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American Offshore Business Tax Planning: Can Australian Lawyers Get a Piece of the Action?¹

J Clifton Fleming, Jr²

Introduction

This paper will investigate: (1) a pair of important American offshore income tax planning strategies; (2) opportunities for Australian lawyers to participate in the implementation of those strategies; and (3) opportunities for Australian lawyers to employ those strategies for the benefit of Australian clients. First, however, a brief explanation is required of the US federal approach to taxing business income. Without this explanation, the information in Part III below would invite incredulity.

The US federal system for classifying business organisations and taxing their incomes

US income tax law regards a branch or sole trading operation as inseparable from the single individual or entity that is the owner.³ Income earned by the branch or sole trading operation is treated as the owner's and it generally bears only the tax imposed on the owner. Except for a branch profits tax on the US branches of foreign corporations,⁴ there is no separate US income tax on a branch or sole trading activity.

Matters are different with respect to corporations (companies) and partnerships. The US federal system of taxing corporate (company) income is, generally speaking, a classical regime, with separate corporate and shareholder taxes and no imputation credits.⁵ Stated differently, corporations are treated as non-transparent and income distributed to shareholders suffers double taxation.

1 Copyright © 2003 by J Clifton Fleming, Jr. All rights reserved. Thanks to Robert J Peroni and Stephen E Shay for comments on an earlier draft. This paper was prepared with the financial support of Malleons Stephen Jacques but does not necessarily represent the views of the firm or its client. That support is gratefully acknowledged.

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3 See United States Code of Federal Regulations, Title 26 (hereinafter cited as Reg) § 301.7701-2(a).

4 See US Internal Revenue Code of 1986 (US Code, Title 26) (hereinafter cited as IRC) § 884.

5 See IRC §§ 1, 11, 63, 301(c), 316(a).

For US income tax purposes, partnerships are also treated as entities separate from the partners, in that partnerships are required to compute their own income, expenses and losses.⁶ In contrast to corporations, however, partnerships are transparent, that is, taxed under a passthrough regime (no tax on the entity; a direct tax on the partners with respect to their shares of the partnership's income, but no tax on distributions to the partners),⁷ unless the partnership elects to be taxed as a corporation under the check-the-box Regulations⁸ explained below, or unless ownership interests in the partnership are regularly traded in a public capital market.⁹ In other words, partnerships that are not publicly traded generally avoid the double taxation that obtains when income earned by corporations is distributed to shareholders.

Before 1997, however, a non-publicly-traded partnership would nevertheless be treated as a corporation for tax purposes if it bore a sufficient resemblance to a corporation.¹⁰ The rules that gave content to this resemblance test were theoretically controversial, complex and subject to manipulation through careful planning. Attempts to enforce the rules could result in unpredictable litigation.¹¹

The resemblance test might, nevertheless, have persisted in US income tax law had it not been for a state law development. Beginning in the 1970s, the legislatures of all 50 US states enacted laws creating a highly flexible new form of business organization: the limited liability company (LLC). Like a corporation, an LLC restricts its owners' personal liability for debts of the business to the amount of their investment. The LLC does not, however, have a corporate charter,¹² and it allows the owners greater freedom than corporate shareholders to determine their rights and duties by agreement. This freedom often results in LLCs having important partnership characteristics. Since its emergence, The LLC has become a highly popular form for organizing new US businesses.

In the 1990s, the unpredictability of the resemblance test collided with the LLC's growing popularity. Specifically, the LLC's mixture of corporate and partnership characteristics, the freedom under state law to vary those

6 See IRC § 703.

7 IRC §§ 701, 702. Corporations are also treated as transparent if they qualify for, and make an election under, IRC § 1362. However, corporations whose shares are publicly traded, foreign corporations and corporations whose shares are owned by another corporation or by a nonresident alien are not eligible to make this election. See IRC § 1361. Thus, the election is not generally useful in international tax planning and will be ignored for purposes this paper.

8 See Reg § 301.7701-3.

9 See IRC § 7704.

10 See *Morrisey v Commissioner* 296 US 344 (1935).

11 See *Larson v Commissioner* 66 TC 159 (1976).

12 An LLC is required, however, to make a public filing that discloses certain organizational details and the relevant public officer will generally issue an official document evidencing the LLC's existence as a juridical entity. See Delaware Limited Liability Company Act §§ 18-201, 18-206; Uniform Limited Liability Company Act (1995) §§ 201, 206, 208.

characteristics and the uncertainty of the resemblance test, caused insecure taxpayers to flood the Internal Revenue Service (IRS) with a plethora of requests for fact-specific rulings that their proposed LLCs would be treated as transparent entities, like partnerships, and not as double-taxed corporations. IRS employees were also uncertain and in need of guidance in their enforcement activities. Finally, the IRS concluded that the costs of administering the resemblance test were no longer worth the benefits.¹³ A radically different approach to classifying business organisations for tax purposes was adopted – the so-called check-the-box Regulations.¹⁴

These Regulations became effective on January 1 1997. In their aftermath, US federal income tax law now treats the following business organisation forms as *per se* corporations that are subject to double taxation:

- 1 all entities formed under US federal or state business corporation acts;¹⁵
- 2 certain specifically identified foreign entities (including an Australian public limited company);¹⁶
- 3 publicly-traded unincorporated organisations.¹⁷

Speaking broadly, other business organisations, domestic or foreign, including LLCs, Australian general and limited partnerships and Australian proprietary limited companies,¹⁸ can elect between classification as corporations and classification as transparent entities.¹⁹ The presence or absence of personal liability on the part of the owner for a business organisation's debts affects the procedure for making the election, but is irrelevant to the election's availability.²⁰

An organisation that is not a *per se* corporation, and that elects not to be taxed as a corporation, is classified as a partnership if it has more than one owner, and as a disregarded entity (that is, as a sole proprietorship or branch) if it has only one owner.²¹ This latter category includes single-owner US LLCs and single-shareholder Australian proprietary limited companies that make

13 See Notice 95-14, 1995-1 CB 297.

14 See Reg §§ 301.7701-1 to -3.

15 See Reg § 301.7701-2(b)(1).

16 See Reg § 301.7701-2(b)(8)(i).

17 See IRC §§ 7704(a), (b); Reg § 301.7701-2(a). Actually, certain narrow classes of publicly-traded unincorporated organisations escape *per se* corporate classification. See IRC §§ 7704(c), (g). These organisations, however, have little importance with respect to current offshore business tax planning and will be ignored in this paper.

18 For this purpose, Australian company law determines whether an entity is a public limited company or a proprietary limited company. See Reg § 301.7701-2(b)(8)(iii). With respect to the distinction between public and proprietary limited companies in Australian company law, see *The Laws of Australia* 4.1[103] to [116] (Law Book Co, 1999).

19 See IRC § 301.7701-3(a). Actually, a few other forms of business organisation are treated as *per se* corporations, see Reg §§ 301.7701-2(b)(1),(3)-(7), but because they are of little importance in most offshore tax planning, this paper will ignore them.

20 See Reg § 301.7701-3(b)(2).

21 See Reg §§ 301.7701-2(a), (c), 301.7701-3(b)(1), (2).

the election. In other words, a single-owner LLC or Australian proprietary limited company that elects under the check-the-box Regulations not to be taxed as a corporation will, for US tax purposes, be treated as a directly-owned activity of the single owner instead of as a separate legal entity.²²

The check-the-box Regulations were a bold simplification move and a remarkable departure from the rigidity that often characterises administrators. However, as will be seen in the remainder of this paper, these Regulations also provide important tax planning opportunities that cause them to serve as a demonstration of the law of unintended consequences.

Offshore transactional structures that exploit the check-the-box Regulations

The first structure: uncoupling the foreign tax credit from the related foreign income and accelerating the benefit of the credit

Assume the following parties:

- 1 US Co, a *per se* US corporation under the check-the-box Regulations.
- 2 US Sub, a *per se* US corporation whose shares are entirely owned by US Co.
- 3 Pship, an Australian general partnership²³ carrying on an active business entirely in Australia through a permanent establishment. The partners are US Co (above), with a 99.9% interest and US Sub (above), with a 0.1% interest.²⁴ Pship is classified as a transparent entity for Australian tax

- 22 Obviously, however, an election or non-election under the Regulations has no effect on an organisation's classification for Australian tax purposes.
- 23 This structure will not produce the desired tax results unless Pship is a foreign entity for purposes of US tax law. See text at fns 28–29. To achieve that result, Pship will be organised in Australia under Australian law. See IRC §§ 7701(a)(3), (4); Reg § 301.7701–1(d). Pship will nevertheless, be viewed as a US partnership for certain purposes of Australian tax law, see Income Tax Assessment Act of 1936 (hereinafter cited as ITAA 36) § 317 Australian partnership, but that fact is irrelevant in the context of this paper. See ITAA 36 § 92.
- 24 To achieve the desired tax results, Pship must be organized as an Australian partnership, which means that Pship must have at least two partners. Reg § 1.7701–2(c)(1). That is the reason for involving US Sub. To be considered a partner, however, US Sub must be a form of business organisation that is recognised as legally distinct from US Co. American lawyers would generally prefer that US Sub be an LLC entirely owned by US Co. However, the status under Australian income tax law of a US LLC with only one owner is uncertain. Such an LLC is clearly not a partnership for Australian tax purposes because partnership classification requires two or more owners. See Income Tax Assessment Act of 1997 (hereinafter cited as ITAA 97) § 995–1(1) partnership. For the same reason, a single-owner US LLC is also not a company under the portion of Australian income tax law that classifies 'any other unincorporated association or body of persons' as a company. See ITAA 97 § 995–1(1) company. LLCs, nevertheless, have certain characteristics of companies. To be specific, LLCs must publicly file a document disclosing certain internal details, they may obtain a certificate from a state official evidencing that they have a legal existence separate from their owner or owners and they confer limited liability on investors. See authorities cited in fn 12. Thus, single-owner LLCs might be treated [cont]

purposes,²⁵ and elects to be classified as an Australian corporation for US purposes.

The income tax consequences of this structure are:

- 1 As Pship earns its income, Australia taxes US Co on 99.9% of the income and US Sub on .1% of the income, because US Co and US Sub are the taxpayers under Australian law with respect to Pship's income.²⁶
- 2 Under US rules, this gives US Co and US Sub immediate foreign tax credits summing up to 100% of the Australian tax²⁷ (99.9% to US Co and 1% to US Sub).
- 3 However, for US tax purposes, Pship's election causes it to be treated as a foreign corporation.²⁸ Therefore, the United States does not tax Pship's Australian income until it is actually distributed to US Co and to US Sub (or until US Co and US Sub sell their interests in Pship).²⁹

[cont] as companies under the portion of Australian income tax law that defines a company as 'a body corporate'. See ITAA 97 § 995-1(1) company. But this conclusion is open to serious doubt because US LLCs are formed under LLC acts, not corporation laws. Thus, they might not be regarded as companies for Australian tax purposes and since a single-owner US LLC is clearly not a partnership, it might be treated as a branch or sole trading operation under Australian law. If US Sub were an LLC wholly-owned by US Co and if US Sub were regarded as US Co's branch or sole trading operation for Australian tax purposes, then Pship might be regarded as having only one owner, US Co, for purposes of the check-the-box regulations. See generally, Phillip R West, 'Foreign law in US international taxation: the search for standards', 3 Fla Tax Rev 147 (1996). If so, Pship would not be a partnership. Instead, it would also be a branch or sole trading operation of US Co. This would likely be disastrous because a branch or sole trading operation is probably not an entity that can elect to be classified as a corporation for US tax purposes under the check-the-box Regulations. See Reg §§ 301.7701-1(a)(2), 1(b), 301.7701-2(a); 2 Joseph Isenbergh, *International Taxation* 49:9-49:10 (3d edn, 2002). Because of these uncertainties, US Sub will be organised as a US corporation so that it will clearly be an entity separate from US Co.

- 25 *Id.*, Pship is subject to the look-through regime in ITAA 36 §§ 91-92 and is not subject to the corporate limited partnership regime in ITAA 36 §§ 94A-94Y.
- 26 See ITAA 36 §§ 91, 92(1). Because US Sub is a company, its share of Pship's income should not be vulnerable to the penalty tax imposed by ITAA 36 § 94(9). See ITAA 36 § 94(1).
- 27 See Reg §§ 1.901-1(a)(2), 1.901-2(f)(1), 1.904-6(a)(1)(i), (iv); Rev Rul 72-197, 1972-1 CB 215; West, *op cit*, fn 24, at 157. See also David S Miller, 'The strange materialization of the tax nothing', 87 Tax Notes 685, 699 n. 112 (2000). To the extent that the contrary holding in *Abbott Laboratories Int'l Co v United States* 160 F Supp 321 (ND Ill 1958), *aff'd* 267 F 2d 940 (7th Cir 1959), cannot be distinguished, it appears to have been overturned by the subsequent promulgation of Reg § 1.901-2(f)(1). See generally, West, *op cit*, fn 24, 177-78.
- 28 See Reg § 301.7701-3(a) and fn 23.
- 29 See generally *Moline Properties, Inc v Commissioner* 319 US 436 (1943); Reg § 1.11-1(a); IRC §§ 7701(a)(4), (5). This result is referred to in US international tax jargon as 'deferral'.

For purposes of US income tax law, Pship is a controlled foreign corporation (see Reg. §§ 301.7701-1(d)-3(a); IRC § 957(a)) and US tax law contains a controlled foreign corporation regime and other anti-deferral provisions. These provisions, however, are easily avoided when the controlled foreign corporation principally earns active business income, as is the case with Pship. See Robert J Peroni, J Clifton Fleming, Jr and Stephen E Shay, 'Getting serious about curtailing deferral of US tax on foreign source income' 52 SMU L Rev 455, 460-64, 501-05 (1999).

Assuming that none of Pship's income is of a character that causes the Australian withholding tax regimes to apply, there will be no Australian tax on actual distributions of Pship's income to US Co and US Sub. See Robin Woellner, Stephen Barkoczy, Shirley Murphy and Chris Evans, *Australian Taxation Law* 2002, 1033-34 (12th edn, 2001) (hereinafter cited as Woellner).

At that point, US Sub's share of Pship's income can be distributed by US Sub to US Co without incurring further US tax.³⁰

- 4 Thus within the US income tax system, both US Co and US Sub get immediate foreign tax credits without having to pay US tax on the related foreign income until that income is repatriated to the United States.³¹ This means that the present value of the credits is greater than the present cost of the US tax which the credits are meant to offset – a highly advantageous result that boosts the profitability of the operations carried on by US Co in Australia through Pship.³²
- 5 In a variation of this structure, US Sub can be replaced by an independent Australian partner which owns a substantially larger interest in Pship than does US Sub (say 50%). In other words, the efficacy of this transactional structure within the US tax system does not depend on US Co having a US partner.³³ Thus, if US Co enters into an Australian business venture with a substantial Australian partner, US Co can still get the US tax benefits of this structure with respect to its share of Pship's income.

30 See IRC § 243.

31 See authorities cited in fns 27, 29. The tax credits will be usable only against US tax on foreign-source income in the IRC § 904(d)(1)(I) general limitation basket. See Reg §§ 1.904-6(a)(1)(i), (iv). Thus, the text assumes that US Co and US Sub have active business income from countries other than Australia and that there is residual US tax on that income.

32 The time period between the present availability of the credits for the Australian tax and the later recognition of Pship's Australian income for US tax purposes is likely to be quite long. A recent empirical study has found that there were virtually no repatriations to the United States of controlled foreign corporation income in the first 15 years after such a corporation had been formed in a low-tax foreign country. See Harry Grubert & John Mutti, *Taxing International Business Income: Dividend Exemption Versus the Current System* 13 (AEI Press, 2001). Thus, assume that US Co and US Sub pay a total of \$100 of Australian tax on Pship's year 1 Australian income and that this income is not distributed, and US tax is not incurred thereon, until 15 years after the Australian tax payment. When the income is repatriated, it will not be accompanied by \$100 of foreign tax credits because the payor of the dividend (Pship) is not considered to have paid the \$100 of Australian tax. See ITAA 36 § 91; Reg § 1.901-2(f)(1). Thus, US Co and US Sub will pay \$100 more US tax at the time of the repatriation than they would have paid if they had not accelerated the credits. But if the correct after-tax discount rate were 7%, then at the time US Co and US Sub enjoyed the benefit of \$100 of credits for payments of year 1 Australian tax, the \$100 of US tax due 15 years later would have a present cost of only about \$36. In other words, US Co and US Sub could use \$36 of the \$100 of credits to save \$36 of year 1 US tax and set this saving aside at 7% interest to grow into \$100 for paying tax in the repatriation year. The approximately \$64 of year 1 excess credits could then be used to offset year 1 US tax on other US Co and US Sub foreign-source income in the IRC § 904(d)(1)(I) general limitation basket. See Reg § 1.904-6(a)(1)(i), (iv). From the standpoint of the policy underlying the foreign tax credit (relief from international double taxation) this is an egregious result because US Co and US Sub get considerably more than double taxation relief. The hybrid entity rules of IRC § 894(c) and the Regulations thereunder have no constraining effect on taxpayers in this context. In January, 1998, the US Treasury expressed concern, see Notice 98-5, 1998-91 CB 334, 337, but no action has been taken or proposed in the intervening five years. Moreover, in two recent important decisions, US courts have allowed US taxpayers the benefit of foreign tax credits generated in transactions that, although different from the transaction under discussion, depended on the credits to yield a profit. See *Compaq Computer Corp v Commissioner* 2002-11 USTC (CCH) 50, 144 (5th Cir 2002); *IES Indus, Inc v United States* 253 F 3d 350 (8th Cir 2001).

33 The efficacy of this structure with respect to US Co's US tax results depends on Pship being an Australian partnership which elects to be treated as a corporation for US tax purposes. These conditions remain satisfied if US Sub is replaced by an independent Australian partner.

- 6 The role for Australian practitioners in this transactional structure is focused on setting up Pship, advising on Australian law and advising any Australian entity that is substituted for US Sub. The provision of advice is, however, facilitated by Australian practitioners understanding what the Americans are trying to accomplish.

An abortive Australian ploy

Because Australian income tax law has nothing like the US check-the-box Regulations, the preceding structure cannot be directly transferred to an Australian setting, but it does suggest an Australian foreign tax credit ploy that should be briefly investigated.

To do so, assume the following parties:

- 1 Oz Co, an Australian public or private limited company.
- 2 US Branch, an unincorporated US branch wholly-owned by Oz Co and exclusively engaged in an active business carried on entirely in the US through a US permanent establishment.

The income tax consequences of this structure are:

- 1 US taxes Oz Co on 100% of US Branch's net income.³⁴
- 2 US Branch's income is exempt from Australian income tax under the branch profits exemption.³⁵

Can the US tax on US Branch's exempt income be taken into account for purposes of calculating the Australian foreign tax credit regarding active business income earned by Oz Co in unlisted countries?³⁶ Australia's foreign tax credit provisions can be read as directing that all of an Australian company's foreign active business income, including exempt income, and all of the foreign taxes paid thereon, must be aggregated for purposes of determining the company's allowable foreign tax credit.³⁷ Under this approach, the US tax paid on US Branch's income would be incorporated into the computation of the foreign tax credit allowable with respect to active business income earned by Oz Co in unlisted countries.³⁸ However, the ATO has expressly ruled that neither exempt foreign income nor the foreign tax paid

34 See Australia-US Income Tax Convention, Arts 7(1),10(6); IRC §§ 882(a), 884 and text at fns 1–2.

35 Oz Co is an Australian company, the US is a broad-exemption listed country (see Income Tax Regulation 1936, 152J, Schedule 10) and all of US Branch's income is active business income earned at or through a US permanent establishment and subject to regular US income taxation as it is earned. Thus, the branch profits exemption applies. See ITAA 36 § 23 AH.

36 The branch profits exemption is not available for business income earned in unlisted countries, see ITAA 36 § 23 AH(1)(b). Such income is includable in the assessable income of an Australian company and foreign tax paid thereon may be eligible for inclusion in the foreign tax credit calculation. See Woellner, *op cit*, fn 29, 1407–08, 1437.

37 See ITAA 36 § 160 AF(7).

38 Indeed, this is arguably the position taken by the ATO in IT 2508 (1988).

thereon is taken into account for purposes of computing the Australian foreign tax credit.³⁹ Although no valiant (or contumacious) Australian taxpayer has tested this conclusion in litigation, the ATO position seems to be the most reasonable interpretation of the Australian foreign tax credit provisions.⁴⁰ Thus, it is unlikely that foreign tax paid on income exempt under the branch profits exemption can be used to enhance the amount of the Australian foreign tax credit.⁴¹

The second structure: converting business profits into interest and royalties

Double tax agreements often provide that interest and royalties are taxed at rates lower than the tax rates applicable to ordinary business income. Thus, to the extent that ordinary business income can be converted into deductible payments of interest or royalty income, tax savings may be possible. To investigate this prospect, assume the following parties:

- 1 US Co, a *per se* US corporation under the check-the-box Regulations.
- 2 Japan Co, which carries on an active business in Japan through a permanent establishment. Japan Co is a Japanese *yugen kaisha* (limited company). It is a company for purposes of Japanese law, but it elects under the check-the-box Regulations to be a branch for US purposes. It is wholly owned by US Co.

Assume that Japan imposes a 40% tax on corporate business profits and a 10% withholding tax on interest and royalties paid to a US resident.⁴² Also assume that the US taxes corporate profits at a 35% rate.⁴³

The following transactions occur:

- 1 US Co loans cash and licenses intangibles directly to Japan Co; the loans and license are not made by a permanent establishment of US Co in Japan.
- 2 Japan Co pays 50% of its business profits to US Co in the form of interest and royalties. Assume that such payments, when made in connection with carrying on a business, are deductible expenses for purposes of Japanese tax law, including Japanese transfer pricing rules.

The income tax consequences of this structure are:

39 See TR 96/15 paragraphs 7–8 (1996). See also IT 2527 para 9 (1989).

40 See ITAA 36 § 160 AF(1). In addition, the purpose of both the branch profits exemption and the foreign tax credit is to relieve double taxation of international income. Either one of them is fully sufficient to achieve this purpose. If a taxpayer is permitted to combine them, the result is to go beyond relieving double taxation and to confer a tax windfall.

41 See The Laws of Australia 31.11[37] (Law Book Co, 1999); Woellner, *op cit*, fn 29, 1410, 1437.

42 This is, in fact, the withholding tax limit set by Arts 13 and 14 of the US-Japan Double Tax Agreement.

43 The US rate of tax on corporate profits ranges from 15% on the first \$50,000 of taxable income to 35% on taxable income exceeding \$10,000,000. See IRC § 11(b).

- 1 Because Japan Co is a juridical entity for Japanese tax purposes, Japan allows Japan Co to deduct the interest and royalty payments. This causes the Japanese company tax on half of Japan Co's business profits to drop from 40% to zero. The 10% Japanese withholding tax applies, however, to the deductible interest and royalty payments.
- 2 Because Japan Co is a branch for US purposes, US tax law regards the interest and royalty payments as intra-corporate transfers that have no US tax significance,⁴⁴ and the US views Japan Co's entire net income (calculated with no deduction for the interest and royalty payments) as part of US Co's income. The half of Japan Co's income that was not paid out to US Co bears a 40% Japanese tax and a zero US tax, after crediting the Japanese tax against the 35% US tax on US Co's profits (this effectively leaves US Co with five percentage points of excess credit). The other half of Japan Co's income that was paid to US Co as interest and royalties (deductible from a Japanese perspective, but treated as disregarded intra-corporate payments from a US perspective), incurs a 35% US tax against which US Co claims a foreign tax credit for the 10% Japanese withholding tax and the five percentage points of excess credit.⁴⁵
- 3 Thus, the 50% of Japan Co's income that has been paid as deductible interest and royalties to US Co has swung from a 40% Japanese tax to a combined Japanese and US tax of only 35%. Five percentage points of tax have been eliminated on half of Japan Co's income – a 12.5% reduction.

Clearly, the advantageous tax consequences of this structure are available only where the foreign country's tax rate on ordinary business profits is higher than the US rate. Therefore, this transactional approach often is not attractive for US corporations investing in Australia, but as the next portion of this paper will demonstrate, this structure is efficacious for Australian companies doing business in the US.

The 'second structure' done by an Australian company

Assume the following parties:

- 1 Oz Co, an Australian public or proprietary limited company.
- 2 OzSub, an Australian proprietary limited company wholly-owned by Oz Co.
- 3 Pship, which carries on an active business exclusively in the US through a US permanent establishment. Pship is a general partnership organized in the US under US law and owned 99.9% by Oz Co and .1% by Oz Sub. Pship elects under the check-the-box Regulations to be treated as a corporation for US purposes, but Pship is transparent (that is, a

⁴⁴ See Miller, *op cit*, fn 27, 690, 699.

⁴⁵ See Miller, *op cit*, fn 27, 690, 699. The hybrid entity rules of IRC § 894(c) and the Regulations thereunder have no effect on these conclusions.

partnership) for Australian tax purposes. Pship's management is performed entirely in the US.

Assume that the US imposes a 35% tax on corporate business profits,⁴⁶ a 5% branch profits tax on foreign-owned US permanent establishments,⁴⁷ and withholding taxes of 10% on interest payments to Australian residents, with 5% on royalties paid to Australian residents.⁴⁸ Also assume that Australia taxes corporate profits at a 30% rate.

The following transactions occur:

- 1 Oz Co loans cash and licenses intangibles to Pship and provides management and technical services to Pship from Australia by fax, telephone and Internet communications.
- 2 Pship pays 75% of its business profits (calculated before such payments) to Oz Co in the following proportions: one-fourth as interest, one-fourth as royalties and one-fourth as fees for management and technical services. Assume that these payments are deductible for purposes of US tax law.⁴⁹

The income tax consequences of this structure are:

- 1 The US deductions allowed to Pship for the interest, royalty and fee payments reduce Pship's US taxable income. Thus, Pship pays no US corporate profits tax on 75% of its US income.⁵⁰ Because Pship is a US corporation for US tax purposes, its income escapes the US branch profits tax.

46 See fn 43.

47 When Art 6 of the 2001 protocol to the Australia-US Double Tax Agreement becomes effective, the US rate of branch profits tax on Australian companies will generally be set at 5%. See Kevin A Bell, Australia, United States Sign Protocol to Tax Treaty, 24 Tax Notes Int'l 95, 96 (2001).

Because Pship does no business in Australia and its management is performed entirely in the United States, Pship will not be considered a dual resident corporation excluded from the benefits of the Australia-US Double Tax Agreement. See Australia-US Double Tax Agreement, Art 3; Woellner, *op cit*, fn 29, 1386-88. However, even if Pship were considered a dual resident corporation under the Double Tax Agreement, its payments of interest and royalties would nevertheless qualify for the withholding rates prescribed in the Agreement. See US Treas Dept, Technical Explanation of the Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, 1986-2 CB 246, 252-53.

48 When Art 8 of the 2001 protocol to the Australia-US Double Tax Agreement becomes effective, the US rate of withholding tax on royalties paid to Australian residents will be 5%. See Bell, *op cit*, fn 47, 96. The protocol generally has no effect on the withholding tax rate with respect to interest received by Australians. That rate generally remains 10%. See Australia-US Double Tax Agreement, Art 11; IRC §§ 871(a)(1)(A), 881(a)(1).

49 Deductibility will be constrained by the arms-length standard of IRC § 482.

50 In an earlier draft of this paper, Pship paid 100% of its profits to Oz Co as deductible interest, royalties and fees, with the result that Pship's US taxable income in this scenario was zero. Stephen E Shay, a leading US international tax lawyer and former International Tax Counsel for the US Treasury Department, had the following reaction:

'While I understand the pedagogical objective, it rings (very) unrealistic to a practitioner's ear. Under the Bulls make money and Bears make money, but Pigs get slaughtered rationale, almost no practitioner would push such planning to the limit. I would prefer leaving some income for the ... [US] taxing jurisdiction and noting in a footnote that as a theoretical matter, there is no apparent limit on application of the technique to zero out the income [of Pship]'. [cont]

- 2 Although Pship's deductible interest payments to Oz Co bear no US corporate profits tax, they do incur a 10% US withholding tax. This is so because, for US purposes, Pship is a US corporation that is paying US-source interest to a separate foreign corporation.⁵¹ For Australian tax purposes, these payments are also treated as interest income of Oz Co from a loan to Pship, and not as part of Oz Co's share in the business income of Pship's US permanent establishment.⁵² Therefore, Oz Co's interest receipts do not qualify for the branch profits exemption.⁵³ Instead, they are includable in Oz Co's assessable income and subject to Australian tax at a 30% rate.⁵⁴ The 10% US withholding tax is, however, creditable against this 30% Australian tax, which leaves a 20% Australian residual tax.⁵⁵ Thus, the one-fourth of Pship's profits that are paid to Oz Co as interest swings from a 35% US corporate profits tax to an aggregate tax of 30% (10% US withholding tax and 20% Australian residual tax) – a 14.3% reduction.

[cont] E-mail from Stephen E Shay to J Clifton Fleming, Jr (June 24, 2002) (on file with the author). Being an academic, I feel compelled to defer to Steve Shay's sense of practical realities. Consequently, I have provided in the final version of this paper that Pship pays only 75% of its income to Oz Co as deductible interest, royalties and fees. As Steve suggests, *supra*, however, there is neither a principled rationale for stopping short of having Pship pay 100% of its profits to Oz Co as deductible expenditures (assuming that the arm's length standard of IRC § 482 is satisfied) nor an objectively determinable amount of income that, if left in Pship for taxation by the US, will clearly placate the Internal Revenue Service and ensure that it will not search for a theory on which to challenge the tax planning advocated in this scenario.

- 51 See IRC §§ 861(a)(1), 7701(a)(4). The Australia-US Double Tax Agreement does not interfere with Pship's classification as a corporation for US purposes and as a partnership for Australian purposes. See Australia-US Double Tax Agreement, Article 3(1)(g), (2) and see generally, Richard L Doernberg and Kees van Raad, *Hybrid Entities and the US Model Income Tax Treaty*, 19 Tax Notes Int'l 745, 757 (1999).

Assuming that the transactional formalities, the behavior of the parties and the interest rate regarding Oz Co's loans to Pship are consistent with a *bona fide* debtor-creditor relationship, Pship's interest payments to Oz Co will be treated as real interest payments for US tax purposes. See *eg*, *Fin Hay Realty Co v United States* 398 F 2d 694 (3d Cir 1968); *Tomlinson v 1661 Corp* 377 F 2d 291 (5th Cir 1967). In addition, the US earnings stripping rules are avoided, see §§ 163(j)(1), (2).

- 52 See Robert Deutsch, Stephen Gates, Margaret Gibson, Peter Hanley, Gary Payne and Wayne Plummer, *1999 Australian Tax Handbook* 1051 (1999) (hereinafter cited as Deutsch); *The Laws of Australia* 31.7[20] (Law Book Co, 1999); Woellner, *op cit*, fn 29, 1038.

- 53 See ITAA 36 § 23AH(1)(b).

- 54 See authorities cited in *op cit*, fn 29, 52.

- 55 See Australia-US Double Tax Agreement, Art 22(2); Woellner, *op cit*, fn 29, 1433–36.

- 3 Pship's deductible fee payments to Oz Co for services bear no US withholding tax or any other US tax.⁵⁶ Moreover, for Australian tax purposes, they are considered part of Oz Co's interest in Pship's US business profits⁵⁷ and are exempt from Australian tax under the branch profits exemption.⁵⁸ Therefore, the one-fourth of Pship's profits that are paid to Oz Co for services swings from a 35% US tax to a zero US and zero Australian tax – a 100% reduction.
- 4 Pship's deductible royalty payments to Oz Co bear no US corporate profits tax, but do incur a 5% US withholding tax. The treatment of these payments for Australian tax purposes is not entirely clear, because there are two possible outcomes but no authority directly in point. In the best-case scenario, the royalty payments are treated like the fee-for-service payments – that is, characterised as simply an allocation of Pship's US profits to Oz Co and exempted from Australian tax under the branch profits exemption. Accordingly, in the best-case scenario, the one-fourth of Pship's profits paid to Oz Co as royalties swings from a 35% US tax to a 5% US tax and no Australian tax. In the worst-case scenario, however, the royalties are treated similarly to the interest payments – that is, subjected to both a 30% Australian tax and to the 5% US royalty withholding tax. But the 5% US royalty withholding tax is creditable against the 30% Australian tax on Pship's US income. Thus, in the worst-case scenario, the one-fourth of Pship's profits that are paid to Oz Co as royalties swings from a 35% US tax to an aggregate tax of 30% (5% US withholding tax and 25% Australian residual tax). Which of these

56 The facts state that Oz Co's services are performed in Australia and delivered to Pship by fax, telephone and Internet communications. Because these services are not performed through a permanent establishment maintained by Oz Co in the US, Oz Co does not incur US tax on payments received from Pship for the services. See Australia-US Double Tax Agreement, Art 7. See also *Piedras Negras Broadcasting Co v Commissioner* 43 BTA 297 (1941), nonacq. 1941-1 CB 18, aff'd, 127 F 2d 260 (5th Cir 1942). Indeed, the fee income generated by Oz Co's services to Pship would be free of US tax even if Oz Co employees made periodic visits to the US to provide management and technical services at Pship's premises. This is so because Oz Co would not be carrying on a services business through an Oz Co permanent establishment. See Australia-US Double Tax Agreement, Art 5(6); Senate Exec Rept No 98-16, 1986-2 CB 229, 234; Rev Rul 77-45, 1977-1 CB 413; OECD, Model Tax Convention on Income and Capital, Commentary on Art 5, para 40.

57 Notice of Withdrawal, IT 2218 (May 22, 2002); Woellner, *op cit*, fn 29, 1037-38.

58 Partners that are companies (in this case Oz Co and Oz Sub) are entitled to the ITAA 36 § 23AH branch profits exemption with respect to their interests in partnership foreign income that otherwise qualifies for the exemption. See ITAA 36 §§ 23AH(3), 90, 92(1); Deutsch, *op cit*, fn 52, at 1305; Woellner, *op cit*, fn 29, 1410. See also Art 4 of the 2002 protocol to the Australia-US Double Tax Agreement. There are no exemption qualification issues regarding Pship's income that is paid to Oz Co for services except for the requirement that the income be subject to tax in a listed country. See ITAA 36 § 23AH(1)(d). As noted in the text, the one-fourth of Pship's income that is paid to Oz Co for services bears no US tax. If, however, it had not been deducted as a business expense for US purposes, it would have been taxed by the US as part of Pship's net profits at the regular 35% US rate. This is significant because in TD 96/38, paras 2 and 3 (1996), the Commissioner held that income is considered subject to tax in a listed country where, but for a generally available deduction under the law of the listed country, the income would have been taxed in the listed country. The one-fourth of Pship's income that is paid to Oz Co for services satisfies this test. Accordingly, the branch profits exemption is available with respect to this income.

scenarios is the more likely? In *Poole and Dight v FC of T*,⁵⁹ it was held that a partnership's rent payments to a partner for the use of real property were rental income to the partner and not part of his interest in the partnership's income. In other words, the rent payments were treated like Pship's interest payments to Oz Co, above. Because the royalties paid by Pship to Oz Co are for the use of Oz Co's intangible property, they are analogous to the partnership's rent payments in *Poole and Dight*. Accordingly, it seems probable that the royalties will be treated like Pship's interest payments for Australian tax purposes, and that the worst-case scenario described above will apply.

- 5 If Oz Co had operated the US business through a branch, the branch's net income would likely have been calculated for US and Australian purposes with a deduction for the interest payments,⁶⁰ with a deduction for the services payments that was limited to Oz Co's actual cost for providing the services – rather than their market value⁶¹ – and with no deduction for the royalty payments.⁶² The net income thus computed would have been eligible for the Australian branch exemption,⁶³ but would have borne a 35% US tax⁶⁴ plus a 5% US branch profits tax,⁶⁵ neither of which would be creditable in Australia.⁶⁶
- 6 If Oz Co had operated the US business through a wholly-owned US corporation, and had repatriated all of the US income by receiving dividends, the dividends paid to Oz Co would have been exempt for Australian purposes.⁶⁷ They would, however, have been paid entirely out of profits which incurred a non-creditable⁶⁸ 35% US tax and, after the dividend withholding tax provisions of the 2002 Protocol to the Australia-US Double Tax Agreement become effective, the dividends would bear a

59 (1970) 122 CLR 427; 70 ATC 4047.

60 See TR 2001/11, paras 3.42–3.43 (2001). The amount of the deduction for a permanent establishment's interest expense is the subject of a dispute under US law that is outside the scope of this paper. Compare Rev Rul 89–115, 1989–2 CB 130, with *National Westminster Bank v United States* 99–2 USTC (CCH) ¶ 50, 654 (Ct of Fed Cls 1999). See also Jessica L. Katz, *Treaties and Interest Expense Allocation: Moving in a Natwesterly Direction* 86 Tax Notes 403 (2000).

61 See TR 2001/11, para 3.38 (2001); Staff of Senate Finance Committee, Senate Executive Rept. No. 98–16, 1986–2 CB 229, 236; 4 Joseph Isenbergh, *International Taxation* 103:27 – 103:28 (3d edn, 2002). See also American Law Institute, *Federal Income Tax Project, International Aspects of United States Income Taxation II: Proposals of the American Law Institute on United States Income Tax Treaties* 210–11 (1992).

62 See TR 2001/11, para 3.38 (2001); US Treas Dept, *United States Model Income Tax Convention of 20 September 1996*, Technical Explanation 32–33. See also American Law Institute, *Federal Income Tax Project, International Aspects of United States Income Taxation II: Proposals of the American Law Institute on United States Income Tax Treaties* 210–11 (1992).

63 See ITAA 36 § 23AH.

64 See Australia-US Double Tax Agreement, Art 7.

65 See fn 47.

66 See text fns 34–41.

67 See ITAA 36 § 23AJ; Woellner, *op cit*, fn 29, 1411–12.

68 See Woellner, *op cit*, fn 29, 1412, 1443.

non-creditable 5% US dividend withholding tax, unless Oz Co satisfied certain stock exchange listing requirements, in which case there would be no US withholding.⁶⁹

- 7 If Oz Co had operated the US business through a wholly-owned US corporation, and had repatriated the US income by having the US corporation make deductible payments to Oz Co of interest, royalties and fees for services, the branch profits exemption would not be available with respect to the fees received by Oz Co because they would not be income of a business carried on by Oz Co, at or through an Oz Co permanent establishment located in the US.⁷⁰ Thus, the deductible fees would escape the 35% US corporate profits tax but would bear the 30% Australian tax. The tax consequences for the interest payments would be as outlined in paragraph 2 of the tax consequences discussion, above, and the tax consequences for the royalty payments would be the same as stated for the worst-case scenario in paragraph 4, above, because the branch profits exemption would clearly be unavailable.

Accordingly, the 'second structure' outlined above for Oz Co is better than the alternatives. Moreover, it is an attractive approach for Australian lawyers to present to Australian clients because it provides that there is no tax on Oz Co's services compensation and only a 30% tax on the interest and royalties (with a remote chance that there will be only a 5% tax on the royalties).⁷¹

From the above comparison of the 'second structure' with the other alternatives available to Oz Co, it is clear that Oz Co has two routes to achieving the Australian branch profits exemption for the one-fourth of Pship's income received by Oz Co as fees for services. Those alternatives are the 'second structure' or a directly-owned US branch.⁷² It is also clear that the superiority of the 'second structure' over the directly-owned US branch is that the 'second structure' reduces US tax vis à vis the directly-owned US branch. The 'second structure' does not lower Australian taxes vis à vis the directly-owned branch. Hopefully, these facts will protect the 'second structure' against an attack under the Australian general anti-avoidance rule.⁷³

69 See 2002 Protocol to Australia-US Double Tax Agreement, Art 6.

70 See ITAA 36 § 23AH(1)(b); Woellner, *op cit*, fn 29, at 1408. Moreover, ITAA 36 § 23AH(3), which passes the branch profits exemption through a partnership to the partners, would be inapplicable because, in this scenario, the business is carried on by a corporation.

71 The hybrid entity rules of IRC § 894(c) and the Regulations thereunder have no effect on these conclusions. See Angela W Yu and Cleve Lisecki, *Recharacterization of Payments by Domestic Reverse Hybrid Entities* 27 Tax Notes Int' 1 1399 (2002).

72 See text at fns 60–66.

73 This rule is found in ITAA 36 §§ 177A–177H.