of its active business.[121] By contrast, widely held and liquid U.S.-organized entities cannot earn material amounts of active business income without becoming subject to U.S. corporate taxation on both their business income and their investment income, because they would not qualify for the PTP Income Exception or as a Statutory Investment Entity.[122] For such entities, this is true whether the active business is from a U.S. or foreign business.

Given the limited scope of the Trading Safe Harbor and given that income effectively connected with a U.S. trade or business is generally subject to net based taxation independently of whether the Trading Safe Harbor applies, we do not believe that allowing offshore incorporated funds to continue to rely on the Trading Safe Harbor is a threat to two-tier taxation of business income.

(b) *U.S. Taxable Investors.*

For U.S. taxable investors, investing through an offshore corporation generally increases instead of decreases total U.S. tax liability. These investors are subject to the anti-deferral rules applicable to their investments in PFICs and CFCs and generally cannot recognize

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[121] Very generally, trading income will be treated as effectively connected with a U.S. trade or business (and subject to net-based taxation) only if the assets producing that income are used in that trade or business or the income is earned as part of that trade or business. Treas. Reg. § 1.864-4(c)(2) and (3). More detailed, somewhat different rules apply if the trade or business is the active conduct of a banking, finance or similar business. Treas. Reg. § 1.864-4(c)(5).

[122] Those in favor of the Funds-Specific Proposal could make the argument that, unlike a PTP, an offshore fund using the Trading Safeharbor can earn more than 10 percent of its income as active, thus effectively end-running the PTP rule. This argument does not make sense because the PTP rule is easily manipulated through blockers. Adding such a rule limiting the use of the Trading Safeharbor by offshore corporations would just mean that these corporations would have to segregate their income among incorporated and unincorporated entities, which would result in more paperwork but no more substance.

losses or credits recognized by the offshore fund.[123] Therefore, offshore incorporated funds do not provide a means for compliant U.S. taxpayers to avoid U.S. tax.

To the extent that offshore incorporated funds may be regarded as vulnerable to being used for unlawful tax evasion, we believe that there are better and more direct ways to achieve those objectives, in particular because the Funds-Specific Proposal would have no effect on funds managed offshore. After the initial introduction of the Funds-Specific Proposal, Congress enacted legislation imposing withholding on certain payments to foreign financial institutions (including offshore investment funds) which do not provide information regarding their direct and indirect U.S. owners and requiring reporting by U.S. taxpayers of their foreign financial assets.[124] We believe that this legislation is a much better tool for curbing evasion than the Funds-Specific Proposal.

We also understand that there is some interest in Congress to encourage investors to invest in domestic rather than offshore funds and that, for example, Representative Levin's proposed relaxation of the UBTI rules, discussed below, was partially motivated by that objective. In our view, however, the Funds-Specific Proposal would be an indirect and ineffective way to further that objective. The most direct way to encourage the use of onshore funds would be to create a new type of U.S.-organized investment vehicle that is flexible and functions as a pass-through vehicle. Constructing one that is workable would require a significant re-writing of the tax law and coordination with the securities laws to provide the necessary exemptions. The new type of vehicle would need to both protect the existing U.S. corporate tax base on operating-type income and be flexible enough to accommodate a wide range of types of assets, types of interests, number of investors and liquidity on a pass-through basis. We would be happy to propose suggestions on how to accomplish this if that would be helpful.

(c) *U.S. Tax-exempt Investors and the Use of Foreign Blockers.*

As described above, U.S. tax-exempt investors routinely invest in offshore investment funds through foreign blocker corporations so that they will not recognize UBTI from the fund's debt-financed assets.[125] In general, because the character of a partnership's income in

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123 See supra note 120.

124 The Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 97, was enacted in March 2010, and (i) imposes a 30 percent withholding tax on payments to foreign financial institutions (including offshore investment funds) unless the institution has entered into an agreement with the Treasury to disclose its U.S. account holders, (ii) imposes a 30 percent withholding tax on payments to non-financial foreign entities unless such entity has certified as to its substantial U.S. owners or certified that it has no substantial U.S. owners and the withholding agent agrees to provide such information to the Treasury and (iii) requires that individuals disclose on their tax return their interests in specified foreign financial assets. See Sections 1471-74, 6038D. The Treasury Department has offered initial guidance on the requirements enacted in (i) and (ii) described above. I.R.S. Notice 2010-60, 2010-37 I.R.B. (August 27, 2010). We commented on the legislation when it was first proposed as well as on Treasury's initial guidance. See NYSBA Tax Section, *Comments on the Foreign Account Tax Compliance Legislation*, Report. No. 1199, TA Doc. 2010-759 (Jan. 11, 2010) and NYSBA Tax Section, *Report on Notice 2010-60*, Report No. 1224, TA Doc 2010-24584 (Nov. 16 2010).

125 Congress has specifically prohibited the use of foreign blockers to avoid UBTI taxation of one type of income, namely income from certain insurance activities earning by a CFC if the exempt investor is treated as

its partners' hands is determined at the partnership level, a tax-exempt partner's share of a partnership's debt-financed income is treated as UBTI in its hands,[126] and gain on dispositions of the exempt investor's interest in a partnership is likewise treated as debt financed, and thus UBTI in proportion to the amount so treated, if there is partnership level debt allocated to the exempt investor.[127] The Internal Revenue Service has acknowledged in several private rulings that, under current law, debt-financed income earned by an offshore corporation does not result in tax-exempt shareholders of the corporation recognizing UBTI.[128]

Congress has considered but not adopted proposals to expand the UBTI rules to cover debt-financed income earned indirectly through an offshore corporation.[129] Congress has also considered encouraging U.S. tax-exempt investors to shift their investments to funds organized as U.S. limited liability partnerships by exempting debt-financed income earned through such partnerships from UBIT.[130] The premise behind that proposal seems to be that determining whether an investment in a fund gives rise to UBTI should be made without regard to debt financing at the fund level, provided that the fund provides limited liability to its investors.

If Congress decides that avoiding UBTI by use of an offshore fund is abusive, then any rule enacted to stop that avoidance should treat all offshore corporations the same. No distinction should be made between U.S. and foreign managed funds, since such a distinction would invite U.S. tax-exempt investors to avoid the rule by investing in foreign-managed incorporated funds. The simplest rule for preventing offshore corporations form being used for UBTI avoidance would be an elective imputation system, perhaps backstopped with a PFIC-type tax if the election is not made. We would be happy to provide a detailed proposal if that would be helpful.[131]

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owning 10 percent of the vote of the CFC. Section 512(b)(17). However, it would be unusual for an investment fund relying on the Trading Safeharbor to earn such income.

126 Sections 702(b) and, as to UBIT generally, 512(c)(1).

127 Treas. Reg. § 1.514(c)-1(a)(2), Ex. 4, illustrating that debt incurred by a partnership and allocable to an exempt holder's interest in such partnership results in gain on such interest being treated as debt financed and thus UBTI. See also TAM 9651001 (Dec. 20, 1996). The regulation and TAM deal with debt financed real estate but those principles would seem to apply equally to other investment assets.

128 See, e.g., I.R.S. Priv. Ltr. Rul. 200315035 (Jan. 14, 2003), which held that charitable remainder trusts did not have UBTI due to their ownership of a foreign corporation that used debt financing to fund its acquisitions. However, the ruling stated that the trusts had valid business purposes for creating the foreign corporation, one of which was the pool the assets of the trusts for economies of scale purposes. See also I.R.S. Priv. Ltr. Rul. 200251018 (Sept. 23, 2002); I.R.S. Priv. Ltr. Rul. 199952086 (Sept. 30, 1999). These rulings rely in part on the fact that Congress has explicitly dealt with foreign blockers in Section 512(b)(17), but only for one type of income.

129 Tax Simplification and Technical Corrections Act of 1993, H.R. 3419, 103rd Cong., Title IX, Section 901 (1993).

130 See supra note 103 and accompanying text.

131 We have previously recommended that Congress review the debt-financed income rules of Section 514. See NYSBA Tax Section, *Section 514: Debt-Financed Income Subject to UBIT*, Report No. 1217, TA Doc 2010-18050 (Aug. 12, 2010).

3. Technical Issues.

In addition to the policy concerns we have discussed above, we have a number of technical issues with the Funds-Specific Proposal as drafted.

(a) *Definition of Investment Assets and Investment Management.*

Several paragraphs of proposed Section 7701(p) refer variously to "assets under management for investors" (Section 7701(p)(2)(A)(ii), Section 7701(p)(2)(B)(ii)(II)) or to "assets being managed on behalf of investors" (Section 7701(p)(3)(C)(i)). These terms are not further defined. Presumably the assets in question are intended to be typical portfolio investments in stock, securities or commodities, so that a holding company that owns primarily stock of operating companies would not fall within these provisions. In order for these provisions to apply to funds and not more broadly, the types of assets should be defined, and the concept of managing on behalf of investors should be explicated further.[132]

(b) *$50 Million Threshold.*

Proposed Section 7701(p) generally would not apply to corporations with gross assets of less than $50 million. While generally it is desirable to limit the application of complex tax rules to small investors, in this case we do not understand the rationale for this threshold as it applies to the Funds-Specific Proposal. It seems designed to exclude precisely the type of offshore corporation that is most likely to be used for tax evasion, namely single investor- or family-owned corporations set up in tax havens. If the threshold is intended simply to ensure that unsophisticated U.S. taxpayers (for example, foreign persons who become U.S. taxpayers because they move to the United States) do not inadvertently blunder into these rules, it should be set much lower.

The application of this threshold to investor-organized foreign corporations also should be clarified. Assume, for example, that in response to an enactment of proposed Section 7701(p) each foreign investor that wishes to invest in a particular offshore fund sets up its own subsidiary (shell) corporation. The sole purpose of each such corporation is to make an investment of $40 million in the fund, which is classified as a partnership. It appears that these corporations would not be subject to Section 7701(p) except by operation of other statutory or common law anti-abuse rules (e.g., Section 269, or economic substance). Harder facts can be envisioned. Suppose each foreign investor sets up a shell corporation that makes all of its investments in offshore funds, each of which is under $50 million, and that there are financing, administrative or other benefits to the investor from centralizing investments in this manner. The policing of such arrangements under general anti-abuse rules would be difficult, as the facts of each are likely to differ.

[132] For a discussion of the difficulties with defining the concept of investment management on behalf of investors, see NYSBA Tax Section, *Report on Proposed Carried Interest and Fee Deferral Legislation*, Report No. 1166, TA Doc 2008-20493 (Sept. 24, 2008).

(c) *Decisions Made in the United States.*

Proposed Section 7701(p)(3)(C) has a special definition of management and control in the United States aimed at foreign-incorporated funds, which applies if among other matters "decisions about how to invest [its] assets are made in the United States." Unlike the General U.S.-Managed Proposal, this standard contains no qualifiers like "substantially all" or "primarily." However, many funds, particularly those that invest both inside and outside the United States, have managers located in various countries. Some threshold amount of decision making in the United States should be necessary before the fund is treated as managed and controlled in the United States.

Legislative history also should provide some guidance on what types of decisions are relevant, so that regulations can address the issue in more detail.[133] For example, a decision to invest in a bond may entail a credit review of the issuer, a pricing determination that compares that issuer's bonds to its loans, and an evaluation as to the liquidity of the bond. Information about all of these factors may be provided to an investment committee, which may authorize a manager to buy up to $X million of the bonds at a price of no more than Y percent. The manager may then decide to buy $17 million bonds at a price of 96 percent. Depending on the level of discretion that the investment committee accords the manager, different conclusions might be drawn about when the "real" decision has been made.

The foreign blocker examples described above also raise a different type of question about decision making. Assume, for example, that ten investors jointly set up a single foreign corporation. The investors decide, outside the United States, that the corporation should make a $400 million investment in an offshore fund taxed as a partnership. The investors periodically review whether to continue that investment, or to sell their fund interests and invest in something else. During the period that the corporation invests in the fund, the management of the fund's assets, and thus indirectly the assets of the corporation, is carried out by the fund's U.S. manager. The fund is indifferent to whether its investors are individuals, corporations, partnerships, sovereigns, etc. Should this investor-organized corporation be within the scope of proposed Section 7701(p). The "right" answer may depend on how robust the investor decision-making process is. Again, that would be difficult to police.

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133 Cf. Treas. Reg. § 1.864-7, providing rules for when a foreign corporation is treated as having an "office" in the United States by reason of management activity in the United States.