D. Recommendations Relating to International Tax Issues

1. Modify the rules for allocating subpart F income[19]

Treasury regulations contain highly mechanical rules for allocating the earnings and profits of a controlled foreign corporation for subpart F purposes. Special allocation abuses similar to those that have been encountered in the partnership taxation area also are possible in the context of controlled foreign corporations under these rules. In particular, a company may attempt to specially allocate subpart F income to tax-indifferent parties. The Joint Committee staff believes that this tactic is inconsistent with the purposes of subpart F and that the results that it purports to produce are inappropriate. The Joint Committee staff recommends adding an exception to the mechanical allocation method set forth in the regulations for cases involving allocations of earnings and profits to tax-indifferent shareholders made for tax-avoidance purposes.

2. Modify the interaction between the subpart F rules and the passive foreign investment company rules[20]

In 1997, Congress enacted rules to mitigate the complexity and uncertainty that arose when a foreign corporation met the definitions of both the controlled foreign corporation rules of subpart F and the passive foreign investment company rules, thus requiring shareholders to negotiate two sets of anti-deferral rules in connection with the same investment. The 1997 legislation largely eliminated this overlap by providing that a controlled foreign corporation generally is not treated as a passive foreign investment company with respect to a "U.S. shareholder" of such controlled foreign corporation within the meaning of subpart F. Because this exception from the passive foreign investment company rules is based on a person's status as a U.S. shareholder, as opposed to the person's likely taxability under subpart F, situations may arise in which a U.S. shareholder of a controlled foreign corporation with mainly passive assets and passive income can take the position that no tax liability arises under either subpart F or the passive foreign investment company rules.

The Joint Committee staff believes that the exception to the passive foreign investment company rules for U.S. shareholders of controlled foreign corporations should be geared more closely to the U.S. shareholder's potential taxability under subpart F, as opposed to mere status as a U.S. shareholder within the meaning of subpart F. Accordingly, the Joint Committee staff recommends adding an exception to the 1997 overlap-elimination rule for cases in which the likelihood that a U.S. shareholder would have to include income under subpart F is remote.

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[19] Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of this Report.

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3. Strengthen the earnings stripping rules[21]

The lack of final regulations under the earnings stripping tax rules has created a void in an area in which more definitive guidance is needed. Proposed regulations provide that entities or arrangements established with a principal purpose of avoiding the earnings stripping rules should be recharacterized or disregarded. The Joint Committee staff believes that this proposed anti-abuse rule would change a company's cost-benefit assessment of certain tax-motivated transactions, and thus recommends that the rule be finalized expeditiously.

4. Require annual information reporting with respect to disregarded entities[22]

Present law requires no ongoing information reporting with respect to entities that are disregarded pursuant to a "check the box" entity classification election. Although the IRS is alerted of the existence and classification of each entity at the time the election is made, there is no regime of ongoing information reporting with respect to these entities. On the one hand, this lack of separate information reporting may be appropriate, given that the entities are supposed to be "disregarded" for Federal tax purposes pursuant to the election. Nevertheless, it is widely recognized that the application of the "check the box" regulations in the international setting raises a number of issues that the IRS is addressing through guidance and on audit.

The Joint Committee staff believes that a regime of annual information reporting with respect to entities disregarded pursuant to a "check the box" election would significantly enhance the IRS's ability to administer the international tax rules and to identify and address specific issues that arise in applying the "check the box" regulations in the international area.

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[21] Further discussion of this recommendation is provided in the description of the transaction known as Project Apache in Part Three of this Report.

[22] Further discussion of this recommendation is provided in the description of Enron's use of foreign entities in Part Three of this Report.