ATTAINING U.S. EFFECTIVELY CONNECTED INCOME IN THE AFTERMATH OF THE AMERICAN JOBS CREATION ACT OF 2004 AND ITS AIM TO REPEAL EXTRATERRITORIAL INCOME EXCLUSION

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I. INTRODUCTION

Generally since 1921, under U.S. law, income has been taxed where it is sourced,[1] and the definitions pertaining to whether a business entity is foreign or domestic have been codified since 1924.[2] Comments regarding the American Jobs Creation Act ("the Act")[3] have already been exercised by leading tax professionals, including PriceWaterhouseCooper,[4] Deloitte & Touche,[5] and Ernst & Young;[6] the majority consensus precludes evolving beyond an emphasis on that aspect of inbound transfers derived from U.S. investments without the U.S., thereby acknowledging only glancing hits on United States sourced income. This type of analysis is one dimensional in light of the deliberate impact resulting from changes that provide incentives for the repatriation of foreign earnings. The more farsighted approach will take into account the policy route broached by the gist of the Act, that being to effect repeal of the Extraterritorial Income provisions previously applied in the codes and regulations while replacing them with tax cuts in other areas that would take the form of tax benefits for investments,

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1. *See* Revenue Act of 1921, Pub. L. 67-98, § 217, 42 Stat. 227, 243-245 (1921-1923).
2. *See* Revenue Act of 1924, Pub. L. 68-167, 43 Stat. 253 (1923-1925).
3. American Jobs Creation Act of 2004, Pub. L. 108-357, 118 Stat. 1418 (2004).
4. PricewaterhouseCoopers, *The American Jobs Creation Act of 2004*, TAX NOTES TODAY, Nov. 1, 2004, at 711.
5. Deloitte & Touche, *The American Jobs Creation Act of 2004,* 4 WORLD TRADE EXECUTIVE 10, 1 (2004).
6. Ernst & Young, *A Guide to the American Jobs Creation Act*, TAX NOTES TODAY, Oct. 18, 2004, at 339.

now qualitatively domestic. An apposite approach is represented in the Act as well, by a tightening of expatriation rules designed to restrict tax avoidance from occurring through the use of offshore operations.

However, it is by virtue of this fact that Effectively Connected Income (ECI) has many avenues for response to the provisions found within the Act, which has certainly turned out to be quite broad in its application. Note that in the larger picture ECI ultimately becomes outbound, and so, the concert with its solely domestic brethren becomes set. Like so many governmental endeavors, the oft-time sprawling breadth of the Act comes at no small cost. As its initial purpose is to repeal the exclusion for a portion of income earned by exporters (extraterritorial income), its political economic shading allows other forms of deductions for income attributable to production in the United States. However, it is now unimpeded on its course toward altering a plethora of laws affecting corporations, both domestic and foreign, as well as individual taxpayers, some special interests (chiefly tobacco production), and an extension of penalties available to combat outbound transfers through the use of abusive tax shelters. In short, this is the most comprehensive tax legislation since 1986. Of course, the bottom line as its title indicates, is to create jobs expressly through U.S. reinvestment, but obliquely its end comeS through its impact on an ability to influence, attract, retain, and generate U.S. source income, and through those investments, whether of persons foreign or domestic, to again create jobs in America.

This paper seeks to propose the construction of ways to facilitate investment in the United States, a suggested mapping, if you will. To that point where U.S. source income is created, it becomes imperative to effect some balance and accomplish an offset regarding the projected decrease in federal revenues resulting from the provisions within the Act, estimated at net $14.5 billion through year 2009, $5.7 billion accounted for in 2005 alone.[7]

When approaching the task of doing business in the world's most lucrative market, measured by the numbers of productivity, consumers, and dollars, a global approach adds clarity to the goals it necessarily attaches. One of the foremost attainable goals derived under the Act is ultimately to enable populations of other countries an opportunity to interplay on a more equal economic standing with the biggest and most

7. ANNABELLE BARTSCH ET AL., CONGRESSIONAL BUDGET OFFICE COST ESTIMATE—H.R. 4520 AMERICAN JOBS CREATION ACT OF 2004, (Nov. 9, 2004), *available at* http://www.cbo.gov/showdoc.cfm?index=6007&sequence=0 (last visited January 7, 2005).

profitable corporations in the world, while remaining in accord with the United States tax code.[8]

When this formula is tied to an appropriate tax treaty, the foreign corporation is encouraged to "repatriate" that investment to its country of origin, ultimately producing some economic balance that could ideally result in global tax neutrality. In 1995, $95.8 billion of U.S. source income paid to foreign persons was reported by withholding agents.[9] Of this sum, $74.2 billion was tax exempt.[10] In comparison, statistics available for the year 1991 demonstrate total receipts of $109.6 billion derived from activities qualified as being "effectively connected" and income tax after credits of $810 million.[11] This is more than a two hundred percent increase over figures available from 1981, which show total income tax collected on net ECI to be $260 million.[12]

From an accounting perspective, a look at the Act reveals it to be comprised of tax cuts amounting to $137 billion over a ten year period structured as a convergence of three major elements addressing manufacturing activities, multinational business, and, to a lesser extent, certain "targeted areas of tax relief."[13] The tax relief – ascribed chiefly to U.S.-based manufacturing in the amount of $77 billion [14] – is the largest aspect of this wholly business-oriented legislation and represents the most direct impact on U.S.-sourced income as a class. The prescribed funding for the tax cuts should be traceable, in part, to the $49 billion from the repeal of the World Trade Organization (WTO)-imposed sanctions that had ruled on legislation emerging from the illegal aspect of the ETI Exclusion Act. This repeal prompted an amendment addressing the exclusion from the definition of gross income of "income derived from certain activities performed outside the United States. . . "[15]

8. *See generally*, The World Bank, *available at* http://www.worldbank.org (last visited November 9, 2004).

9. Data Release, Foreign Recipients of U.S. Income, 1995, 18 Stat. Income Bull. 136 (Summer 1998) (cited in BORIS BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INT'L TAXATION, ¶ 67.2.1, n.1. (Warren, Gorham, & Lamont) (2003/2004)).

10. *Id*.

11. SARAH NUTTER, STATISTICS OF INCOME STUDIES OF INT'L INCOME AND TAXES 162 (1999), *available at* http://www.irs.gov/pub/irs-soi/intstart.pdf (last visited May 11, 2006).

12. INTERNAL REVENUE SERV. PUB. NO. 267, STATISTICS OF INCOME: COMPENDIUM OF STUDIES OF INT'L INCOME AND TAXES at 311 (1979-1983).

13. Deloitte & Touche, *The American Jobs Creation Act of 2004; Overview of Key Domestic Provisions*, TAX POLICY SERVICES GROUP, Oct. 2004.

14. *Id.* The remainder of the tax relief originates from $43 billion in reforms to the taxation of multinational businesses and $10 billion ascribed approximately four dozen other items targeted business interests for tax relief. *Id.*

15. S. Rep. No. 106-416, at 5 (2000).

Since its formal inception to the Internal Revenue Code in 1966, the the phrase "effectively connected" has carried a special meaning. A brief chronological illumination of its meaning is offered here as part of the intended focus of this article.

II. LEGISLATIVE CHRONICLE OF ECI

A. The Revenue Act of 1962[16]

The Revenue Act of 1962, from which Subpart F income[17] would arise, is quite possibly the first act to embody a semblance of what would become income recognized as "effectively connected." This device came about as a method to target the deferral of income earned through a foreign corporation resulting from the tax codes separation of shareholder and corporation,[18] coupled with the lack of jurisdiction over foreign corporations.[19] The end result was that Subpart F bypassed direct impact on the corporate entity to apply to its shareholders, chiefly looking at closely-held corporations wherein the U.S. citizen was the owner of at least ten percent of the foreign corporation's voting power. The most overt goal was to eliminate deferral of "foreign base company (FBC) income" earned by controlled foreign corporations (CFC's) in tax-haven countries.[20] Previously, the benefit of this deferral could be illustrated as an example of the "time-value" of money, the equivalent of which here is the interest earned on the tax amount over the course of the deferral period.[21] FBC income includes profits from handling the sales of

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16. The Revenue Act of 1962, 12 U.S.C. § 1464 (1962).

17. I.R.C. § 952(a) (2006).

18. *See* Moline Properties, Inc. v. Comm'r, 319 U.S. 436, 439 (1943) (noting that a proper business purpose will support the taxpayer's identity as separate from that of the shareholder). *Cf.* Comm'r v. Bollinger, 485 U.S. 340, 345-346 (1988) (discussing that control by the shareholder is in substance a purported agency-principle relationship seeking to provide separation of entity and shareholder).

19. *See* I.R.C. § 882(a)(2).

20. President Kennedy's Special Message to Congress on Taxation, 1961 PUB. PAPERS 290 (April 20, 1961), *available at* http://worldnetdaily.com/news/article.asp?ARTICLE_ID=39517 (last visited Feb. 28, 2006).

> In those countries where income taxes are lower than in the United States, the ability to defer the payment of U.S. tax by retaining income in the subsidiary companies provides a tax advantage for companies operating through overseas subsidiaries that is not available to companies operating solely in the United States. Many American investors properly made use of this deferral in the conduct of their foreign investment.

Id.

21. BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL INCOME TAX'N OF INCOME, ESTATES, AND GIFTS; BASIC CONCEPTS OF THE TIME VALUE OF MONEY ¶ 53.2 (Warren, Gorham, & Lamont,

U.S. exports to third-party countries, and is comprised of the sum result of five types of gross income:[22] Foreign Personal Holding Company (FPHC) income, FBC sales income, FBC services income, FBC shipping income,[23] and FBC oil-related income.[24] Although the U.S. is among those nations taxing its citizens on income wherever sourced,[25] this "anti-abuse" provision addressing the deferral of recognized income puts U.S. exporters at a tax disadvantage compared to other industrial country exporters.

The aim of heading off any implications of noncompliance by an accord with the usage of trade in the multinational setting while still keeping U.S. corporations on competitive footing with multinational corporations of other states, has resulted in legislation reflecting the chief reason of the U.S. Congress to refashion its remedy, again, into quick compliance with the previous WTO findings.[26] Still, the Act provides that deductions are allowable for amounts accrued but unpaid by either a U.S. or a foreign person to related FPHC's, CFC's,[27] or passive foreign investment companies (PFIC's),[28] so long as the amount does not exceed the amount to be currently includible in the income of the direct or indirect U.S. owners of the related foreign entity.[29]

A component of Subpart F income may be excluded from aggregate Subpart F income baskets if it is qualified ECI, U.S. sourced, or unable to avail itself of reduced rate exemption under treaty.[30] To this end, the 1962 legislation continues to distinguish ECI and its reinvestment into U.S. sources from earnings and profits accumulated after its inception.[31]

3d ed. 1999).

22. I.R.C. § 952(a)(1)-(5).

23. *Id.* at § 954(a)(4), *repealed by* Pub. L. 108-357, Title IV, § 415(a)(1), 118 Stat. 1511 (Oct. 22, 2004).

24. *Id.* at § 954(a).

25. Cook v. Tait, 265 U.S. 47, 56 (1924) (noting that in a comparison of taxing powers, domestic sourced income was found to be limited to taxation within the borders of the individual state while income sourced outside of federal borders remained subject to taxation thereof by virtue of the taxpayer's native citizenry).

26. Referring to the final decision released in that case of European Union challenges to the United States-Tax Treatment of "Foreign Sales Corporations." World Trade Organization, Dispute Settlement System Training Module: Chapter 6, The Process – Stages in a Typical WTO Dispute Settlement Case, *availabe at* http://www.wto.org/english/tratop_e/dispu_e/disp_settlement_cbt_e /c6s10p2_e.htm (last viewed Nov., 12, 2004).

27. I.R.C. § 957.

28. *Id.* at § 1297.

29. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 841(b)(2)(B)(i), 118 Stat. 1418, 1597-1598 (2004).

30. I.R.C. § 952(b).

31. *Id.* at § 952(c)(2).

In a somewhat circuitous fashion, the code, in essence, exempts ECI from taxation to the extent it is offset by retained U.S. property interests to include tangible property located within the United States, stock and debt obligations of related domestic corporations, as well as patents, copyrights, and other intangibles acquired or developed for use in the United States.[32] The running theme to this approach is the prevention of double taxation. Legislation passed in 1993 takes the analysis to a next level in providing that the amount includible in gross income may be the lesser of two separate methods of measuring the income. One is the pro rata share of the average amounts of the CFC's directly or indirectly held U.S. property at the end of the tax year, reduced by its undistributed earnings and profits as reported by, or ascertained of[33] the shareholder's[34] already taxed income.[35] The second amount is a determination of the shareholder's pro rata share of the corporation's applicable earnings.[36]

B. The Foreign Investors Tax Act of 1966 (FITA)[37]

FITA may properly be thought of as the genesis of the "effectively connected" concept in the form it has taken today,[38] introducing it to the arena of income produced by foreign persons – income "effectively connected with the conduct of a trade or business within the United States."[39] While exactly what constitutes a trade or business in the United States remains, following certain guidelines, open to interpretation in consideration of the multitude of variable facts and circumstances in tireless pursuit of a more precise definition,[40] it provides a new, polarized and multilateral approach for addressing income produced by U.S. businesses owned by foreign persons.

32. *Id.* at § 956(c)(1).
33. *Id.* at § 956(a)(1).
34. *Id.* at § 951(b) (defining a "shareholder" for this purpose as a U.S. person owning at least a ten percent interest in a foreign corporation). *See also id.* at § 957(c); i*d.* at § 958(a),(b).
35. *Id.* at § 959(d).
36. *Id.* at § 956(a)(2).
37. Pub. L. No. 89-809, Title 1, 80 Stat. 1539 (1966).
38. *See* I.R.C. § 864(c); Rev. Rul. 81-78, 1981-1 C.B. 604, 1981-10 I.R.B. 38.
39. Foreign Investors Tax Act of 1966, Pub. L. 89-809, § 102(c), 80 Stat. 1539, 1541 (1966); I.R.C. § 102(c).
40. I.R.C. § 864(b) provides a foundation for the finding of what is meant by conducting a U.S. trade or business, but leaves much open to interpretation as its approach is in the negative by exclusion.

1. Force of Attraction Principle[41]

Prior to the effective date of FITA, a foreign person doing business in the United States was taxed on all U.S. sourced income at progressive rates,[42] but foreign source income remained untaxed. This nexus for taxing all U.S. source income by the rules then in place was deemed to "attract" the income into that grouping, whether or not an actual connection existed between the business and the income itself.[43] By Congress' estimation, this "attraction" had two unsavory results. First, it deflected the foreign person away from the prospect of further investing profits into the United States where the tax "web" could assign a penalty.[44] This resulted in inadvertent incentives to invest that money in another country.[45] Second, it allowed foreign business to escape U.S. taxation on foreign source income even if all of the foreign person's business was conducted within the borders of the United States.[46] However, with the advent of ECI, what was U.S. source income under the pre-1966 rules would now be taxed absent those incremental increases that had been previously based on progressive rates. Further, that previously untaxed income derived by varying and certain classes of foreign source income could now qualify as includible in the U.S. source gross income by that same net-progressive tax regime. This is a developing theme found throughout the maturation of ECI and its effect on foreign persons investing in U.S. interests.[47]

41. I.R.C. § 864(c)(3).

42. *Id.* at §§ 871(b)(1), 882(a)(1); Treas. Reg. §§ 1.871-8(b)(2), 1.882-1(b)(2)(ii) (1966).

43. For an overview to the historical background of ECI as a lineal descendent of the Force of Attraction Principle, see generally Harvey Dale, *Effectively Connected Income,* 42 TAX L. REV. 689 (1987). For a more detailed discussion of prior law which lead to the inception of the ECI concept in light of the Force of Attraction Principle see generally Ross, *United States Taxation of Aliens and Foreign Corporations*: *The Foreign Investors Tax Act of 1966 and Related Developments*, 22 TAX L. REV. 279 (1967) (cited in Dale, *supra*, at 690).

44. Dale, *supra* note 43, at 690.

45. *Id.*

46. *Id.* at 690-91.

47. For a chronological and practical illustration of this premise, see generally I.R.C. §§ 861, 862, 863, 865, 871, 875, 881,882, 892, 893, 894, 7701(a),(b).

C. The Revenue Act of 1971,[48] *the Resulting Domestic International Sales Corporation (DISC),*[49] *and General Agreements on Tariffs and Trade (GATT)*

Predecessor to the WTO, GATT was the then-authoritative body with which nations could liaison for the purpose of concluding agreements, concessions, or settlements. The enforcement of any agreements arising from GATT would today be carried out under authority of the WTO. [50]

1. Domestic International Sales Corporation (DISC)

The DISC acted as an export incentive that allowed U.S. businesses to defer tax derived from income realized by sales of products sold abroad. Congress enacted the DISC rules as a method to address increased competition presented by foreign trade. The DISC approach, in contrast to the general bent of ECI which encourages foreign investment, is designed to keep domestic investors from having to contemplate deferment before repatriation. Just as the FITA is recognized as siring what has come to be known as ECI today, so is the 1971 Act the most likely origin of what has since become labeled no more than a formula to subsidize the export of goods produced in the U.S., ultimately becoming an extremely attractive means for deferring income recognition without the income ever leaving its native borders.[51] The idea itself, however, was in no terms new; at one time its purpose from a global perspective was benign, if not beneficial, when it served as a tool of war in 1942.[52]

2. General Agreement on Tariff's and Trade (GATT)

In 1973, in a move that is reminiscent of what eventually led to that impetus for the majority portion of the Act, three signatory members from the European Community (EC) filed a complaint with the GATT

48. Pub. L. 92–178, 85 Stat. 508 (1971).

49. I.R.C. § 995 (2002); I.R.C. § 991 (1998); I.R.C. § 992 (1996); I.R.C. § 996 (1986); I.R.C. § 993 (1976); I.R.C. § 994 (1971); I.R.C. § 997 (1971).

50. World Trade Organization, GATT and the Goods Council, *available at* http://www.wto.org/english/tratop_e/gatt_e/gatt_e.htm (last visited November 14, 2004).

51. BORIS BITTKER & LAWRENCE LOKKEN, FUNDAMENTAL OF INT'L TAX'N, U.S. TAXATION OF FOREIGN INCOME AND FOREIGN TAXPAYERS ¶ 71.3 (Warren, Gorham, & Lamont) (2003/2004).

52. One of the first direct predecessors of this concept was known as the Western Hemisphere Trade Corporation (WHTC), first implemented in 1942, qualification thereby provided a fourteen percent reduction on corporate tax prior to its phase out in 1976. *Id.* at ¶ 71.3.1.

Council contending that the DISC was an export subsidy and therefore in contention with the GATT.[53] In response, the United States filed a counterclaim alleging that the "territorial" income tax systems of France, the Netherlands, and Belgium resulted in the implementation of export subsidies there.[54] Under a territorial tax system, a nation does not tax the income of its corporations if that income is earned by a branch located abroad.[55] The GATT Panel sustained the European challenges to the DISC regime, as well as the United States' counter challenges to export incentives provided by France, Belgium, and the Netherlands.[56] Pursuant to these findings, the United States acquiesced, along with the European countries, under a 1981 GATT Counsel Decision (1981 Understanding) which held that the countries were not required to tax income arising from extraterritorial processes, that arm's length pricing applied to territorial system exporters and related foreign buyers, and the prevention of double taxation on foreign source income would be permitted.[57]

Pursuant to varying interests of economic competitors, this is a tactic employed not just for actions perceived as being in contention with agreements in force. While the EU considers whether the Act is going to be the final motion in its pursuit of WTO compliance, it has asked the WTO to rule on the legality of continued sanctions by the U.S. and Canadian governments in relation to a dispute over the importation of beef affected by growth hormones.[58]

D. Foreign Investors Real Property Tax Act of 1980 (FIRPTA)

While it does not in form directly address the production of ECI, FIRPTA results in more than just a peripheral impact thereto when interpreted in light of exclusions to income that becomes available under

53. DAVID L. BRUMBAUGH, CONG. RESEARCH SERV., EXPORT TAX BENEFITS AND THE WTO: FOREIGN SALES CORPORATIONS AND THE EXTRATERRITORIAL REPLACEMENT PROVISIONS 2 (2002), *available at* http://www.cnie.org/nle/crsreports/economics/econ-113.pdf (last visited May 11, 2006).

54. *Id.*

55. *Id.*

56. *Id.*

57. *See* DAVID L. BRUMBAUGH CONG. RESEARCH SERV., A HISTORY OF THE EXTRATERRITORIAL INCOME (ETI) AND FOREIGN SALESCORPORATION (FSC) EXPORT TAX-BENEFIT CONTROVERSY (2004), *available at* http://www.taxhistory.org/thp/readings.nsf/cf7c9c870b600b9585256df80075b9dd/d1e0dcc337b804385256f860068159e?OpenDocument (last visited May 11, 2006).

58. Ulrika Lomas, *EU Launches WTO Action Against US and Canada*, LAW AND TAX NEWS, November 10, 2004, *available at* http://www.LawAndTax-News.com (last visited May 11, 2006).

this legislation. Real Estate Investment Trusts (REIT)[59] provide an example of the look-through treatment afforded income derived from a U.S. real property interest in the form of stocks or securities when "such class of stock" is one that is regularly traded on an established securities market located in the United States. The Act amends § 897(h) by providing an exception to FIRPTA and excluding from recognition distributions from said stock so long as ownership is comprised of five percent or less of the existing class of stock.[60] While this has an unfavorable, but in all probability minimal, swing on the development of ECI, the more impressive aspect is the departure from the longstanding and inherent treatment of a U.S. real property interest as inextricably U.S. source income. However much a concession this may be, it seems out of place towards making conciliations arising from the EU sanctions targeting U.S. manufacturers. Still, it must be kept in mind that the authors of this bill have in no uncertain terms provided for offset to the exception. Likewise, any conciliatory response may be short-lived. The Act provides for the expansion of U.S. income by amending the heart of ECI at § 864[61] to include classes of income "equivalent of any item of income or gain" heretofore deemed ECI although "from sources without United States."[62]

E. The Deficit Reduction Act of 1984[63]

The stage was now set for the creation of two new tax entities that were intended to be the successors of the DISC as it emerged from the Revenue Act of 1971: the Foreign Sales Corporation (FSC), and the Interest-Charge Domestic International Sales Corporation (IC-DISC). The most popular vehicle quickly became the FSC, designed to replace the DISC in compliance with the GATT Counsel's 1981 Understanding. Because of the U.S. general imposition of taxation on worldwide income based on the residence of its citizens, as opposed to a territorial tax system as in France or the Netherlands for example, wherein taxation excludes extraterritorial income, a U.S. corporation (one that is registered in the United States) would ordinarily expect to be taxed on income derived from exports, both foreign and domestic sourced. By

59. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 243, 118 Stat. 1418, 1439 (2004); I.R.C. §§ 856, 857 (2005).

60. American Jobs Creation Act § 418. The Act also amends § 857(b) to conform therewith regarding income characterized as capital gain when derived through an REIT. *Id*.

61. American Jobs Creation Act § 894.

62. I.R.C. § 864(c)(4)(B).

63. Pub. L. 98-369, 98 Stat. 494 (1984).

utilizing a qualified FSC, a corporation was taxed only on the portion of export income from U.S. sources, thus, allowing it to be treated the same as a foreign corporation in regard to that income not determined to be from the conduct of a trade or business within the United States. By this method, a portion of export income remained exempt from tax until repatriation occurred. This equal-footing provision allowed the U.S. business entity a significant advantage over its foreign competition in their own native markets, and would soon come to be charged as subsidized governmental benefits in derogation of obligations in force under the WTO Agreement on Agriculture and the WTO Agreement on Subsidies and Countervailing Measures.[64]

F. Tax Reform Act of 1986:[65] *A Primary Target of the Act*

The lack of an avenue enabling taxation of the worldwide income of foreign U.S. investors combined with a function for attracting the reinvestment of U.S. source income by foreign investors required a remedy. The 1986 Act reclassified what had previously been foreign source income, exempt from U.S. taxation, into U.S. source income[66] by shifting the emphasis onto the attributable location of the income.[67] To amplify this latest and broadened approach towards qualifying ECI, the code also enlarged the classifications for income.[68]

1. Income Recognized in an Earlier or Later Year

Under prior law, foreign taxpayers could avoid U.S. tax by receiving income that was earned by a U.S. trade or business in a year after the trade or business had ceased to exist. For example, the business could sell property and accept an installment obligation as payment. By recognizing the gain on the installment basis, the taxpayer could defer the income to a later taxable year. If the taxpayer had no U.S. trade or business in that year, then the income recognized in that year was not treated as "effectively connected" with a United States trade or business.[69] Congress believed that income earned by a foreign person's

64. "Subsidy" is defined for this purpose in the WTO Agreement on Subsidies and Countervailing Measures Art. 1. World Trade Organization, *availabe at* http://www.wto.org/english/docs_e/legal_e/24-scm.pdf (last visited November 15, 2004).

65. Pub. L. No. 99-514, 100 Stat. 2085 (1986).

66. I.R.C. § 865(e)(2).

67. *Id.* at § 864(c)(5).

68. *Id.* at § 884(d) (1996) ("effectively connecting earnings and profits"); *Id.* at § 1446(b)(2) (1989) ("effectively connected taxable income").

69. IRC § 864(c)(6).

U.S. trade or business should be taxed as such, regardless of whether recognition of that income is deferred until a later taxable year. Similarly, Congress believed that foreign persons should not be able to avoid U.S. tax on their income from the performance of services in the U.S. where payment of the income is deferred until a subsequent year in which the individual is not present in the U.S.[70] The inclusion of qualifying income in effectively connected earnings and profits without necessarily being recognized as earnings and profits in that same year is illustrative of Congress' efforts to address this issue.[71]

2. Use of Property in a Trade or Business

One example of a look-through rule is found following property used in a trade or business, and gains realized thereby on transfer to a related person in another country. The strategy of shifting property towards another purpose becomes subject to a tax on gains realized upon a disposition thereof for a period of ten years following the shift.

> Congress believed that gains accrued by a foreign person's U.S. trade or business should be subject to U.S. tax, and that such tax should not be avoidable through the simple expedient of removing property from the country prior to its disposition. . . . U.S. persons that transfer assets out of U.S. tax jurisdiction may be subject to tax on unrealized appreciation.[72]

Congress believed that a similar rule is appropriate for foreign persons as well.[73]

G. FSC (Foreign Sales Corporation) Repeal and ETI Exclusion Act of 2000[74]

The momentum behind the ETI Repeal is an intended goal of the American Jobs Creation Act stemming from the WTO rulings.[75] ETI Exclusion, however, is more directly the result of allegations made by the EU in 1997 that the FSC regime was an illegal export subsidy,

70. STAFF OF JOINT COMM. ON TAX'N, 99TH CONG., 2d Sess., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 1048 (Comm. Print 1987).

71. I.R.C. § 884(d); Treas. Reg. § 1.884-1(f)(1) (1992).

72. *Id.* at § 367.

73. BORIS & LOKKEN, *supra* note 51.

74. FSC Repeal and Extraterritorial Income Exclusion Act of 200, Pub. L. No. 106-519, 114 Stat. 2423 (2000).

75. *See* I.R.C. § 114 (repealed October 22, 2004).

eventually leading to a WTO Dispute Settlement Panel ruling in 1999.[76] The ruling provided that the U.S. would have one year to satisfactorily either repeal or modify the FSC rules.[77] The IC-DISC was not a target of the 1997 EU challenge. The EU challenged the repeal with arguments that the subsidizations were perpetuated in substance – an argument that the EU will likely renew against the recent U.S. legislation addressing this issue.

H. The American Jobs Creation Act of 2004

In order to understand the major thrust of the Act, one must look to the WTO rulings which found that the FSC constitutes an illegal export subsidy under both the Subsidies Agreement and the Agricultural Agreement.[78] On February 24, 2000, the Appellate Body of the WTO affirmed a panel's report based on three WTO consultations between the United States and the EU over a five-month period.[79] At that time, the United States was given until October 1, 2000 to withdraw the FSC scheme.[80] The United States responded by enacting the FSC Repeal and ETI Exclusion Act. The WTO confirmed further challenges to U.S. exports arising from ETI Exclusion in January, 2002.[81] In a special session of the Dispute Settlement Body on May 7, 2003, the WTO authorized EU countermeasures in the amount of $4.043 billion on U.S. exports.[82] The EU, in a move that seems invented for the purpose of enticing the United States into compliance, opted to implement the sanctions over a prescribed period of time on 1,608 products,[83] beginning on March 1, 2004.

The course taken towards U.S. withdrawal of the illegal measures provided for a graduated imposition in the form of tariffs starting at five

76. WTO Dispute Settlement DS108, *available at* http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds108_e.htm (last visited May 11, 2006).

77. *Id.*

78. WTO Council Regulation, OJ L 328 p.3, December 17, 2003. For a specific list of the affected products, see Panel Report, *United States – Tax Treatment for "Foreign Sales Corporations*, WT/DS108/26 (Apr. 25, 2003), *available at* http://mkaccdb.eu.int/dsu/doc/ds108-26.doc (last visited May 11, 2006).

79. *Id.*

80. *Id.*

81. *See id.*

82. Official Journal of the European Union, Council Regulation (EC) No 2193/2003. December 8, 2003, *available at* http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_328/l_32820031217en00030012.pdf (last visited May 11, 2006).

83. International Trade Administration – Home Page, *available at* http://www.ita.doc.gov/eu_030104.html (last visited October 16, 2004).

percent, followed by automatic monthly increases of one percent up to a ceiling of seventeen percent, which occurred in March, 2005.[84] However, it is more likely that the resultant sting of additional duties collected by the EU in this fashion[85] represents more of a firm invitation as opposed to any sort of strong push towards compliance. It is conjecture at this point to wonder what would have resulted if the U.S. had chosen to abstain from any overt response to the EU tariffs. This more appropriately requires input from an economist's point of view to measure the impact of the percentage of the authorized $4 billion as part of the total amount of export revenue. This should appropriately entail analysis in context with the $723.8 billion in registered exports which must be tallied by the United States less than one taxable year prior to the time the sanctions were initiated.[86] The tariffs would reduce the gross amount of export to some extent, albeit over a protracted period that allows for some compensatory shifts expressed by adjustments in the currency exchange rate thus offsetting some of its intended punitive effect by allowing further frustration of the intent to bring the United States into compliance through economic reprisals.[87] However, an overt acquiescence to the tariffs *in toto* is likely to evoke negative repercussions in future trade with the EU, with an accompanying level of provisions that will decrease free trade between the two economies.[88] One approach that warrants analysis of the impact of the tariff's implementation is the value-added-tax (VAT), which is widely used in many countries, particularly in Europe. When a foreign person exports goods from a country that applies VAT, it generally receives an effective tax refund of VAT paid up to that point. Typically that same country will add VAT to imported products. The U.S. export benefits have ineffectively purported to mirror this approach.[89]

84. *Id.*

85. *Id*. According to a report from the U.S. Dept. of Commerce this could result in as little as $475 million during the first twelve months. *Id.*

86. WORLD TRADE ORGANIZATION, INT'L TRADE STATISTICS 2004; WORLD TRADE IN 2003 – OVERVIEW 19 (2003), *available at* http://www.wto.org/english/res_e/statis_e/its2004_e/its04_overview_e.pdf (last visited May 11, 2006).

87. *See* FRANCES FISHWICK, EXPORT SALES STATISTICS: A NOTE FOR BDCI CONFERENCE 4 (2001), *available at* http://www.publishers.org.uk/gpi.nsf/0/90df672797f2f375802569f4005e1783/$FILE/export%20Sales%20Statistics.pdf (last visited May 11, 2006).

88. *See* Raymond J. Ahearn, *European Trade Retaliation: The FSC-ETI Case,* CONGRESSIONAL RESEARCH SERVICE, Oct. 12, 2004, *available at* http://www.pennyhill.com/europe/rs21742.html (last visited May 11, 2006).

89. *See generally* Harry Grubert & T. Scott Newlon, *Taxing Consumption in a Global Economy*, (American Enterprise Inst. Press 1997), *available at* http://www.aei.org/docLib/2002 1130_70698.pdf (last visited December 5, 2004).

From a purely financial standpoint, the phase-in of ETI Repeal, which is scheduled to take place over a three year period, has a projected net tax revenue gain of $49 billion based on figures which factor budgetary needs over a ten year period.[90] The U.S. production tax breaks included in the Act provide a deduction of nine percent of income generated from domestic production activities with a projected total cost of $77 billion; business tax breaks included for targeted tax relief in provisions that are projected at $7 billion; and changes of international tax sources under the Act are set to have net cost of $43 billion.[91] Revenue raising provisions are projected to demonstrate a gain of $82 billion.[92]

III. THE COMPONENTS OF ECI PRODUCTION[93]

In looking at the way a foreign corporation will be exposed to tax on U.S. source income, it is imperative to be vigilant regarding the multiple approaches that are available to be summed up, weighed, and sometimes looked through, in order to finally determine what amount, if any, of exposure to U.S. taxation and those ensuing potential benefits and penalties, has been incurred. The following approaches should be concurrently applied in the primary analysis as elemental to our discussion. Distinguishing U.S. source income from that of other sources initially requires an analysis of when the foreign person[94] is engaged in the conduct of a trade or business in or within the United States as reflected by the code. If so, one must establish whether there is a permanent establishment or fixed base that would demonstrate a significant contribution manifested as an "essential," even if not necessarily a "major," economic element thereof so as to qualify as a "material factor,"[95] and thereby form sufficient ties to the U.S. market under an all facts and circumstances analysis.[96] The material factor test may also be satisfied in light of income derived from U.S. sources.

90. *Id.*

91. *See generally* Kimberly Clausing, *Report Examines Shortcomings of American Jobs Creation Act of 2004*, TAX NOTES TODAY, Dec. 29, 2004.

92. JOINT COMMITTEE ON TAXATION, ESTIMATED BUDGET EFFECTS OF THE CONFERENCE COMMITTEE AGREEMENT FOR H.R. 4520, THE AMERICAN JOBS CREATION ACT OF 2004, JCX-69-04 (October 7, 2004), *available at* http://www.house.gov/jct/x-69-04.pdf (last visited May 11, 2006).

93. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, § 102(d)(2), 80 Stat. 1539, 1544 (1966) (amended 1986); Treas. Reg. § 1.864-4 (2005); Treas. Reg. § 1.864-5 (2005); Treas. Reg. § 1.864-6 (1992); Treas. Reg. § 1.864-3 (1972); Treas. Reg. §1.864-7 (1972).

94. I.R.C. § 7701(a)(1) (2006).

95. Treas. Reg. § 1.864-6(b)(1).

96. *See* Rev. Rul. 68-23, 1968-1 C.B. 144.

While paradoxically, the intent is to analyze U.S. source income in the form of ECI, one must be cognizant of the fact that the definition of a foreign corporation is provided in form by exclusion as one that is not domestic.[97] Multinational sourcing of income and incorporation will fall under the scrutiny of multiple tax regimes. It should be noted in advance of this strategy that a business entity created or organized both in the United States and in a foreign jurisdiction is a domestic entity for United States tax purposes.[98] Conversely, the treasury regulations are rather specific in outlining the countries of which corporate entities will be recognized for Federal tax purposes.[99]

Many entities are formed under and therefore governed by the laws of a particular jurisdiction pursuant to having filed creative or organizational documents, such as a charter or certificate, within that jurisdiction. Pursuant to income taxation of foreign persons, the Internal Revenue Code (IRC) recognizes two classes of foreign corporations: those which at no time during the tax year were engaged in trade or business in the United States,[100] and those which at any time during the tax year were engaged in trade or business in the U.S.[101] Analyzing a tax plan from a strategic approach should inherently evolve from a mapping that will determine all taxes under which the income will be exposed. Furthermore, one must bear in mind that the variation of rates applied will significantly guide efficiently planning acceptable avoidance[102] without further skirting lines that may soil the regime and remain cognizant of the end goal to perpetuate its success and longevity.[103] The classification and nationality of a dually-chartered entity, is provided for as a foreign per se entity[104] that has domesticated under U.S. law as an eligible entity and is treated as a domestic corporation for tax purposes. Recently drafted regulations imply this two-avenue approach so long as the form of the entity warrants treatment as a business in any jurisdiction where it is organized. Also, classification as a domestic entity applies so

97. I.R.C. § 7701(a)(5).

98. Treas. Reg. § 301.7701-5T(a) (2004).

99. Treas. Reg. § 301.7701-2(b)(8) (2005).

100. Treas. Reg. § 1.881-1(c).

101. Treas. Reg. § 1.881-1(a).

102. Louisville & N.R. Co. v. United States, 242 U.S. 60, 74 (1916). "But the very meaning of a line in the law is that right and wrong touch each other and that anyone may get as close to the line as he can if he keeps on the right side." *Id.*

103. For a brief overview of global economic impact on the business decisions of a multinational technology company, see James H. Mack, Testimony Before the House Committee on Ways and Means (Apr. 12, 2004), *available at* http://waysandmeans.house.gov/legacy/fullcomm/106cong/4-12-00/4-12mack.htm (last visited May 9, 2006).

104. Treas. Reg. § 301.7701-2(b)(8).

long as it is organized in the United States regardless of the form taken by the entity, such as a corporation, limited liability company, or partnership.[105]

A. Engaging in Trade or Business in the United States

Some qualifying connection must be present, in some form that demonstrably provides "an office or other fixed place of business"[106] (FPB) within the United States and the erstwhile ECI must be "attributable" thereto,[107] else ECI will not be present. The use of an agent may in certain circumstances fulfill the definition of a FPB for the foreign principal. The agent's activities must fall within those prescribed in the regulations: as one which is dependent as opposed to one which is independent; as largely founded on the premise of the regularity and continuity of the agents actions, coupled with the representation of the agent; and as representing themselves or as representing the principal when viewed from the perspective of a third party.[108] The accounting method utilized to make the determination of whether an item of income, gain, or loss was accounted for through the trade or business of the taxpayer is considered a material activity and is to be given "due regard."[109] Due regard here is qualified by adherence to four elements:[110] (1) the accounting records must be "separately kept for that business;" (2) the separateness of the record-keeping for that business is not considered controlling; (3) the accounting method is reflective of generally accepted accounting principles; (4) and the accounting method as utilized during the life of the business is consistent from year to year.[111] The reach for applying U.S. jurisdictional laws may have a paradoxical effect at times. The IRS has been consistent in treating an entity as created or organized under a particular jurisdiction, even where the only FPB is in a foreign country, and all of its business operations

105. Rules and Regulations Department of the Treasury Claification of Definitions, 69 Fed. Reg. 49809, 49810 (Aug. 12, 2004) (to be codified at 26 C.F.R. pt. 301). This temporary regulation revises Treas. Reg. § 301.7701-5 by clarifying that "a dually chartered entity is domestic if it is organized as any form of entity in the United States, regardless of how it is organized in any foreign jurisdiction." *Id*.

106. B.W. Jones Trust v. Comm'r, 132 F.2d 914, 915 (4th Cir. 1943) (explaining that residence for tax purposes could be ascribed to the location where bank accounts, a permanent staff, and an office were maintained).

107. I.R.C. §§ 864(c)(4)(B), 864(c)(5), 865(e)(2),(3); Treas. Reg. § 1.864-4(a).

108. I.R.C. § 864(c)(5)(A); Treas. Reg. 1.864-7(d).

109. I.R.C. § 864(c)(2)(B).

110. Treas. Reg. § 1.864-4(c)(4).

111. *Id.*

remain extraterritorial, such as a credit union under U.S. military regulations although established on a military base inside a foreign country.[112]

Whether inadvertently or by design, a foreign corporation may find itself engaged in a trade or business within the U.S. by a number of ways, so long as a prescribed set of elements falling under particular guidelines are in place.[113] In the face of such a qualified trade or business, the requirements for presence that may expose the non-resident alien to U.S. taxation may not necessarily be a prerequisite and the fulfillment of the substantial presence test may not be applicable if the foreign person is not an individual,[114] whether the income source is U.S. or foreign.[115]

While the actions resulting from the independent agent will not qualify as the presence needed to constitute a FPB, the dependent agent's activities may give rise to one for the purpose of finding a FPB of which the income may therefore be sourced as appropriate for ECI.[116] Unlike the U.S. citizen, whose worldwide income is subject to taxation under U.S. laws, the foreign person's income attributable to business activities related to their domestic permanent establishment is not subject to U.S. taxation on that foreign source income where the manufacturer sells the product in the United States through an independent contractor.[117] Dividends from a foreign corporation are subject to a rule ascribing a twenty-five percent threshold from which the source, foreign or domestic, is to be determined based on a look-back rule of up to three years.[118] If at least twenty-five percent of the corporation's income is qualified as ECI, the dividend will be treated as U.S. source income.[119] For the sale of products through a captured agent, an ordinary principal-agent arrangement may be defined,[120] and for all intents and purposes still be realizable ECI[121] while retaining its status as a foreign person.[122] This approach has strong precedence as an extension

112. Rev. Rul. 68-521, 1968-2 C.B. 600.

113. I.R.C. § 864(c)(1)(B).

114. *Id.* at § 7701(b)(3). *See* Treas. Reg. § 301.7701(b)-2(d) (1993) (stating that a facts and circumstances analysis may be permitted to demonstrate an alien individual's closer connection to a foreign country despite meeting the substantial presence test).

115. I.R.C. § 861(a)(2).

116. Treas. Reg. § 1.864-7(d) (2005).

117. Rev. Rul. 81-78, 1970-2 C.B. 150.

118. I.R.C. § 861(a)(2)(B).

119. *Id.*

120. Rev. Rul. 70-424, 1970-C.B. 150.

121. I.R.C. § 882.

122. *See* I.R.S. Notice 2001-16, 2001-1 C.B. 730 (identifies the use of an intermediary to sell

of recognizing the doctrine of economic substance over form,[123] here applied to determining the presence of a proper business purpose to that end of separating the corporation from the shareholder as noted by *Moline Properties*.[124] The applicable rules as of August 12, 2004, provide that any business entity that is created or organized in, or under the law of, the United States and any foreign jurisdiction is a domestic entity.[125] As a corollary, it follows that an entity that is separate from its domestic subsidiary may remain foreign so long as the parent is not organized under U.S. law.[126]

B. Fixed, Determinable, Annual, or Periodical (FDAP) Income[127]

While the force of attraction principle, as embodied in the FITA, extends formal recognition of the IRC's ability to prevent avoidance of foreign source income even where the foundation of domestic sourcing may otherwise be absent, FDAP income continues to comprise the front line of ECI as a manner by which the foreign corporation is subject to taxation.[128] Because of the generic format, the code provides in defining the composition of FDAP income, for further elucidation one must look to the regulations which define FDAP income in the negative as "income from sources within the United States, even though such income is not fixed or determinable annual or periodical income,"[129] as well as specifically including into its class such income interest (including interest on certain deferred payments),[130] dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and royalties, regardless of whether the income is received in payments or as a lump sum.[131] Income becomes reasonably fixed "when it is to be paid in amounts definitely predetermined," which for

the assets of a corporation as a listed transaction).

123. Under I.R.C. § 482, the reallocation pursuant to economic substance over form remains one of the most powerful tools in the IRS arsenal. For a view of the IRS approach to its application see T.D. 6952, 1968-1 C.B. 218 and the explanations provided on the IRS website at Internal Revenue Service, *available at* http://www.irs.gov/irb/2003-44_IRB/ar13.html (last visited Nov. 20, 2004).

124. Moline Properties, Inc. v. Comm'r, 319 U.S. 436 (1943). *See supra* note 18 (discussing this holding).

125. FISHWICK, *supra* note 87.

126. *Id.*

127. I.R.C. §§ 871(a)(1)(A), 881(a)(1).

128. *See* Treas. Reg. §§ 1.881-1(b) (2005).

129. Treas. Reg. § 1.1541(b).

130. I.R.C. § 483 (2006).

131. *See* Treas. Reg. § 1.1441-2(a)(1) (2000).

this purpose means an amount with an ascertainable calculation.[132] This would include sales commissions, distributions of an estate or trust from sources within the United States regardless of whether actually paid, so long as a credit thereof has been effected, taxes, interest on mortgages, and insurance premiums paid "pursuant to the terms of the lease."[133] The Act places a ceiling on deductions arising from leasing property to tax exempt entities. However, those deduction limitations can be successfully avoided so long as the liquid income does not exceed twenty percent of the tax-exempt lessee's adjusted basis and the lessor maintains a substantial equity investment in the leased property, for terms greater than five years while incurring minimal risk, or for a lease term greater than seven years, and the tax-exempt lessee does not have an option to buy the property for less than fair market value (FMV).[134]

C. Outbound Transfers of Investment Income

While acknowledging that interest income for the non-resident alien can generally be tax exempt,[135] its domestic cousin – investment income – is generally one of a class of income types that includes dividends, rents, and royalties.[136] While the regulations avoid an application of the asset-use test[137] and the business activities test,[138] as applied in search of determining the presence of qualified ECI, the tests remain a part of the primary analysis when applying the code.[139] While the two are typically found listing the asset-use test first, it is actually the business activities test that should comprise the primary analysis so long as ECI is of conduct arising from a trade or business within the United States. Further analysis of interest income provides that under U.S. law it shall be treated as income "from sources within the United States [when it is]. . . interest on bonds, notes, or other interest-bearing obligations of domestic corporations or certain non-corporate residents"[140] subject to the foreign business requirements test if "at least [eighty] percent of the

132. Treas. Reg. § 1.1441-2(a)(2).

133. *Id.*

134. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 407(d), 118 Stat. 1604, 1605 (2004).

135. This is expressed by I.R.C. §§ 871(h), 881(c) which emerged from the Deficit Reduction Act of 1984 (DEFRA), Pub. L. 98-369, § 127, 98 Stat. 494, 648 (1984).

136. I.R.C. § 861(a)(1),(2),(4).

137. Treas. Reg. § 1.864-4(c)(2).

138. Treas. Reg. § 1.864-4(c)(3).

139. Internal Revenue Service, *available at* http://www.irs.gov/businesses/small/international/article/0,,id=96409,00.html (last visited Nov. 16, 2004).

140. I.R.C. § 861(a)(1).

gross income from all sources . . . for the testing period is active foreign business income."[141]

1. Business-Activities Test

> The business-activities test is of primary significance, for example, where (a) dividends or interest are derived by a dealer in stocks or securities, (b) gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business by an investment company, (c) royalties are derived in the active conduct of a business consisting of the licensing of patents or similar intangible property, or (d) service fees are derived in the active conduct of a servicing business.[142]

"In applying the business-activities test, activities relating to the management of investment portfolios shall not be treated as activities of the trade or business conducted in the United States unless the maintenance of the investments constitutes the principal activity of that trade or business."[143] The examples provided in the regulations find ECI for a corporation whose business purpose is to invest in stocks and securities, compared with the non-resident individual, for whom this income would likely be tax exempt as portfolio income.[144] The principal difference in the result is that the income attributed to the foreign corporation becomes connected to the conduct of a U.S. business by way of having a principle office within the United States, the activity emanating from the U.S. office is to be compared with activity of the corporation emanating from such office or other fixed place of business located outside the United States.[145]

2. Asset-Use Test

"[T]he asset-use test ordinarily shall apply in making a determination with respect to income, gain, or loss of a passive type where the trade or business activities as such do not give rise directly to the realization of the income, gain, or loss."[146]

> However, even in the case of such income, gain, or loss, any activities

141. *Id.* at § 861(c)(1)(A).
142. Treas. Reg. § 1.864-4(c)(3)(i) (1975).
143. *Id.*
144. Treas. Reg. § 1.864-2(c)(2)(i)(a).
145. Treas. Reg. § 1.864-2(c)(2)(iii).
146. Treas. Reg. § 1.864-4(c)(2)(i).

> of the trade or business which materially contribute to the realization of such income, gain, or loss shall also be taken into account as a factor in determining whether the income, gain, or loss is effectively connected with the conduct of a trade or business in the United States.[147]

"The asset-use test is of primary significance where, for example, interest income is derived from sources within the United States by a nonresident alien individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the United States."[148] Examples of asset use leading to ECI include a U.S. branch of a foreign manufacturer's investment in U.S. Treasury bills and securities held in a fund comprised of corporate ECI. [149]

D. Stapled Entities[150]

A stapled entity can refer to any group of two or more entities formed for the purpose of carrying on a business,[151] so long as more than fifty percent in value of the beneficial ownership in each of such entities consists of stapled interests.[152] The interests are considered stapled at the point that the acquisition of an interest in the entity is subsequently required to be transferred along with the other of such owned interest.[153] Significant to the topic of foreign corporations with stapled interests doing business in the United States is an analysis of a foreign person when operating in the form of either a domestic branch[154] or a domestic subsidiary and the difference in treatment afforded thereby.

Pursuant to this is a reduction of the branch profits tax as specified by treaty.[155] Further treatment of "branch profits" also would preclude exposure to the flat thirty percent tax by way of utilizing a business purpose to reinvest that income. If the U.S. trade or business is in the form of a branch of a foreign corporation, earnings and profits that are derived thereby, that are not reinvested in that trade or business, become subject to the thirty percent branch profits tax.[156] Although the

147. *Id.*
148. *Id.*
149. Treas. Reg. § 1.864-4(c)(2)(v).
150. I.R.C. §§ 269B, 367(b) (2006).
151. *Id.* at § 269B(c)(1).
152. *Id.* at § 269B(c)(2).
153. *Id.* at § 269B(c)(3).
154. *Id.* at § 884.
155. *Id.* at § 884(e)(2)(A).
156. *See id.* at § 884(a).

mechanism of taxing the withdrawn earnings and profits under § 884 is different from the withholding tax by way of § 881(a), the result is the same – the transfer of profits to a foreign person is subject to a withholding rate of thirty percent.[157] Section 884, like the underlying motive recognizing income as "effectively connected," is intended to provide uniformity of treatment for foreign taxpayers doing business in the United States through branches and domestic subsidiaries.

Perhaps the most illustrative example of the balance between income sources under an analysis from the perspective of ECI occurs in light of domestic entities and foreign entities creating trade and business in the United States is at its termination. At this point, income arising from the gain of a sale will be realized and the strongest incentive for an outbound transfer will occur. However, to provide parity of footing, just as the domestic subsidiary may be liquidated and the dividend is exempt from tax to the parent, so the foreign corporation is allowed to terminate the domestic branch by making such an election, so long as the subsidiary is a domestic corporation, the exchange qualifies for non-recognition treatment under the rules of § 351,[158] and the foreign corporation holds a minimum of eighty percent of the domestic corporation's stock pursuant to reorganization[159] and immediately after the exchange.[160]

E. Foreign Source ECI[161]

Foreign source income is entitled to treatment as ECI only in certain circumstances.[162] Such circumstances are centered around the concept of a fixed place of business (FPB)[163] and are analogous and derivative of a permanent establishment.[164] Such foreign source income

157. Miller v. Comm'r, T.C.1997-134 (1997) (mem.).

158. *See* BORIS BITTKER & JAMES EUSTICE, FEDERAL INCOME TAX'N OF CORP. AND S'HOLDER; TRANSFERS UNDER § 351 TO FOREIGN CORPORATIONS ¶ 3.21 (Warren, Gorham, & Lamont, 7th ed. 2000). The intricacies of the § 351 transfer provide a micro view of how the foreign corporation is presented with a firm set of guidelines by the code that will avail the foreign investor of many tax benefits derivative of continued investment of a class of income character towards the goal of attaining ECI. *Id.* The result, as noted, a positive influence towards continued reinvestment within the U.S. *Id.*

159. I.R.C. § 368(c).

160. Treas. Reg. § 1.884-2T(d) (1996).

161. I.R.C. § 864(c)(4).

162. *Id.* at § 865(e)(2).

163. *Id.* at § 864(c)(5)(A).

164. Rev. Rul. 75-131, 1975-1 C.B. 389 (stating that for definition of the term fixed base reference may be made to the term permanent establishment).

must be in limited amounts as denoted by the locations contribution to the production of the income and in comparison to the result of an identical transaction had it been performed in the United States instead of reaching final consummation through an FPB in a foreign jurisdiction.[165] To determine the presence of an FPB to qualify income as ECI, income of a foreign source may only consist of two classes. One class would "consist of rents or royalties for the use or privilege of using intangible property"[166] including rentals or royalties for the use of or for the privilege of using without the United States: patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties[167] derived in the active conduct of a trade or business. The other class would consist of dividends or interest, provided that either is derived in the active conduct of banking, financing, or some such "similar business"[168] which is specifically listed as being comprised of one of six specific categories of activity which are marketed to the public: receiving deposits of funds; making loans; purchasing; selling; discounting or negotiating notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness; issuance of letters of credit and subsequent negotiations thereof; trust services; and financing foreign transactions.[169]

A foreign corporation whose principal business is the trading of stocks and securities for its own account also qualifies for treatment as ECI provided the other necessary factors are present.[170] The purpose of the FPB concept emerged as part of the FITA in order to prevent the utilization, or even the taint of the perception, of the United States as a tax haven.[171] ECI status will not follow foreign source inventory income "if the property is sold or exchanged for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer outside the United States participated materially in such sale" or exchange.[172] Otherwise, with certain exceptions,[173] ECI status is

165. I.R.C. § 864(c)(5)(B),(C).
166. *Id.* at § 864(c)(4)(B)(i).
167. *Id.* at § 862(a)(4).
168. *Id.* at § 864(a)(4)(ii).
169. Treas. Reg. § 1.864-4(c)(5)(i) (2005).
170. For an analysis of how a corporation could be construed to be engaged in the conduct of a U.S. trade or business, seemingly in contention with § 871(h), see generally Robert Rothman & David Hryck, *Ten Commandments Repeal Leaves a Trap for the Unwary*, TAX NOTES TODAY, May 28, 2001, at 1621.
171. H.R. Rep. No. 89-1450, at 14 (1966).
172. I.R.C. § 864(c)(4)(B)(iii).
173. Treas. Reg. § 1.864-5(b)(3)(ii)-(iii).

conferred when the foreign corporation engages in the sale of goods or merchandise through a U.S. office, even where the sale is transacted outside the United States, and irrespective of the destination to which such property is sent for use, consumption, or disposition.[174] Further elucidation on this matter is provided in the regulations, but a search for said income is generally satisfied if the income or gain is attributable to an office or other fixed place of business within the United States[175] so long as the merchandise sold is not inventory property.[176]

Regarding attribution of the sale of goods to a source, physical location traditionally has guarded this aspect with a facts and circumstance approach. For the purpose of finding U.S. source income from the disposition of property held for use in trade or business conducted in the United States, there are consequences that provide a look-back period of ten years even where the disposition occurs subsequent to use of said property for conduct in the United States.[177] Further, the taxpayer need not be engaged in the conduct of a U.S. trade or business for the tax year of the disposition to qualify the gain or income as ECI. Such an office may exist where the income is generated by sales of personal property through various locations.[178] Conversely, the use of the facilities of an affiliated corporation[179] may not meet the test if such use is lacking in adequate regularity so as to demonstrate some ongoing conduct satisfying an examination of all facts and circumstances.[180] Another element falling into this mix is the degree of authority imputed to the decision-making emanating from that office as maintained on a day to day basis.[181]

F. Real Property Income[182]

While most income derived from real property falls within the classification of FDAP and would thereby be subject to a thirty percent

174. Treas. Reg. § 1.864-5(b)(1).

175. I.R.C. § 865(e)(2)(A).

176. *Id.* at § 865(b).

177. I.R.C. § 864(c)(7). It is of note that the language utilized for this purpose expressly qualifies that gain, and in another provision located at § 864(c)(3), loss as well, is to be characterized by its basis at the time the original use in the U.S. business is discontinued and not at the time of disposition.

178. Treas. Reg. § 1.864-7(b)(1). An example of such an office is a hotel if this is in line with the ordinary conduct of the trade or business.

179. *See* I.R.C. § 482.

180. *See* Treas. Reg. § 1.864-7(b)(2).

181. *See* I.R.C. § 864(c)(5)(A); Treas. Reg. § 1.864-7(g).

182. I.R.C. § 871(d).

tax, the code continues to retain a rebuttable presumption that the disposition of an interest in real property which results in gain or loss to the foreign corporation or nonresident alien individual falls under the umbrella of ECI.[183] It follows then that if the income is not ECI, no deductions would be allowed regardless of its character.[184] However, an exception exists in the code that enables the foreign taxpayer to elect certain types of income derived from real property in the United States to be ECI.[185] The availability of this election is unique in the annals of ECI because, although taking the election need not be predicated on the conduct of a trade or business within the United States,[186] it is basically an example of practicality and reasonableness within the IRC. Further, the IRC's interpretive regulations may express that reasonableness in attributing the source to the United States in what is certainly an aspect of its most basic form. The election requires the presence of some portion of income that is subsequently determined not qualified as ECI, and the prudent taxpayer will ensure the election remains in effect for subsequent years by making the election annually, to include years wherein there is no income derived from the property or interest.[187]

The income affected includes interests in the property arising from the sale or exchange of the property, rents or royalties from natural deposits thereon, and the gain from certain sales of timber, coal, or iron ore, although, the election may not be made exclusive to one or another of such source, but must include all income arising from that property.[188] If certain income is desired to be excluded from the election it is an option that may be availed through the use of holding it in another corporation for which the election would not be made.[189] However, the election is not available for mortgage interest income, corporate dividends which are derived from an interest in U.S. real property (USRP),[190] or a personal residence of a non-resident alien individual not held for the production of income.[191] In a deference typically given to ECI, in the event gain on a sale of U.S. realty under the election is treated as a capital asset if not deemed related to the conduct of a U.S. trade or business, the net operating loss deductions under § 172 will not

183. I.R.C. §§ 871(b)(1), 882(a)(1), 897(a)(1).
184. *See* I.R.C. § 864(c)(1)(B).
185. I.R.C. §§ 871(d), 882(d).
186. Treas. Reg. § 1.871-10(a) (2005).
187. *See id.*
188. Treas. Reg. § 1.871-10(b)
189. Treas. Reg. § 1.871-10(b)(3).
190. *Id.*
191. Treas. Reg. § 1.871-10(b)(2)

be available to the nonresident alien individual.[192]

One instance of income excluded from qualifying as effectively connected arises from the gain recognized by a foreign corporation on the disposition of an interest in real property arising from the sale of stock of a USRP holding corporation to the extent that the income is includible in the corporation's earnings and profits (E&P) to prevent a third level of taxation under § 884 where taxation has already been asserted at both the corporate and shareholder levels.[193]

G. Personal Services[194]

While more likely to be encountered in the role of a nonresident alien individual, through an all facts and circumstance approach, personal services include ECI derived while in the employ of a foreign person.[195] Income derived from the performance of personal services provides an exception to the general rule of excluding ECI from withholding.[196]

However, its value is not to be impeded starting in 2005. Under the Act, services for qualifying film property will be treated to the deductions against domestic production gross receipts for the services performed in the United States of actors, production personnel, directors, and producers.[197] The allure of U.S. gross receipts as an offset should be contemplated as a targeted source of income without a doubt.[198] The Act provides an exception to treatment of income derived from personal service contracts as through a FPHC if some person other than the corporation has the right to designate the person to perform the services or if the amount of gain received under the contract is designated therein.[199]

H. Direct Incentives for the Production of ECI; Withholding,[200]

192. Treas. Reg. § 1.871-10(c)(2).
193. *See* I.R.C. §§ 884(d)(2)(c), 897 (2006).
194. I.R.C. § 864(b). Treas. Reg. § 1.864-2(a).
195. I.R.C. § 864(b)(1).
196. *Id.* at § 1441(c)(1).
197. *Id.* at § 199(c)(6).
198. *Cf.* Francisco v. Comm'r, 119 T.C. 317 (2002) (finding that a taxpayer's income from performing personal services in international waters was U.S. effectively connected income under the Internal Revenue Code).
199. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 413(b)(2), 118 Stat. 1418, 1506 (2004).
200. I.R.C. §§ 1441, 1442.

Deductions, Credits,[201] *and Graduated Tax Rates*[202]

In general, every entity to which U.S. sourced income is attributable is subject to withholding and filing requirements,[203] including foreign corporations.[204] However, one of the goals of establishing ECI is to attain exemption from withholding is accomplished so long as it is currently includible in the beneficial owner's gross income.[205] In comparison, ECI produced by a U.S. partnership with a foreign partner remains subject to withholding at a rate of 35% to 39.6%, depending on the form of the foreign partner. Certain distributions by domestic corporations to foreign shareholders and partners are another notable exception to the filing requirements for which a foreign corporation may qualify.[206] As a class, this could include portfolio income,[207] which is considered interest income, but does not include income derived from an ongoing trade or business.[208] If a foreign person receives income from a U.S. trade or business of a foreign corporation then the income is classed as U.S. source income and subject to withholding thereby.[209]

When a foreign corporation has income that is realizable as ECI, the status changes markedly. Previously unreachable deductions are then available, and therefore, prevent any refuge from the flat thirty percent tax[210] which is so prevalent for U.S. source income, thus accessing those more efficient deductions and credits available to an entity organized under U.S. law.[211] This appears to be little more than the utilization of applying a driving economic force that should be acknowledged when examining the taxation aspect of any transaction, that the ability to reduce taxes predicates incentives to attract and promote investment. This philosophy is readily discernible in the availability of graduated tax

201. *Id.* at § 873(a), § 874, § 882(c).

202. *Id.* at § 11(b), § 871(b), § 882(a).

203. *See id.* at § 1442(b); Treas. Reg. § 1.1441-4(a)(1) (2000).

204. Treas. Reg. § 1.6012-2(a),(g)(1)(i) (1982).

205. Treas. Reg. § 1.1441-4(a)(1).

206. *See* I.R.S. Notice 97-18, 1997-1 CB 389.

207. I.R.C. §§ 871(h)(4)(A)(i), 881(c). Of note are specific types of income excluded form the portfolio exemption including interest relating to receipts, sales, or cash flow of debtor; income or profits of the debtor; change in value of depreciation or appreciation of debtor's property; or dividends or similar payments made by the debtor. *Id.*

208. *See id.* at § 864(b).

209. *Id.* at § 881(a).

210. *Id.* at §§ 871(a), 881(a).

211. *See Id.* at § 882(c).

rates,[212] the gateway to which is one means of reducing income tax without avoiding it, by generating ECI for the foreign investor. By this route as well, the character of the income may be treated as a capital gain[213] to be taxed at the graduated rates,[214] thus exposing it to the alternative minimum tax (AMT),[215] and, taking the good with the bad, including the corporate environmental tax.[216]

I. Treaty Considerations[217]

While the Act expressly provides for it to dominate over such exempting provisions present in an applicable treaty,[218] the elements comprising a treaty warrant continued attention to treaties as a corollary to qualifying income as effectively connected.

1. Components of a Permanent Establishment[219]

By provisions in a treaty, U.S. source income arising from the permanent establishment of a trade or business may still be excluded from the ECI qualification.[220] This is simply an express method of deferring to a treaty in force as is found within the regulations.[221] It is of note that the option is not available by election. Further, it does not pertain to income from real property wherein an election to treat an apportioned amount as ECI is in effect.[222] While the distinction between the meaning for treaty purposes versus the application of the IRC should be respected, the U.S. Model Convention, when looking for a permanent establishment, "especially" includes a place of management, a branch, an office, a factory, a workshop, or a location wherein the extraction of natural resources is taking place.[223] A foreign taxpayer with a dependent agent in the United States is deemed to have a permanent establishment if the agent has and "habitually exercises" authority to make contracts

212. *See Id.* at §§ 1, 11.
213. *Id.* at § 1201(a).
214. *Id.* at § 11(d).
215. *Id.* at § 55.
216. *Id.* at § 59A.
217. United States Model Income Tax Convention (Sept. 20, 1996).
218. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 7874(f), 118 Stat. 1418, 1562 (2004).
219. United States Model Income Tax Convention, *supra* note 217, at art. 5(4), 7(1).
220. I.R.C. § 894(b); Treas. Reg. § 1.894-1 (2002).
221. *See* Treas. Reg. § 1.894-1.
222. Treas. Reg. § 1.894-1(b).
223. U.S. Model Income Tax Convention, *supra* note 217 at art. 5(2).

for the principle, extending the agent's role beyond mere purchasing, preparatory, or auxiliary acts.[224] Still, some examples of that which does not meet the permanent establishment test for treaty purposes could be if the fixed place of business is used solely for activities auxiliary to the taxpayer's business, such as a warehouse for purchasing, storing, showcasing, delivering inventory, or any combination thereof.

> With respect to business operations, the general principle espoused in the [Convention Between the Government of the United States of America] . . . is that business profits also shall be taxed only by the country of residence, unless the enterprise carries on business in the other state through a permanent establishment located in the other state. A permanent establishment as defined in the Treaty, Art. 5(1) & (2), is a fixed place of business through which the business of an enterprise is wholly or partly carried on and includes a branch and an office.[225]

This approach is not unique to the U.S. Model Treaty as reflected in the U.K. manual and is aptly depictive of the internationally accepted method for determining the source of income, that of "arm's length pricing."[226] The method ascribed to transactions between related parties' hypothetical prices is based on pricing of like transactions between non-related parties. Under this approach there is little room for exemption of export income when applying rules based on internationally more frequently encountered territorial income as opposed to income based on residency. Further, a taxpayer's independent agent in the U.S. is not considered a permanent establishment if the agent is performing services for the foreign taxpayer that are already in the ordinary course of the agent's business.[227]

Compare this test of agency with the asset-use test,[228] which provides that business profits are attributable to the permanent establishment when derived from the assets or activities thereof.[229] When a domestic branch is at issue, the U.S.–U.K. treaty follows the United States Model Convention closely in this regard, hinging exposure

224. United State Model Income Tax Convention, *supra* note 217, at art. 5(5).

225. Nat'l Westminster Bank, PLC v. United States, 44 Fed. Cl. 120, 122 (1999) (determining plaintiff's taxable income of the U.S. Branch was to be regarded as a separate entity dealing at arm's length with other units of plaintiff).

226. *See* U.K. Inland Revenue Manual, *CFM500 – Corporate Finance*, *available at* http://www.hmrc.gov.uk/manuals/cfmanual/cfm500a.htm (last visited Feb. 21, 2006).

227. United State Model Income Tax Convention, *supra* note 217, at art. 5(6).

228. BITTKER & LOKKEN, *supra* note 51, at 11.

229. United State Model Income Tax Convention, *supra* note 217, at art. 7(2).

to tax in that other state only to the extent profits are attributable to the domestic branch.[230] While implications of existing treaties that may be in force between the other state and the United States are of primary consideration, when in contention with statute, the last in time generally prevails.[231] Additionally, the office of the fixed place need not necessarily be present at the time the income, gain, or loss is realized.

2. FDAP Income Under Treaty

Provisions in the treaty addressing the issue of FDAP as a class arise frequently enough to warrant analysis for any treatment afforded its class of income thereunder, which is inherently domestic, so long as derived of a qualifying permanent establishment or fixed base.[232]

IV. ECI AFTER ETI EXCLUSION REPEAL, THE DOMESTIC RESPONSE TO THE AJCA

A. Entity Approach

1. Corporations

Inversion transactions[233] were previously enjoyed as insulation against later extricating the taxpayer unnecessarily from certain confines within the U.S. tax code where a U.S. parent is registering expatriated funds under a foreign entity; the Act, if not the IRS, expressly seeks to limit that benefit and, in the process, may quite possibly apply ECI status to what is foreign source income. This inadvertent connection is touched upon by the following:

> The flurry of corporate inversion transactions over the last decade or so, combined with recent wars and recession, has resulted in a dramatic

230. *See* I.R.S. Pub. 901, U.S. Tax Treaties (2004).

231. *See* I.R.C. § 7852(d) (2006). *See* Lindsay v. Comm'r, 98 T.C. 672 (1992), *action on dec.* 9529-90 (concerning subsequent legislation prescribing § 59 treatment over treaty in force held to limit tax credit under last in time rule pursuant to legislation under the TAMRA Act). *Cf.* United States v. Felter, 752 F.2d 1505 (10th Cir. 1985) (explaining that defendant-appellee's rights are maintained absent explicit language in subsequent legislation to the contrary); *see also Nat'l Westminster Bank, PLC,* 44 Fed. Cl. at 128 (noting that in determining plaintiff's taxable income of the U.S. branch to avoid inconsistencies under treaty it was to be regarded as an independent and separate entity dealing at arm's length with other unites of plaintiff).

232. United State Model Income Tax Convention, *supra* note 217, at art. 21(1).

233. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 801-02, 118 Stat. 1418, 1562 (2004).

> increase in the scrutiny of and attention paid to this transaction by government officials, individual citizens, and media outlets over the last few years. . . . The most common methods used to execute the corporate inversion transaction include exchanging stock for stock, assets for stock, or through the "drop down" transaction, which occurs when the new foreign parent corporation creates a U.S. subsidiary and "drops down" some exchanged assets. . . . There is generally no shareholder recognition for the portion of assets transferred to the foreign corporation. . . . On the other hand, this legislation may completely convince all U.S. corporations to look beyond the corporate inversion transaction for their next tax-saving technique. . . . As previously discussed, the proposed legislation will change the current definition of a U.S. corporation when it engages in a corporate inversion transaction. . . . Removing the debt to equity threshold and limiting the allowable interest deductions to twenty-five percent of taxable income, as proposed by Senator Grassley's bill, would significantly deter future corporate inversion transactions. . . . As a result, the corporate inversion transaction will be significantly impacted because the United States will see through it and not recognize the new foreign corporation.[234]

Although methods for restricting certain forms of inversion transactions were contemplated as amendments to the code, they did not make it into the final version of the Act. Deductions for built-in losses are allowable so long as gain or loss to the transferee of qualifying property is taxable.[235]

2. Pass-Through Entities

a. S Corporations[236]

The major impact on the S corporation provided for by the Act is the allowance of an increase in the maximum number of shareholders from seventy-five to one hundred.[237] This provides the regime with more

234. Derek Anderson, *Turning the Corporate Inversion Transaction Right Side Up: Proposed Legislation in the 108th Congress Aims to Stamp Out Any Economic Vitality of the Corporate Inversion Transaction,* 16 FLA. J. INT'L L. 267, 268-300 (2004).

235. American Jobs Creation Act § 836. However, reflective of the rhetoric presented as preceding an attempt to replace the attitude that takes with one hand, and sometimes gives with the other, IRS associate chief counsel Hal Hicks has presented a more benevolent approach to the U.S. corporation as by one example the "Helen of Troy" rules which currently place a restraint on "legitimate minnow-whale deals." *See* Treas. Reg. § 1.367(a)-3(c) (2000).

236. American Jobs Creation Act §§ 231-240.

237. *Id*. at 1433; *see also* I.R.C. § 1361(b)(1)(A) (2006).

clout by permitting more investors with a commensurate increase in the potential investment base. This approach is broadened on another level by providing for spouses to be treated as one member, as well as members of a family.[238]

b. Partnerships

So long as a partnership has a U.S. permanent establishment, its partner will be deemed to also have a U.S. permanent establishment.[239] An eligible business entity that is not classified as a corporation can elect to be classified as either a corporation or a partnership; an eligible entity with a single owner may, pursuant to certain default rules, elect to be classified as a corporation or to be disregarded as an entity separate from its owner, by checking a box on Form 8832 properly filed with the IRS.[240] An eligible foreign partnership having more than one member will by default be classified as a U.S. entity if it has more than one member and at least one member does not have limited liability.[241] A foreign entity that has only a single member by default will be disregarded as an entity separate from that member for U.S. tax purposes if that member does not have limited liability.[242] Further, under the regulations' default rules, a foreign eligible entity will be classified as a corporation for U.S. tax purposes, regardless of the number of members, if all of its members have limited liability.[243] The attribution of income to an office or other fixed place of business[244] applies to the sale of an interest in a partnership as well.[245] The reasoning is appropriate primarily under the asset-use test.[246] The nod continues expressly in regard to interest paid by foreign partnerships in the Act, providing that it qualifies as U.S. source income so long as the income is derived from a U.S. trade or business conducted by the partnership.[247] The Act provides that this provision is retroactive to the whole of the 2004 taxable year,[248] although it seems unlikely that some party would prefer

238. American Jobs Creation Act §232; I.R.C. § 1361(c).
239. I.R.C. § 875(2).
240. *See* Treas. Reg. § 301.7701-3(c) (2005).
241. Treas. Reg. § 301.7701-3(b)(2)(i)(A).
242. Treas. Reg. § 301.7701-3(b)(2)(i)(C).
243. Treas. Reg. § 301.7701-3(b)(2)(i)(B).
244. I.R.C. §§ 864(c)(5), 865(e).
245. *Id.* at § 875(1). *See* Rev. Rul. 91-32, 1991-1 C.B. 107.
246. BITTKER & LOKKEN, *supra* note 51, at 11.
247. I.R.C. § 861(a)(1)(C).
248. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 410(b) 118 Stat. 1418, 1500 (2004).

a posture contentious with the benefit of being able to expressly sidestep taxes arising from repatriation were it deemed foreign source income by way of an *ex post facto* argument founded on the U.S. Constitution.[249]

Partnership income is also given deference as the largest aspect of the Act addresses the shelter scheme that involves the transfer of substantial losses exceeding $250,000 of the FVM's adjusted basis immediately after the transfer.[250] This is one place where the Act does provide a simpler, modified, successor version of the Senate amendment that would have limited its loss to the aggregate basis of the FMV of the transferred property, were the adjusted aggregate basis greater than the aggregate FMV when transferred in a tax-free incorporation. Still not barren of alternatives on this course, an election is available to defer the loss with respect to transfers.[251] If the partnership was in place on or before June 4, 2004, a provision in the partnership agreement may proscribe availability of the election, so long as the proscription does not exceed a term of fifteen years.[252]

c. Regulated Investment Companies (RIC)[253]

The RIC may generate income exempt from the withholding tax in the form of certain qualifying mutual fund dividends[254] earned by a foreign person under the amended form of § 871 emerging from the Act.[255] The exemption will not follow a non-resident alien's capital gains where said individual remains in the United States for a period longer than one hundred and eighty-three days[256] and so is eligible for treatment as ECI by being classed as interest income, rather than income that is derived from the conduct of a U.S. trade or business. This is another place where deference has allowed for a look-through rule to be applied to RIC stock held by a decedent's estate, providing like kind treatment for that portion of stock held directly by the decedent to remain exempt. An RIC held by a qualified publicly-traded partnership[257] is exempt so long as ninety percent of its income meets the requirements of the

249. *See* U.S. CONST. art.1, § 9.
250. American Jobs Creation Act § 833(d)(1).
251. *Id.*; I.R.C. § 743(e)(6)(A).
252. I.R.C. § 743(e)(6)(H),(I).
253. *Id.* at § 851.
254. *See id.* at § 871(k), *amended by* American Jobs Creation Act § 411.
255. *See* American Jobs Creation Act § 409.
256. I.R.C. § 871(a)(2).
257. *Id.* at § 851(h).

Investment Company Act of 1940 § (2)(a)(36).[258] The Act[259] exempts from taxation, interest-related dividends of RIC's, so long as the person realizing the income does not also own at least ten percent of the RIC's shares,[260] is qualified to receive a statement attesting to the recipients' status as a foreign person,[261] and the payment is transacted within the U.S. with enough information available so as to prevent the Secretary of the Treasury to be able to discern the transaction at hand from one whose purpose is avoidance.[262] In a TAM dated May 5, 2003, the IRS found that interest income received by an Ownership-FSC (O-FSC) through a leasing transaction entered into by a domestic financial services institution and its FSC was noted as having an effect that would increase available foreign tax credit. Ultimately this has an outbound transfer effect.

d. Trusts and Estates[263]

B.W. Jones Trust v. *Commissioner*, a seminal case arising from the taxation of foreign investment of U.S. soil, found that an alien trust taxable on capital gains where it maintained an office with a permanent intent demonstrated by hiring of staff and maintaining a domestic bank account as distinguished from a "desk room" maintained for casual transactions.[264] While this certainly points to consideration for the purpose of determining a permanent establishment, the Act takes note to include this type of investment vehicle as a pass-through entity again, for purposes of taxation to be classed when generating "income attributable to the production of domestic activities."[265] In furtherance thereof, the Act does not extend to differentiate one form or the other beyond that, except to look at the class of income or type of property held thereby.

Under the Act such affected property is held to include that related to an interest in aviation fuel, real estate, tobacco, and offshore holdings.[266]

258. American Jobs Creation Act § 331(a).

259. American Jobs Creation Act § 441; *see also* I.R.C. § 871(k).

260. I.R.C. § 871(k)(1)(B)(i). In fact, this mirrors the requirements to qualify for the portfolio interest exemption that is in place at § 871(h)(3). *Id.*

261. *Id.* at § 871(h)(2)(B)(ii),(5).

262. *Id.* at § 871(h)(6).

263. Rev. Rul. 85-60, 1985-1 C.B. 187 (referring to a non-resident alien beneficiary of trust deemed engaged in U.S. business by way of income being attributed to a permanent establishment).

264. B.W. Jones Trust v. Comm'r, 132 F.2d 914 (1943).

265. I.R.C. § 199(d)(1).

266. American Jobs Creation Act §§ 243, 409A(b), 626, 853(c)(1).

B. Source Approach

1. Domestic Production Activities[267]

Manufacturing is the prime target in the context of complying with the WTO rulings; therefore, an analysis need bear in mind that assertions of subsidized manufacturing exports were at the heart of the WTO's 2002 findings and the impact of new § 199[268] added to the IRC by the Act will be a primary focus of the European Commission's analysis when making a determination as to whether or not the Act brings the United States into compliance. At the forefront, analysis includes providing for a phase-in[269] of the deductions which could account for up to eighteen percent of "qualified production income"[270] based on wages received by a "shareholder, partner, or similar person" of a pass-through entity.[271] This provision has the potential to provide a stream of generated inbound transfers taking the form of ECI and the commensurate production of jobs thereby, subject to provisions designating that a corporation eligible for the deduction with respect to income of a subsidiary must own more than fifty percent of the subsidiary by vote and value.[272] However, this deduction concerning income attributable to qualified domestic production activities became effective in 2005.

No doubt guidance and proposed guidance will be forthcoming for quite some time, commensurate with the hefty breadth of the statute. The Treasury's Office of Tax Policy has noted that Congress has "left considerable discretion in implementing the new provision."[273] In 2004, Eric Solomon, deputy assistant secretary for regulatory affairs in the Treasury's office of Tax Policy, outlined an agenda addressing the top four guidance priorities in which domestic production activities and incentives for repatriation of foreign corporate earnings lead by those corporations checking in for their eighty-five percent deduction for cash dividends received from a CFC leading the list, which also includes the new nonqualified deferred compensation plan rules, and amendments to

267. American Jobs Creation Act § 102.
268. American Jobs Creation Act § 102(a).
269. I.R.C. § 199(a)(2).
270. *Id.* at § 199(c)(1).
271. *Id.* at § 199(d)(1)(B)(ii).
272. *Id.* at § 199(d)(4).
273. *See generally* Sheryl Stratton, *Treasury Officials Review Mfg. Deduction Guidance Challenges*, TAX NOTES TODAY, November 22, 2004.

tax shelter registration rules.[274] However, as scrutiny and analysis continues, ACJA's evolution led to a more definitive form on January of 2005 by way of Interim Guidance shaping specific definitions of the key terms comprising § 199.[275] Perhaps because in no small measure, income derived from domestic production activities is likely to have the broadest impact on U.S. sourced income, it has led the pack as being the section in most need of guidance as it strode toward its enactment. Section 199, taken by itself provides ample, yet non-specific, definitions for what is income that may be classified as qualifying "domestic production gross receipts."[276] Absent a definition of the phrase "produced by the taxpayer"[277] the producer was given much more latitude with which to be able to shift the income into this class. With the arrival of the Treasury's Interim Guidance the boundaries, while at times simply pointing out the bright-line,[278] are at minimum palpable now rather than speculative, at least so far as those categories addressed therein.

One must still consider how to qualify gross receipts arising from the sale of products manufactured or produced in the U.S. pursuant to a contract manufacturing agreement with the taxpayer, for third party production or manufacture.[279] Manufacturing contracts with foreign party production of apparel and footwear will present a leading indication of how stringently the definition will be utilized to bring those types of jobs within the borders of the United States. Therefore, a potential backlash of increased prices may arise for the domestic consumer now paying for goods that compete with the low wages often paid to the workers of countries that have enjoyed this type of outsourcing by U.S. manufacturers, usually in Asian markets. The position taken by the American Apparel and Footwear Association is to acknowledge the design and development of the product at the inception of its manufacture and to recognize any subcontracts that occur thereby

274. Karla L. Miller, Treasury, IRS Officials Outline Top Priorities, Pitfalls in Jobs Act Guidance, TaxAnalysts, November 9, 2004.

275. Treasury Department Notice 2005-14, Guidance on Section 199 – Income Attributable to Manufacturing Activities, January 19, 2005. *availabe at* http://www.ustreas.gov/press/releases/reports/notice200514js2200.pdf (last visited May 11, 2006).

276. American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 601-643, 118 Stat. 1418, 1425(2004).

277. *Id*.

278. Definitions provided by Notice 2005-14, pg.7, *supra* n.274, include specific graduated rates for deduction of Qualified Production Activity Income (QPAI).

279. *See generally* Linda Carlisle*, Attorney Suggests How To Treat Contract Manufacturing Arrangements*, TAX NOTES TODAY, December 23, 2004.

as part of that domestic production process.[280]

Another response to § 199 has been from the telecommunications industry seeking qualification for the treatment of income arising from the sale and lease of rights to use fiber optic cables, as well as income from the production of computer software.[281] While AT&T analogizes that the cable should be treated as depreciable "real property,"[282] it seems to be aptly taken without comment that income derived by home builders and general contractors from the sale of homes constructed will be classed as a domestic production activity, but even here, PricewaterhouseCoopers is taking no chances.[283] Perhaps the most telling issue to be addressed in detail follow instances where production is substantially completed in the United States, but the final assembly is completed abroad.[284]

If the Act can be thought of as being comprised of three segments, then certainly the top half of those in need of the most immediate guidance, per the Treasury, are those most efficiently bringing money to some bent towards the production of ECI. For now, it can be expected that eligible taxpayers may claim a three percent deduction in 2005 and 2006, graduating to a six percent deduction in 2007 through 2009, and reaching the nine percent ceiling starting for years 2010 and following. At the nine percent deduction, corporations qualifying for the thirty-five percent marginal tax rate would be subject to an effective tax rate of 31.85 percent on qualifying income. The Financial Accounting Standards Board (FASB) has proposed taking the position that the domestic manufacturing deduction should be accounted for as a special deduction or tax rate reduction, with a stated preference for the former "because the domestic manufacturing deduction is based on the future performance of specific activities."[285] Those taxpayers subject to the AMT[286] may now elect to deduct either based on the lesser of qualified production activities income or the amount of AMT taxable income

280. *See generally* Kevin Burke, *Group Articulates Stance On Contract Manufacturing Arrangements*, TAX NOTES TODAY, January 3, 2005.

281. *See generally* Gregory T. Miller, *AT&T Seeks Guidance On Issues Arising Under New Jobs Creation Act*, TAX NOTES TODAY, January 3, 2005.

282. *Id.*

283. *See generally* Brian Meighan, *PwC Comments On Definition of 'Construction' Under Manufacturing Deduction Provision*, TAX NOTES TODAY, January 3, 2005.

284. *See generally* Nanci S. Palmintere, *Company Seeks Guidance On Manufacturing Deduction*, TAX NOTES TODAY, January 3, 2005.

285. *See* Proposed FSP on FASB Statement 109-a, pg.1-2, *available at* http://www.fasb.org/fasb_staff_positions/prop_fsp_fas109-a.pdf (last visited December 1, 2004).

286. I.R.C. §§ 55, 56 (2006).

calculated prior to the deduction. Eligibility of qualified production income is determined by calculating the domestic production gross receipts reduced by the sum of the cost of goods sold which are allocable to receipts, other deductions, expenses or losses allocable to the receipts, and a share of other deductions, expenses, and losses not directly allocable to the some other class of income.[287] The Act defines domestic production gross receipts as those "derived from any lease, rental, sale, exchange, or other disposition of qualifying production property that was manufactured, produced, grown, or extracted in whole or in significant part by the taxpayer in the U.S."[288] Directly impacting ECI as well in this class of receipts would be those of a taxpayer from construction, engineering, or architectural services performed in the United States for construction projects within the U.S., creating American jobs. In that regard, it is of no consequence that the investment is made by foreign persons. While the production within the United States of electricity, natural gas, or potable water are includible, the transmission of those products is not, and so presents an example of when an allocation of receipts need be implemented for the taxpayer who is both producer and transmitter of these products, which is typically the case. One drawback inherent to the approach taken by the Act in relation to this most important aspect, its goal of offsetting the increases of tax incurred as a result of the repeal of ETI exclusion, is the unavoidable attempts to force the income source into one of the qualifying classifications.

SUMMARY OF BUDGETARY EFFECTS OF H.R. 4520, AS ENACTED[289]

	By Fiscal Year, in Millions of Dollars									
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
CHANGES IN REVENUES										
Estimated Revenues	-4,927	-8,284	-4,711	1,987	5,832	1,607	850	826	224	-207

287. *Id.* at § 199(c)(1)(B).
288. *Id.* at § 199(c)(4).
289. BARTSCH ET AL., *supra* note 7.

CHANGES IN DIRECT SPENDING

Estimated Budget Authority	764	-437	-431	-530	-638	-745	-921	-1,064	-1,165	-1,287
Estimated Outlays	764	-437	-431	-530	-638	-745	-921	-1,064	-1,165	-1,287

3. Special Interests

While not specifically expressing the primary prescribed intent of the Act, to address international tax provisions and their offset through the implementation of tax reductions for domestic production activities, certain special interest provisions have found their way into the body of the legislation as enacted.

a. Fair and Equitable Tobacco Reform Act of 2004[290]

Initially proposed as a stand-alone bill in March, 2004,[291] the Fair and Equitable Tobacco Reform Act is inserted for the most part intact in the Act. In effect, this portion of the Act serves to repeal the federal tobacco price support/production control program, provide compensation to the owners of the government-created tobacco quota for its discontinuation, and provide transition payments to active tobacco producers. These government buyout payments are estimated to cost $10.1 billion over a ten year period.[292]

b. Restaurant Property[293]

The Act specifically excludes the "sale of food and beverage prepared by the taxpayer at a retail establishment" from qualifying as domestic production gross receipts thereby preventing its access to deductions in this manner.[294] This aspect of § 199 sets the stage for the type of classification stuffing where, for example, coffee roasting, but not coffee preparation, is a qualified manufacturing activity.[295] This

290. American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 601-643, 118 Stat. 1418, 1420 (2004).
291. H.R. 4033.
292. BARTSCH ET AL., *supra* note 7.
293. American Jobs Creation Act § 211.
294. I.R.C. § 199(c)(4)(B).
295. *See* Edmund Andrews, *Negotiators Approve Big Tax Cuts For Producers*, N.Y. TIMES, October 7, 2004.

result of successful lobbying on the part of the Starbucks Coffee Company provides a tax incentive for increasing the price of coffee beans to its retail outlets because the roasting (manufacturing) part of the business is now more profitable.[296] As this has the effect of minimizing Starbuck's corporate taxable income, it serves "no other discernable public policy purpose."[297]

While this illustrates a position bent on protecting U.S. interests, it will be interesting to look for the development of some similarly styled legislation arising out of the EU, provided this section of the Act is exposed to and survives WTO scrutiny.

4. Business Tax Incentives[298]

a. Small Business Expensing[299]

As an example of a direct method to promote domestic income by businesses already in place, small business expenses are increased by an additional two year time period under § 179.[300] This allows the previous time frame for property expensed under § 179 to seven years, to be deducted ratably from earnings and profits. Section 179 property includes certain tangible property,[301] certain computer software,[302] § 1245 property,[303] so long as it is "acquired by purchase for use in the active conduct of a trade or business."[304]

5. Dividends Received Deduction[305]

Perhaps one of the largest incentives in looking at the encouragement afforded the production of ECI that is available under the Act is the implementation of this specific repatriation exemption tool, to

296. *See id.*

297. *See* Kimberly Clausing, *The American Jobs Creation Act of 2004: Creating Jobs for Accountants and Lawyers*, URBAN-BROOKINGS TAX POLICY CENTER (December 2004), at 3, *available at* http://www.urban.org/UploadedPDF/311122_AmericanJobsAct.pdf (last visited May 11, 2006).

298. American Jobs Creation Act §§ 201, 251.

299. American Jobs Creation Act § 201.

300. *See* I.R.C. § 179(b)-(d) (2006).

301. *Id.* at § 179(d)(1)(A)(i).

302. *Id.* at § 179(d)(1)(A)(ii).

303. *Id.* at §§ 179(d)(1)(B), 1245(a)(3).

304. *Id.* at § 179(d)(1)(c).

305. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 422, 118 Stat. 1418, 1420 (2004).

encourage reinvestment in the United States by including a special provision allowing for the one time deduction of eighty-five percent of qualifying cash dividends in the repatriation of foreign earnings.[306] In order to qualify the dividends must be reinvested as the result of a plan approved by the corporation's officers and board.[307] While it expressly disqualifies expenditures of executive compensation, it goes on to expressly include expenditures for the hiring and training of workers, infrastructure, research and development, capital investments, or financial stabilization of the corporation pursuant to the retention or creation of jobs.[308] In a letter requesting guidance on repatriation, the American Institute of Certified Public Accountants expressly anticipates that "many companies are expected to revisit their policy of indefinitely reinvesting foreign subsidiary or foreign corporate joint venture earning in foreign operations."[309] When placed in context with the top corporate rate the deduction produces an effective rate of 5.25 percent. In order to receive the deduction, the dividends must be distributed to a U.S. shareholder from a CFC,[310] and all of a group's CFC's must be treated as a single corporation for this purpose.[311] The amount of the dividends qualifying for the deduction must be deemed extraordinary,[312] includible in the taxpayer's gross income,[313] and subject to a $500,000 ceiling.[314]

Transfer pricing and the powers inherently enjoyed by the IRS thereto, should be taken into account, by the degree to which any related party incurs indebtedness, whether by distribution, allocation or apportionment, particularly as it involves a reportable or "listed transaction."[315] The Act provides suitable access to avenues of reorganizing the entity to take advantage of applications of this new legislation that would expound directionally to look at potential avoidance as well as tactical evasion.[316]

However, the underlying intent of § 965 – spearheading the Act's approach in light of eventually being capable of producing ECI – is the

306. I.R.C. § 965(a)(1).
307. *Id.* at § 965(b)(4)(A).
308. *Id.* at § 965(b)(4)(B).
309. *See generally* Thomas Purcell III, *AICPA Asks Treasury To Address Questions On Repatriation Provision In Guidance*, TAX NOTES TODAY, Dec. 23, 2004.
310. I.R.C. § 965(a).
311. *Id.* at § 965(a)(2).
312. *Id.* at § 965(b)(2).
313. *Id.* at §§ 959(a),(b), 965(a)(2).
314. *Id.* at § 965(b)(1).
315. *Id.* at § 6707A(b)(2).
316. *See id.* at §§ 482, 965(b)(3).

objective of encouraging investment in the United States generally.[317] This is accomplished by supplying further restrictions on the distributions' qualifying for the deduction, including qualifying transactions if there is no general (net) outbound transfer of property,[318] providing no offset for a foreign tax credit,[319] and not allowing the dividends to exceed a pro rata proportion of the distributing foreign corporation's E&P for the taxable year.[320] The election to take the deduction may be done in either the last tax year beginning before the date of enactment or the first tax year beginning during the one-year period following the enactment. The overall scope of the dividends receiving deductions under the Act takes perspective in light of the fact that it is flexible to the extent that the corporation has access to it measured by the very extent to which the income is reinvested, especially for the creation of domestic jobs, "or the financial stabilization of the corporation for the purposes of job retention or creation."[321] The time limits on executing the repatriation, phase-in, and application of tracing rules to the income is further and takes some precedence among the new amendments.[322] One suggestion of a proper use for qualifying repatriated dividends for reinvestment is repaying debt pursuant to the language of financial stabilization.

An ill advised use at this point would be that of share repurchasing, an area in which Mr. Hicks has advised that one should "tread carefully."[323]

6. Foreign Tax Credit

The Act makes a significant change to Subpart F income by decreasing the previously recognized nine categories of income[324] to

317. *See id.* at § 965(d).

318. *Id.* at § 367.

319. *See id.* at § 78.

320. *See id.* at § 1248.

321. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 422(b)(4)(B), 118 Stat. 1418, 1420 (2004); I.R.C. § 965.

322. *See generally* Karla Miller, *Treasury, IRS Officials Outline Top Priorities, Pitfalls in Jobs Act Guidance*, TAX NOTES TODAY, Nov. 9, 2004.

323. Lee A. Sheppard, Tax Analysts, 2004 WTD 234-3, December 6, 2004.

324. IRC § 951(a)(1)(A). The categories are: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from non-controlled foreign corporations under § 902, (6) certain dividends from a DISC, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from an FSC, and (9) a basket of general income if not falling into one of the afore listed categories. *Id.*

two: passive category income and general category income.[325] Passive category income consists of passive income and specified passive category income, which includes certain income from a DISC or former DISC,[326] taxable income attributable to foreign trade income,[327] and certain distributions from an FSC or former FSC.[328] General category income includes all income not classified as passive category income.[329]

In furthering its aim to promote reinvestment so as to encourage the "funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation," there is no foreign tax credit for the amount attributable to the deductible portion of the dividend.[330] However, the structure of the deduction falls well within the bounds of reason because to do otherwise would result in a double deduction which should be tolerated no more than double taxation. Another aspect at this juncture is ensuring adequate attention is paid to the new dividends' received deduction because its current interpretation allows a ceiling on foreign tax credits to be determined by offsetting amounts of the other fifteen percent of the repatriated dividend.[331]

7. U.S. Possessions

The Act satisfyingly coincides the successor to the code's § 936,[332] the benefits of which provided for tax-sparing to negate the need for foreign taxes to have been paid before a credit is allowed,[333] with the implementation of new § 937,[334] which provides that similar source rules for the determination of U.S. ECI are to be applied in determining possession source income.[335] In observance of this application the code stipulates that income treated as U.S. sourced income or income "effectively connected with the conduct of a trade or business within the

325. American Jobs Creation Act § 404(a)(1)(a), (b).
326. I.R.C. § 992(a).
327. *Id.* at § 923(b).
328. *Id* at 921(c)
329. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 422(b)(4)(B), 118 Stat. 1418, 1494 (2004); I.R.C. § 904(d).
330. American Jobs Creation Act § 422(b)(4)(B).
331. *See* I.R.C. §§ 78, 901, 965.
332. The tax sparing incentive implemented by § 936(a) had been due for sunset by § 936(j)(1) effective 2005. *See* BITTKER & LOKKEN, *supra* note 9, at ¶ 68.2.1.
333. *See* I.R.C. § 901(a).
334. American Jobs Creation Act § 908.
335. I.R.C. § 937(b)(1).

United States" is not possession source income.[336] There are within the code certain provisions that invoke ECI status as mandatory irrespective of the factors to be taken into account at § 864(c)(2). An example of this is a bank organized and doing business in a U.S. possession.[337] Under these facts the interest derived from obligations of the bank are to be considered a U.S. asset, the interest of which is to be treated as ECI.[338]

Once it is found to be a qualifying asset, two further steps are applied whereby a ratio of worldwide liabilities is divided by an aggregate of worldwide assets.[339] The sum of U.S. connected liabilities is then compared with liabilities entered on the books of the corporation.[340] Amended under the Act, outbound transfers of U.S. source dividends paid to corporations registered in Puerto Rico are to receive a reduced withholding tax rate from thirty percent to ten percent.[341] The decrease went into effect at the time President Bush signed the Act on October 22, 2002.[342] This reflects the disposition of U.S.-possession residents to shelter U.S. income pursuant to §§ 931-935 under which special tax-exempt rules had been in place for residents of Puerto Rico, Guam, American Samoa, the Northern Mariana Islands, and the Virgin Islands.[343] Towards this end the broadened implementation of the "effectively connected" rules will be utilized in determining the source of the income.[344]

V. EUROPEAN UNION RESPONSE TO ETI EXCLUSION REPEAL

The EU Commission[345] will be the leading body to formulate a necessary response based on its interpretation of the Act. While the EU is primarily analyzing the Act's apprehension of the "subsidization" of U.S. corporations and its approach towards retaining income in the United States to offset revenues lost there, it hardly stands to reason that the EU Commission's analysis would contain a look at what advantages may be seen as coming out of the expanse of the new legislation towards

336. *Id.* at § 937(b)(2).
337. *Id.* at § 882(e).
338. Treas. Reg. § 1.882-2(b) (1973).
339. Treas. Reg. § 1.882-5(c)(2)(i) (1996).
340. Treas. Reg. § 1.882-5(d).
341. I.R.C. § 1442(c)(2)(A).
342. *See id.* at § 1442(c)(2)(B).
343. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 908, 118 Stat. 1418, 1654 (2004).
344. *See* I.R.C. § 937(b).
345. European Union – Delegation of the European Commission to the USA, *available at* http://www.eurunion.org (last visited Feb. 21, 2006).

the treatment of foreign investors in their realization of ECI and the manner of taxing foreign corporations. The EU quickly honed in on the "grandfather" clauses that provide for a phasing out of subsidization, which takes steps necessary to bring the U.S. into formal consultations before the WTO. Nevertheless, EU Trade Commissioner Pascal Lamy has made statements concurrent with the actions initiating formal WTO proceedings, that the process of repealing legislation towards lifting the retaliatory tariffs sanctioned by the WTO pursuant to its 2002 ruling will continue unimpeded towards the goal date of January 1, 2005.[346]

Perhaps as a sign of what is to come, a scheduled meeting between the U.S. and the EU under the auspices of the WTO has never occurred.[347] The two bodies, however, have, with Airbus and Boeing as models,[348] agreed to structure their subsidizations in a more transparent fashion. If nothing else, this presents an opportunity for collaboration between the two world financial superpowers.[349]

The impact of global inter-relatedness is illustrated very sharply by virtue of results in other countries that can be directly attributed to the Act. Ireland for example, cites the Act's repatriation provisions as having an adverse impact on the Republic's economy.[350] However, their position is couched in extreme language that points to an amount of holdings equal to $350 billion dollars repatriated by U.S. companies with foreign profits and further suggests that the move will encourage businesses that currently have operations there to curtail investments in Europe as a result.[351] While the substance of this argument is likely to be availed of by most EU members, it should be scrutinized in light of the fact that those investors' operations are no less the result of tax

346. *See generally* Chuck Gnaedinger, *EU Says Proposal for Lifting ETI Act Sanctions Moving Quickly*, TAX NOTES TODAY, Nov. 8, 2004.

347. Phone call to Maeve O'Beirne, media relations officer for the EU Commission in Washington, D.C. confirmed that this meeting, scheduled for January 11, 2005, has not occurred. Maeve O'Beirne's contact information is as follows: European Union, Press & Media Relations Team Communications & Public Affairs Section, Washington D.C. Telephone: 202-862-9549, Email: maeve.obeirne@cec.eu.int.

348. *See* CHINAdaily, *US, EU Spar Over Airbus, Boeing Subsidies*, CHINADAILY, Oct. 7, 2004, *available at* http://www.chinadaily.com.cn/english/doc/2004-10/07/content_380131.htm (last visited May 11, 2006).

349. *See generally* Anthony Gooch & Maeve O'Beirne, *Airbus/Boeing Breaking News: EU/US Agreement on Terms of Negotiation To End Subsidies For Large Civil Aircraft*, EUROPEAN UNION NEWS RELEASE, Jan. 11, 2005, *available at* http://www.eurunion.org/News/press/2005/2005003. Htm (last visited May 11, 2006).

350. Jason Gorringe, *American Jobs Creation Act Will Have Negative Impact On Ireland*, TAX-NEWS.COM, November 10, 2004, *available at* http://tax-news.com/asp/newsjir.asp (last visited May 11, 2006).

351. *Id.*

incentives in that jurisdiction. If some global tax relief pinball could be directed along a planned path, the Act represents no more than an expression that the United States is recognizing the relative weakness of its economy and an attempt to secure a fix. By its own measure, the U.S. government incurred a deficit of $114 billion in the first two months of fiscal 2005, exceeding the same period of the prior fiscal year by $2 billion.[352]

Further illustrative of the continuously evolving set of measures and counter-measures which result in a workable, ongoing, "give and take" environment, are the WTO consultations between the United States and the EU which took place twelve days after the Act was signed and lasted for two days. Apparently, pursuant to the goal of repealing legislation imposing the tariffs, the EU is going to take a case by case approach to determine whether challenges to the transition period incorporated in the Act are resolved.[353] It is logical for the tax treatment of Boeing to be the initial test put forth by the EU as it is considered to be the major beneficiary of the proscribed subsidies, with total ascribed benefits of $1.6 billion between years 1992 to 2003.[354] No doubt this is in pursuit of Commissioner Lamy's desire to make a determinative success of the EU endeavor to that end of "trying to put FSC to bed for a long time. It is now in bed, but we need to just check before the lights go out."[355] As an issue relative to the production of ECI, it should be noted that one aspect of the EU's contention to the instant facts are that Boeing has benefited indirectly from European launch investments. However, at the same time these subsidizations are curbing application of the WTO agreements, they are also being offset by realizing foreign investment dollars that are stimulating production and promoting jobs sourced in the EU. The EU version of income is thereby effectively connected.

352. *See generally* Congressional Budget Office, *Monthly Budget Review, Fiscal Year 2005*, TAX NOTES TODAY, Dec. 7, 2004.

353. *See* Anthony Gooch & Maeve O'Beirne, *US-Boeing: EU Takes US to the WTO Over Subsidies Granted To Boeing*, EUROPEAN UNION NEWS RELEASE, Oct. 6, 2004, *available at* http://www.eurunion.org/news/press/2004/200400137.htm (last visited May 11, 2006).

354. *Id*.

355. *See generally* Anthony Gooch & Maeve O'Beirne, *Foreign Sales Corporations (FSC): EU Welcomes US Repeal Of Illegal Export Subsidies – EU To Lift Sanctions And Ask For Check On WTO Compatibility*, TAX NOTES TODAY, Oct. 25, 2004.

VI. ENFORCEMENT AND OTHER PROVISIONS

A. Transfer Pricing

Transfer pricing is the charge, or cost, assigned to an exchange of goods or services between a corporation's organizational units[356] and is most readily apparent for our purpose here in transactions occurring between the foreign parent and its domestic subsidiary.[357]

> Section 482 of the Code authorizes the IRS to adjust the income, deductions, credit or allowances of commonly controlled taxpayers to prevent evasion of taxes or to clearly reflect income. The regulations under section 482 generally provide that prices charged b one affiliate or another, in an intercompany transaction involving the transfer of goods, services, or intangibles, yield results that are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.[358]

Pursuant to the powers arising from § 482 the Act continues their expansion by decreasing the requirements for treatment as an affiliated group by replacing the eighty percent test for control with fifty percent under § 1504(a).[359] This also implicates access to deductions for domestic production gross receipts under the new § 199, where such qualifying income may not arise from property that is "leased, licensed, or rented by the taxpayer for the end use of any related person."[360]

Ultimately these rules are designed to apply a standard of reasonableness based on factual economic analysis when conducting business with a related party, as compared to one conducted with a third party, and will include a broad range of considerations exchanged.[361] A valuation misstatement may result in a "transactional penalty" of twenty percent or forty percent depending on whether it is "substantial"[362] or

356. I.R.C. § 482.
357. *Id.* at § 424(e),(f).
358. Internal Revenue Service, Transfer Pricing, *available at* http://www.irs.gov/businesses/international/article/0,,id=120220,00.html (last visited November 22, 2004).
359. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 801, 118 Stat. 1418, 1562 (2004); *see also* I.R.C. § 7874(c)(1).
360. I.R.C. § 199(c)(7)(A).
361. *See* Treas. Dec. Int. Rev. 8519; Imposition of Accuracy-Related Penalty, 59 Fed. Reg. 4791 (Feb. 2, 1994).
362. I.R.C. § 6662(e).

"gross."[363] The potency of supporting documentation to substantiate the figures a corporation has used to determine a transfer pricing scheme is most respected when it is obtained contemporaneously with the transaction.[364] Pursuant to analysis of taxing related entities, the IRS has indicated that its willingness to give credence to the needs of U.S. businesses includes input from taxpayers under the "no-rule" policy under which taxpayers must submit representations on the business purpose and device utilized in pursuit of a distribution of stock or securities to a controlled corporation.[365] As William D. Alexander, IRS Associate Chief (Corporate) Counsel, stated in reference to the "no-rule" policy under § 355, if "deals can't be done anymore than you used to be able to do, we need to hear that."[366] This may be nothing short of an express intent to look through the corporate income source to examine the balance sheet in an effort to assist successful perpetuation of the entity, perhaps allowing an all facts and circumstances viewpoint to determine the business purpose as complying with the holding that there is no obligation to pay more tax than is lawful. Along these lines – in light of the striking down of "duplicated loss factor"[367] actively "welcoming comments" on methods for determining what costs are associated with the capitalization of mergers and acquisitions[368] – the IRS is demonstrating an invaluable asset in the form of some semblance of an atmosphere of cooperation. Ultimately, this could easily be interpreted as a state defense tactic whereby this administration has positioned the Treasury so as to make aim of promoting the FISC by way of stemming the current deficit brought on by the tremendous expenditures this current administration has borne. Hal Hicks, IRS Associate Chief (International) Counsel, remarked that guidance on the Act would "crowd out" other guidance while confirming that the new law's provisions would be "generously" interpreted.[369] Guidance specifically addressing cost-sharing is forthcoming in the spring of 2005 and exists in two parts: one for definitions and one for valuations.

363. *Id.* at § 6662(h).

364. *See* Internal Revenue Service, Study: The Effectiveness of I.R.C. Section 6662(e), at 41, (2000-2001).

365. *See* I.R.C. § 355.

366. Miller, *supra* note 322.

367. *See* Rite Aid Corp. v. United States, 255 F.3d 1357 (2001) (demonstrating how a Treasury Regulation applying the duplicated loss factor to consolidated returns for corporations and subsidiaries denied a deduction and imposed a tax that would otherwise not be taxed was invalid).

368. *See* I.R.S. Notice 2004-18, 2004-11 I.R.B. 605.

369. Lee Sheppard, *U.S. IRS's Hicks Previews Jobs Act Guidance,* WORLD TAX DAILY, Dec. 6, 2004.

B. Additional Reportable Transactions

The taxpayer has the burden of declaring benefits under a treaty and reporting[370] when income falls under the auspices of a treaty.[371] This is typically applied as a staunch nod towards disapproval of outbound transfers related to tax shelters in regard to availment of the tax advisor–client privilege. These outbound transfers are particularly discouraged as they stem from current law limitations with the inclusion of individuals, partnerships, tax-exempt entities, or any other entity, as well as the corporations holding an interest in a tax shelter.[372] In furtherance of this goal, a "material advisor" is now required to file, rather than just maintain, lists of tax-shelter investors, including a description of the transaction and associated tax benefits.[373]

Enhanced penalties accompany the previous requirements as well, including the maintenance of a list of investors,[374] furnishing a false or fraudulent statement in connection with the organization or sale of an abusive tax shelter,[375] or the failure to report foreign accounts.[376] For reportable transactions other than listed transactions[377] the penalty is \$50,000.[378] For listed transactions the penalty is assessed starting at the greater of either \$200,000, or, fifty percent of the gross income the material advisor received regarding the transaction; if the failure is intentional, the penalty is seventy-five percent.[379] It is advisable to conform with the typical fees for these services because the Act alludes to that standard as as the standard for a material advisor in these instances, and will likely utilize this standard in determining the dollar

370. *See* Treas. Reg. § 1.6012-2(g)(1)(ii) (1996).

371. Treas. Reg. § 1.871-12(b)(1)(i).

372. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 841(b)(2)(B)(i),118 Stat. 1581, (2004); I.R.C. § 7525(b) (2006).

373. American Jobs Creation Act § 815.

374. *Id.* at § 817.

375. *Id.*

376. American Jobs Creation Act § 823.

377. Internal Revenue Bulletin 2004-67, 2004-41 I.R.B. 600, released Sep. 24, 2004 serves to update those transactions deemed to be "listed transactions" by the IRS under Treas. Reg. §§ 1.6011-4(b)(2), 301.6111-2(b)(2), 301.6112-1(b)(2). *See also* Internal Revenue Bulletin 2000-60, 2000-49 C.B. 568 (listing transactions involving the purchase of a parent corporation's stock by a subsidiary, a subsequent transfer of the purchased parent stock from the subsidiary to the parent's employees, and the eventual l liquidation or sale of the subsidiary); I.R.S. Notice 2004-20, 2004-11 I.R.B. 608 (dealing with a transaction in which, pursuant to a prearranged plan, a domestic corporation purports to acquire stock in a foreign target corporation and to make an election under § 338 before selling all or substantially all of the target corporation's assets in a preplanned transaction that generates a taxable gain for foreign tax purposes but not for U.S. tax purposes).

378. I.R.C. § 6707(b)(1) (2006).

379. I.R.C. § 6707(b)(2).

percentage amount. In providing rules pertaining to the reporting of tax shelters, the AJCA seems to have loosened the restrictions on at least three points. Where previously two persons were required to meet the requirements for a material advisor,[380] the amendment provides that one person will now suffice, exemptions from the requirements are provided for,[381] as well as other rules that may be necessary or appropriate to carry out the purposes of § 6111.[382] While § 815 of the AJCA now requires the material advisor, at least, to maintain a list of the advisees of the transaction, the end result nonetheless militates towards a larger lumen through which outbound transactions may occur, in derision of the stated intent of the Act, both in title as to create jobs, and in purpose, as to comply with the 2002 WTO ruling.

In order to bolster the general requirements of a return, statement, or list,[383] the Act provides in new § 6707A[384] a separate additional penalty pursuant to any transactions deemed to have a strong potential for avoidance or evasion of taxes which are either "reportable transactions" or "listed transactions," the latter of which carries a $100,000 fine for a natural person, or a $200,000 fine "in any other case."[385] There is some language in that section of the code that the IRS may seek to find self-destructive because it precludes judicial review[386] of any determination made under the section allowing for a penalty to be rescinded where the violation is in respect to a reportable transaction but not a listed one, and "rescinding the penalty would promote compliance of this title and effective tax administration."[387]

While certain restrictions may have been loosened, accuracy-related penalties for tax years starting with 2005 are given new vigor with the implementation of § 6662A for understatements attributable to "listed transactions" and reportable avoidance transactions[388] to equal twenty percent of the difference in amount determined due and the amount as disclosed on the taxpayer's return. If the transaction was not adequately disclosed, a thirty percent penalty that may not be waived will be

380. Treas. Reg. § 301.6112-1(c)(2) (2003).
381. I.R.C. § 6111(c).
382. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 815, 118 Stat. 1418, 1581 (2004); I.R.C. § 6111(c)(3). *See* I.R.S. Notice 2004-80, 2004-50 I.R.B. 963.
383. I.R.C. § 6011.
384. American Jobs Creation Act § 811.
385. I.R.C. § 6707A(b)(2).
386. *Id.* at § 6707A(d)(2).
387. *Id.* at § 6707A(d)(1).
388. *Id.* at § 6662A(b)(2),(d).

substituted.[389]

On the "tightening up" side, individuals engaged in practice before the Treasury are exposed to expanded sanctions imposed on practitioners failing to comply with the Circular 230 rules governing tax practice.[390] Additional penalties may be incurred if the practitioner is acting in the role of an employee if the noncompliant conduct should have reasonably been known.[391]

1. Reasonable Cause Exception[392]

The Act continues to provide for an all facts and circumstances approach in determining whether to employ the penalty, else it may, as was provided for in the prior § 6664(b), be waived for reasonable cause implemented in good faith.[393] It may be waived so long as it is accompanied by adequate disclosure premised on substantial authority and based on reasonable (good faith) belief.[394]

a. Certain Tax Advisor Opinions[395]

Reasonable reliance on the opinion of a qualified tax advisor may allow the taxpayer to avoid the imposition of penalties in the event that the tax treatment of a transaction does not hold up under review by the IRS. The Act does narrow the specifics of when tax advisor opinions are reasonably in good faith. There should be no doubt that this is a targeted response to the IRS having to respond to the taxpayer pleading some detrimental reliance on faulty tax advice and should be looked for as resulting in those stricter penalties under §§ 6111 and 6112. At the same time however, the application of those guidelines are broadened in a manner that minimizes any focus on transfer pricing regardless of the material advisor's[396] relation to the taxpayer *pro tanto* the transaction at issue.[397]

389. *Id.* at § 6662A(c).
390. 31 CFR 10, TD 9165, *availabe at* http://www.irs.gov/pub/irs-regs/td9165.pdf (last visited May 11, 2006).
391. American Jobs Creation Act § 812(d)(3).
392. *Id.* at § 812(b).
393. I.R.C. § 6664(d).
394. American Jobs Creation Act § 812(d)(3).
395. I.R.C. § 6664(d) as amended; American Jobs Creation Act § 812(c).
396. I.R.C. § 6111(b).
397. Treas. Reg. § 1.6662-6(b)(3) (1997).

C. Noncompliance[398]

While noncompliance is not expressly addressed in the Act, due notice should be given to the dogged determination the Service will employ subsequent to its discovery, *ex post facto* measures of remedy notwithstanding.[399]

VII. CONCLUSION

While the original legislative intent behind the concept of ECI was primarily to prevent foreign persons from using the United States as a tax haven and to include income that may arise from, or be attributed to a U.S. trade or business, as includible to U.S. source income, the acceptance of ECI as a tax tool is not unique to the United States.[400] In furtherance of this outlook and in recognition of the burgeoning economic impact today's global market irretrievably puts forth, the next layer of analysis should include the way ECI may afford a "canary in a coal mine" perspective of the strength of the U.S. economy. The more robust and ventilating the economy, the greater the desire for production of ECI.

The ultimate value in this pursuit is to equalize the stem of outbound income by channeling to fruition that concept labeled in the most current legislation here, the "Jobs" part of the American Jobs Creation Act. Towards this end, had ETI Repeal been effected absent any other balancing contributions forthcoming therein, the ensuing alteration in exchange rates could have pushed employment downward in those economies that are based on a dependence of exports, as those jobs would of course flow towards the more receptive environment afforded its class under those import based economies.[401] The degree

398. I.R.S. 6038C(d); INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL, PART XX—INT'L PENALTIES, Ch. 1, § 9.

399. *See* I.R.C. § 874(a); *see also* Espinosa v. Comm'r, 107 T.C. 146 (1996) (noting that a subsequent submission by taxpayer of substitute returns that had been prepared by the Commissioner after notice that deductions were not allowable was insufficient to avoid sanctions).

400. *See* U.K. Inland Revenue Manual, Int'l Tax Handbook – ITH549, *DT: OECD Model: Effectively Connected: Dividends Excluded*, *available at* http://www.inlandrevenue.gov.uk/manuals/ithmanual/html/ITH0500/06_0031_ITH549.htm (last visited Dec. 1, 2004).

401. For an overview on the susceptibilities and strengths of an export dependent economy, see generally Tony Jackson & John Curry, *Community-based Sustainability in an Export Dependent Natural Resource Economy: The British Columbian Experiment to Deliver 'Sustainability in One Province,' available at* http://www.trp.dundee.ac.uk/library/pubs/cbsinbc.pdf (last visited Dec. 4, 2004). For example, in the city which comprises the metropolitan area of St. Louis, Missouri, export industries for a taxable year produce $2.5 billion, which equals five percent of labor income alone. Lucia De Maio & David Peters, IMPACTS OF THE GLOBAL ECONOMY: EXPORT DEPENDENT

and reach of this amount of funds would impact a location economically denotes this to be a primary consideration for both the short and long term tax model, furthered in light of the revenues available there, generated for use by the local tax coffers. By applying a strategy that is parallel to that employed by the availability of credits and deductions found in the IRC, the community will be self-sustainable.

On the whole, visionary planning should ideally contain a substantive location-neutral / produce-neutral / export-neutral effect towards achieving the optimal in global economic efficiency, mindful that sourcing income from one state without replenishing it in some way, only to bring that income to the other state, has the potential of sending an unbalancing ripple through world economies with an ensuing commensurate degree of inflationary backlash. For instance, an ideal scenario might employ a multinational approach by coordinating income from sources where the tax is higher and lower relative to the native rate with a resulting neutral tax position. In the analysis of foreign source ECI[402] in this article,[403] we looked at ways to attract foreign source income towards domestic U.S. investments. To retreat from this approach further detracts from the U.S. economic welfare. The condolence afforded to export benefits through most of the bill effects the passing of the benefit to the recipient foreign consumer, at least in part, in the form of lower prices.[404] Although in contention with those EU allegations which have been the main pursuit of our reading here, if a business entity which has been utilizing ETI is not directly generating export income, it will necessarily be defined as making investments domestically. The result is that by cutting off any "subsidizations," those foreign corporations that are investing in U.S.-export income will also be affected, which in turn no doubt is one goal of the EU: to encourage and retain investments within its own borders.

The net effect is a following general transfer of economic welfare thereto. This is simply another avenue for outbound transfer, but the degree of impact it has should be measured as a percentage of change demonstrated by the quantity of U.S. exports affected thereby.

The larger picture demonstrates a way for a fast approaching, if not already present, shift in the historical balance of global economics, of

INDUSTRIES IN THE ST. LOUIS, MO METRO AREA (October, 2004), *available at* http://www.missourieconomy.org/pdfs/stl_exports_04.pdf (last visited May 11, 2006).

402. *See also* I.R.S. Pub. 519, U.S. Tax Guide for Aliens (2006).

403. *See* IRC § 368(c).

404. DAVID BRUMBAUGH, CONG. RESEARCH SERV., POLICY OPTIONS FOR U.S. EXPORT TAXATION 2 (Nov. 5, 2004).

which the United States has been top heavy for at least the last fifty years. This necessitates embracing the contemplation of what could happen if the shift occurs too quickly, so as to avoid unnecessary economic and political instability which are easy fallout developments of an uncontrollable economy. This will ultimately affect most directly those countries that are most reliant on the United States to provide economic supports. While this siphoning effect will eventually lead towards economic efficiency, its optimal approach would entail close conscription of a method that could subjectively outline a mapped path approved of by consensus. Only a uniform objective stands any chance of presenting such a clear cut consensus and any welcomed opportunity for its success would be required of all the participant states. Inevitably, the goal should be that all states will become participant members.

Compare this with another descendant of the common law approach, one from the U.K., which seems borne of a more unilateral, segregated, and colonial self in comparison to some encompassing of the idea of tax neutrality:

> Where a transfer is to be treated as one on 'tax-neutral' terms, the transfer is regarded for this purpose as not involving any realization of the asset by the transferor, nor any acquisition by the transferee. There is then a 'stand in shoes' approach such that the transferee is treated as having held the asset throughout, and having done all the things in relation to the asset as were done by the transferor. In particular this means the transferor inherits the transferor's tax cost for the asset (see CIRD12720), and all such debits and credits as have been brought into account under Schedule 29 by the transferor are treated for this purpose as thought they had been brought into account by the transferee.[405]

Along this vein, while the United States has enjoyed economic dominance for a very significant part of time relative to its history as a nation, it must be acknowledged that its currency is not necessarily going to be the premier measure of exchange rates indefinitely.[406] The shift resulting from the maturation of the EU and its ability to be

405. U.K. Inland Revenue Manual, *CIRD40300 – Intangible Assets: Groups: Tax-Neutral Transfers: Effect*, *available at* http://www.inlandrevenue.gov.uk/manuals/cirdmanual/cird40300.htm (last visited Oct. 12, 2004).

406. Global rankings of gross domestic product for year 2003 using the current exchange rate method give the lead to the European Union at USD 10,958,833, with the U.S. a close second at USD 10,881,609, while mainland China is seventh on the list of states at USD 1,409,852. *See* Gross Domestic Product, in Iridis Encyclopedia, *available at* http://www.iridis.com/glivar/Gross_domestic_product (last visited Dec. 2, 2004).

perceived as a single economic entity,[407] coupled with the expenditures of the United States economically through siphoning of funds as necessitated by increased security needs, especially domestically, plus current military support requirements, could cause a destabilization resulting in a negative rate of world economic growth. One remedy to that end could be the exercise of self-restraint by other WTO member states toward any suppression of ECI that would deter some balance in the deficit to which these aforementioned factors have irrefutable ties.

As noted, guidance from the Treasury that addresses the intricacies of the Act is already in short supply as a multitude of theoretical scenarios are purported by a number of tax professionals. The Treasury's Office of Tax Policy will surely be kept busy by the Act's need for quick and continued regulations for some time to come. Senate Finance Committee Chair Charles E. Grassley,[408] and House Ways and Means Committee Chair William Thomas, made an attempt at clarification while engaged in dialogue addressing how the Act affects multinational corporations in their repatriation of profits during a formal floor explanation that: "The rule and the Statement of Managers, upon closer examination, we believe, contain some ambiguity as to which deductions are disallowed."[409] Pursuant to its role of providing the much touted tax relief is that it will certainly bring quick attention to the definitions of what will encompass those items qualifying for the phase-in deductions by way of treatment as domestic production gross receipts. In doing so, it should be realized that heretofore the IRS will have sought to classify an expense as foreign sourced so as to avoid the sheltering of U.S. income. However, in light of the deductions that are to be available from qualifying production activities the argument is likely to take an apposite, but converse approach. This is illustrative, in no small measure, of the continued lack of that oft-anticipated diminished complexity accompanying the Act and, sourcing rules being the crux of ECI, the direction to be taken by the regulations and rulings that eventually shape and refine the definition of what a qualifying production activity consists of, with the realization that it will have a direct and continuing impact on its production, increasing commensurately with the phase-in rates over the next ten years. Further, it is of little import to emphasize performance under the Act as not

407. *Id*.

408. Senator Grassley was a prodigious source of illumination regarding expectations of what was to be provided by the Act as it wended its way to enactment.

409. Heidi Glenn, *Treasury to Issue Repatriation Regs "Very Quickly"*, TAX NOTES TODAY, Oct. 25, 2004, at 493.

"contingent on export performance"[410] so as to conform to the WTO guidelines when the phase-in of a graduated reduction in tax rates for manufacturers that will ultimately export their products continue to have entrance to benefits that effectively replace those lost under ETI Repeal. However, it must be recognized that those U.S. manufacturers who are producing the least amount of income will realize the least amount of benefits under the Act by way of these deductions. As a corollary. those businesses most in need of relief may be the ones with the least amount of access thereto.

Looking ahead along these lines, the phase-in period is necessary to head off a loss of jobs among export industries with a subsequent commensurate loss realized by their stockholders, foreign as well as domestic. The U.S. tax code continues to primarily retain its cloak of enigma, frequently so rigid in its application while constantly in flux as to its substantive intent, while the global economy rapidly and continuously decreases its response time in regard to the economic impact in one country as a result of activities that are taking place in what have been disconnected activities in seemingly more overtly, unrelated countries. This only serves to spotlight the reality that the United States continues to have the largest gross domestic product (GDP) by far, measured in millions of U.S. dollars at 10,881609 for 2003.[411] This is more than two times the GDP of Japan, ranked next at $4,326,444 for the same period.[412] While Norway may currently lead the world in per capita income, the overwhelming indication is that the U.S. remains the end investment forum of choice for multinational corporations. The pursuit of strategies to develop business and trade within the U.S. will result in ECI becoming a strategic foundation from the outset of building the structure those corporations will be employing.

410. *See* WTO – Tax Treatment for "Foreign Sales Corporations" Recourse to Art. 21.5, sec.5, of the DSU by the European Communities, WT/DS108/RW August 20, 2001, *available at* http://www.wto.org/english/tratop_e/dispu_e/108abrw_e.pdf (last visited May 11, 2006).

411. World Bank, World Development Indicators 2004, http://devdata.worldbank.org/data-query/ (enter country, year, and series into query tool) (last cisited Feb. 28, 2006).

412. *Id.*

WORLD INCOME PER CAPITA- 2002[413]

Rank	Country	Population (millions)	Population density (people per sq. km)	Gross national income per capita
1.	Norway	5	15	$38,730
2.	Switzerland	7	184	$36,170
3.	United States	288	31	$35,400
4.	Japan	127	349	$34,010
5.	Denmark	5	127	$30,260
6.	Sweden	9	22	$25,970
7.	United Kingdom	59	246	$25,510
8.	Hong Kong, China	7		$24,690
9.	Finland	5	17	$23,890
10.	Austria	8	97	$23,860
11.	Netherlands	16	477	$23,390
12.	Ireland	4	57	$23,030
13.	Belgium	10	315	$22,940
14.	Germany	82	236	$22,740
15.	Canada	31	3	$22,390
16.	France	59	108	$22,240
17.	Singapore	4	6,826	$20,690
18.	Australia	20	3	$19,530
19.	Italy	58	196	$19,080

413. *Id.*

20.	Kuwait	2	131	$16,340
21.	Israel	7	318	$16,020
22.	Spain	41	82	$14,580
23.	New Zealand	4	15	$13,260
24.	Greece	11	82	$11,660
25.	Portugal	10	111	$10,720

Gross National Income-GNI (GNP) per capita,[414] measured in U.S. dollars.

1. Luxembourg	39470	43940
2. Norway	38730	43350
3. Switzerland	36170	39880
4. United States	35400	37610
5. Japan	34010	34510
6. Denmark	30260	33750
7. Iceland	27960	30810
High income:[415] OECD	27240	29310
High income	26550	28550
8. Sweden	25970	28840
9. United Kingdom	25490	28350

414. *Id.*

415. *Income group:* Economies are divided according to 2003 GNI per capita, calculated using the World Bank Atlas method. The groups are: *low income*, $765 or less; *lower middle income*, $766 - $3,035; *upper middle income*, $3,036 - $9,385; and *high income*, $9,386 or more. World Bank, Data & Statistics, *available at* http://www.worldbank.org/data/countryclass/countryclass.html (last visited Dec. 2, 2004).

10. Hong Kong, China	24500	25430
11. Finland	23890	27020
12. Austria	23860	26720
13. Netherlands	23390	26310
14. Ireland	23030	26960
15. Belgium	22940	25820
16. Germany	22740	25250
17. Canada	22390	23930
18. France	22240	24770
19. Singapore	21180	21230
20. European Monetary Union	20320	22850
21. Australia	19530	21650
22. Italy	19080	21560
23. Kuwait	16340	..
24. Israel	16020	..

Purposefully attaining ECI through the establishment of an ongoing domestic trade or business, not only makes the world's largest market available, but allows the foreign corporation to take advantage of the same credits, deductions, and graduated rates that are available to the U.S. domestic corporation. A broadened approach to those issues arising from worldwide taxation entails looking at avenues to attain some equilibrium with the export deficits existing in the largest origin of U.S. outbound income. Commentary by Mr. Brumbaugh in a Congressional Research Report addressing this issue ascribes characterization to a state as if each were a partner to the whole global economy, each with a stake therein as measured by their net contribution and distribution:

> [W]hen a country runs a trade deficit, it is using more goods and services than it produces. To finance these purchases, it must necessarily borrow from abroad by importing more foreign investment

> than it exports. A country's trade deficit, in other words is matched by a deficit on capital account (investment outflows minus investment inflows). And a country's trade balance changes only if the balance on capital account changes. Thus, if we assume that the export benefits do not change the balance on capital account, they cannot change the trade balance. . .By definition, an export incentive encourages only domestic investment, since exports cannot be produced abroad. Also, if ETI's reduction in tax revenues is not offset by higher taxes elsewhere, then the provisions likely increase the U.S. federal budget deficit and drive up real interest rates, attracting capital to the United States. Thus when capital flows are considered, ETI may increase the trade deficit.[416]

Even though 2002 did not arrive in the company of an abundance of optimism in light of the previous year's 9/11 terrorist attacks on the United States, the world economy experienced net growth of 1.9%, a slight increase from 1.3% in 2001, but below the 2.7% annual average in the 1990's. Interestingly the fastest economic growth levels were recorded in lower-middle-income economies, with low-income economies next. This is likely due in no small part to the exponential growth seen in the advent of the internet, its use as a tool for the Internet, and the inexorable bond it enjoys with the FISC as it continues on its march toward becoming evermore efficient in exploiting its commercial channels. As this mode continues it will eventually bring to fruition the goal of signatory members of the WTO in pursuit of bridging the "digital divide."[417] Perhaps not as surprisingly in light of the events of 2001, upper-middle-income countries experienced negative growth, attributable to a decrease in the worldwide markets stemming from decreased overall investment and widespread uncertainty in the finance markets. High-income economies which account for eighty-one percent of the world's GDP achieved a seventy percent increase over the previous years' level. This is extremely significant in light of the fact that the high-income economies account for eighty-one percent of global GDP, China and India were the economic leaders of the fastest growing area of the last decade, East Asia and the Pacific Rim (averaging 7.3% a year) and South Asia (5.4%). China and India alone accounted for seventy percent of the regions output.[418] Another consideration to shift

416. DAVID BRUMBAUGH, CONG. RESEARCH SERV., POLICY OPTIONS FOR U.S. EXPORT TAXATION, RS21143 (November 5, 2004).

417. United Nations Conference on Trade and Development, E-Commerce Report and Development Report 2002 – INCTAD, *available at* http://r0.unctad.org/ecommerce/ecommerce_en/edr02_en.htm (last visited Nov. 30, 2004).

418. World Bank, World Development Indicators 2005, *available at* http://www.worldbank.

the focus from the EU to Asia is the newest burden imposed on non-EU producers utilizing e-commerce as a medium in which to conduct transactions. In 2002, the EU adopted Council Directive 2002/38/EC which imposed a VAT on non-EU based suppliers of digital goods beginning July 1, 2003. While the model on which this taxation will be effected is likely to be used as a reference when other jurisdictions follow suit, the fact that it currently stands as a unilateral action does not bode well for the near future of this economic medium which carries so much potential for growth. Hopefully this will not signal the posture for future relations between the EU and its trading partners.

The U.S.-China Tax Treaty currently in effect emerged from agreements originating in 1984 under the administration of President Reagan.[419] Presently, it provides for determining the presence of ECI in several forms: dividends, interest, and royalties, as business profits, when attributable to a permanent establishment or fixed base.[420] This could be utilized to set up a platform pursuant to targeting China with provisions of certain incentives based on a progressive rate of generated ECI income that should result in more jobs being created here. Likewise, a model for attaining similar treatment when generating ECI income by foreign corporations doing business in a deficit condition should be structured and put in place as soon as feasible. This concept should readily be interpreted as following in the footsteps of the exempt status granted to portfolio income under § 871(h), whereby interest derived from investments into U.S. sources are rewarded with access to those graduated rates; when acknowledged at the inception of structuring the business plan and applied adroitly, this treatment has the potential to eliminate taxation prior to that foreign person's "repatriation" of U.S. sourced income. However, while China presents a model for such a campaign, it should take a long-term approach based on the fact that the Chinese government has not been more than minutely responsive to the creation of foreign investments realizing Chinese source income. In the meantime, the model should be implemented and perfected in those more receptive developing countries to the extent that the spirit of the

org/data/wdi2004/economy.htm (last visited Nov. 30, 2004).

419. Tax Agreement with the People's Republic of China, U.S.-P.R.C., art 27, Jan. 1, 1987, *available at* http://www.irs.gov/pub/irs-trty/china.pdf (last visited May 11, 2006).

420. United States Department of the Treasury, Technical Explanation of the Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Prevention of Double Taxation and the Prevention of Tax Evasion With Respect to Taxes on Income, U.S.-P.R.C., art. 7(7), Jan. 1, 1987, *available at* http://www.irs.gov/pub/irs-trty/chintech.pdf.

Act remains intact.[421]

Illustrating the continued ability of the EU to hold itself out as an economic superpower are the Hague Summit agreements of December 8, 2004, wherein subsequent to six prior meetings between the two, China signed agreements encompassing a wide range of issues addressing the fields of science, technology, energy and customs, social security, training programs, information technology, and education, as well as a bolstering of the nuclear arms non-proliferation that had previously been in place.[422] The most efficient method of carrying out these policies are elements of taxation issues. At the same time both countries acknowledged that during 2004 the EU became China's largest trading partner, and China became the EU's second largest trading partner.[423] By taking a similar approach, the U.S. should be able to expand relations on a variety of levels with a resultant flourish of opportunities for reducing tax neutrality that can ultimately produce a trade balance with only necessary, controlled fluctuations that would arise where and when indicated.

This type of overall approach taken under the WTO agreements has facilitated the EU's ability as a whole to compete with the U.S. on a most even economic field, as demonstrated by the genesis of the Act itself which is borne of agreements that the EU was able to negotiate through WTO rulings. Now is the time to anticipate the pendulum's eventual return, using this extensive legislation as a tool to beneficially produce an increase in U.S. source investment income by partaking of these new aspects of generating ECI.

421. *See* WTO Breakdown Warning, BBC NEWS, Apr. 7, 2000, *available at* http://news.bbc.co.uk/1/hi/business/704430.stm (last visited May 11, 2006).

422. Press Release, European Union, Report joint press conference EU-China Summit (Aug. 12, 2004), *availabe at* http://www.eu2004.nl/default.asp?CMS_ITEM=0957BB07E26B4F4EA16D6DC3FF9F9982X1X80576X53 (last visited Dec. 9, 2004).

423. Council of the European Union, *7th EU-China Summit*, THE HAGUE, (December 8, 2004) *available at* http://ue.eu.int/ueDocs/cms_Data/docs/pressdata/en/er/82998.pdf (last visitedd Feb. 28, 2006).