1986

Tax Reform Act of 1986: Summary of Selected Foreign Tax Provisions

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I. Taxation of Foreign Subsidiaries

A. Controlled Foreign Corporation

Under present law, U.S. persons owning at least 10 percent of the stock (U.S. shareholders) of a foreign corporation in which such U.S. shareholders or related persons hold more than 50 percent of the voting stock (controlled foreign corporation or CFC) must include in gross income their ratable share of the CFC's income from certain activities defined in subpart F of the Internal Revenue Code (subpart F income). I.R.C. §§ 951, 957. Present law arguably allows U.S. shareholders to avoid recognizing subpart F income by limiting their voting stock ownership in foreign corporations even though they hold dominant equity positions. The Tax Reform Act of 1986 (the Act) now defines a CFC as any foreign corporation in which U.S. shareholders or related persons hold more than 50 percent of the stock as measured by either voting power or value. Act § 1222(a).

B. Includible Income

1. Foreign Personal Holding Company Income

The foreign personal holding company income (FPHCI) of a controlled foreign corporation (a type of subpart F income includible in the income of its U.S. shareholders) includes such types of passive income as dividends, interest, royalties, rents, and gains on stock, securities, or regulated commodities. The Act expands the definition of FPHCI to subject more types of passive income to U.S. taxation as well as to reach passive income earned in active businesses conducted offshore.

a. Active business exception

Present law does not include in FPHCI the dividends, interest, and other passive income earned in the active conduct of banking, financial, or insurance businesses. I.R.C. § 954(c)(3). Those active business exceptions have prompted the proliferation of offshore banks and insurance companies to defer U.S. tax on easily diverted types of income. The Act repeals the active business exceptions except as applied to bank interest on export financing. Act § 1221(a)(1).

b. Rents

Under present law, FPHCI includes rents other than those received from a related person for the use of property located in the country of the lessor's incorporation. I.R.C. §§ 954(c)(2) and (4)(C), 553(a)(7). Thus, a foreign subsidiary created to hold rental property can shelter income from U.S. taxation in some cases. The Act includes all rents in FPHCI unless they are derived in the active conduct of a trade or business and received from an unrelated person. Act § 1221(a)(1).

c. Property gains

Present law includes in FPHCI non-dealer gains from the sale or exchange of stock or securities. I.R.C. §§ 954(c), 553(a)(2). The Act extends the same treatment to all gains from the sale or exchange of any property that yields passive income or no income. Act § 1221(a)(1). The provision reaches dealers as well as CFCs that have invested in metals or other property for appreciation.

d. Commodity gains

Present law treats gains from certain commodity futures transactions as FPHCI. I.R.C. §§ 954(c), 553(a)(3). The ambiguous language of the law has invited abusively narrow constructions, so the Act sweeps net gains on all commodities transactions into FPHCI unless they arise from an active commodity trading business or bona fide hedging. Act § 1221(a)(1).

e. Certain foreign currency gains

Foreign currency generally is a commodity for purposes of the FPHCI rules, but net foreign currency gains from transactions in certain financial assets and liabilities (such as a debt denominated in a nonfunctional currency or a forward contract marked to market) are not FPHCI if directly related to the CFC's business needs.

f. Related party exception

Under present law, dividends, interest, rents, and royalties are not FPHCI if the payor is a related party organized and devoting a substantial part of its assets to an active business in the same country as the recipient. I.R.C. § 954(c)(4). The Act narrows that exception in several ways, most notably by withdrawing it whenever the payment reduces the payor's subpart F income. Act § 1221(a)(1).

2. Insurance Income

Although income from the insurance of U.S. risks is included in subpart F income under present law, I.R.C. §§ 952(a)(1), 953, taxpayers have used a variety of planning techniques to establish offshore insurance companies that escape taxation of both premium and investment incomes. The Act broadly attacks such arrangements.

a. Insurance income defined

The Act first expands the definition of subpart F income to include a CFC's "insurance income," which the Act defines as any taxable income from insuring or reinsuring risks outside the CFC's country of incorporation. Act § 1221(b)(1).

b. Captive insurance companies

The Act then takes direct aim at captive insurance companies, offshore entities which are formed to insure their own shareholders. Act § 1221(b)(2).

i. Captive insurer. The Act's special rules do not apply unless (A) the offshore entity's primary insureds own at least 20 percent of its stock (measured by voting power and value) and (B) "related person insurance income" represents at least 20 percent of the entity's insurance income for the year. The rules will apply to mutual companies under regulations. Id.

ii. Related person insurance income. The Act's captive insurance rules apply only to "related person insurance income," which is income from insuring or reinsuring the insurer's shareholders or related persons. Id.

iii. U.S. shareholder redefined. Under present law, a U.S. person owning stock in a captive insurer would not recognize any of the captive's insurance income unless the person owned at least 10 percent of the captive's voting stock. I.R.C. §§ 951(b). The Act now requires a U.S. person owning any of the captive's stock to recognize a share of the captive's related person insurance income. Act § 1221(b)(2).

iv. Election to come ashore. A captive insurer can avoid application of the rules just described by electing to subject its related person insurance income to U.S. taxation. Electing entities will be able to claim the same tax benefits as U.S. insurers, such as net operating loss treatment for bad years.

3. Shipping Income

Under present law, a CFC's subpart F income from shipping generally does not include any amounts reinvested in its offshore shipping operations. I.R.C. § 954(b)(2). The Act repeals that provision. The Act also broadens the definition of subpart F shipping income to include income from space or ocean activities (as defined in the new sourcing rules discussed at page 8 below). Act § 1221(c).

4. Related Party Income

Subpart F income includes income from sales and service transactions involving related persons. I.R.C. § 954(d) and (e). Since partnerships controlled by a CFC or its shareholders are not treated as related persons under present law, taxpayers have been able to arrange related party transactions outside the ambit of the rules. The Act broadens the definition of related persons to include partnerships, trusts, and estates controlled by the CFC or the same persons who control the CFC. Act § 1221(e).

5. Under-Taxed Income

Subpart F income does not include any item of income if the CFC receiving it is "not availed of to reduce taxes." I.R.C. § 954(b)(4). Under present law, that test involves a comparison of the effect tax rate applicable to the income item in the country where the CFC is resident with the effective tax rate that would apply in the country where the income item is earned if the CFC were resident there. Treas. Reg. § 1.954-1(b)(4). The Act now requires taxpayers claiming the exception to show that the income incurred foreign tax at an effective rate greater than 90 percent of the highest applicable U.S. rate. Act § 1221(d).

6. Deficit Offsets

Under present law, a CFC's subpart F income cannot exceed its earnings and profits as reduced by accumulated deficits. I.R.C. § 952(c). The so-called chain deficit rule further reduces a CFC's subpart F income by the deficits of its subsidiaries. Id. § 952(d). The Act repeals the chain deficit rule. The Act also repeals provision for the accumulated deficit offset, except in the cases of deficits specifically allocable to shipping income, oil-related income, insurance income, and FPHCI. Act § 1221(f).

7. De Minimus Rule

Present law allows a CFC to earn modest amounts of subpart F income before any of its gross income becomes includible in the incomes of its U.S. shareholders. I.R.C. § 954(b)(3). The Act reduces the de minimus threshold from 10 percent of the CFC's gross income to the lesser of 5 percent or $1 million. Act § 1223.

C. Dividends Received Deduction

If a foreign corporation earns at least half of its gross income from a U.S. business, a U.S. corporation receiving dividends from the foreign corporation may claim the generally available 85 percent dividends received deduction on the portion of the dividend equal to the ratio that the payor's U.S. gross income bears to its total gross income. The 100 percent dividends received deduction also is available if a wholly-owned foreign subsidiary's entire gross income is from a U.S. business. I.R.C. § 245. The Act reduces the generally available 85 percent dividends received deduction to 80 percent. Act § 611. The Act also modifies the deduction as applied to dividends from foreign corporations by (1) allowing it only to shareholders with at least a 10 percent interest and (2) extending it to the portion of a dividend paid out of dividends received from a controlled U.S. subsidiary. No deemed foreign tax credit is to be allowed for foreign taxes on the U.S. source portion of deductible dividends. Id. § 1226.

II. Sources of Income

Present law contains a system of rules for determining whether income is from foreign or U.S. sources. I.R.C. §§ 861-864. Since U.S. corporations must pay U.S. tax on their income from all sources, the source of a U.S. corporation's income simply determines the size of its foreign tax credit limitation. A U.S. corporation's foreign tax credit limitation is the proportion of the corporation's U.S. tax equal to the proportion of its taxable income attributable to foreign sources. Id. § 904(a). In the case of a foreign corporation not engaged in U.S. business, however, the source of its income generally determines whether that income is subject to U.S. taxation. Id. §§ 881-884. The Act makes very significant changes in the source rules of present law. Act §§ 1211-1216.

A. Sales of Personal Property

Under present law, income from the resale of personal property generally is sourced where title passes to the purchaser. I.R.C. §§ 861(a)(6), 862(a)(6). Income from the sale of manufactured personal property is sourced in both the place of manufacture and the place of sale, usually on a 50/50 basis. Id. § 863(b). Since the title passage rules have permitted substantial manipulation, the Act sets out a more particular system. Act § 1211.

1. General Rule

Except as otherwise provided, income from the sale of personal property is sourced at the seller's residence.

2. Inventory Property

Income from the sale of purchased or manufactured inventory property continues to be sourced as it is under present law. The rule aims to preserve the benefit of present law for exports.

3. Depreciable Property

Gain not in excess of the depreciation claimed on depreciable personal property is allocated between U.S. and foreign sources in the same proportion that U.S.

depreciation adjustments bore to total depreciation adjustments. The rule ensures that recapture income has a U.S. source.

4. Intangibles

If income from the sale of intangibles is contingent on the use, productivity, or disposition of the property, then the contingent payments are sourced like royalties (based on the location of the property).

5. Stock of Affiliates

A U.S. resident's gain from selling the stock of a foreign affiliate is foreign source income if the affiliate actively engages in business abroad and the sale occurs in the foreign country where the affiliate earns most of its gross income.

6. Fixed Placed of Business

A U.S. resident's income from sales attributable to a fixed place of business outside the U.S. and not sourced under the specific rules above is foreign source income if a foreign tax of at least 10 percent is paid on the income. A foreign resident's income from sales attributable to a fixed place of business in the U.S. is U.S. source income in most cases unless (a) the property is inventory sold for use outside the U.S. with the material participation of a foreign office or (b) the income is subpart F income.

B. <u>Transportation Income</u>

Present law allocates income from transportation touching foreign points in proportion to the U.S. and foreign expenses incurred in providing such transportation. Treas. Reg. § 1.863-4. Under present law, the U.S. does not tax a foreign person's income from ships and aircraft registered in foreign countries that grant reciprocal exemptions to U.S. persons. I.R.C. § 883(a). The Act provides that income from transportation between U.S. and foreign points is to be allocated equally between U.S. and foreign sources. Act § 1212(a). The reciprocal exemption for the transportation income of foreign persons doing business in the U.S. now depends upon the reciprocity offered by the foreign person's country of residence.

Id. § 1212(c). Finally, the Act imposes a 4 percent tax on a foreign person's gross transportation income from U.S. sources. The 4 percent tax applies even to income effectively connected with a U.S. business, unless the foreign person is a common carrier earning the income through a fixed place of business in the U.S. Act § 1212(b).

C. Income from Space and Oceans

Income from activities in space or on the high seas generally is treated as foreign source income under present law. The Act contains an entirely new provision that generally sources such income at the recipient's residence. A special exception equally divides a U.S. person's international communications income between foreign and U.S. sources. The Act sources in the U.S., however, a foreign person's international communications income from a fixed place of business in the U.S.

D. Dividend and Interest Income

1. Dividend Income

Present law treats dividends received from a U.S. corporation deriving less than 20 percent of its gross income from U.S. sources (an 80-20 company) as foreign source income. I.R.C. § 861(a)(2). Through the use of such 80-20 companies, U.S. multinationals have been able to enhance their foreign tax credit limitations. The Act undermines this planning technique by providing that all dividends received by a U.S. person from U.S. corporations (other than certain companies operating in U.S. possessions) are U.S. source income. Act § 1214(b). The Act preserves a modified version of the old rule for foreign persons, providing for a look-through to the source of the payor's income. Id. § 1214(c).

2. Interest Income

a. 80-20 Companies

Interest received from 80-20 companies continues to be treated as foreign source income under the Act. I.R.C. § 861(a)(1)(B); Act § 1214(a). But the Act attacks past abuses by adopting a look-through rule for interest received by related persons. Id.

b. Deposits

A foreign resident's interest on U.S. deposits not effectively connected with a U.S. business long has been treated as foreign source income. I.R.C. § 861(a)(1)(A). The purpose of that illogical provision was to exempt such interest from U.S. withholding taxes. The Act repeals the provision and then provides a withholding tax exemption for a foreign resident's U.S. source income from deposits. Act § 1214(c).

E. Expense Allocations

Present law provides for the allocation of interest and other expenses between foreign and U.S. source gross income on a company-by-company basis. Treas. Reg. § 1.861-8. Thus, companies in an affiliated group can reduce deductions offsetting foreign source income by placing expenses in companies that earn only U.S. source income. Other provisions in present law present opportunities for minimizing the amount of expenses allocated against foreign income. The Act makes major reforms in this area. Act § 1215.

1. Interest Expense

Under the Act, the interest expense of each member in an affiliated group is allocated and apportioned as if all members of the group were one corporation. Allocations and apportionments must be on the basis of assets rather than gross income. The basis of tax-exempt assets is excluded, and the basis of stock in at least 10-percent owned companies not in the affiliated group (i.e. foreign subsidiaries) is increased by the earnings and profits accumulated during the taxpayer's holding period. Financial institutions in a group can allocate interest expenses separately among themselves if their predominant business is with unrelated persons. Since the new interest apportionment rules will have a dramatic impact on many companies, the Act contains elaborate transitional rules generally phasing in the changes over 3 to 5 years.

2. General Expenses

Expenses other than interest not directly allocable to specific income also are to be allocated and apportioned across the affiliated group. Regulations are to provide for resourcing income and apportioning interest and other expenses among the categories of income subject to separate foreign tax credit limitations (see III(A) below).

3. R&D Expenses

Half of all expenses for research and development done in the U.S. is allocable to U.S. source income, and the balance is to be apportioned on the basis of gross sales.

III. Foreign Tax Credits

A. Separate Limitations

The amount of foreign taxes that a taxpayer can credit against its U.S. tax liability is limited to the portion of its U.S. tax liability equal to the portion of its taxable income received from foreign sources. I.R.C. § 904. That foreign tax credit limitation is computed on a so-called overall basis (rather than country-by-country), but certain categories of income are subject to separate limitations. The separate limitations are intended (1) to prevent cross-crediting of high foreign taxes against income that generally bears low foreign taxes and (2) to discourage the expatriation of income that easily can be diverted to a foreign source in order to inflate the overall foreign tax credit limitation. The Act significantly expands the number of income categories subject to separate foreign tax credit limitation. Act § 1201(a) and (b).

1. Passive Income

The separate limitation for passive interest income in present law has been expanded to include all passive income, which generally includes any income of a type that would be FPHCI (see page 1 above). The Act makes an exception for (a) interest from financing exports, (b) high-taxed income which bears foreign taxes at a rate higher than the U.S. rate (the so-called "high-tax kick-out"), and (c) oil and gas extraction income.

2. High Withholding Tax Interest

Interest bearing a foreign withholding tax of at least 5 percent is subject to separate limitation, again with an exception for export financing interest. Important transition rules mitigate the otherwise dramatic effect of this rule on U.S. lenders to many developing nations. In the case of noncontrolled foreign corporations, withholding taxes on interest at rates over 5 percent are eliminated entirely for deemed foreign tax credit purposes.

3. Financial Services Income

Income from active banking, financing, or insurance businesses is subject to separate limitation, but an entity predominantly engaged in such businesses can aggregate all of its passive income under this limitation. Export financing again is excepted from the separate limitation.

4. Shipping Income

Shipping income of a kind that would be subpart F income falls under a separate limitation.

5. Dividends from Non-CFCs

Dividends from each foreign corporation in which the U.S. recipients own between 10 and 50 percent of the stock are subject to a separate limitation. In other words, a company-by-company limitation applies to prevent cross-crediting of taxes between noncontrolled entities. No look-through rule applies.

6. Look-Through Rules

Dividends, interest, rents, and royalties received by U.S. shareholders from controlled foreign corporations are subjected to separate limitations to the extent allocable to the CFCs' income in separate limitation categories. Subpart F inclusions generally are subject to the same look-through rules, with special rules that prevent the use of CFCs to blend high withholding tax interest or dividends from certain other foreign companies into the overall credit limitation. Furthermore, interest paid by a CFC to its U.S. shareholders is treated as allocable to the CFC's passive income. Act § 1201(c).

B. Deemed-Paid Credits

Under present law, a U.S. corporation holding at least 10 percent of a foreign company's voting stock generally can claim a so-called deemed-paid foreign tax credit for a ratable portion of the foreign taxes that the foreign company paid on the earnings out of which any dividend is paid or subpart F income is imputed. I.R.C. §§ 902, 960. Such dividends or subpart F amounts are treated as coming first from the earnings and profits of the current year and then from the earnings and profits of the most recent year for which the company still has undistributed earnings and profits. Dividends paid within 60 days after the end of a tax year are deemed to come from the earnings and profits of the year just ended. The Act fundamentally alters the calculation of deemed-paid credits by abolishing the vintage year method and treating all dividends as paid from a pool containing all earnings and profits accumulated since 1986. Act § 1202.

C. Foreign Loss Recapture

Under present law, a taxpayer can use a foreign-source loss in any foreign tax credit limitation category to reduce its U.S. source taxable income. In order to recapture the benefit of the foreign loss, foreign source income in succeeding years is recharacterized as U.S. source income in an amount equal to the loss. I.R.C. § 904(f). The Act provides that foreign losses in separate limitations ratably must reduce foreign source income in other separate limitations before they reduce U.S. source income. Foreign source income in subsequent years is recharacterized as U.S. source income only if it is in the same limitation category as the previous loss. Act § 1203.

D. Tax Subsidies

Treasury regulations provide that a foreign tax used to provide a direct or indirect subsidy to the taxpayer or a related person is not creditable. Treas. Reg. § 1.901-2(e)(3). The Act codifies the regulation and extends it to subsidies for any party to the transaction or a related transaction. Act § 1204.

IV. Treatment of Foreign Taxpayers

A. Branch-Level Tax

Under present law, amounts remitted to a foreign corporation by its U.S. branch are not subject to U.S. withholding tax. Instead, dividends and interest paid by the foreign corporation are subject to U.S. withholding tax (the second-level withholding tax) if at least 50 percent of the payor's gross income for a 3-year period is effectively connected with the U.S. business. I.R.C. §§ 861(a)(1)(D), (2)(B), 871(a)(1), 881(a). The second-level withholding tax applies only to the portion of the dividend or interest payment attributable to the payor's effectively-connected income. Id. Thus, a foreign corporation with U.S. operations typically can reduce its U.S. income and withholding tax burden by operating through a branch rather than a U.S. subsidiary. The Act aims to eliminate the inequality between branch and subsidiary tax treatment by replacing the second-level withholding tax with a direct tax on the profits remitted and the interest paid by a foreign corporation's U.S. branch. Act § 1241. Like the withholding tax on remittances to foreigners, the new branch-level tax (the BLT) is imposed at the flat rate of 30 percent even though the Act has reduced the rate on net income to about the same level. The rate is reduced in many cases by treaty.

1. Branch Profits Tax

The Act subjects a U.S. branch's post-1986 unreinvested current or accumulated earnings and profits (E&P) attributable to its U.S. business to a tax at the applicable withholding rate (generally 30-percent tax unless reduced by treaty). The amount considered unreinvested in any taxable year is the U.S. branch's current or accumulated E&P (a) decreased by any increase in the U.S. branch's net equity and (b) increased by any reduction in its net equity. The Act excludes from the BLT the earnings from the sale of an interest in a U.S. real property holding corporation and earnings of certain captive offshore insurance companies that elect to be treated as engaged in a U.S. business. The second-level withholding tax continues to apply where a treaty precludes imposition of the BLT.

2. Branch-Level Interest Tax

The Act treats any interest paid by a U.S. branch to a foreign recipient as U.S.-source income subject to gross-basis taxation at the applicable withholding rate (generally 30 percent unless reduced by treaty). If interest expense in excess of the interest actually paid is allocated to the branch for U.S. tax purposes, the excess interest also is subject to the BLT. Regulations will deal with situations where indebtedness of the home office is attributed to the branch and with actual debtor-creditor relationships between a branch and a home office or between branches.

3. Treaty Shopping

The Act generally permits existing U.S. income tax treaties to reduce or eliminate the BLT and the second-level withholding tax on dividends, except in cases of treaty shopping. Treaty shopping is considered to occur where (a) the recipient of the income is not a "qualified resident" of the treaty country and (b) the treaty does not permit a second-level withholding tax on dividends. A foreign corporation is not a qualified resident of a treaty country if (a) persons not taxable in the treaty country or the U.S. own more than 50 percent (by value) of the corporation's stock or (b) at least 50 percent of the corporation's income goes to meet liabilities to such persons. In any case, a company whose stock regularly is traded on an established market in the treaty country is a qualified resident.

4. Other Rules

a. Second-level withholding tax

The Act repeals the second-level withholding tax on interest and keeps the second-level withholding tax on dividends only for cases where treaty obligations preclude imposition of the BLT. The Act also reduces present law's threshold for imposition of the second-level withholding tax so that foreign companies are subject to the tax if at least 25 percent (rather than 50 percent) of their incomes are effectively connected with a U.S. business.

b. Back-to-back loans

The legislative history of the Act indicates concern that the BLT on interest may lead to increased use of back-to-back loans by nontreaty country residents and improper characterization of interbranch loans by both treaty and nontreaty country residents. Conference Report at 650. The legislative history endorses the IRS's current position that back-to-back loans may be collapsed even though the terms of the loans do not match precisely. Id.; see Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383.

B. Retain Character of Effectively-Connected Income

Under current law, foreign persons may avoid U.S. tax if they receive income earned by a U.S. business or dispose of U.S. business property at a gain in a year after the business has ceased to exist. See I.R.C. §§ 871(b), 882. Under the Act, such income is subject to U.S. income tax if it would have been effectively connected with a U.S. business had it been received before the business ceased. Gain from the sale of an asset used in a U.S. business is considered effectively-connected income if the asset is sold within 10 years after the business ceases. Act § 1242(a).

C. Reporting by Foreign-Controlled Corporations

Under present law, foreign-controlled corporations doing business in the U.S. and foreign-controlled U.S. corporations are required to report transactions with related foreign corporations. I.R.C. § 6038A. The Act requires such corporations to report transactions with any related foreign person, regardless of whether the foreign person is a corporation. The Act defines a related person as any person who is related to the reporting corporation under I.R.C. sections 482, 267(b), or 707(b)(1). Act § 1245(b).

D. Foreign Investors in Partnerships

Under present law, foreign persons who invest in partnerships generally are not subject to U.S. withholding tax on either partnership distributions or their distributive share of the partnership's income except to the extent that the partnership has (1) U.S.-source fixed or determinable income that is not effectively connected with a U.S. business or (2) gain from the disposition of a U.S. real property interest. Treas. Reg. § 1.1441-3(f);

Temp. Treas. Reg. § 1.1445-5T(c). The Act generally requires any partnership engaged in a U.S. business to withhold 20 percent of amounts distributed to a foreign partner that would not otherwise be subject to withholding. If less than 80 percent of the partnership's gross income over the 3 preceding taxable years was effectively connected with a U.S. business, only the effectively-connected portion of any distribution is subject to withholding. The withholding tax generally does not apply if substantially all of the U.S.-source and effectively-connected income is allocated to U.S. persons. Act § 1246.

E. Income of Foreign Governments

Present law subjects foreign governments and governmental entities to U.S. tax on income from commercial activities in the U.S., but not on U.S.-source investment income. I.R.C. § 892; Treas. Reg. § 1.892-1. The Act expands the definition of commercial activity to include ownership of a controlling interest in an entity engaged in commercial activity anywhere in the world. Act § 1247(a).

F. Transfer Prices for Imports

Importers presently may claim a transfer price for income tax purposes that is higher than the value claimed for customs purposes. See Brittingham v. Commissioner, 66 T.C. 373 (1976), aff'd, 79-2 U.S.T.C. ¶ 9499 (5th Cir. 1979). The practice artificially reduces the importer's U.S. income on resales. The Act prohibits the practice. Act § 1248(a). Regulations will attempt to coordinate customs and tax valuation principles.

G. Dual Resident Companies

Under present law, a U.S. corporation with a tax loss that is resident in a foreign country for purposes of that country's income tax law may be included in consolidated income tax returns with profitable companies in both the U.S. and the foreign country. See I.R.C. § 1504. Such a dual resident company thereby obtains the benefit of a deduction in both countries. The Act provides that the tax losses of a U.S. corporation taxed as a resident abroad generally cannot reduce the taxable income of any other member of a U.S. affiliated group. Act § 1249(a). Regulations may exempt a dual resident corporation from the loss limitation rule to the extent that its losses do not offset the income of foreign corporations for foreign tax purposes.

V. Foreign Currency Gains and Losses

A. Adoption of Functional Currency Concept

Under present law, there are no statutory rules for determining either the amount or the timing of gain or loss generated by fluctuations in the rate of exchange between currencies. The Act establishes a statutory scheme for foreign currency transactions based on a "functional currency" concept. Act § 1261(a). Except as otherwise provided, a taxpayer's functional currency is the U.S. dollar. Exchange gain or loss on transactions denominated in a currency other than the taxpayer's functional currency generally is recognized for U.S. income tax purposes on a transaction-by-transaction basis.

1. Business Entities

In the case of a qualified business unit (QBU), the taxpayer must account for the results of operations by measuring income or loss in the QBU's functional currency. A QBU is any separate and clearly identified unit of a taxpayer's active trade or business that maintains separate books and records. The functional currency of a QBU is the currency (a) used in keeping the QBU's books and records and (b) in which the QBU conducts a significant part of its activities. The QBU's functional currency is the U.S. dollar if (a) no currency satisfies the functional currency requirements or (b) the QBU's activities are primarily conducted in U.S. dollars.

2. Election to Use U.S. Dollar

A taxpayer may elect to use the U.S. dollar as the functional currency of a QBU only to the extent provided by regulations. The election generally will be available only for QBUs operating in hyperinflationary economies where local currency accounting may not reflect accurately income and loss. Conference Report at 661-62.

3. Effect of Functional Currency Choice

The choice of a functional currency, including a dollar election, is an accounting election which may not be changed without the consent of the Secretary.

B. Foreign Currency Transactions

Under present law, foreign currency is treated as personal property for federal income tax purposes. Gain or loss from exchange rate fluctuation is accounted for separately from the gain or loss from any underlying transaction. The Act retains that rule for certain types of transactions denominated in a nonfunctional currency (section 988 transactions). The Act also resolves many of the issues relating to the treatment of foreign currency transactions that are unclear under current law.

1. Section 988 Transactions

A section 988 transaction is a transaction denominated in a nonfunctional currency (NFC) that fits one of the following descriptions: (a) acquiring a debt instrument or incurring an obligation under such an instrument; (b) accruing any item of expense, gross income, or receipts that is to be paid or received after the date upon which it is accrued; (c) entering into or acquiring any forward contract, futures contract, option, or similar financial instrument (if such instrument is not marked to market under section 1256); or (d) disposing of NFC. Foreign currency gain or loss on a section 988 transaction is calculated by multiplying the difference in exchange rates between the time an asset or liability is booked for U.S. income tax purposes (the "booking date") and the date it is disposed of or paid (the "payment date") by the number of units of functional currency originally booked by the taxpayer. The taxpayer recognizes foreign currency gain or loss, however, only to the extent of the total gain or loss from the entire transaction.

2. Treatment as Ordinary Income or Loss

Foreign currency gain or loss generally is ordinary income or loss. Regulations will provide that foreign currency gain or loss treated as ordinary income is to be characterized as interest income for certain purposes.

3. Hedging Transactions

If a section 988 transaction is part of a hedging transaction, regulations will provide for the integration of all transactions in the hedge for purposes of determining the character, source, and timing of income or loss. In the case of fully-hedged transactions where cash flows are insulated entirely from exchange rate fluctuation risks through offsetting currency rights and obligations, the regulations are to integrate such rights and obligations into a single transaction. (For example, fully hedged NFC borrowings are to be treated as dollar borrowings with dollar interest payments and are to be subject to the OID rules.) In cases where a taxpayer enters a transaction simply to reduce fluctuation exposure with respect to a particular currency, the regulations need not provide for complete integration.

4. Sourcing Rules

The source of foreign currency gain or loss generally is the residence of the taxpayer or QBU on whose books the item properly is reflected. A QBU's residence is the country of its principal place of business. An individual's residence is his "tax home" (as defined by I.R.C. § 911(d)(3)). In the case of any non-individual taxpayer (other than a QBU) that is a U.S. person, its residence is the U.S. In all other cases, the taxpayer's residence is outside of the U.S.

5. Transactions of a Personal Nature

The section 988 rules apply to an individual's transactions only to the extent that expenses attributable to such transactions would be deductible.

6. Tax Straddle Provisions

A tax straddle involves holding offsetting positions in actively-traded personal property so that the risk of loss with respect to such property is substantially diminished. I.R.C. § 1092. Given a straddle's potential for deferring income, present law limits deductions for loss on the disposition of a straddle to the amount by which the loss exceeds unrecognized gain inherent in the offsetting position. Id. These so-called mark-to-market rules also treat certain investment products (section 1256 contracts) as if they were sold at fair market value on the last day of the year. Id. § 1256. The tax straddle rules presently apply to most transactions undertaken to hedge foreign currency exposure, except those that satisfy the requirements of a special hedging exception. Id. §§ 1092(c), 1256(c). The Act exempts hedging transactions covered by the new foreign currency rules from the loss deferral and mark-to-market rules. In addition, the general rule that treats foreign currency gain or loss as ordinary income does not apply to a section 1256 contract.

C. Foreign Currency Translation

Under present law, a taxpayer operating abroad may maintain the foreign operation's books and records in a foreign currency. The method used to translate foreign operating results into U.S. dollars generally depends upon whether the activity is conducted through a branch or a subsidiary corporation. Under the Act, the same translation method applies to (1) the earnings and profits of a foreign corporation and (2) the income and loss of a branch or other QBU. Any entity using NFC to measure the results of its operations must use a profit-and-loss method to translate the income or loss into the functional currency.

1. Translation of Earnings and Profits

Under present law, the E&P of a CFC generally are calculated by adding the CFC's profit or loss to the exchange gain or loss determined by comparing year-end balance sheets (after taking account of the translated profit or loss and certain other items). I.R.C. § 964(a). The Act provides that a foreign corporation's E&P are determined in the corporation's functional currency and then translated into dollars at the appropriate exchange rate when such E&P is distributed or otherwise taken into account for U.S. tax purposes. In the case of an actual distribution, the appropriate exchange rate is the spot rate on the date when the dividend is included in income. In the case of deemed distributions of subpart F income, foreign personal holding company income, and passive foreign investment company income, however, the appropriate exchange rate is the weighted average exchange rate for the taxable year in question.

a. Foreign taxes

In determining the amount of foreign taxes deemed paid under I.R.C. §§ 902 or 960, foreign income taxes are translated into dollars using the exchange rate as of the time the taxes were paid.

b. Previously-taxed income

Foreign currency gain or loss may arise between the time when a U.S. taxpayer recognizes subpart F income and the time when the amount recognized actually is distributed. Any such gain or loss with respect to distributions of previously-taxed income is recognized as ordinary income or loss from the same source as the associated income inclusion.

2. Translation of Branch Income and Losses

Under present law, a foreign branch maintaining separate books in a foreign currency may use one of two methods to determine the U.S. taxable income attributable to it: (a) the profit and loss method or (b) the net worth method. See Rev. Rul. 75-107, 1975-1 C.B. 32 (profit and loss method); Rev. Rul. 75-106, 1975-1 C.B. 31 (net worth method). Under the profit and loss method, the net profit computed in the foreign currency is translated into dollars at the exchange rate in effect at the end of the taxable year. Under the net worth method, U.S. taxable income is the excess of the net worth of the branch for the year over that of the previous year. Current assets and liabilities are translated at the year-end exchange rate, while fixed assets are translated at the "historical rate" in effect when the asset was acquired. The Act effectively adopts the profit and loss method for a foreign branch that is a QBU using a functional currency other than the dollar. The taxpayer calculates the taxable income or loss of each QBU in its functional currency and then translates that income or loss at the weighted average exchange rate for the QBU's taxable year. Foreign income taxes paid by a QBU are treated like those paid by a foreign corporation.

VI. Other Rules Applicable to U.S. Possessions

The U.S. Virgin Islands, Guam, the Commonwealth of the Northern Mariana Islands, and American Samoa generally use the Code as it changes from time to time as their local tax code. For corporate tax purposes, the U.S. treats each of those possessions as a foreign country, and each possession treats the U.S. as a foreign country. That system of taxation has become known as the "mirror system." The Act generally modifies the mirror system applicable to the possessions to eliminate a number of potential abuses, including (1) the avoidance of both U.S. and possessions income tax through the use of corporations headquartered in the possession (see Danbury, Inc. v. Olive, 86-1 U.S.T.C. ¶ 9223 (D.V.I. 1986) and (2) the use of possessions corporations to avoid U.S. withholding tax on U.S.-source portfolio income.