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## "Hybrid" Entities and Evolving Issues on Acquisition Structures for Foreign Acquirors

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# “Hybrid” Entities and Evolving Issues on Acquisition Structures for Foreign Acquirors

WM. L. BURKE\*

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The last decade has brought a number of fundamental changes to the internal United States tax structure, its tax treaties and the tax structures of other countries.<sup>1</sup> Within the United States internal tax system, changes have included: repeal of the *General Utilities* doctrine, new limitations on the amount of stock and assets that U.S. taxpayers can transfer tax-free to foreign entities, enactment of “earnings stripping” restrictions, adoption of regulations specifically directed at policing conduit financing, a pending proposal to change the entity classification rules, more intense scrutiny and aggressive enforcement of arm’s-length dealings between related parties, and increased restrictions on the extent to which foreign persons can avoid U.S. tax by removing appreciated property from a U.S. trade or business prior to its disposition.

Likewise, in its tax treaty policy, the United States has been aggressively seeking to restrict “treaty shopping.” Witness, for example, the recent termination of the last vestiges of the long-standing treaty covering the Netherlands Antilles and, the systematic inclusion of limitation-of-benefits provisions in virtually all recent United States treaties, including the elaborate development of those concepts in the recent Netherlands treaty. The United States has also been seeking more effective exchange of information provisions to reduce tax evasion.

In terms of the tax structures of other countries, several industrialized countries have adopted one form or another of so-called “anti-deferral” regimes that limit the extent to which parent companies can defer tax on earnings of subsidiaries in other countries, especially “passive” income. Most industrialized countries have also adopted an “imputa-

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1. This paper reflects the law through January 31, 1996.

tion" form of tax system that integrates corporate and shareholder level taxation, rather than the full two-tier tax system as in the United States. Moreover, other countries now are paying a more active (some would say more aggressive) attention to intercompany pricing issues.

While the technical aspects and separate implications of a number of these developments are addressed in other parts of the program at this Institute, collectively they have fundamental implications for inbound acquisitions. For foreign purchasers contemplating acquisitions of interests in U.S. businesses, they should review the impact of these changes on traditional practice. Though their complexity is such that all of the implications are not yet fully appreciated, it is clear that the cumulative weight of the changes makes it important not to simply follow "standard" patterns of the past.

## I. TYPE OF ENTITY; TAX RESIDENCE

### A. *Traditional Practices*

In the past, a foreign acquiror typically took an ownership interest in a U.S. business through a corporation organized in the United States and operated so that it was a U.S. tax resident under the tax rules of the foreign acquiror's home country.<sup>2</sup> Where the foreign acquiror purchased the entire interest in a U.S. business, the ownership structure depended on what form the acquisition took. If the opinion was a stock purchase, the owner was usually the existing U.S. corporation carrying on the business. If the acquisition was an assets purchase, the owner was often a newly created United States subsidiary of the foreign acquiror.<sup>3</sup> For transactions involving the creation of a joint venture, it

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2. Where the acquiror's home country determined tax residence on some test other than place of incorporation (*e.g.*, place of management and control), care was generally taken to insure that residence of the corporation was also placed in the United States under that other test.

At one time, foreign acquirors sometimes used "dual resident" companies. Acquirors based in the United Kingdom, for example, would incorporate the company in the United States but manage and control it from the United Kingdom. *Cf.* S. Rep. No. 313, 99th Cong., 2d Sess. 419-23 (1986). The use of such companies, however, has declined since enactment of § 1503(d) and comparable legislation in the United Kingdom. *See* I.R.C. § 1503(d) (1994) (restricting dual consolidated loss deduction on consolidated tax return of foreign and domestic affiliates); *Id.* (discussing U.K. "mirror" legislation).

In the past, ownership chains sometimes would also include third-country holding companies for the purpose of obtaining tax treaty benefits as well as avoiding exchange control restraints once the acquiror repatriated funds to its home country. The development of restrictions limiting treaty benefits to corporations whose ownership is substantially in, and whose expenditures are paid substantially to, residents of the signatory countries has adversely impacted the use of third-country holding companies.

3. The enactment of § 338, including § 338(h)(10) in particular, has caused many foreign acquirors to opt for an "assets acquisition" by purchasing the stock of a corporation and electing to treat the single transaction as a sale of assets to a new corporation for income tax purposes. Such

has become increasingly common for parties to set up the joint venture itself as a partnership, particularly if its geographical scope of operation was limited to the United States or North America. In that event, the foreign acquiror generally would use a U.S. corporation to hold its partnership interest. Typically, the purchase price was paid in cash, rather than stock or securities, and the U.S. corporation was frequently leveraged with considerable debt loaned (or guaranteed) by related parties outside the United States.

From the perspective of the foreign acquiror, tax isolation is among the most frequently given tax reasons for using a U.S. corporation to own a U.S. business or partnership interest in the case of a joint venture set up as a partnership. The foreign owned corporation could file a U.S. tax return based on the separate income and assets of the corporation, without having to report or otherwise bring into issue other income, expense or assets of the foreign owner.<sup>4</sup> Likewise, the foreign owner's tax jurisdiction would not tax income from the U.S. corporation until it was distributed or the foreign owner sold his stock. Even when the income was subsequently distributed, the foreign owner generally paid no more tax in its home tax jurisdiction than it would have if the income had been included currently as earned.<sup>5</sup>

Apart from certain businesses traditionally conducted through branches,<sup>6</sup> few foreign acquirors have been willing to structure their U.S. businesses as a branch of the foreign owner or even through foreign

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a transaction can have a number of benefits, including the potential for avoiding the transfer taxes that an actual assets sale would involve and the additional legal work needed to make actual transfers of title to assets. I.R.C. § 338 (1994).

4. One exception to this rule has been those few states, most notably California, that require returns to be filed on the basis of a unitary group that could extend to include the foreign owner. See Cal. Revenue and Tax'n Code §§ 25101-25115 (West 1992).

5. With the rise of "imputation" and other systems of integration, the relative benefits of not shifting income to the home country to be taxed currently has become more problematic. Of course, shifting income to a "tax haven" with no more than a nominal tax could produce an overall tax benefit when coupled with exemption or sharp reduction in taxation at the income's source. But restrictions on availability of treaty benefits and other constraints, such as the recent "conduit financing" regulations, have made such practices increasingly difficult. Where such shifting is not feasible, the present level of corporate rates can result in the United States being a relative "tax haven," at least for the last marginal dollar of revenue that would be subjected to full statutory tax rates in whatever jurisdiction it was lodged. There have been instances in the writer's experience where the client's interests have been more effectively served by claiming as much revenue and as few expenses in the United States as possible, as compared with the foreign owner's home country. On the other hand, in those countries that have adopted an "imputation" system, the operation of that system frequently places a premium on having the foreign owner's income taxed in that jurisdiction (even at higher rates), rather than another jurisdiction. Because of the ability to "pass-on" the home country tax as a credit to shareholders, the foreign owner can avoid making what may effectively be an extra tax deposit with the home country in the amount of the foreign taxes.

6. Banking and the practice of law would be notable examples of such exceptions.

subsidiary whose sole activity would be the U.S. business. In those cases where ownership of the U.S. business has been placed in a foreign entity, however, it was generally because the foreigner owner expected that the U.S. business would initially generate tax losses that could be used by the foreign owner to offset other taxable income in its home country. In some cases, the foreign owner's desire to avoid a U.S. withholding tax on repatriation of profits was also a consideration.

### B. *Choices Today*

The interest in jurisdictional isolation underlying the "traditional" pattern of ownership of U.S. businesses by foreign acquirors remains largely as it has always been. However, the combination of tax changes that occurred in the last decade has put stress on the "traditional" pattern of using ownership through a U.S. corporation to achieve that isolation. Imputation systems tend to encourage a country's multinational business enterprises to reduce tax burdens borne by the overall enterprise in the United States and other jurisdictions, but the increasing restrictions on effective techniques to accomplish that result, at least when the United States is the other country, are making that task ever more difficult without compromising the jurisdictional isolation of the U.S. business. Even where nationalistic pressures of an imputation system are not present, traditional tax isolation is eroding with increasingly sophisticated (and more spirited) attention to intercompany provision of goods and services by both the United States and other countries.

One of the evolving developments spawned by the pressures on traditional acquisition structures is the increasing consideration that is now given to the use of "hybrid" entities—entities that are treated for tax purposes as a corporation in one country and as a partnership (or other kind of pass-through type of entity) in the other country. The last few years have seen a proliferation of entities that blur the traditional U.S. tax distinctions between corporation and partnership classification. The U.S. tax rules for entity classification have long presented difficulties in classifying the corporation or partnership status of arrangements permitted under foreign laws.<sup>7</sup> With the widespread adoption among the

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7. A particularly graphic example of the difficulty is presented by the position that the IRS has taken with respect to "atypische stille Gesellschaft" agreements that are common in Germany. First, the I.R.S. issued a private letter ruling that such arrangements should be treated as stock in a GmbH with whom the agreement is made. Priv. Ltr. Rul. 78-52-027 (Sept. 27, 1978). Shortly thereafter, the I.R.S. revoked that letter ruling. See Priv. Ltr. Rul. 79-35-019 (May 29, 1979). It has since issued several private letter rulings in which the arrangement has been treated as creating a separate entity that would be classified as a partnership for U.S. tax purposes. See Priv. Ltr. Rul. 80-12-063 (Dec. 27, 1979). Later, the I.R.S. Chief Counsel's office rejected a proposal to issue a formal revenue ruling (on which all taxpayers would be entitled to rely). There, it was concluded that the potential for different provisions requiring possibly different classification conclusions

various states in the United States of statutes permitting limited liability companies and limited liability partnerships, the distinctions have now been so eroded that the IRS has recently acknowledged that the choice of classification is virtually elective, at least with respect to domestic entities in the United States.<sup>8</sup>

In making the acknowledgment, the IRS invited comments on whether the present classification rules should be replaced with a "check the box" system that would allow taxpayers to choose how an entity would be classified for U.S. federal income tax purposes. The Service has announced publicly that proposed regulations will soon be published which, if enacted, would make such a change for classifying domestic entities. While it is unclear whether such a "check the box" approach might also be extended to the classification of foreign entities, the adoption of such an approach for only domestic entities would have relevance to issues raised when foreign acquirors structure acquisitions. Moreover, even if this approach was not adopted, it would not change the fact that elective opportunities exist today, as a practical matter, particularly for "inward" investment into U.S. business made through a foreign entity.

Thus, the decision as to how and where a foreign acquiror should hold its ownership interest in a U.S. business involves two questions today. First, whether the ownership entity should be organized so as to be treated for U.S. tax purposes as a U.S. corporation or as some other form. Second, whether it is necessary or desirable that the foreign acquiror choose an ownership entity that would be treated the same for purposes of both the U.S. tax laws and the tax laws of the foreign acquiror's resident country.

### C. *Stock Acquisitions*

Whether a choice is available with respect to the first question

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made such a formal ruling inadvisable. Gen. Couns. Mem. 38,200 (Dec. 13, 1979). With respect to the "typische stille Gesellschaft" agreements, the same General Counsel's Memorandum raises the possibility that they might be classified as loans instead of creating either a separate entity or a second class of stock in the GmbH. *Id.*

More recently, there has been a controversy over whether United Kingdom unlimited liability companies should be classified as corporations or partnerships.

Various other countries have statutes with optional provisions that appear to permit entities created under such a statutory scheme to be classified for U.S. tax purposes as either corporations or partnerships, depending upon which provisions are chosen. An example would be a German GmbH or a Dutch CV ("commanditaire vennootschap"). See Rev. Rul. 93-4, 1993-1 C.B. 225 (GmbH); Priv. Ltr. Rul. 81-030-92 (Oct. 24, 1980) (CV). Other countries are starting to follow the lead of the United States in adopting statutory schemes for limited liability companies as well as limited liability partnerships that have optional provisions which could result in either corporation or partnership classification.

8. See I.R.S. Notice 95-14, 1995-1 C.B. 297.

depends on what form the acquisition takes. If the purchase is a stock acquisition of an already existing U.S. corporation, and an election to treat the transaction as an assets sale under section 338<sup>9</sup> does *not* apply, it is unlikely the acquiror will be able to transfer the business to a foreign entity without the transfer being treated as at least a partially taxable sale of the business. Although a subsidiary generally can be liquidated into its corporate parent tax-free,<sup>10</sup> section 367 and the regulations promulgated thereunder deny tax-free treatment where the corporation is owned by a foreign corporation.<sup>11</sup> If it is the purchase of an interest in the assets of an existing U.S. business that will then be carried on as a joint venture with the U.S. party selling the interest, the foreign acquiror can purchase its interest through a domestic or foreign entity that need not be a corporation. Each party can then contribute their interest in the assets to a domestic partnership or corporation to carry on the business. However, essentially the same rules would restrict the U.S. partner from making a tax-free transfer of its remaining interest in the assets comprising the business to either a corporation or a partnership organized outside the United States.<sup>12</sup>

Even where the form of the transaction is a purchase of stock that does not permit the business to be withdrawn from a U.S. corporation, the "hybrid" question is still relevant. As an illustration, consider the following example:

*Example 1.* Prior to the purchase of the stock of a domestic corporation ("T") by the foreign acquiror ("F"), the structure of T is changed so that it remains a corporation for U.S. tax purposes, but is treated as a partnership (or branch) for purposes of the tax laws of the acquiror's resident country (country "A"). A uses the credit method for eliminating double taxation, rather than the exemption method. The income tax treaty between A and the United States reduces to zero the rate of withholding on interest on a loan by F to T.

From the United States perspective, nothing has changed. The

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9. I.R.C. § 338 (1994).

10. *Id.* § 332.

11. To prevent any built-in appreciation from escaping U.S. tax, transfers of property from a domestic corporation to a foreign corporation are permitted tax-free in a complete liquidation only if the property is to be used in an active business *within* the United States for the following 10 year period (except for sales of inventory in the ordinary course). See Temp. Treas. Reg. § 1.367(e)-2T(b)(2). Even then, the transfer of certain intangibles (patents, trademarks, etc.) is still subject to the requirements of the "super royalty" provisions of § 367(d). I.R.C. § 367(d) (1994).

12. See I.R.C. §§ 1491-92 imposing an excise tax on the gain on such a transfer, unless the transfer would be exempt under I.R.C. § 367 rules if the transferee were a corporation or the transferor elects to have those rules apply or the similar rules of I.R.C. § 1057. In addition, those provisions would bring into play the special "super royalty" rules of I.R.C. § 367(d) for certain intangibles transferred unless those intangibles were sold for an arm's-length price in a bona fide sale or licensed for an appropriate annual royalty.

business is still in a U.S. corporation and F would not be required to file a U.S. tax return or be subject to any of the rules that would apply if it were treated as being engaged in a U.S. trade or business (or having a permanent U.S. establishment) as a result of having an interest in a partnership (or branch) conducting business in the United States. If the transaction was done by leveraging the purchase—by T borrowing funds to redeem part of its stock and F purchasing the rest—the taxable income in the United States would be reduced by the interest expense on the borrowing. This would, of course, be subject to the usual "thin capitalization" restrictions and also to the "earnings stripping" restrictions of section 163(j) if T borrows from F or with F as guarantor.<sup>13</sup>

From A's perspective, however, since T would be regarded as a partnership, F might be treated as having purchased assets. In such event, F would then include the income or loss of the business with its other income or loss taxable by A (as computed under A's tax laws after giving effect to any amortization from the write-up of the tax basis of the T assets). F would also be allowed a credit for any U.S. taxes paid in accordance with the foreign tax credit rules of A. Whether such a result would be advantageous to F would depend on other aspects of A's tax laws. If, for example, A would allow a very rapid amortization of the purchase price by allowing an immediate deduction for any amount allocated to goodwill, the result could be a net current loss from T in F's tax computation in A. It could also be advantageous if the effective U.S. tax rate, after the interest expense were still sufficiently high to provide an excess tax credit that A's laws would allow F to offset against other income subject to tax by A.<sup>14</sup>

To see the full effects of using a "hybrid" in such situation, however, consider the following modification of Example 1:

*Example 2.* T is not changed into a hybrid. Instead of T borrowing to redeem some of its stock with F itself purchasing the rest of the T stock, F sets up an intervening entity ("X"). X is organized in the United States as a hybrid treated as a corporation for U.S. tax purposes and as a partnership (or branch of F) for A's tax purposes. X purchases all of T's stock, borrowing a substantial amount of the necessary funds and obtaining the rest from F by way of a capital contribution.

For U.S. tax purposes, X and T, both being treated as corporations,

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13. I.R.C. § 163(j) (1994).

14. Presumably, the interest expense to T and the interest income to F (if it made the loan to T) would nullify each other in A's tax system. Depending on A's amortization allowances and other rules in A's tax laws, it could still be possible for the overall net income inclusion under A's rules to be less than that for United States purposes—even after the U.S. deduction allowed to T for the interest expense.



may elect to file a consolidated return so that the interest expense on X's borrowing can be offset against the income generated by T's business. This is subject to one caveat, as discussed below, and to the usual "thin capitalization" and "earnings stripping" limitations if the loan is from F or guaranteed by F. Since the interest paid to F is exempt from U.S. withholding tax, that much of the profits of T's business is effectively removed from the U.S. tax system, the usual effect of leveraging a normal foreign-owned subsidiary with debt.

Consider, however, the effects in country A. Because A treats X as a partnership, in which F is the partner (or as a branch of F), the interest expense of X effectively nullifies the interest income of F (if F is the lender). Since T is now a corporation under A's rules, T's income or loss is no longer subject to tax currently in A. Moreover, if X borrows from a third party, the result would be two separate net current interest deductions—one in the United States through the tax consolidation of X and T, and one in A through the net deduction of F from the interest deduction through X.

Assuming X funds its interest payment out of its own resources, without a dividend or other corresponding income from T, the net economic result in Example 2 is the same as that intended to be prevented by the "dual consolidation loss" restrictions in section 1503(d).<sup>15</sup> The present Treasury Regulations promulgated under that section, however, would not appear to deny the use of the loss in the U.S. tax consolidation. While X would have a net operating loss from the interest expense on a separate company basis if it had no income, X itself would not be subject to an income tax in a foreign country (the partners rather than the partnership are subject to income tax in A).<sup>16</sup>

Section 1503(d) gives the IRS the authority to issue regulations treating a loss from a separate business unit of a domestic corporation as a loss incurred by a separate domestic subsidiary. The present regulations, however, define a "hybrid" as a "separate unit" only when it is treated as a partnership by the United States and as a corporation by the foreign country, the reverse of the present case. The regulations otherwise define a "separate unit" to include only a foreign branch or an interest in a partnership or trust.<sup>17</sup> Putting aside the policy question of whether it is appropriate to restrict dual consolidated losses at all, query

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15. I.R.C. § 1503(d) (1994).

16. Treas. Reg. § 1.1503-2(c)(15)(i) (as amended in 1993). The regulations suggest that "subject to tax" means actually taxed (even if the tax is zero) rather than just being included in income of a reporting unit for determining taxation of others.

17. Treas. Reg. § 1.1503-2(c)(3)-(4).

whether the IRS can and should amend the regulations under section 1503(d) to preclude the result in Example 2.

#### D. *Assets Acquisitions*

Where the business is acquired in an assets transaction, or a stock purchase as to which a section 338 election is made, the constraint of having to continue with a U.S. corporation for at least U.S. tax purposes does not exist so definitively.<sup>18</sup> Assuming that a limited liability entity, taxed by all relevant countries as a corporation, will have to be present somewhere in the chain, two additional options would be possible before consideration is given to the use of a hybrid. One possibility would be a partnership, organized in the United States or abroad, with the foreign corporation as a partner; the other would be for the U.S. business to be conducted directly as a branch of the foreign corporation.

If the foreign corporation has no other income, expenses or assets, the substantive tax differences among those three alternatives would be minimal with two important caveats. One caveat, discussed below, relates to the expenses that may be deductible in reaching net effectively connected income.

The other caveat is whether the use of the foreign partnership would result in the loss of any treaty benefits that might otherwise be available to the foreign partner. Instinctively, one would think that the answer to that inquiry would be "no," and U.S. policy, in its recent treaties, does in fact suggest that the foreign corporation should continue to have the benefits that would be available if it carried on the activity directly. Both the 1977 and the 1981 versions of the United States Model Income Tax Treaty provide that in the case of income derived or paid by a partnership, the term "resident" for purposes of the treaty "applies only to the extent that the income derived by such partnership . . . is subject to tax as the income of a resident of that State, either in its hands or in the hands of its partners."<sup>19</sup> Although this language can be viewed as ambiguous, the legislative histories for recent treaties that follow those model treaties generally clarify that at least the provisions reducing withholding at source apply to that portion of the partnership's income that goes to partners that are residents of a signatory country.

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18. Although the assets continue in a U.S. corporation after a § 338 election, that corporation has a new tax basis in the assets. Assuming the purchase price reflects the current fair market value (i.e., it is not a bargain purchase), the corporation can immediately be liquidated, or converted into another entity that might be treated as a liquidation for tax purposes, in a fully taxable transaction without further federal income tax liability. I.R.C. § 338(a) (1994).

19. Treasury Department's Model Income Tax Treaty of June 16, 1981, Tax Treaties (CCH) ¶ 211 at 10,574; Treasury Department's Model Income Tax Treaty of May 17, 1977, Tax Treaties (CCH) ¶ 208 at 10,540-10,541.

Almost all treaties entered into by the United States since the model treaties were first published have language identical to the model treaties. Earlier U.S. treaties, however, generally do not have comparable language and may not have any references to partnerships. Their legislative histories are similarly uninformative. Moreover, available case law holds only that a partner has a permanent establishment in the United States if the partnership has one.<sup>20</sup> Recent commentaries on the issue of treaty rights in partnership contexts have acknowledged the lack of clarity and reliable guidance on this issue.<sup>21</sup> It is understood that the IRS is reviewing this issue in connection with the preparation of a new United States model treaty. It should not be automatically assumed, therefore, that interposing a partnership in the chain of ownership will leave treaty benefits unaffected.

The issue of treaty rights, at least as regards the partner, should not arise if the partnership is a domestic partnership. In that event, the partner would be claiming any treaty benefits in its own right rather than through the treaty. Similarly, any party to whom the partnership made payments that would be potentially subject to taxation at source on a gross basis would have an opportunity to claim treaty benefits in their own right. The same would be true in the case of a foreign partnership as well.

There are three substantive differences between the situation of a U.S. corporation and any of the three alternatives listed above.<sup>22</sup> First, there can be differences in the amount of income that is taxed by the United States. The U.S. corporation would be subject to U.S. tax on all of its income on a net basis. By contrast, the foreign corporation, whether through a direct branch or partnership interest, would be taxed on a net basis only on that income effectively connected with the con-

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20. See *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962); *Unger v. Commissioner*, 58 T.C.M. (CCH) 1157 (1990), *aff'd*, 936 F.2d 1316 (D.C. Cir. 1991); *Johnston v. Commissioner*, 24 T.C. 920 (1955). Strictly speaking, the cases are precedent only for the interpretation of the particular treaty before the court, but in each instance, the resulting holding was only as noted above.

21. See generally INTERNATIONAL FISCAL ASSOCIATION, INTERNATIONAL INCOME TAX PROBLEMS OF PARTNERSHIPS (1995) and Commentaries 2-6 to Article 1 (Scope) of the 1993 Model Income Tax Treaty released by the Organization for Economic Co-Operation and Development.

22. As a means of insuring payment of the U.S. federal income tax due from the partner, the partnerships would have a withholding obligation with respect to the foreign partner's share of profits in the partnership income effectively connected with the conduct of a trade or business in the United States (or income attributable to the permanent establishment from the U.S. business if a treaty were invoked). See I.R.C. § 1446 (1994). No similar withholding is required if the business were owned through a domestic corporation (either directly or through a partnership). However, the withholding required in the case of a foreign corporate partner can be applied against the estimated tax payments required of the corporation, and any excess over the foreign corporation's ultimate actual tax liability is refundable.

duct of its trade or business in the United States or attributable to its U.S. permanent establishment if a treaty is claimed. The foreign corporation would be taxed on other U.S. source income on a gross basis by way of withholding (with available treaty reductions in the rate of withholding). Because of the interplay between the U.S. income characterization and source rules with the "effectively connected" concept, not all of the income of the U.S. business (in the normal accounting sense) may be subject to U.S. tax on either a net or a gross withholding basis. For example, if working capital of the business is temporarily placed on deposit with a foreign bank outside the United States (and the business in the United States was not a financial services business or trading in stocks or securities as a principal), the interest income earned on that deposit would not be subject to U.S. tax in the hands of the foreign partner.<sup>23</sup>

As another example, suppose the business involves sales of inventory, not produced by the business within the United States, for use or consumption outside the United States. The business also has an office outside the United States that participates materially in helping to arrange the sale, and title to the property passes to the buyer outside the United States at a point that is not artificial to the transaction. Then that income is also not taxed by the United States even though an office of the business in the United States may have played a principal role in the sale.<sup>24</sup> Even if the property were inventory produced by the business in the United States, a portion of the income would still be excluded from U.S. tax.<sup>25</sup>

The treatment of foreign sales illustrates an important point. Frequently, the business acquired will include not only the business in the United States, but also the business in Canada as well (or for all of the North American Free Trade Association). Depending upon how U.S. income tax interrelates with the foreign acquiror's home tax regime, it may or may not be desirable to exclude some of the total business income from U.S. tax. However, the possibility will exist only if the business is not conducted through a U.S. corporation.

Second, there can be differences between the amount of expenses allowed as deductions against the taxable income. A U.S. corporation would be entitled to a U.S. tax deduction for all of its ordinary business expenses in arriving at its net taxable income. By contrast, if a foreign

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23. See I.R.C. § 864(c)(4) (1994).

24. See *id.* I.R.C. §§ 862, 864(c)(4)(A), 864(c)(4)(B)(iii), 865(b), 865(e)(2). For purposes of § 865, a U.S. "resident" does not include a foreign corporation, even if that corporation is a partner in a partnership organized in the United States.

25. See Treas. Reg. §§ 1.863-3(b) (as amended in 1988); Temp. Treas. Reg. § 1.863-3T(b) (1988).

corporation is substituted, the deductible expenses are limited to those effectively connected with its U.S. trade or business (or those attributable to its U.S. permanent establishment in the case of a treaty). In determining what is effectively connected for expenses other than interest, deductions directly related to a category of income are specifically allocated to that category of income. Remaining expenses are then generally allocated to each category of income on the basis of the proportion of the gross income in that category to total gross income ("gross-to-gross" allocation) or some other specific, largely mechanical rule.<sup>26</sup> Interest expense is generally treated as fungible instead of as an expenditure of the funds or the source of the borrowing being traced. It is allocated on the basis of relative value of assets in a category. Interest allocation is determined by several factors, including tax book value or fair market value, the ratio of liabilities to assets and the choice of a "branch book/dollar pool" or "foreign currency pool" accounting convention.<sup>27</sup>

Despite all of the recent rhetoric against adopting formulary apportionments of income and expenses, the regulations use a formulary approach for the expenses not regarded as specifically allocable. Where a foreign corporation has no separate income, expenses or assets other than its branch, those rules would produce the same resulting net taxable income as for a domestic corporation. Where, however, some income is excluded, the formulary approach of the regulations may exclude deductions that are neither correspondingly proportionate to the total deductions that would be allowed to a domestic corporation nor equal to the expenses that a domestic corporation actually would have avoided if it had not had the excluded income. The formulary approach of the regulations thus has the potential virtue of providing greater certainty and minimizing controversies. On the other hand, it can produce results that conflict with the view of another country which does not use such an approach (with interest allocation and allocation of research and development expenses being the items that frequently result in the biggest differences).

There is also the other point mentioned above, where there may be different results depending upon whether the U.S. business is a direct branch of the foreign corporation or the foreign corporation is a partner in a partnership carrying on the business. The general provisions in the partnership tax rules specify that an item of partnership income and

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26. See Temp. Treas. Reg. § 1.861-8T (as amended in 1991). The IRS uses essentially the same approach in determining the expenses attributable to the income of a permanent establishment. See Rev. Rul. 89-115, 1989-2 C.B. 130.

27. Treas. Reg. § 1.882-5 (as amended in 1973).

expense is to be taken into account separately by a partner if it changes the tax liability of the partner.<sup>28</sup> In addition, the IRS has recently issued a formal revenue ruling treating the proceeds from the sale of a partnership interest by a foreign partner as taxable income that is effectively connected with a U.S. trade or business to the extent that the partnership's assets are part of the U.S. trade or business.<sup>29</sup>

On the other hand, the section 702 regulations and the Revenue Ruling together do not necessarily dictate that an expense incurred at the level of the partner is "effectively connected" with the trade or business conducted in the partnership, especially when the partnership interest is, for at least some purposes, treated as if it were a separate item of property. Provisions for allocation of interest and research and development expenditures specifically state that those items are to be passed through, and determined by the partner at the partner level (as might be expected), but there are no comparable provisions in the rest of the expense allocation regulations.<sup>30</sup> Further uncertainty is raised by the requirement that when an individual personally incurs an expense in connection with being a partner, he can only deduct that expense as an itemized deduction (subject to the percentage exclusion for such expenses) in arriving at taxable income, rather than as a business expense deductible (without such percentage exclusion) in arriving at adjusted gross income, unless the partnership agreement provides that he is expected to incur and pay for such costs. The requirement effectively forces the partner to treat the expense as personal and not business, unless it is agreed that such expenses will be incurred and treated as a special allocation to him, which he will bear out of the totals he receives from the partnership.

Thus Revenue Ruling 91-32 and the fungibility approach to interest allocation suggest that interest expense incurred at the partner level would be at least partially deductible by the partner in computing his effectively connected income from the partnership. However, the result for other types of expenses may be less clear, even though those expenses might well be deductible in full if a foreign corporation carried on the business directly as a branch.

A final difference between the three alternatives with regard to withholding bears consideration. The dividends and interest paid by a domestic corporation are generally subject to withholding as and when paid. By contrast, a foreign corporation, whether it has a direct branch in the United States or an interest in a partnership carrying on business

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28. I.R.C. § 702(a)(7); Treas. Reg. § 1.702-1(a)(8)(ii) (as amended in 1992).

29. Rev. Rul. 91-32, 1991-1 C.B. 107.

30. See Temp. Treas. Reg. §§ 1.861-9T(e) (as amended in 1989); 1.861-17(f)(1) (1995).

in the United States, is potentially subject to the branch level taxes of section 884 (including the special rule treating as U.S.-sourced any interest deductible by the foreign corporation in computing taxable income from the U.S. business<sup>31</sup>). Withholding on interest paid by a domestic corporation and on branch level interest expense are both frequently reduced to zero by a treaty. The withholding rate on dividends paid by a domestic corporation is almost never reduced to zero by a treaty. However, the branch profits tax equivalent is eliminated entirely under many treaties if the rather stringent, special anti-treaty shopping limitations in section 884(d)(4) are met.<sup>32</sup>

How do the considerations about using a U.S. corporation versus another entity in the ownership structure vary when the possibility of a "hybrid" entity is added to the equation? In the two numbered examples of hybrid situations discussed above, the purchase of stock (without a section 338 election) constrained the choice to alternatives in which the hybrid would continue to be treated as a corporation for U.S. tax purposes. As noted above, that constraint does not apply when the transaction is an assets purchase (or a stock purchase with a section 338 election). As an illustration of how the use of a hybrid might change the effects of the transaction, consider the following example:

*Example 3.* F organizes FS in country A as an entity that is treated as a corporation for the purposes of the tax laws of both A and the United States. FS, in turn, creates X as a domestic limited liability company that is a hybrid treated as a partnership for U.S. tax purposes and as a corporation for country A tax purposes. F funds FS with debt and equity, all of which FS, in turn, contributes to X as equity. X uses the funds to purchase all of the assets of U.S. business T. Under the tax treaty between A and the United States, for which both F and FS fully qualify (and also meet the anti-treaty shopping restrictions of § 884), the withholding rate on interest paid to F is reduced to zero, and no branch profits tax is imposed. FS has no other assets or liabilities and no other income or expense. A permits F and FS to file a consolidated return in country A and does not tax the income of X until that income is distributed to FS.

For U.S. tax purposes, under the apportionment rules in Temporary Treasury Regulation section 1.861-9T(e)(2), the assets of FS's interest in X should be included in FS's assets, which should result in all of FS's interest expense being effectively connected.<sup>33</sup> After the interest deduction, FS still may not have a net loss. Even if FS has a net loss, however, there would be no disallowance of the loss under the dual

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31. I.R.C. § 884(f)(1) (1994).

32. *Id.* § 884(e)(4).

33. Temp. Treas. Reg. § 1.861-9T(e)(2) (as amended in 1989).

consolidated loss rules in section 1503(d) because FS is not a domestic corporation and is not a member of a U.S. tax consolidated tax group.<sup>34</sup> Even if the language of section 1503(d)(3) were changed to provide that the IRS could designate separate units of a foreign corporation as a wholly-owned subsidiary, FS could not be made a member. The only effective constraints on the deductibility of FS's interest expense thus would seem to be the usual thin capitalization and "earnings stripping" restrictions.

The treatment of FS as a corporation by the United States also "isolates" F from having to file a U.S. income tax return and having to subject its entire enterprise to the effectively connected rules (or rules on income attributable to a permanent establishment) and the related deduction apportionment rules of the Treasury regulations. Unless the treaty benefits of FS with respect to income from X depend upon the treaty status of X, since FS is treated by all parties as a corporation, there would appear to be no issue as to whether FS (or any lender to FS) would be denied any U.S. treaty benefits due to uncertainty about how the U.S. treaty is applied to a partnership.

For country A tax purposes, as in example 2, there is no net current income or expense if, as postulated, FS borrows from F. There would be a net expense if FS borrowed from a third party to whom it paid the interest (or if F made such a borrowing itself).

The structure may have one other effect. To the extent that the business also operates in third countries, those other countries may be more likely to treat the limited liability company form as a corporation, rather than as a pass-through entity or an entity whose benefits under any U.S. tax treaty with that third country are problematic. While such an issue would have to be determined by an examination of the tax laws of the third country and that country's specific treaty with the U.S., countries with less involved approaches to entity classification may be more likely to accept the corporate structure of the limited liability company (particularly Latin American countries that are accustomed to taxing a "limitada" as a separate taxpayer).

Each of the three numbered examples above has the potential to give the taxpayer what could be described as a "double deduction." It is possible that the U.S. may take action to prohibit the consequences described in the examples, particularly if the United States switches to an elective "check the box" classification system for at least domestic entities. The effects, however, stem from each country applying its own tax law independently, and do not exhaust the circumstances where dif-

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34. I.R.C. § 1503(d) (1994).



ferent policies lead to such a situation. At some point it should be noted that the "double deduction" reverses and everything should net out, albeit with possible delays that have time-value-of-money implications for revenue collection. When the dual consolidated loss restrictions were originally proposed, there was considerable controversy over whether the effects were something with which the United States should be concerned, since it did not frustrate U.S. laws on a stand-alone basis, and the provisions aimed at controlling the situation introduced additional complexity into the U.S. tax laws. Expanding restrictions to cover hybrids is likely to be an even more complex exercise and would probably result in renewed debate over whether the burdens of such additional complexity outweigh whatever evil is perceived.

## II. HOLDING COMPANY STRUCTURES

Where a foreign acquiror will have more than one business venture in the United States, it has been a popular practice to create a U.S. holding company with separate subsidiaries for each business. Separation of the businesses was conveniently maintained, and the ability to file a consolidated federal income tax return made the choice relatively benign, from a tax point of view, once it had been decided to own the businesses through a vehicle that would be treated as a U.S. corporation for tax purposes.

Consolidated returns are still available. With the repeal of the *General Utilities* doctrine, however, the traditional holding company structure is not quite as cost-free as it once was.

The problem arises when a decision is made to dispose of one of the businesses. In today's business climate, with the increase in corporate prices that has occurred over the last few years, a direct sale of either the assets or the stock of the unwanted business could involve a substantial taxable gain. The repeal of the *General Utilities* doctrine has cut off the easy route of simply distributing the stock of the unwanted subsidiary and then selling the stock from abroad. For such a transaction to be tax-free now, it must pass the fairly stringent tests for a tax-free spin-off under section 355.<sup>35</sup> In addition, the transferee must agree to a five-year "gain recognition" agreement. Under the agreement, gain will be retroactively reinstated to the extent that the distributee disposes of its interest in either the spun-off company or the distributing company, in the five-year period following the end of the year of the spin-off.<sup>36</sup> As a practical matter, the latter requirement forecloses any early disposition other than a further tax-free exchange (if that can be

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35. I.R.C. § 355 (1994).

36. Treas. Reg. § 1.367(e)-1(c)(3) (1993).

arranged with the continued restraint on further taxable transfers within the gain recognition period).

A complete liquidation of the holding company would not, in itself, appear to meet the requirements of Temporary Treasury Regulation section 1.367(e)-2T,<sup>37</sup> necessary to allow the liquidation to be tax-free under section 332,<sup>38</sup> unless the stock of the subsidiaries could somehow be said to have been used in a trade or business in the United States in a way that brings them within section 864(c)(7).<sup>39</sup> Even then, the result would be that the stock could not be sold for ten years thereafter without triggering a taxable gain in the United States. Short of an "inversion" transaction, which would have its own business and technical problems, the result of choosing to use a holding company structure will be to lock-in any appreciation in the business for U.S. taxation on any disposition other than a tax-free exchange with the buyer.

This is not a problem that the use of hybrids is likely to be effective in solving. An ownership chain of hybrids that were all taxed as partnerships for U.S. tax purposes would potentially provide business separation and as much limited liability protection as corporate subsidiaries. It would also allow for de facto consolidation for income tax purposes by flowing all of the partnership interests into a single taxpayer at the top of the chain. But even if that top taxpayer were a partner outside of the United States, the combined effect of Revenue Ruling 91-32<sup>40</sup> and section 864(c)(7) would seem to effectively preclude any gain on the unwanted business being recognized beyond the reach of the U.S. tax net.

This is a potential consequence that would seem to require a decision at the outset about whether to opt for a single U.S. holding company structure, or at least perhaps postpone the contribution of a new acquisition to an existing holding company structure until there was a suitable degree of confidence that the business will be one that truly will be retained for the long term.

### III. CONCLUSION

The foregoing discussion is clearly a sampler, rather than an exhaustive analysis of the implications for inbound acquisition struc-

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37. Temp. Treas. Reg. § 1.367(e)-2T (1990).

38. I.R.C. § 332 (1994).

39. See Temp. Treas. Reg. § 1.367(e)-2T; see also I.R.C. § 864(c)(7) (1994). Although the validity of this temporary treasury regulation has technically expired under the sunset restrictions on temporary regulations, the IRS has just recently reaffirmed, yet again, that it intends to continue the principles stated in those temporary regulations with respect to outbound § 332 transactions.

40. Rev. Rul. 91-32, *supra* note 29.

tures arising from the growing availability of hybrid entities in conjunction with the other changes in the last several years. It does illustrate, however, that matters are now at the point where the traditional approaches to cross-border acquisition structures need to be approached with a fresh perspective and an open mind.