U.S. INTERNATIONAL TAXATION: A MATTER OF TAXPAYER ELECTION?

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Abstract

The United States provides broad taxpayer autonomy to choose the classification of foreign entities. The result of this elective entity classification regime is that taxpayers can elect to create mismatches in the classification treatment of foreign entities that, in turn, results in income escaping taxation everywhere. Given today's global effort to harmonize international taxation among the G-20 countries to assure that multinational enterprises pay a minimum tax, the continuation of an elective U.S. entity classification regime hinders the policy goals of both the United States and its treaty partners. The Organisation for Economic Co-operation and Development (OECD) has attempted to address these mismatches, but this paper argues that the OECD prescription set forth in its Global Anti-Base Erosion (GloBE) rules does not adequately or effectively remedy the use of flow-through entities by large U.S. multinational enterprises. In the end, a more effective solution would be for the United States to conform its classification of a foreign entity to that of the foreign entity's situs jurisdiction. If the foreign situs jurisdiction treats its own juridical entity as a separate and distinct corporate taxpayer, then the U.S. should classify that foreign entity as a foreign corporation. If the foreign situs jurisdiction treats its juridical entity as a flow-through entity such that the owners of the entity are responsible for paying tax on the entity's income on a flow-through basis, then the entity should be treated as a foreign partnership if two or more owners own it, and as a disregarded entity if its owned by a single owner. The article argues that this entity classification conformity in entity classification better promotes the design goals of the United States and its treaty partners in this era.

I. INTRODUCTION

The OECD has engaged in a multi-year effort to address base erosion and profit shifting. The OECD began its work on this topic in 2013-2015 through the Base Erosion and Profit Shifting (BEPS 1.0) plan and set forth fifteen action items at that time.[1] The OECD also set forth a proposed multilateral instrument that nations would adopt to revise their income tax treaties to address base erosion and profit shifting concerns.[2] The OECD re-engaged in this effort in 2018 (BEPS 2.0), and the result of its BEPS 2.0 work was the promulgation of a proposed inclusive framework comprised of two pillars: Pillar One and Pillar Two. The OECD Pillar One project sets forth a compromise among nations on the scope of nexus over ongoing electronic commerce activities that do not rise to the level of a traditional permanent establishment. The OECD Pillar Two project is designed to ensure that large multinational enterprises pay a minimum tax regardless of where they are headquartered and regardless of the jurisdictions where they operate.[3] The OECD's Pillar Two project introduces the concept of Global Anti-Base Erosion rules (so-called "GloBE" rules) that implement a minimum tax through interlocking top-up taxes. The minimum tax is determined on a country-by-country basis; a design challenge posed by the GloBE rules is that countries adopting Pillar Two must come to a common understanding as to which country the items of income are assigned for them to coordinate the interlocking top-up taxes.[4] The need to harmonize the country-by-country income allocation under this OECD framework is more fully addressed in Part I below.

After properly framing the need for achieving a common understanding of where income is generated on a country-by-country

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1. *See* OECD, *BEPS Actions*, https://www.oecd.org/tax/beps/beps-actions/.

2. *See* OECD, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*, https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm.

3. *See* OECD, *OECD/G20 Base Erosion and Profit Shifting Project: Tax Challenges Arising from Digitalisation—Report on the Pillar Two Blueprint*, at 11 (Oct. 14, 2020), https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint-abb4c3d1-en.htm [hereinafter *OECD Report on the Pillar Two Blueprint*].

4. *See* OECD, *Public Consultation Document —Pillar Two: Tax Certainty for the GloBE Rules*, at 13 (Mar. 16, 2023), https://web-archive.oecd.org/2022-12-20/648356-public-consultation-document-pillar-two-tax-certainty-for-the-globe-rules.pdf ("The Model Rules incorporate a number of mechanisms designed to ensure consistent outcomes for MNE Groups under the laws of each jurisdiction including through the correct application of the agreed rule order and allocation of top-up tax to each jurisdiction. . . .Since the common approach contemplates that GloBE rules would be enacted into the domestic law of each jurisdiction and applied by the tax authorities of that jurisdiction, there is still a possibility that differences could arise in the interpretation or application of such rules among jurisdictions that could give rise to divergent outcomes under the GloBE rules. . . .This document outlines various mechanisms for achieving tax certainty under the GloBE Rules that the Inclusive Framework on BEPS under the GloBE Implementation Framework is exploring. Those mechanisms could apply in advance of any taxation action being taken by jurisdictions (dispute prevention mechanisms) as well as mechanisms that could be relied upon once a taxation action has been taken (dispute resolution mechanisms).").

basis, a reevaluation of the elective United States entity classification regime emerges in light of this design goal. An appropriate analogy is the iconic children's book *Harold and the Purple Crayon*.[5] In it, Harold wanders around using his large purple crayon to draw whatever comes into his imagination. Once one's young child reads the story, it is impossible for crayons to peacefully coexist in the same home with the toddler. The book fosters the value of imaginative drawing on bedroom walls with crayons in the child's mind. The parent is then required to vigilantly clean the crayon markings off walls and to be on constant guard for new instances of toddler crayon creativity. The elective U.S. entity classification regime has a similar influence on taxpayer imagination. Shortly after the adoption of the elective U.S. entity classification regime, a respected practitioner observed that many in the tax community trumpeted the elective U.S. entity classification regulations as the greatest tax-planning development since the invention of numbers.[6] The elective U.S. entity classification regulations allow taxpayers to create classification mismatches that allow income to escape taxation everywhere due to the entity classification mismatches that taxpayers, through their own ingenuity, imagine into existence.

Many examples can be given, but the docketed case of *Perrigo v. United States* provides an illustrative example.[7] In this case, the Perrigo parent entity (Perrigo) negotiated an agreement with an unrelated pharmaceutical company to acquire a generic pharmaceutical that would be marketed throughout the United States. After substantially negotiating the agreement, Perrigo formed a new affiliate, the Perrigo Israel Trading Limited Partnership (PITLP), which was treated as a corporation for U.S. tax purposes but as a partnership for Israeli tax purposes. Thus, PITLP had a mismatched entity classification between the United States and the foreign situs jurisdiction. The United States treated PITLP as a separate and distinct taxpayer, whereas Israel treated the entity as a flow-through entity where the owners are responsible for the income. PITLP then formed a Delaware limited liability company (Perrigo LLC) that was treated as a disregarded entity for U.S. tax purposes. Perrigo then assigned its rights in the Dexcel contract to Perrigo LLC. Perrigo, the parent entity, then entered into a supply contract to acquire the omeprazole pharmaceutical that Perrigo LLC would acquire on a back-to-back basis from Dexcel under the supply

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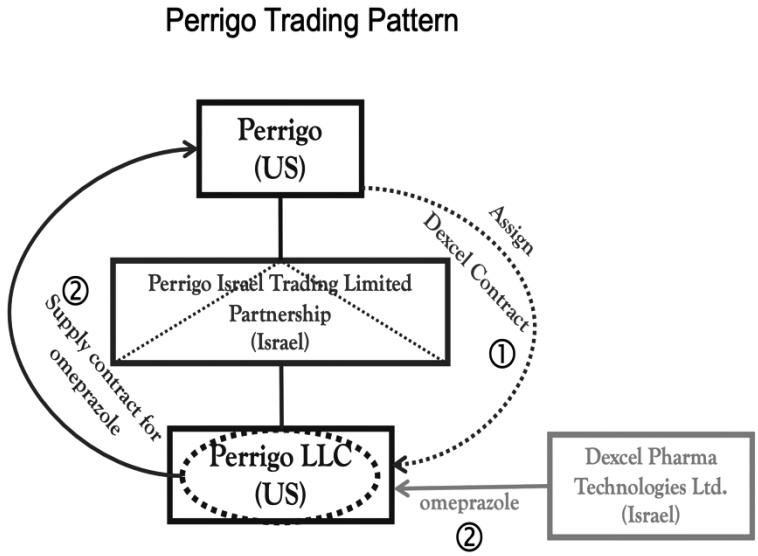
5. CROCKETT JOHNSON, HAROLD AND THE PURPLE CRAYON (HarperCollins 1955).

6. Joni L. Walser & Robert E. Culbertson, *Encore Une Fois: Check-the-Box on the International Stage*, 15 TAX NOTES INT'L 53, 53 (1997).

7. Docket at 1, *Perrigo Co. v. United States*, No. 1:17-cv-00737 (W.D. Mich. 2021). On a separate but related note, Perrigo has announced that the U.S. government conceded another contest with respect to a transfer pricing dispute over royalties paid by the U.S. subsidiary to Ireland, which were lightly taxed in Ireland. *See* Perrigo Co. PLC, Current Report (Form 810-K) of Perrigo Company PLC (April 25, 2023); *see also* Amanda Athanasiou, *Perrigo Prevails in $843 Million Transfer Pricing Dispute*, 110 TAX NOTES INT'L 650-51 (2023).

contract. The resulting corporate structure and trade flows are depicted in the below diagram.



Based on the purchase rights under the assigned Dexcel contract and the resale price of the pharmaceuticals under the intercompany supply contract, Perrigo LLC garnered a substantial profit.[8] However, Perrigo LLC was treated as a disregarded entity for U.S. tax purposes, so for U.S. tax purposes, the income it earned was treated as having been earned by PITLP. PITLP, in turn, was treated as a foreign corporation with no U.S. taxable presence, so its income was not taxed in the United States. However, in Israel, PITLP was treated as a flow-through entity, so its income wasn't taxable in Israel either because, for Israeli tax purposes, the income earned through Perrigo LLC/PITLP was assigned to United States entities that conducted no activities in Israel. Said differently, the mismatch in entity classification treatment between the United States and the foreign situs jurisdiction resulted in income that each jurisdiction believed belonged to the other jurisdiction for tax purposes, but neither did.[9] The windfall of double nontaxation over

8. Evidently, because the sales income was earned in the same country to which the pharmaceuticals were manufactured by Dexcel, Perrigo took the position that the income earned by its Israeli controlled foreign corporation was entitled to the same country exception to the foreign base company sales income rules. *See* I.R.C. § 954(d)(1).

9. The U.S. government is apparently contesting the outcome by arguing that the assignment of contracts lacked economic substance because the functions and activities performed by PITLP were not significant and that the naked assignment of a business opportunity lacked economic substance. The case is currently docketed for decision. The legislative history to section 7701(o) provides, however, that "[t]he provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice, are respected merely because the choice between meaningful economic alternatives is largely or

income created through such examples of taxpayer ingenuity has been called a variety of names in the academic literature, including homeless income,[10] stateless income,[11] ocean income,[12] and nowhere income,[13] to name a few. From a normative perspective, which country does this income relate to? Should this income be assigned to the United States so that Perrigo can blend it with its other United States country income to determine whether a minimum tax on the blended income was paid? Or should this income be assigned to Israel and get blended with other Israeli income, if any? The identification of which country is assigned this income is not clear because the mismatch in treatment obfuscates this determination.

The Congressional enactment of a corporate alternative minimum tax as part of the Inflation Reduction Act of 2022[14] provides certain U.S. multinational enterprises[15] with an effective escape hatch from the restrictions the OECD model rules constructed to address entity classification mismatches. The OECD model rules define a flow-through entity in Article 10.2 of the OECD Model Rules,[16] and the OECD model

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entirely based on comparative tax advantages." STAFF OF THE JOINT COMM. ON TAX'N, 111TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL 2010 BUDGET PROPOSAL PART TWO: BUSINESS TAX PROVISIONS, at 34 (Comm. Print 2009); STAFF OF THE JOINT COMM. ON TAX'N, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE RECONCILIATION ACT OF 2010, AS AMENDED, IN COMBINATION WITH THE PATIENT PROTECTION AND AFFORDABLE CARE ACT, at 152 (Comm. Print 2010). The list of transactions intended to be immunized from the application of section 7701 includes the U.S. person's choice between utilizing a foreign corporation or a domestic corporation, so this legislative history appears to make it more difficult for the IRS to argue against the economic substance of the entity classification. A more compelling argument may be that the profits earned by PITLP should not be significant and that the large profits should be related to a marketing intangible owned by Perrigo in the United States. For a discussion of marketing intangibles and the transfer pricing issues generally, see Bret Wells & Cym Lowell, *Tax Base Erosion: Reformation of Section 482's Arm's Length Standard*, 15 FLA. TAX REV. 737 (2014).

10. *See* Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535, 598, 616–17 (2012).

11. *See* Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 146, 170–71 (2012).

12. Testimony of Stephen E. Shay before the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, Hearing on the Offshore profit Shifting and the Internal Revenue Code (2013).

13. Don Griswold, *Innovative Principles for Multistate CIT Planning—Part 1*, 104 TAX NOTES 729, 730 (2022).

14. *See* Pub. L. No. 117-169, § 10101, 136 Stat. 1818 (2022).

15. I.R.C. § 55(b)(2)(A) (applies the minimum alternative tax to only applicable corporations); I.R.C. § 59(k)(1) (defines an applicable corporation as any corporation with average annual financial statement income in excess of $1 billion).

16. Under the model rules, a flow-through entity is a tax-transparent entity with respect to its income, expenditure, profit, or loss to the extent that it is fiscally transparent in the jurisdiction in which its owner is located. *See* OECD, *Tax Challenges Arising from the Digitilisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two),* art. 10.2.1.(a) (Dec. 14, 2021), https://www.oecd-ilibrary.org/docserver/782bac33-en.pdf?expires=1716326936&id=id&accname=guest&checksum=A69E6F1259BA890495F5C1F8B2DC30F9 [hereinafter *OECD Model Rules*]. A flow-through entity (Entity) is a reverse hybrid entity with respect to its income, expenditure, profit, or loss to the extent that it is not fiscally transparent in the jurisdiction in which the owner is located. *See id.* at art. 10.2.1(b). An Entity is treated as fiscally transparent under the laws of a jurisdiction if that jurisdiction treats the income, expenditure, profit, or loss of that Entity

rules carefully prescribe rules to determine the country location of a flow-through entity in Article 10.3.[17] But, income earned by a flow-through entity does not remain part of that flow-through entity's income when that income is not taxed in the flow-through entity's jurisdiction and instead is subject to tax in the ultimate parent entity's jurisdiction.[18] In that scenario, the flow-through entity's income is assigned under Articles 3.5 and 4.3.2(b) of the model rules to the owner of the flow-through entity whenever that income is included in the ultimate parent entity's tax base. The OECD commentary clarifies that the rules for allocating income away from flow-through entities have the practical consequence of ensuring that the income of a flow-through entity is treated as "stateless income" only in situations when neither the jurisdiction where the flow-through entity is created and the jurisdiction of the ultimate parent entity both fail to include the income in their respective tax bases.[19]

With the above prescripts in mind, let's return to the Perrigo fact pattern as it would be analyzed after the enactment of the Inflation Reduction Act of 2022. Even though PITLP would be a reverse hybrid entity under the U.S.' regular income tax laws, its income gets included as part of the U.S. corporate alternative minimum tax computation of the ultimate parent entity (Perrigo) because the income of all affiliates, including the reverse hybrid entity of PITLP, are part of the applicable financial statements of the U.S. parent entity that in turn forms the basis for computing the U.S. parent entity's corporate alternative minimum tax liability.[20] Thus, after the enactment of the Inflation Reduction Act of 2022, it appears that the income arising from reverse hybrid entities such as PITLP gets combined into the country income of the United States parent entity given that PITLP is a fiscally transparent entity that is not a tax resident of Israel and given that the PITLP income, at the end of the day, is included in the corporate alternative minimum tax

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as if it were derived or incurred by the direct owner of that Entity in proportion to its interest in that Entity. *See id.* at art. 10.2.2.

17. The location of an entity that is not a flow-through entity is determined as follows: (a) if it is a tax resident in a jurisdiction based on its place of management, place of creation or similar criteria, it is located in that jurisdiction; and (b) in other cases, it is located in the jurisdiction in which it was created. *See id.* at art. 10.3.1. The location of an Entity that is a Flow-through Entity is determined as follows: (a) if it is the Ultimate Parent Entity of the MNE Group or it is required to apply an IIR in accordance with Article 2.1, it is located in the jurisdiction where it was created; and (b) in other cases, it shall be treated as a stateless Entity. *See id.* at art. 10.3.2. Further tie-breaker rules exist if the constituent entity is a dual-located entity. *Id.* at arts. 10.3.4, 10.3.5.

18. *See* OECD, *Tax Challenges Arising from the Digitalisation of the Economy — Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two),* art. 10.3.2, ¶ 188 (Mar. 11, 2022) https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf [hereinafter *OECD Commentary*].

19. *See id.* at art. 10, ¶ 176. The commentary refers to this situation as a situation where the flow-through entity is a reverse hybrid entity.

20. I.R.C. § 55(b)(2); I.R.C § 56A(a).

computation of the ultimate U.S. parent entity.[21] The consequence of this result is that the low-taxed PITLP income gets blended with all other country income assigned to the United States to determine whether a minimum tax on the U.S. country income, on an overall basis, was assessed.[22] This appears to be the result even in situations where the U.S. corporate alternative tax does not create an incremental tax liability as the OECD model rules assign income away from the flow-through entity any time that the flow-through entity income is included into the tax base of the ultimate parent entity, which again is what in fact happens under section 56A(a). This outcome appears to be the case even if the U.S. tentative tax liability of the ultimate U.S. parent entity is largely (albeit not completely) offset by tax credits[23] as long as a minimum tax is ultimately paid.[24] Thus, the enactment of the self-described U.S. minimum tax on financial statement income appears to have had the (perhaps unintended) consequence of curtailing the reach of the OECD model rules with respect to entity classification mismatches for flow-through entities owned by U.S. multinational enterprises. The blending of the PITLP income with other U.S. country income is likely to be viewed as an unexpected and unacceptable outcome to nations adopting Pillar Two as those nations likely expected that the global minimum tax imposed on a country-by-country basis would not have afforded such a blending result, so a policy response is likely needed. However, the premise of this article is that the best avenue for fixing this loophole would be for the U.S. Treasury Department to do so before the

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21. *See OECD Model Rules*, *supra* note 16, at art. 3.5.1.(b). The only exclusion for this allocation is when the income is allocated to a permanent establishment in another jurisdiction. See *id.* at 3.5.1(a); *see also OECD Commentary*, *supra* note 18, at art. 3.5, ¶¶ 208, 214, 215. The commentary makes clear that this intended ordering rule prevents allocation of the same amount of income or loss to the permanent establishment and to the constituent entity-owner of the tax transparent entity; this ordering rule also prevents the income included in the Financial Accounting Net Income or Loss of the constituent entity-owner cannot then be allocated to a stateless Tax Transparent Entity. As a result, the model rules appear to treat the PITLP income as the country income of the United States based on the inclusion of the income into the ultimate parent entity's tax base whether or not that income inclusion results in an increase in the amount of the tax assessed on such income in the United States.

22. *See OECD Model Rules*, *supra* note 16, at art. 5.1.2.

23. Note that a taxpayer's general business tax credits can offset up to 75% of the tentative tax liability computed under either the regular tax or alternative minimum tax. *See* I.R.C. § 38(c). However, the OECD model rules assign income to the ultimate parent entity as long as the income is included in the ultimate parent entity's tax computation, which is the case under the corporate alternative minimum tax. *See OECD Model Rules*, *supra* note 16, at art. 3.5.1(b).

24. The OECD model rules treat qualified refundable credits as additional income for purposes of computing the GloBE income, but the OECD model rules do not treat tax credit as a reduction of tax the tax liability for purposes of determining the minimum tax computation. *See OECD Model Rules*, *supra* note 16, at arts. 3.2.4, 4.1.2(d). In the Inflation Reduction Act, the United States greatly increased the amount of refundable credits by allowing monetization or transfer of credits. *See* I.R.C. § 6418. Whether these transferrable credits are effectively "qualified refundable credits" as defined under the OECD framework is unclear and is important for computing the minimum tax under the OECD model rules.

OECD and other adopting nations address it through more punitive measures.[25]

The U.S. entity classification regime was fashioned in an era when the harmonization of the tax treatment of entities and transactions between the United States and other foreign jurisdictions was not perceived to be a relevant design feature of U.S. law at that time.[26] In that earlier era, the Treasury Department provided taxpayers the elective choice to classify foreign entities according to their own imagination, and the result has been that taxpayers have created mismatches in entity classification that are limited only by the extent of their ingenuity. The Treasury Department has been left with the need to create workarounds that do not allow the resulting mismatch to create substantial mischief. However, it is time for the Treasury Department to rethink the elective entity classification regime because its continuance can no longer peacefully coexist with a U.S. international taxation regime that attempts to achieve harmonized outcomes with treaty partners. The Treasury Department should no longer play the role of the dutiful parent who cleans up the resulting mismatch mess that taxpayers, through their active imagination, electively color into existence. Given today's global effort to harmonize international taxation among the G-20 countries,[27] the continuation of an elective U.S. entity classification regime that eschews any need to conform the U.S. classification of a foreign entity with how that very same foreign entity is classified under the foreign entity's situs jurisdiction hinders the

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25. The extent to which the Treasury Department may have allowed the OECD to adopt a framework that is punitive towards U.S. multinational enterprises as a backhanded way of forcing Congress to enact further U.S. tax reforms along the lines advocated by the Treasury Department is an important topic that is outside the scope of this article. For some preliminary commentary on this issue, see Mindy Herzfeld, *Can Congress Fix Treasury's GLOBE Mistakes?*, 179 TAX NOTES 18 (Apr. 3, 2023). At this juncture, this author simply wants to make the comment that the best means to avoid punitive measures that address entity classification mismatch outcomes is for the Treasury Department to utilize its regulatory authority to proactively minimize instances of such entity classification mismatches. Doing so promotes the policy goals of the United States and forestalls a need for its treaty partners to take matters into their own hands.

26. A thoughtful synthesis of the thinking of that prior era in terms of the role that foreign law played on the application of U.S. law is set forth in Philip R. West, *Foreign Law In U.S. International Taxation: The Search for Standards*, 3 FLA. TAX REV. 147 (1996).

27. *See* Statement by President Joseph R. Biden, Jr. on the Unprecedented OECD Agreement for a Global Minimum Tax, WHITE HOUSE (Oct. 8, 2021), https://www.whitehouse.gov/briefing-room/statements-releases/2021/10/08/statement-by-president-joseph-r-biden-jr-on-the-unprecedented-oecd-agreement-for-a-global-minimum-tax/; Statement from Secretary of the Treasury Janet L. Yellen on the OECD Inclusive Framework Announcement, WHITE HOUSE (Oct. 8, 2021), https://home.treasury.gov/news/press-releases/jy0394; Statement by President Joe Biden on Today's Agreement of 130 Countries to Support a Global Minimum Tax for the World's Largest Corporations, WHITE HOUSE (July 1, 2021), https://www.whitehouse.gov/briefing-room/statements-releases/2021/07/01/statement-by-president-joe-biden-on-todays-agreement-of-130-countries-to-support-a-global-minimum-tax-for-the-worlds-largest-corporations/; Statement from Secretary of the Treasury Janet L. Yellen on Today's Agreement of 130 Countries to Support a Global Minimum Tax for the World's Largest Corporations, WHITE HOUSE (July 1, 2021), https://home.treasury.gov/news/press-releases/jy0255. The U.S. implementation may be delayed, but even so, the United States has adopted significant reforms to bolster a minimum tax both in 2017 and in 2022.

current policy goals that matter now. In this regard, cross-border payments regarded in the foreign situs jurisdiction but disregarded for U.S. tax purposes (or vice versa) complicate the achievement of a common understanding of where income is generated and by which relevant entity. Creative and imaginative taxpayers opportunistically create these inconsistencies to their benefit. That is what creative and imaginative minds do.

This article sets forth a straightforward and administrable proposal that would reduce instances of nonconforming misclassification of foreign entities between the United States and the foreign situs jurisdiction to facilitate a path towards a common understanding of where income is earned and by which relevant entity. Under this article's proposal, if the foreign situs jurisdiction treats its own juridical entity as a separate and distinct corporate taxpayer, then the U.S. should classify that foreign entity as a foreign corporation for U.S. tax purposes. If, instead, the foreign situs jurisdiction treats its juridical entity as a flow-through entity such that the owners of the entity are responsible for paying tax on the entity's income on a flow-through basis, then the entity should be treated as a foreign partnership if it's owned by two or more owners and as a disregarded entity if owned by single owner. The reform advocated in this article was, in fact, the Treasury Department's administrative practice prior to 1973,[28] and so, ironically, this article argues that the Treasury Department should simply re-adopt an earlier entity classification paradigm that the agency abandoned fifty years ago. In Part II, this article sets forth how the U.S. abandoned a perfectly sensible entity classification approach in favor of a unilateral approach that eventually evolved into an elective U.S. entity classification regime. In Part III, this article analyzes how the elective U.S. entity classification regime has created needless complexity, hinders the United States' policy goals, and ironically also deters the originally stated goal of simplification. But first, it is important to evaluate the growing importance of conformity in treatment with respect to how income is assigned on a country-by-country basis, which is the topic addressed in the next section.

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28. The abandonment of the prior position commenced in 1973. *See* Rev. Rul. 73-254, 1973-1 C.B. 613 (holding that the classification of a foreign entity will be determined under the multi-factor Kintner regulations and that local law of the foreign jurisdiction is relevant only for purposes of determining the legal relationships of the members of the organization among themselves and with the public at large, as well as the interests of the members of the organization in its assets); G.C.M. 39,693 (Feb. 1, 1988) (revoking I.R.S. G.C.M. 34,736 (Nov. 13, 1970)); G.C.M. 36,910 (Nov. 4, 1976) (revoking G.C.M. 35,294 (Apr. 6, 1973)). Later-published rulings simply amplified this already existing change in the classification paradigm. *See* Rev Rul. 88-8, 1988-1 C.B. 403 (providing that all foreign entities are to be considered "unincorporated organizations" for purposes of Treas. Reg. § 301.7701-2(a)(3) and then holding that when classifying a foreign entity, the applicable foreign statute and the entity's organization agreements must be examined to determine whether the entity is classified as a corporation); *see also* Rev. Rul. 93-4, 1993-1 C.B. 225.

II. PILLAR TWO'S COUNTRY-BY-COUNTRY ADMINISTRATION APPLICATION OF THE GLOBE TOP-UP TAXES

As previously mentioned, the OECD Pillar Two project is designed to ensure that large multinational enterprises pay a minimum tax regardless of where they are headquartered and regardless of the jurisdictions where they operate[29]; the enterprises do so through a series of top-up taxes outlined in the GloBE rules. Under these rules, the first-in-line top-up tax is a qualified domestic minimum top-up tax (Qualified Domestic Minimum Top-Up Tax), which is defined to be a minimum tax included in the domestic law of a jurisdiction and that: (a) determines the excess profits of the constituent entities located in the jurisdiction (referred to as domestic excess profits) and (b) operates to increase the taxpayer's domestic tax liability with respect to domestic excess profits up to the minimum rate for the jurisdiction.[30] The next-in-line top-up tax is the IIR, which is applied by the residency jurisdiction of the owner of the underlying constituent entity. Because the IIR is asserted by the residency jurisdiction of the entity's owner, when it applies, it imposes a minimum tax on the parent entity and not on the constituent entity.[31] Said differently, when the IIR is applied, the jurisdiction of residence of the parent entity imposes a minimum tax on the parent entity's share of income earned by a constituent entity owned directly or indirectly by the parent entity when the income is low-tax.[32] The last-in-line top-up tax is called the UTPR, which seeks to impose a top-up tax on a constituent entity by a jurisdiction other than the jurisdiction of the constituent entity or the jurisdiction of the owner of the constituent entity.[33] The UTPR acts as a backstop that can be triggered into operation if and only if a sufficient Qualified Domestic Minimum Top-Up Tax or a sufficient IIR top-up tax were not assessed such that the low-taxed country income has not borne a minimum tax rate.[34] Thus, the GloBE rules set forth a pecking order. The Qualified Domestic Minimum Top-Up Tax is at the front of the line. The IIR is in the middle position. A top-up tax applied under the UTPR is last in line. However, the Qualified Domestic Minimum Top-Up Tax, the IIR, and the UTPR apply only after covered taxes are taken into account, and covered taxes are defined in the GloBE rules as those taxes paid by the

29. *See OECD Report on the Pillar Two Blueprint*, *supra* note 3, at 14.

30. *See OECD Model Rules*, *supra* note 16, at art. 4.2.1. The qualified domestic minimum tax is given priority over the IIR in Model Rule 5.2.3.

31. In most cases, the jurisdiction applying the IIR is the jurisdiction of the ultimate parent entity, but if that jurisdiction were not to apply their own IIR, then a jurisdiction of an intermediate holding company could apply its IIR.

32. *See OECD Model Rules*, *supra* note 16, at art. 2.1–2.3.

33. *See id.* at arts. 2.4–2.6.

34. *See OECD Report on the Pillar Two Blueprint*, *supra* note 3, at 15.

constituent entity and taxes paid by the owners of a constituent entity under a CFC tax regime.[35]

Importantly, the OECD model rules explicitly exclude qualifying top-up taxes envisioned by the IIR and UTPR rules from the definition of a covered tax.[36] Thus, the OECD model rules make clear that the imposition of a top-up tax under the IIR or a qualifying top-up tax under the UTPR are themselves ignored for purposes of determining whether a minimum tax has been paid to avoid a circularity problem. Because these taxes, in effect, are denied foreign tax credit relief under the OECD model rules, the top-up taxes operate more closely in design to an international alternative minimum tax[37] applied after covered taxes are assessed. However, as a concession to allow the source jurisdiction to assert taxation first on low-taxed income, any top-up tax assessed under a Qualified Domestic Minimum Top-Up Tax excludes any tax imposed under a CFC tax regime for purposes of computing the amount of the Qualified Domestic Minimum Top-Up Tax.[38]

But, there is a critical design challenge behind all of this that lies at the heart of the GloBE rules: one must determine whether the income of a particular jurisdiction is low-taxed after considering the relevant covered taxes. This determination requires one to assign items of income to a particular jurisdiction because that assignment allows the blending of that income with other income assigned to that same jurisdiction to see whether the combined country income was subjected to the required minimum tax. Second, the particular country to which the income is assigned must also be determined because the designation of that country determines the pecking order for the various top-up taxes if the minimum tax has not been paid. Applying the three interlocking top-up taxes outlined in the GloBE rules, therefore, requires income to be assigned to a particular country and also requires that the relevant jurisdictions agree on that allocation so that jurisdictional priority can be consistently determined.

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35. *See OECD Model Rules*, *supra* note 16, at art. 4.2.1. A qualified domestic minimum tax applied by the jurisdiction of the constituent entity would appear to also be a covered tax because it is recorded on the financial statements of the constituent entity per article 4.2.1(a) and is not excluded by article 4.2.

36. *See id.* at art. 4.2.2.

37. *See OECD Commentary*, *supra* note 18, at Introduction, ¶ 2.

38. *See* OECD, *Tax Challenges Arising from the Digitalisation of the Economy — Administrative Guidance to the Global Anti-Base Erosion Model Rules (Pillar Two)*, art. 5.1.3, ¶ 118.30 (Feb. 1, 2023), https://www.oecd.org/tax/beps/agreed-administrative-guidance-for-the-pillar-two-globe-rules.pdf [hereinafter *OECD Administrative Guidance*].

Moreover, even if the United States, at the end of the day, never adopts the GloBE rules, any U.S. tax imposed under Subpart F,[39] GILTI,[40] or the U.S. version of the corporate alternative minimum tax[41] must be assigned on a country-by-country basis to give appropriate recognition to the covered taxes borne on that particular country income in the minimum tax computation.[42] Thus, the United States has an interest in ensuring that its own asserted taxes can be appropriately treated as covered taxes assigned on a country-by-country basis whether or not it ultimately adopts the GloBE top-up taxes. Such coordination is now an important design goal given this evolution in the international taxation regimes of the United States and its treaty partners.

As will be more fully addressed in Part III, the country-by-country assignment of income is made all the more complex because cross-border payments classified as disregarded payments or that involve disregarded entities obfuscate the determination of which entity earned the income and from which country. Moreover, as the discussion of the Perrigo fact pattern indicates, [43] the U.S.' adoption of the corporate alternative minimum tax in the Inflation Reduction Act of 2022 likely causes income of reverse hybrid entities owned by U.S. multinational enterprises to be considered U.S. country income under the OECD model rules. The Treasury Department has exerted considerable effort to provide workarounds that seek to harmonize the tax treatment of disregarded entities and disregarded payments with how other jurisdictions treat those payments and entities for a number of U.S. tax provisions, but the most straightforward manner to harmonize the U.S. treatment would be for the United States simply to accept the separate corporate existence of a foreign entity when the foreign entity's situs jurisdiction treats the foreign entity as a separate taxpayer and to not treat the foreign entity as a separate foreign corporation when the foreign situs jurisdiction does not do so. How it came to be that the United States adopted a decidedly nonconformist and flawed approach to foreign entity classification is the topic that is addressed in the following Part II.

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39. *See* I.R.C. § 951. The OECD model rules treat the U.S. Subpart F regime as a CFC regime. *See OECD Model Rules*, *supra* note 16, at art. 4.3.2(c); *see OECD Commentary*, *supra* note 18, at ¶ 5–8.

40. *See* I.R.C. § 951A. The OECD model rules treat this regime as a blended CFC regime. *See OECD Model Rules*, *supra* note 16, art. 2.10; *see also OECD Administrative Guidance*, *supra* note 39, at art. 2.10.

41. *See* I.R.C. § 55.

42. This point is discussed in greater detail by the author and a co-author in another article that posits that the United States may actually prefer to have its taxes considered as covered taxes and not a compliant GloBE top-up tax given priority over top-up taxes in lieu of adopting a compliant set of GloBE rules. *See* Reuven Avi-Yonah and Bret Wells, *Pillar 2 and the Corporate AMT*, 107 TAX NOTES INT'L 693 (Aug. 8, 2022).

43. See text and discussion accompanying note 6 through note 24.

III. CHECK-THE-BOX REGULATIONS IN A MULTILATERAL WORLD

It is fascinating to think through how historical choices altered the law's development. This is particularly true when one considers the decisions that need not have been made but were made with respect to the U.S. entity classification regulations. The elective U.S. entity classification regulations are a poster child for a unilateral approach to international taxation that eschews any desire for classification conformity with other countries. By making the U.S. classification of a foreign entity a matter of taxpayer election, the Treasury Department's regulatory approach has conceded that mismatches in entity classification arise simply by taxpayer choice regardless of the impact that these entity classification mismatches create among the United States and its treaty partners. Taxpayers have also argued that these mismatches are immune from attack under the economic substance doctrine as the taxpayer choice is dispositive.[44] The resulting mismatches have created their own vocabulary: hybrid entities,[45] reverse hybrid entities,[46] and hybrid payments.[47]

What is remarkable, even ironic, is that the purported rationale for forging this unilateral approach to U.S. entity classification was a desire to promote the *simplification* of the United States tax laws. Much can be said about how the U.S. tax law has evolved to handle hybrid entities, reverse hybrid entities, and disregarded payments; Part III of this article seeks to synthesize that learning and its implications. However, what can be said now is that the resulting mismatches caused by hybrid entities, reverse hybrid entities, and disregarded payments have resulted in a set of U.S. laws that are anything but simple. There is nothing *"simple"* about these concepts or about how the U.S. tax law has evolved to handle them. Yes, it is simple enough to electively classify foreign entities for U.S. tax purposes, but once that simple taxpayer

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44. *See* Brief of the Taxpayer in Liberty Global, Inc. v. United States, Civ. Act. No. 20-cv-03501-RBJ (July 28, 2023). The legislative history accompanying the codification of the economic substance doctrine in section 7701(o) indicated that entity classification was not subject to the economic substance doctrine, but that carve-out exception in the legislative history does not address whether that carve-out exception extends to a multi-step transaction where entity classification is one step and failed to change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and have a substantial purpose (apart from Federal income tax effects) for entering into such transaction as prescribed by section 7701(o)(1). *See* H.R. Rep. No. 443, 111st Cong. 2d Sess. at 296 (March 17, 2010). The text of section 7701(o)(5)(D) allows the doctrine to apply to a series of transactions of which entity classification could be one of the transaction steps. For a discussion of the impact of the codification of the economic doctrine on the judicially created economic substance doctrine, see Bret Wells, *Economic Substance: How Codification Changes Decided Cases*, 10 FLA. TAX REV. 411 (2010).

45. A hybrid entity is an entity that is treated as a flow-through entity for U.S. tax purposes but as a separate and distinct corporate taxpayer in the foreign situs jurisdiction.

46. *See OECD Model Rules*, *supra* note 16, at art. 10.2.1(b). A reverse hybrid entity is an entity that is treated as a separate and distinct foreign corporation for U.S. tax purposes but as a flow-through entity in the foreign situs jurisdiction.

47. *See id.* at art. 10.2.5. A hybrid payment is a payment that is regarded as a transaction in the foreign jurisdiction but is disregarded for U.S. tax purposes.

election has been made, the resulting mismatches trigger an exceedingly complex set of U.S. rules designed to address the collateral nonconformity. The proposal in this article achieves the conformity goals that are now an important design goal in this era, but even so, it is also true to say that this article's reform proposal also better achieves the original historic goal of simplicity. Before addressing those matters further, however, it is helpful to consider how the U.S. entity classification regime evolved into an elective entity classification regime over time, and so the remainder of this Part II seeks to assess how those historic choices failed to consider a need for international conformity in entity classification between the United States and its treaty partners.

From its inception,[48] the Code has set forth the need to distinguish between a partnership,[49] corporation,[50] and sole proprietorship. Early case law made it clear that a trust engaged in business for profit would be treated as an association, removing trusts from a possible classification overlap concern, at least when determining that the underlying activity is not held for mere conservation.[51]

Moreover, section 7702(a)(2) makes it clear that a partnership does not include a corporation, and the regulations have consistently treated a state law corporation as automatically a corporation for U.S. federal income tax purposes. Section 7702(a)(3) states that an entity that is an unincorporated association could still be classified as a corporation for U.S. tax purposes, but the determination of whether an unincorporated entity should be classified as a partnership or as a corporation for federal income tax purposes requires a further determination as the statute does not explicitly state how one is to make that distinction. The courts have determined that the Treasury

48. *See* Revenue Act of 1913, ch. 16, § 2(G)(a)(1).

49. I.R.C. § 7701(a)(2) provides that a "partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and *which is not . . . a trust or estate or a corporation*." (emphasis added). For further analysis of when an activity that is not a corporation or trust could represent a partnership, see Bradley T. Bordon, *The Federal Definition of Tax Partnership*, 26 HOUS. L. REV. 925 (2006).

50. I.R.C. § 7701(a)(3) provides that a corporation includes associations.

51. Morrissey v. Commissioner, 296 U.S. 344 (1935); Outlaw v. United States, 494 F.2d 1376 (Ct. Cl. 1974). Treas. Reg. § 301.7701-4(a)–(c) distinguishes between "ordinary" trusts, the purpose of which is the protection or conservation of trust property, and trusts that are in effect a joint enterprise of the beneficiaries to conduct a business for profit and which will be classified as either a partnership or a corporation under Treas. Reg. § 301.7701-2 and Treas. Reg. § 301.7701-3. With this said, Treas. Reg. § 301.7701-4(d) provides, however, a special rule for "liquidating trusts;" under this rule, as long as the primary purpose of the trust is the liquidation and distribution of the assets transferred to it, the trust will not be treated as an association taxable as a corporation. *See* Rev. Rul. 75-379, 1975-2 C.B. 505; Rev. Rul. 63-228, 1963-2 C.B. 229 (finding certain trusts that engaged in business activities to fall within the "liquidation" exception); Rev. Proc. 82-58, 1982-2 C.B. 847, amplified by Rev. Proc. 91-15, 1991-1 C.B. 484 (guidelines for advance rulings on classification of liquidation trusts), modified and amplified by Rev. Proc. 94-45, 1994-2 C.B. 684 (income reporting requirements and checklist for ruling requests).

Department has broad regulatory authority to adopt classification distinctions.[52]

To make this entity classification determination for unincorporated entities, early regulations looked solely at whether or not the interests of the owners could be freely transferrable to differentiate between a partnership and a corporation.[53] But, the case law evolved differently. Initially, the case law utilized an ordinary meaning test,[54] but later cases settled on a set of factors that the courts used to distinguish between a partnership, corporation, and trust.[55] In response to this evolving case law, the Treasury Department issued explicit entity classification regulations in 1960 (colloquially often referred to as the "*Kintner* regulations") that largely adopted the classification factors enunciated in the case law to determine the ultimate classification of an unincorporated entity as either a corporation or a partnership.[56] The prior *Kintner* regulations identified six major characteristics normally found in an ordinary corporation: (i) associates, (ii) an objective to carry on a business and divide the profits therefrom, (iii) continuity of life, (iv) centralization of management, (v) limited liability, and (vi) free transferability of interests. Because associates and an objective to carry on a business and divide the profits are common to all business organizations, those factors are disregarded in classifying an entity as a partnership or an association taxable as a corporation. Thus, under the prior *Kintner* regulations, the classification of an entity as either a partnership or an association depended upon whether the entity more closely resembled a corporation adjudged in terms of the following four corporate characteristics: (i) continuity of

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52. *See* Littriello v. U.S., 484 F.3d 372 (6th Cir. 2007); McNamee v. Dep't of the Treasury, 488 F.3d 100 (2d Cir. 2007). Scholars had taken divergent views on the Treasury Department's authority to issue the check-the-box regulations prior to these court decisions, but the issue seems to now be resolved. *Compare* Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185, 216 (2004) (arguing the Treasury Department did not have such authority under a plain textual reading of the statute) *with* Victor E. Fleischer, *"If It Looks like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification*, 96 Colum. L. Rev. 518 (1996) (arguing the Treasury Department does have such authority); *see also* Daniel J. Hemel, *The President's Power to Tax*, 102 CORNELL L. REV. 633, 690 (2017) (stating that the issue has now been laid to rest).

53. See Treas. Reg. 45, § 1, art. 1503 (1921) provided as follows:

> Association distinguished from partnership —An organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association and not a partnership. A partnership bank conducted like a corporation and so organized that the interests of its members may be transferred without the consent of the other members is a joint-stock company or association within the meaning of the statute. A partnership bank the interests of whose members cannot be so transferred is a partnership.

54. Hecht v. Malley, 265 U.S. 144, 163-64 (1924).

55. Morrissey, 296 U.S. at 359-6; United States v. Kintner, 216 F.2d 418, 421 (9th Cir. 1954); Larson v. Commissioner, 66 T.C. 159 (1976), *acq.* 1979-1 C.B. 1; Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975).

56. Prop. Reg. § 301.7701, 24 Fed. Reg. 10,450 (Dec. 23, 1959). The regulations were adopted as final regulations the next year. *See* T.D. 6503, 1960-2 C.B. 409.

life, (ii) centralization of management, (iii) limited liability, and (iv) free transferability of interests. If the unincorporated entity possessed two or less corporate characteristics, it did not more closely resemble a corporation, so the entity would be treated as a partnership. In contrast, if an unincorporated entity possessed a majority of corporate characteristics, then it would be treated as a corporation under the prior *Kintner* regulations. It was widely understood that these prior entity classification regulations were a response to the *Kintner* decision[57] and had sought to make it difficult for professional unincorporated groups to obtain corporate classification in an era when corporate tax rates were significantly lower than individual rates.[58] The *Kintner* regulations achieved this goal by requiring a preponderance of the four factors to exist before corporate status was afforded to the unincorporated entity.[59] Entities organized under corporate law statutes in a state in the United States, however, would automatically be classified as corporations without the need to consider the *Kintner* regulations, as those regulations only applied to unincorporated entities.[60]

At one time, the Treasury Department took the position that an entity organized in a foreign jurisdiction, that was treated as a separate taxable entity in the foreign situs jurisdiction, would be automatically treated as a foreign corporation without the need to look into the multi-factor entity classification tests of the *Kintner* regulations that applied to unincorporated entities.[61] This per se treatment of foreign legal entities as foreign corporations when the foreign situs jurisdiction treated them as such created broad conformity in the manner in which an entity was classified in the foreign situs jurisdiction and how it was classified in a state within the United States. This treatment, in effect, affords foreign situs jurisdictions the same deference that is afforded to the various states that enact corporate statutes. With that said, however, the prior case law was inconsistent on how to classify foreign entities.[62] However, instead of utilizing its regulatory authority to clarify that the U.S. classification of a foreign entity would conform to how the foreign

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57. Kintner, *supra* note 55, at 420-22.

58. Committee on Foreign Activities of U.S. Taxpayers, N.Y. State Bar Ass'n, Tax Section, *Report on Foreign Entity Characterization for Federal Income Tax Purposes*, 35 TAX L. REV. 167, 189 (1980).

59. Henry J. Lischer, Jr., *Elective Tax Classification for Qualifying Foreign and Domestic Business Entities under the Final Check-the-Box Regulations*, 51 SMU L. REV. 99, 104 (1998).

60. *See* Rev. Rul. 82-212, 1982-2 C.B. 401; Rev. Rul. 70-101, 1970-1 C.B. 278, modified by Rev. Rul. 73-596, 1973-2 C.B. 424, and amplified by Rev. Rul. 70-455, 1970-2 C.B. 297; Rev. Rul. 72-468, 1972-2 C.B. 647; Rev. Ru. 74-439, 1974-2 C.B. 405.

61. *See* G.C.M. 34,376 (Nov. 13, 1970) (treating a Nicaraguan sociedad de responsabilidad limitada as a per se corporation without the need to review the corporate factors set forth in the *Kintner* regulations); G.C.M. 35,294 (Apr. 6, 1973) (treating a Colombian sociedad de responsabilidad limitada as a per se corporation without the need to review the corporate factors set forth in the *Kintner* regulations).

62. Committee on Foreign Activities of U.S. Taxpayers, N.Y. State Bar Ass'n, Tax Section, *supra* note 58 at 192-195.

situs jurisdiction treated its own entity, the Treasury Department, starting in 1973, changed its administrative position[63] so that it began to treat all foreign entities as unincorporated entities whose status must be tested under the multi-factor test set forth in the *Kintner* regulations.[64] The organizational documents of the foreign entity and the substantive effect of foreign law were relevant in determining whether the foreign entity possessed a preponderance of corporate characteristics under the U.S. standards, but the foreign law characterization of the entity as a corporation was not, as such, relevant any longer to the U.S. entity classification inquiry.[65] This change in IRS administrative practice opened the door for taxpayers to create entities that would be classified as a corporation or partnership under the laws of the foreign situs jurisdiction but could then be classified in a different manner in the United States for U.S. tax purposes.[66]

The need to analyze every foreign entity and its organizational documents in light of the U.S. classification criteria created a detailed and complex body of law.[67] Since the foreign entity classification is critical and potentially uncertain, taxpayers often sought private rulings

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63. The abandonment of the prior position commenced in 1973. *See* Rev. Rul. 73-254, 1973-1 C.B. 613 (holding that the classification of a foreign entity will be determined under the multi-factor *Kintner* regulations and that local law of the foreign jurisdiction is relevant only for purposes of determining the legal relationships of the members of the organization among themselves and with the public at large, as well as the interests of the members of the organization in its assets); G.C.M. 39,693 (Feb. 1, 1988), revoking G.C.M. 34,736 (Nov. 13, 1970); G.C.M. 36,910 (Nov. 4, 1976), revoking G.C.M. 35,294 (Apr. 6, 1973). Later published rulings simply amplified this already existing change in classification paradigm. *See* Rev Rul. 88-8, 1988-1 C.B. 403 (providing that all foreign entities are to be considered "unincorporated organizations," for purposes of Treas. Reg. § 301.7701-2(a)(3) and then holding that when classifying a foreign entity the applicable foreign statute and the entity's organization agreements must be examined to determine whether the entity is classified as a corporation); *see also* Rev. Rul. 93-4, 1993-1 C.B. 225.

64. *See* Rev. Rul. 93-4, 1993-1 C.B. 225; Rev. Rul. 88-8, 1988-1 C.B. 403 (stating that every foreign entity must be tested as an unincorporated entity under the multi-factor test set forth in the *Kintner* regulations); Rev. Rul. 73-254, 1973-1 C.B. 613 (holding that the classification of a foreign entity will be determined under the multi-factor *Kintner* regulations and that local law of the foreign jurisdiction is relevant only for purposes of determining the legal relationships); G.C.M. 39,693 (Feb. 1, 1988), revoking G.C.M. 34,376 (Nov. 13, 1970); G.C.M. 36,910 (Nov. 4, 1976), revoking G.C.M. 35,294 (Apr. 6, 1973).

65. *See* Rev. Rul. 73-254, 1973-1 C.B. 613 (holding that the classification of a foreign entity will be determined under the multi-factor *Kintner* regulations and that local law of the foreign jurisdiction is relevant only for purposes of determining the legal relationships of the members of the organization among themselves and with the public at large, as well as the interests of the members of the organization in its assets); Rev Rul. 88-8, 1988-1 C.B. 403 (providing that all foreign entities are to be considered "unincorporated organizations," for purposes of Treas. Reg. § 301.7701-2(a)(3) and holding that when classifying a foreign entity the applicable foreign statute and the entity's organization agreements must be examined to determine whether the entity is classified as a corporation); *see also* Lischer, *supra* note 59, at 105.

66. Michael B. Nelson, *Critical Analysis and Strategies for U.S. Overseas Businesses Participating as a Foreign Joint Venture Partner*, 9 TRANSNAT'L LAW. 1, 12 (1996); Bruce N. Davis & Steven R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 TAX L. REV. 165, 173 (1991).

67. For an overview of the entity classification criteria in the foreign context in this era, see Davis & Lainoff, *supra* note 66; Nelson, *supra* note 66; Committee on Foreign Activities of U.S. Taxpayers, N.Y. State Bar Ass'n, Tax Section, *supra* note 58.

from the IRS regarding the classification of foreign entities,[68] and the results of the classification of various foreign entities were set forth in tables contained in the Internal Revenue Manual that became required reading.[69] Moreover, several nonbinding administrative rulings concluded that a single member entity that failed to have a preponderance of corporate characteristics was a disregarded entity for federal income tax purposes under the prior *Kintner* regulations,[70] but no authoritative guidance or case had so held in this period.[71] Another important turning point occurred in 1988. In that year, the IRS issued its first ruling on a state law limited liability company and ruled that an entity organized under Wyoming's limited liability company provisions would be classified as a partnership for U.S. tax purposes.[72] In the intervening years, every state in the United States adopted limited liability company statutes that afforded similar entity classification flexibility to taxpayers.[73]

In Notice 95-14, the Treasury Department announced that it contemplated a further course correction in its entity classification regulations.[74] In this notice, the Treasury Department observed that the proliferation of state limited liability company statutes had eliminated the traditional distinctions between corporations and partnerships and had made the entity classification rubric largely elective through

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68. *See* Rev. Proc. 95-10, 1995-1 C.B. 501, modifying Rev. Proc. 89-12, 1989-1 C.B. 798. However, during this era, the IRS for a period refused to rule on a foreign entity's classification if the entity did not have a meaningful independent owner. *See* Rev. Proc. 91-3, Sec. 3.01(44), 1991-1 C.B. 364. A practice then developed of having a taxpayer obtain a private ruling on the classification of a particular type of entity in a particular country as a test case that could provide a roadmap for how an entity could obtain the classification that the taxpayer desired. *See e.g.,* P.L.R. 9643023 (Oct. 25, 1996) (addressing entity classification of a German GmbH); *see also* P.L.R. 9642019 (Oct. 18, 1996) (addressing entity classification of a Nova Scotia unlimited company). Sometimes the publicly disclosed ruling would not specify the specific jurisdiction, so only the law firm or accounting firm that sought the ruling on behalf of the taxpayer knew which jurisdiction had been considered. *See e.g*., P.L.R. 9633025 (Aug. 16, 1996). In these instances, those in the inner-circle would know the administrative working law more clearly than those that were not regularly involved in this ruling process.

69. Those early versions of the Internal Revenue Manual are no longer available to the public, but articles from the era memorialize that the Internal Revenue Manual listed nearly 200 entities by 1980 in Exhibit 600-8 from 45 different countries and indicated the potential classification for each. *See* Committee on Foreign Activities of U.S. Taxpayers, N.Y. State Bar Ass'n, Tax Section, *supra* note 58 at 196; *see also* Bruce N. Davis & Steven R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 TAX L. REV. 165, 170-172 (1991) (extensively discussing the Internal Revenue Manual's listing of entity classification as of 1991);. The author's memory is that by 1995, fifteen years after this law review article, the entity classification listing was even more exhaustive.

70. *See* T.A.M. 8533003 (May 7, 1985); T.A.M. 8552010 (Sept. 25, 1985); G.C.M. 39395 (Aug. 5, 1985); P.L.R. 8139048 (June 30, 1981).

71. N.Y. STATE BAR ASS'N, *Report on the "Check the Box" Entity Classification Scheme Proposed in Notice 95-14*, Rep. No. 845 at 39–42 (1995).

72. *See* Rev. Rul. 88-76, 1988-2 C.B. 360.

73. *See* Bruce P. Ely & Joseph K. Beach, *The LLC Scoreboard*, 74 TAX NOTES 1329 (1997).

74. Rev. Rul. 95-14, 1995-1 C.B. 297.

taxpayer planning.[75] As a result, the Treasury Department announced that it was considering simplifying the United States entity classification regulations to afford taxpayers with an explicit election as to how to treat unincorporated business organizations. Moreover, as part of its justification for affording an explicit taxpayer election for the classification of an unincorporated entity, the government asserted that the classification analysis was difficult in the international context because the prior regulations required both the Treasury Department and taxpayers to review the organization documents and also garner a thorough understanding of the controlling foreign law to determine an entity's ultimate classification for United States tax purposes.[76] The government then issued proposed regulations that provided a simplified elective classification regime. Ultimately, the regulations set forth a list of foreign entities that would automatically be treated as corporations for U.S. federal income tax purposes,[77] but this per se listing had nothing to do with whether or not the foreign situs jurisdiction had treated its juridical entity as a separate and distinct taxpayer. Rather, the Treasury Department explained that this per se corporate classification represented a list of the foreign entities that were virtually always classified as corporations under the multi-factor test set forth in the prior *Kintner* regulations.[78] The Treasury Department then argued that significant simplification could be obtained with an elective classification regime where taxpayers were allowed to designate the tax classification of non-per se foreign entities.[79] The elective entity classification regulations, the so-called "check-the-box" regulations, were finalized in 1996,[80] and the basic contours of the elective check-the-box election regime have remained in place since then.

However, after articulating its stated goal of promoting simplification, the government made the following cautionary statement in the preamble to its proposed check-the-box regulations:

> In light of the increased flexibility under an elective regime for the creation of organizations classified as partnerships, the Treasury Department and the IRS will continue to monitor carefully the uses of partnerships in the international context and will issue

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75. Notice of Proposed Rulemaking, RIN 1545-AT91, 61 Fed. Reg. 21,989, 21,990 (May 13, 1996) (citing Rev. Rul. 88-76, 1988-2 C.B. 360) (the government observed that entities could provide limited liability and yet still be considered partnerships under the prior regulations).

76. Notice of Proposed Rulemaking, RIN 1545-AT91, 61 Fed. Reg. 21,989, 21,990 (May 13, 1996).

77. *See* Treas. Reg. § 301.7701-2(b)(8).

78. *See* Notice of Proposed Rulemaking, RIN 1545-AT91, 61 Fed. Reg. 21,989, 21,991 (May 13, 1996) (making the assertion for how the per se list of foreign corporations was determined); T.D. 8697, 61 Fed. Reg. 66,584, 66,586 (Dec. 18, 1996) (stating that most comments agreed with that the per se list was appropriate).

79. Notice of Proposed Rulemaking, RIN 1545-AT91, 61 Fed. Reg. 21,989 (May 13, 1996).

80. *See* T.D. 8697, 61 Fed. Reg. 66,584 (Dec. 18, 1996).

> appropriate substantive guidance when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties.[81]

This statement signaled a desire on the part of the Treasury Department to ensure that its effort to achieve entity classification simplification did not result in unintended consequences that hindered the international tax policy goals of the United States or of its treaty partners.[82] It is now time for the Treasury Department to revisit this statement with the benefit of hindsight as doing so would lead the Treasury Department to the inescapable conclusion that its elective U.S. entity classification regime for foreign entity classification has created substantial mischief as the discussion in the following Part III will make plain.

IV. THE ELECTIVE ENTITY CLASSIFICATION REGIME AND THE CONSEQUENCES OF HYBRID PAYMENTS AND HYBRID ENTITIES

A consequence of the elective classification regime is that entities treated as a separate taxpayer for foreign law purposes can be electively treated as "a disregarded entity" (if owned by a single owner) or as a "partnership" (if owned by more than one owner) for U.S. tax purposes.[83] The elective classification regime has greatly expanded the scope and significance of asymmetrical mismatches in entity classification between the United States and the foreign situs jurisdiction because a taxpayer can simply choose to disregard the separateness of an entity for U.S. tax purposes regardless of how that same entity and its payments are characterized in the foreign situs jurisdiction.[84] In 2022, the Office of Information and Regulatory Affairs published an announcement on its website that the Treasury Department was considering a notice of proposed rulemaking to re-examine the elective United States entity classification regime for foreign entities, including a potential update to the list of foreign per se corporate entities under Treas. Reg. section 301-7701-2(b)(8).[85] However, at a recent ABA tax section meeting, a Treasury official, in a prepared statement, indicated that practitioners should not read "too much into this website posting" and that this regulatory project had

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81. Notice of Proposed Rulemaking, RIN 1545-AT91, 61 Fed. Reg. 21,989, 21,990 (May 13, 1996).

82. As this article will argue, given the evolution of the OECD inclusive framework that has now been forged, it is appropriate for the Treasury Department to reconsider the efficacy of its entity classification regime for the reasons foreshadowed by this early cautionary statement.

83. Treas. Reg. § 301.7701-3(b)(2); Treas. Reg. § 301.7701-3(c).

84. Treas. Reg. § 301.7701-3(c).

85. *See* Office of Information and Regulatory Affairs, https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202204&RIN=1545-BO21. The website indicated the notice of proposed rulemaking is designated as REG-132697-17 but as yet no official publication of that notice of proposed rulemaking has appeared in the Federal Register, Westlaw, or Lexis.

been on the Treasury Department's agenda since 2017.[86] For the reasons that will be further discussed in Part III, this article asserts that a regulatory project should now be commenced to fundamentally reformulate the United States entity classification regime with all due haste.

Seen in its historical context, it is ironic that the stated policy goal for the elective United States entity classification regime was the goal of promoting *simplification*. As will be discussed in more detail in Part III, the elective entity classification regime has greatly increased the complexity of the Treasury Department's regulations because of the need to address asymmetrical outcomes arising from the entity classification mismatches that the elective U.S. entity classification regime fosters. The resulting Treasury regulations treat certain disregarded payments and certain disregarded entities as "regarded entities" and "regarded payments" for certain purposes but not for other purposes. This *partial regarding* and *partial disregarding* of entities and of payments creates a mishmash of rules that in the end adds enormous complexity. The more straightforward and less complex manner of achieving the policy goals in this area would be to adopt a U.S. entity classification regime that treats a foreign entity as a foreign corporation when the foreign situs jurisdiction treats it as a separate taxpayer and to treat a foreign entity as a partnership (if owned by two persons) or a disregarded entity (if owned by a single owner) when the foreign situs jurisdiction does not treat the entity as a separate taxpayer but instead seeks to tax the entity's owners on the income earned by the entity. The remainder of this Part III attempts to demonstrate that the regulatory responses to the entity classification mismatches provide unmistakable evidence of the need to now reformulate the elective United States entity classification regime along the lines advocated in this article. Thus, unlike in 1996, when the Treasury Department believed it had no compelling interest to conform its classification of foreign entities with that of the foreign situs jurisdiction, the myriad of regulatory workarounds adopted by the Treasury Department since then impeach the accuracy of that original assessment.

A. Treas. Reg. § 1.861-20 and the Elective Classification Regime

One fundamental concern of the foreign tax credit regime is to allocate potentially creditable foreign taxes to the foreign income to which they relate. Prior to 2017, foreign income taxes assessed on amounts that were not treated as income for U.S. tax purposes would typically be assigned to the general basket.[87] However, after the 2017

86. *See* Andrew Velarde, *Treasury Tries to Quash Rumors on Release of Check-the-Box Regs*, 108 TAX NOTES INT'L 508 (October 24, 2022).

87. *See* Prior Treas. Reg. § 1.904-6(a)(1)(iv) in T.D. 8412, 57 Fed. Reg. 20,639, 20,652 (1992). When Congress reduced the number of foreign tax credit baskets to two baskets in 2004, Congress

Tax Act, the allocation of taxes takes on more significance because the allocation of taxes assessed on items that are not income impacts not just the foreign tax credit basket to which those taxes will be placed[88] but also impacts whether or not those taxes are outright disallowed credit relief by reason of section 245(d) if allocated to exempt income, allowed credit relief in full if allocated to Subpart F income by reason of section 960(a), or partially allowed credit relief under section 960(d) if allocated to inclusions taxable under section 951A. Because hybrid entities and disregarded payments create the potential for mismatches between the United States and the foreign jurisdiction in terms of taxable events and taxable income, the United States and the foreign jurisdiction often construe the events that create that income differently when there is a mismatch in entity classification. Thus, there is a need to "match" the "unmatched" foreign taxes to items of income so that those taxes are placed in an appropriate separate limitation foreign tax credit basket, and the Treasury Department has recognized that significantly more guidance has now become necessary in terms of how to allocate foreign taxes paid on non-income items in order for those "unmatched" foreign taxes to be placed into a reasonably appropriate foreign tax credit basket.[89]

In terms of associating foreign tax credits to particular income, the starting point for allocating foreign taxes among the statutory and residual groupings is to first assign the items of foreign gross income as determined under foreign law (designated as "foreign gross income" in the regulations) upon which the tax was assessed.[90] Thus, in order to assign foreign taxes to a particular foreign tax credit basket, income as defined under foreign law (not U.S. tax law) must be identified. Once foreign gross income is so identified under foreign law, then those items of foreign gross income are placed in the appropriate separate limitation basket. The associated foreign taxes assessed on that foreign

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made it clear that any taxes attributable to basis differences would be placed in the general basket with the enactment of prior section 904(d)(2)(H). *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, Sec. 404(a), 118 Stat. 1418, 1494 (Oct. 22, 2004).

88. In what appears to be a statutory glitch, section 904(d)(2)(H)(i), which had been added in 2004 and had indicated that foreign taxes related to basis differences would be placed in the general basket, was not amended in 2017, so the renumbered placement of the general basket caused the cross-reference to now reference the foreign branch basket. The Treasury Department received several comments indicating that taxpayers believed that this was an inadvertent failure to revise the cross-reference in section 904(d)(2)(H)(i) and that the regulations should assign taxes associated with base differences to the general basket or should provide a rule assigning the taxes depending on whether the base difference related to general category income or foreign branch category income, but the Treasury Department refused to provide such a rule because in its view the statute was clear. T.D. 9882, 84 Fed. Reg. 69,022, 69,037 (Dec. 17, 2019).

89. *See* Notice of Proposed Rulemaking, REG-105495-19, 84 Fed. Reg. 69,124, 69,132 (Dec. 17, 2019); *see also* T.D. 9882, 84 Fed. Reg. 69,022, 69,038 (Dec. 17, 2019).

90. Treas. Reg. § 1.861-20(c)(1). This process is done under the rules set forth in Treas. Reg. § 1.861-20(d).

law income are then allocated to that same foreign tax credit basket.[91] Once that is done, then deductions are allocated and apportioned to that foreign gross income using U.S. tax principles.[92] If the foreign tax base includes income in more than one separate category, the foreign tax is apportioned among the separate categories on the basis of the relative amounts of foreign taxable income in each category.[93]

Thus, the starting point of the analysis is foreign gross income *as defined under foreign law*. If one concludes that the correct starting point is to begin with how foreign law classifies income and classifies the transactions involved, then the best way to effectuate that foreign law classification is to conform the U.S. entity classification regime to how the foreign situs jurisdiction classifies the foreign entity. Simply adopting the foreign situs jurisdiction's entity classification would be a more straightforward beginning point to then apply the rubric of Treas. Reg. section 1.861-20. This assertion is grounded even further when one works through the regulatory framework of Treas. Reg. section 1.861-20. In this regard, a critical decision point in the regulations is determining whether the foreign transaction that generates foreign gross income has a "corresponding U.S. item." A corresponding U.S. item is any U.S. gross income or loss item that arises from the same transaction or other realization event that generates a foreign gross income item,[94] and this is likely to be the case when the U.S. and the foreign jurisdiction conform their treatment of entities because the two jurisdictions have a common framework in terms of the same relevant entity and its treatment. If a particular transaction does possess a corresponding U.S. gross income item, then the foreign gross income is assigned to the same statutory and residual grouping as the corresponding U.S. gross income item is assigned. Thus, the end result is that a foreign gross income item is assigned to a statutory or residual grouping based on how the U.S. corresponding item would be characterized under Treas. Reg. section 1.861-20(d)(1) if a corresponding U.S. gross income item exists.[95] Due to the expansive

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91. Treas. Reg. § 1.861-20(c)(3). This process is done under the rules set forth in Treas. Reg. § 1.861-20(f).

92. Treas. Reg. § 1.861-20(c)(2). This process is done under the rules set forth in Treas. Reg. § 1.861-20(e).

93. Treas. Reg. § 1.861-20(f).

94. Treas. Reg. § 1.861-20(b)(2).

95. Treas. Reg. § 1.861-20(d)(1); Treas. Reg. § 1.861-20(g)(2) Example 1. Treas. Reg. § 1.861-20(b)(2) defines a corresponding U.S. item as the item of U.S. gross income or U.S. loss, if any, that arises from the same transaction or other realization event from which an item of foreign gross income also arises. The regulations provide that an item of U.S. gross income or U.S. loss is a corresponding U.S. item even if the item of foreign gross income if it arises from the same transaction or realization event even though the amount of the U.S. gross income or U.S. loss diverges from the amount that is foreign gross income under foreign law. However, a corresponding U.S. item does not include an item of gross income that is exempt, excluded, or eliminated from U.S. gross income. In addition, an item of U.S. gross income or U.S. loss that is not realized, recognized or taken into account by the taxpayer in the U.S. taxable year in which the

definition of a U.S. corresponding item,[96] it doesn't matter that the United States characterizes the nature of the income differently in character or amount as those differences are not relevant as long as both jurisdictions conform to the treatment of the payment as a regarded transaction involving some sort of income. Therefore, the allocation of foreign taxes is straightforward when the U.S. entity classification conforms to how the foreign situs jurisdiction classifies the foreign entity in the same manner because this convergence in treatment minimizes the nonconformity in how transactions are treated.[97]

If there is no corresponding U.S. item, then the regulations seek to determine the root cause for this mismatch. Noticeably absent in this inquiry, however, is a re-examination of the role that the taxpayer's classification election made in creating the mismatch in the dislocation of foreign taxes away from items of gross income that have a corresponding U.S. item. Instead of addressing that root cause head-on, the regulations instead construct an alternative construct. In this regard, if the foreign gross income does not give rise to a corresponding U.S. item because the transaction gives rise to amounts that constitute exempt income in the United States, then the foreign gross income is assigned to the grouping to which the gross income would be assigned if that income were taxable U.S. gross income.[98] In contrast, if the nonexistence of a corresponding U.S. item is attributable to a permanent basis difference in the two jurisdictions, then the foreign gross income is assigned to the residual group.[99] The regulations avoid the impossible factual challenge of distinguishing between what foreign gross income relates to "excluded income" and what foreign gross income relates to a "tax basis difference" by stating that a tax basis difference only exists in five explicitly defined situations.[100] In all other situations, the foreign gross income is treated as attributable to excluded income, and the final regulations provide specific rules for assigning taxes imposed on a taxpayer in its capacity as a shareholder or a partner, on disregarded payments, on transactions involving reverse hybrid entities, and upon the sale of a disregarded entity.[101] Different rules apply to different

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taxpayer paid or accrued the foreign income tax is not considered a corresponding U.S. item unless the difference relates to a one-year timing difference.

96. A U.S. gross income or loss item is a corresponding U.S. item even if the foreign gross income item that arises from the same transaction or event differs in amount from the U.S. gross income or loss item. *See* Treas. Reg. § 1.861-20(d)(2). Moreover, even if the corresponding U.S. item is a U.S. loss (or zero), then foreign gross income is assigned to the grouping to which a gain would be assigned had the transaction or other realization event given rise to a gain. *See* Treas. Reg. § 1.861-20(d)(1).

97. Once the foreign gross income to which the foreign tax is assessed is determined, then the analysis shifts to how the U.S. treats that transaction Treas. Reg. § 1.861-20(d)(1).

98. Treas. Reg. § 1.861-20(d)(2)(iii)(A); *see also* Treas. Reg. § 1.861-20(g)(4) Example 3.

99. Treas. Reg. § 1.861-20(d)(2)(iii)(B).

100. Treas. Reg. § 1.861-20(d)(2)(iii)(B).

101. Treas. Reg. § 1.861-20(d)(3). For disregarded payments, the amount that is a reattribution amount must be assigned by the payee to the same statutory group as the associated

types of disregarded payments depending on whether the disregarded payment is treated as a reattribution payment, a disregarded remittance, a disregarded contribution, or a disregarded sale. For corporate distributions, the foreign gross income is treated as a dividend[102] or as capital gain[103] to the extent the corresponding U.S. item is so treated.[104] However, if foreign gross income arises from a distribution that is treated as a return of capital for U.S. tax purposes, then the final regulations treat the foreign gross income in the same manner as how a dividend would have been treated under U.S. tax law.[105] If foreign law recognizes a deemed distribution or consent dividend (a "foreign law distribution") that is not recognized as such for U.S. tax purposes (like would arise from a reverse hybrid distribution), then the foreign gross income is assigned to a statutory or residual grouping in the same manner it would be assigned if U.S. tax law had recognized the distribution as a taxable distribution.[106] The regulations then address a myriad of other fact patterns, including the treatment of distributions from partnerships and sales of partnership interests, including partnerships that are treated as corporations for foreign law purposes[107] and the treatment of foreign taxes associated with foreign gross income arising from disregarded payments between a taxable unit and its owner.[108]

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reattribution amount and the payer does not reduce its gross income by for purposes of allocating and apportioning the payer's foreign taxes. *See* Treas. Reg. § 1.861-20(d)(3)(v)(B).

102. And thus assigned to the statutory and residual grouping to which the distribution was made from. *See* Treas. Reg. § 1.861-20(d)(3)(i)(B)(2).

103. And thus assigned in accordance to how the capital gain would be assigned to the statutory and residual groupings under U.S. tax law. *See* Treas. Reg. § 1.861-20(d)(3)(i)(B)(3).

104. Prop. Treas. Reg. § 1.861-20(d)(3)(i)(B)(1).

105. *See* Treas. Reg. § 1.861-20(d)(2)(ii)(D). The preamble to the proposed regulations explains that the government believes this result is appropriate because a foreign country generally recognizes more gain on a disposition of stock than is recognized for U.S. tax purposes when the shareholder's tax basis in the stock is greater for U.S. tax purposes than for foreign tax purposes. This disparity typically occurs when the shareholder's U.S. tax basis in the stock has been increased under section 961 to reflect Subpart F or GILTI inclusions of earnings attributable to the stock. *See* Notice of Proposed Rulemaking, REG-101657-20, 85 Fed. Reg. 72,078, 72,084 (Nov. 12, 2020).

106. Treas. Reg. § 1.861-20(d)(3)(i)(C). Thus, if a taxpayer recognizes foreign gross income arising from a foreign law distribution from a reverse hybrid entity, the distribution is treated as made from general category section 965(a) previously taxed earnings and profits if that is the characterization that would have arisen had the distribution been treated as an actual distribution for U.S. tax purposes. *See* Treas. Reg. § 1.861-20(g) Example 5.

107. Treas. Reg. § 1.861-20(d)(3)(ii).

108. Treas. Reg. § 1.861-20(d)(3)(v). Where the owner of the taxable unit is an individual or a domestic corporation, the term taxable unit means a foreign branch, a foreign branch owner, or a non-branch taxable unit, as defined in § 1.904-6(b)(2)(i)(B). In the case of a taxpayer that is a foreign corporation, the term taxable unit means a tested unit, as defined in § 1.951A-2(c)(7)(iv)(A). *See* Treas. Reg. § 1.861-20(d)(3)(v)(E)(9). Prior proposed regulations had proposed an alternative rule. *See* Notice of Proposed Rulemaking, REG-105495-19, 84 Fed. Reg. 69,124, 69,133 (Dec. 17, 2019). Again, as a result of comments, the Treasury Department re-proposed a new rule for how to address disregarded payments and in the process moved and renumbered the regulation provisions addressing disregarded payments. *See* Notice of Proposed Rulemaking, REG-101657-20, 85 Fed. Reg. 72,078, 72,084 (Nov. 12, 2020). The approach was largely followed with some adjustments in the final regulations. *See* T.D. 9959, 87 Fed. Reg. 276, 280-281 (Jan. 4, 2022).

The final regulations provide an ordering rule for attributing the amount of foreign gross income that arises from the receipt of a disregarded payment that includes both a reattribution payment and a remittance or contribution. Under the ordering rule, a disregarded payment is first treated as a reattribution payment. Any excess amount of the foreign gross income item then is treated as a remittance or a contribution.[109] In addition, final regulations provide that if an item of foreign gross income arises from an event that for foreign law purposes is treated as a distribution, contribution, accrual, or payment between taxable units, but for U.S. tax purposes is not treated as a disregarded payment (for example, a consent dividend from a disregarded entity), the foreign gross income and associated foreign tax are assigned in the same manner as an actual transfer of property in the amount of the disregarded payment would have been treated.[110]

These rules create a considerable amount of complexity, but when working through the complexity, a lingering question emerges: what is the point of an elective U.S. entity classification regime when any differences in entity classification result in a mismatch that greatly increases the number of instances where foreign gross income may have no U.S. corresponding item that then triggers a complex set of proxies for determining the manner of allocating and apportioning foreign taxes to the "most appropriate" statutory or residual grouping? The elective entity classification regime was justified in terms of its simplification, but the collateral consequence of this *"simple entity classification"* is that the taxpayer and the government now must work through an analysis of items of foreign income on an item-by-item basis to determine why the U.S. and foreign jurisdiction diverged in their respective treatments to then ascertain how the resulting mismatched taxes should be allocated to the various statutory groupings. This item-by-item determination is significantly more complex than the upfront determination of how an entity was organized in a foreign jurisdiction. If, as it does, Treas. Reg. section 1.861-20 requires the starting point for payments and entities to begin with the foreign law entity and foreign gross income classification in the foreign jurisdiction, then why not simply conform the U.S. classification of the foreign entity to that of the foreign situs jurisdiction?

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109. Treas. Reg. § 1.861-20(d)(3)(v)(C)(3).

110. Treas. Reg. § 1.861-20(d)(2)(ii)(D). If an item of foreign gross income is attributable to gain recognized under foreign law by reason of a disregarded payment received in exchange for property that results in a timing difference, the final regulations assign the foreign gross income based on how the corresponding U.S. item would be assigned. *See* Treas. Reg. § 1.861-20(d)(3)(v)(D). However, proposed regulations issued in 2022 change this result by providing that disregarded payments received in exchange for property do not constitute reattribution assets for purposes of allocating and apportioning taxes upon a disregarded remittance. *See* Prop. Treas. Reg. § 1.861-20(d)(3)(v)(D). The effect of the proposed regulations is to regard the disregarded payment and the disregarded sale or exchange for purposes of determining the balance sheet of the entities that can then be used for asset-based apportionment.

In the end, the mismatch in entity characterization creates needless complexity for no reason. The mere statement that *disregarded* payments are to be *regarded* as the starting point for determining the statutory and residual grouping for foreign gross income and the foreign taxes attributable to those items of foreign gross income creates an acrobatic role reversal. After determining the items of foreign gross income determined under foreign law, the regulations then require one to identify why there is a divergence in classification. This analysis requires a Herculean exercise, but what should be kept in the back of one's mind is that the regulations are infused with this complexity exactly because the regulations are attempting to treat disregarded payments and disregarded entities as regarded for purposes of assigning the mismatched foreign taxes to a reasonably accurate U.S. foreign tax credit basket.

So, let's return to the policy rationale articulated for the adoption of the elective entity classification regime in the first place. In 1995, the government stated that the entity classification analysis was difficult in the international context because the prior regulations required both the Treasury Department and taxpayers to review the organization documents and also to garner a thorough understanding of the controlling foreign law.[111] An obvious but unchosen path would have been to simply treat a foreign entity in the same manner that the foreign situs jurisdiction treats its own entity in terms of whether or not it is a separate taxpayer. Such an approach would be equally simple, but this was not the chosen path. Instead of choosing that alternatively simple path, the simplification proposal that was adopted in 1996 was one that affords taxpayers with a broad ability to elect the U.S. entity classification of foreign entities that in turn has resulted in an exponential increase in the number of mismatches for how the entity and its tax payments are treated between the United States and the foreign situs jurisdiction. The need to address these mismatches has created considerable complexity, so one should juxtapose the "simplicity" of electing an entity's classification with the complex outworking of Treas. Reg. section 1.861-20.

Taxpayers now have to have a granular understanding of transactions that are regarded for foreign law purposes in order to determine foreign gross income as the starting point for then applying Treas. Reg. section 1.861-20. Once that foreign law characterization is understood at a very granular level by both the taxpayer and the U.S. government, then the taxpayer is required to bridge why the foreign law characterization diverged from the U.S. characterization by providing specific rules for assigning items of foreign gross income on amounts that are imposed on a taxpayer in its capacity as a shareholder or a

111. Notice of Proposed Rulemaking, RIN 1545-AT91, 61 Fed. Reg. 21,989, 21,990 (May 13, 1996).

partner, on disregarded payments, on transactions involving reverse hybrid entities, and upon the sale of a disregarded entity.[112] Different rules apply to different types of disregarded payments. If the goal of an elective classification regime was to avoid the need for taxpayers to garner a thorough understanding of foreign law and how that law creates divergencies with U.S. outcomes, the elective U.S. entity classification regime has not achieved that stated policy goal. In contrast, it has exasperated the complexity for everyone. But, the above outcomes should also be considered in terms of the metric of whether the U.S. and foreign jurisdiction are benefitted or hindered in coming to a common understanding of which jurisdiction has income when there is a mismatch in entity classification. The United States may well believe that its attempt in Treas. Reg. section 1.861-20 to allocate the unmatched foreign taxes to items of income utilizes reasonable proxies, but there is certainly no assurance that any other jurisdiction will accept this assignment of income and taxes as accurate workarounds from their perspective. Given the need under the GloBE rules to assure conformity in treatment for how covered taxes are allocated to income in order to determine whether a correct minimum tax has been paid, the best way for the United States to position itself to ensure that its allocation is acceptable to its other treaty partners is to conform the U.S. entity classification criteria of foreign entities with how the foreign situs jurisdiction classifies that entity so that the United States and the foreign situs jurisdiction have the same starting point for this country-by-country assignment of income and covered taxes.

B. Foreign Tax Credit Splitter Events and the Elective Classification Regime

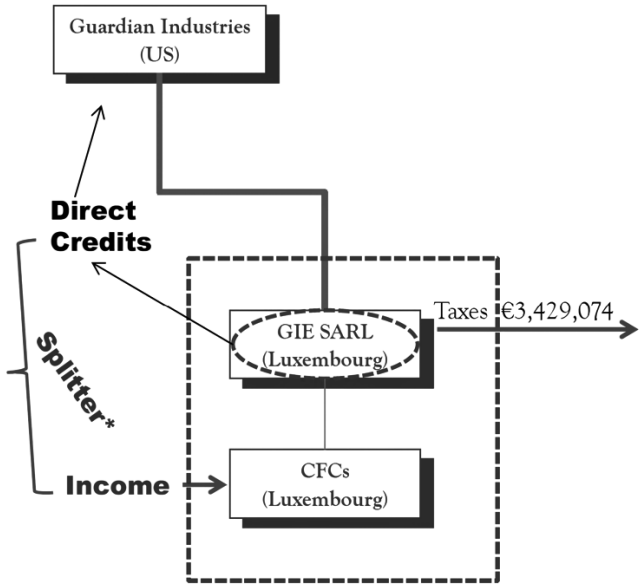
When the U.S. and a foreign jurisdiction have a mismatch in terms of identifying the entity responsible for earning income and paying taxes, then the opportunity exists for the entity classification divergencies to create splitter transactions where the entity responsible for the income for U.S. tax purposes can be different from the entity that is considered to have paid the associated foreign taxes under foreign law. As an example, if a foreign jurisdiction treats an entity as a flow-through entity, then the entity's owner is the person to whom foreign law imposes the taxes on the income earned in the flow-through entity. Under U.S. law, the person who is entitled to claim a foreign tax credit is the person who is legally liable for the tax under foreign law.[113] But, if the foreign flow-through entity is classified as a corporation for U.S. tax

112. Treas. Reg. § 1.861-20(d)(3). For disregarded payments, the amount that is a reattribution amount must be assigned by the payee to the same statutory group as the associated reattribution amount and the payer does not reduce its gross income by for purposes of allocating and apportioning the payer's foreign taxes. See Treas. Reg. § 1.861-20(d)(3)(v)(B).

113. Treas. Reg. § 1.901-2(f)(3)(i).

purposes, then the income it earns is considered to be earned by the foreign entity in its capacity as a separate and distinct foreign corporation.

his splitter outcome arising from the classification mismatch is illustrated in *Guardian Industries Corp. v. United States*.[114] In *Guardian Industries*, a U.S. domestic corporation owned a Luxembourg entity (the acronym of which was "GIE") that was treated as a corporation for U.S. tax purposes but as a flow-through entity for Luxembourg tax purposes. Thus, it was a reverse hybrid entity. Because the entity was regarded as a separate foreign corporation for U.S. tax purposes, Guardian Industries took the position that the Luxembourg income was earned by GIE and thus was not the income of the U.S. owner of GIE for U.S. tax purposes. However, because Luxembourg law treated the U.S. owner of GIE as the technical taxpayer liable for the Luxembourg taxes assessed on GIE, the U.S. owner claimed that it was the technical taxpayer of the Luxembourg income taxes and, as such, was entitled to claim direct foreign tax credits even though it did not report any of the foreign income to which those taxes related. A simplified ownership structure is set forth in the below diagram.



The Federal Circuit agreed with Guardian Industries, holding that the U.S. owner of GIE was entitled to claim U.S. foreign tax credits for the Luxembourg taxes and was not taxable on the income earned by GIE until those earnings were remitted as a dividend because GIE was treated as a foreign corporation under the elective U.S. entity

114. Guardian Industries Corp. v. U.S., 77 F.3d 1368, 1373–75 (Fed. Cir. 2007).

classification regime. Thus, the foreign tax credits were split away from the income to which they relate.

In the midst of this litigation, the Service in 2006 proposed to modify the technical taxpayer rule to not allow the owners of a flow-through entity to be treated as the technical taxpayer,[115] but the Service abandoned those regulations[116] because Congress enacted section 909 to address the policy concerns posed by foreign tax credit splitter transactions like the one posited in *Guardian Industries* in another manner. In this regard, section 909 requires any foreign tax that is attributable to a foreign tax credit splitter event to be deferred until the taxpayer who paid the tax also includes the foreign income in its own tax return. The regulations that implement section 909 are complex and have a set of coordination rules,[117] but the point that should be made is that the need for section 909 to address foreign tax credit splitter events is only necessary if the United States does not conform its treatment of the foreign entity the manner that the foreign situs jurisdiction treats its own entity.

However, even with section 909, discontinuities from the mismatch in entity classification have created a need for further refinements outside of section 909 to address the lingering mismatch asymmetries. In this regard, in the case of an entity that is treated as a partnership for U.S. income tax purposes but is treated as a corporation for foreign tax purposes; the resulting mismatch in entity classification creates a hybrid partnership (a partnership for U.S. tax purposes but corporation for foreign tax purposes).[118] Importantly, under foreign law, the entity is considered to have legal liability under foreign law for the foreign taxes imposed on the income of the entity, notwithstanding that the entity is characterized as a partnership for U.S. tax purposes.[119] The regulations allocate the foreign tax paid by the hybrid partnership to its partners if the partnership's U.S. taxable year closes with respect to one or more (or all) partners or if there is a change in ownership of the hybrid partnership.[120] In addition, if an entity is treated as a disregarded

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115. Notice of Proposed Rulemaking, 71 Fed. Reg. 44,240, 44,242 (Aug. 4, 2006). The Service announced that its proposal to modify the technical taxpayer rule with a new Prop. Treas. Reg. § 1.901-2(f)(3)(iii) was necessary to prevent the inappropriate separation of foreign tax from the related income and to prevent dissimilar treatment of foreign consolidated groups and foreign groups containing reverse hybrids. With the enactment of section 909 that explicitly addresses foreign tax credit splitter transactions, this necessity was made moot.

116. T.D. 9576, 77 Fed. Reg. 8,120, 8,122 (Feb. 14, 2012).

117. *See* Treas. Reg. § 1.909-1 through Treas. Reg. § 1.909-5.

118. Treas. Reg. § 1.901-2(f)(4)(i).

119. Treas. Reg. § 1.901-2(f)(4)(i).

120. Treas. Reg. § 1.901-2(f)(4)(i). The regulations generally provide that for hybrid partnerships and disregarded entities, allocations of tax will be made under the principles of § 1.1502-76(b) based on the respective portions of the taxable income of the hybrid entity (as determined under foreign law) for the foreign taxable year that are attributable to the period ending on the date of the ownership change (or the last day of the terminating partnership's U.S. taxable year) and the period ending after such date. *See* Treas. Reg. § 1.901-2(f)(5)(i). The

entity for U.S. federal income tax purposes, the person that is treated as owning the assets of such entity for U.S. tax purposes is considered to have legal liability under foreign law for tax imposed on the income of the entity.[121] Importantly, if there is a change in the ownership of a partnership or disregarded entity during the entity's foreign taxable year, this may create a partnership termination and thus a closing of the books for U.S. tax purposes with the consequence that a foreign tax allocation is required if the partnership undergoes a section 708 termination that arises under section 708(b)(1)(A). Regulations issued in 2022 move the allocation rules related to partnership terminations and entity classification changes into Treas. Reg. section 1.901-2(f)(5) and then modify those rules further. However, the beginning point remains that a partnership is considered to pay a tax that foreign law imposes on the entity.[122] For entities that are treated as disregarded entities, the regulations continue the rule that the owner of the disregarded entity is the person who is considered to be legally liable for paying a tax imposed on a disregarded entity.[123]

As to ownership changes involving partnerships and disregarded entities, the final regulations provide for a single allocation rule that applies to a partnership, disregarded entity, or corporation that undergoes one or more "covered events" during its foreign taxable year that do not result in a closing of the foreign taxable year.[124] A covered event is a partnership termination under section 708(b)(1), a transfer of a disregarded entity, or a change in the entity classification of a disregarded entity or a corporation.[125] In addition, the final regulations also address the allocation of foreign tax paid or accrued with respect to certain changes in a partner's interest in a partnership (a "variance") by treating the variance as a covered event.[126] These final regulations also ensure that the allocation rules apply if there is a combination of covered events.[127] Consistent with the prior regulations, the final

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regulations also prescribe closing book rules to allocate foreign taxes in a manner consistent with Treas. Reg. § 1.338-9(d) for apportioning foreign tax paid by a target corporation that is acquired in a transaction that is treated as an asset acquisition pursuant to an election under I.R.C. § 338, if the foreign taxable year of the target does not close at the end of the acquisition date. *See* Treas. Reg. § 1.901-2(f)(6).

121. Treas. Reg. § 1.901-2(f)(4)(ii).

122. Treas. Reg. § 1.901-2(f)(4)(i).

123. Treas. Reg. § 1.901-2(f)(4)(ii).

124. Treas. Reg. § 1.901-2(f)(5)(i).

125. Treas. Reg. § 1.901-2(f)(5)(ii). These proposed regulations therefore apply to allocate foreign tax paid or accrued with respect to the continuing foreign taxable year of a partnership that terminates under section 708(b)(1), a disregarded entity that becomes a partnership or a corporation, and a corporation that becomes a partnership or a disregarded entity.

126. Treas. Reg. § 1.901-2(f)(5)(iv).

127. Treas. Reg. § 1.901-2(f)(5)(i) (applies if a partnership, disregarded entity, or corporation undergoes "one or more covered events"). The preamble to the proposed regulations illustrates this rule by stating that a foreign tax that is paid or accrued with respect to a continuing foreign taxable year in which a corporation elects to be treated as a disregarded entity and the disregarded

regulations allocate a portion of foreign tax among all persons that were predecessor entities (namely, a terminating partnership or corporation undergoing an entity classification change) or prior owners (namely, the owner of a disregarded entity that is transferred or undergoes an entity classification change) based on the respective portions of the foreign tax base for the continuing foreign taxable year that are attributable under the principles of Treas. Reg. section 1.1502-76(b) to the period of existence or ownership of each predecessor entity or prior owner during such year.[128] In addition, the final regulations provide that tax allocated to a predecessor entity is treated as paid or accrued as of the close of the last day of its last U.S. taxable year, and tax allocated to the prior owner of a disregarded entity is treated as paid or accrued as of the close of the last day of its U.S. taxable year in which the change in ownership occurs.[129]

Again, the elective entity classification regime set forth in Treas. Reg. section 301.7701-2 was adopted to promote simplification, but the opposite has occurred. Foreign tax credit splitter events are more common exactly because of divergent classification treatment of foreign entities. Section 909, its regulations, and the regulations under section 901 that address hybrid partnerships all evolved because the asymmetrical treatment of the foreign entity's classification creates inappropriate mismatches that require a U.S. response. With the benefit of hindsight, this evolution of the law demonstrates that U.S. law would be simplified if the United States simply conformed its treatment of foreign entities to the manner in which the jurisdiction in which the entity is formed treats that entity. But, more importantly, the development of the GloBE rules and the need for a country-by-country determination of income and the covered taxes attributable to that income requires countries to have a common understanding of where income is earned and which juridical person paid those taxes. The efforts utilized by the United States to reassociate foreign taxes with the underlying income in instances of splitter events may well utilize reasonable proxies, but these workaround rules may not be commonly understood or agreeable to other jurisdictions that don't see the relevant transaction similarly. If such agreement were not reached, then the United States would be potentially disadvantaged if its covered taxes are not appropriately matched to a common agreement on how to determine the minimum tax. Seen in this light, an important design parameter would be for the United States to minimize instances where splitter events can and do occur. This would be best accomplished by adopting an entity classification regime for foreign entities that

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entity subsequently becomes a partnership. *See* Notice of Proposed Rulemaking, REG-101657-20, 85 Fed. Reg. 72,078, 72,097 (Nov. 12, 2020).

128. Treas. Reg. § 1.901-2(f)(5)(i).

129. Treas. Reg. § 1.901-2(f)(5)(i).

conforms the U.S. classification to how the foreign situs jurisdiction classifies its own juridical entity.

C. The Foreign Branch Basket and the Elective Classification Regime

Congress added further complexity in 2017 by enacting a separate foreign branch basket that is separate and distinct from the general basket.[130] Section 904(d)(2)(j) defines foreign branch category income as business profits attributable to one or more qualified business units in one or more foreign countries. However, even though the need to separately maintain a foreign branch basket is a creation of the statute, the elective classification regime makes this branch analysis even more complex as the election to treat an entity as a disregarded entity causes that entity to be treated as a foreign branch for U.S. tax purposes when owned by a single owner whereas in the foreign situs jurisdiction, the foreign entity is regarded as a separate taxpayer. When foreign law treats its entity as a separate taxpayer, but the foreign entity is disregarded for U.S. tax purposes, the effect is that the instances of mismatches in the characterization of transactions between foreign and U.S. law are more pronounced. In contrast, when the foreign branch is consistently treated as a branch in both jurisdictions, the incidences of mismatches in the two jurisdictions are significantly diminished. Given that mismatches are likely to arise due to the divergence in entity classification between the United States and the foreign situs jurisdiction, the regulations that implement the foreign branch basket have been infused with rules on how to address these mismatches. In this regard, the regulations define foreign branch income to include income attributable to a foreign branch held directly or through disregarded entities, a distributive share of partnership income that is attributable to a foreign branch of the partnership that is held directly or indirectly through disregard entities or other partnerships, and income of other pass-through entities that is attributable to a foreign branch.[131] However, income that is simultaneously described as passive income is excluded from foreign branch category income and classified as passive basket income.[132]

The regulations generally attribute gross income to a foreign branch by reference to the books and records maintained by the foreign branch, subject to certain adjustments.[133] Nevertheless, any income from activities conducted in the United States is not considered foreign branch income, even if that income is reflected on the foreign books and records of the foreign branch.[134] Gains on the disposition of stock is not

130. I.R.C. §§ 904(d)(1)(B), 904(d)(1)(D), 904(d)(2)(J).
131. Treas. Reg. § 1.904-4(f)(1)(i).
132. I.R.C. § 904(d)(2)(j)(ii); Treas. Reg. § 1.904-4(f)(1)(ii).
133. Treas. Reg. § 1.904-4(f)(2)(i).
134. Treas. Reg. § 1.904-4(f)(2)(ii).

considered foreign branch income unless the stock represents dealer property.[135] Also excluded from the definition of foreign branch income are gains on the sale of an interest in a partnership or disregarded entity unless those sales occur in the ordinary course of the foreign branch's business.[136] Finally, the regulations allow for adjustments for transactions that were done with the principal purpose of manipulating the amount of income or expense that is reflected in the foreign books and records of the foreign branch.[137] Despite this litany of adjustments, it remains true to say that the regulations rely heavily on the "separate books and records approach" as defined by the foreign situs jurisdiction. Disregarded payments that are reflected on the books and records of the foreign branch are given effect (not disregarded) for purposes of determining the income and expense of the foreign branch.[138] Thus, a disregarded payment that represents income in the foreign branch's books and records is generally treated as foreign branch income, and a disregarded payment that generally reduces foreign branch income adjusts downward the foreign branch income.[139]

Of course, the mere statement that *disregarded* payments are to be *respected* for purposes of determining the foreign branch income and expense brings on a number of complexities. How are disregarded payments allocated between passive income that may exist in the foreign branch? How are the sourcing rules applied to disregarded payments that are received or paid by a foreign branch? In answer to these questions, the Service decided that its "disregarded payment rule" would not change the sourcing or character of income, but would change the category (the foreign tax credit basket) to which such foreign income or expense relates.[140] Similarly, the Service explicitly refused to "net" disregarded payments; instead, the regulations treat each disregarded payment[141] as a separately regarded transaction for purposes of determining the income and expense attributable to the foreign branch basket but only for that purpose.[142]

Thus, the "disregarded payment rule" seeks to sort out how to treat income and expense attributable to disregarded payments under prescriptive rules.[143] With respect to disregarded payments arising

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135. Treas. Reg. § 1.904-4(f)(2)(iii).

136. Treas. Reg. § 1.904-4(f)(2)(iv) .

137. Treas. Reg. § 1.904-4(f)(2)(v).

138. Treas. Reg. § 1.904-4(f)(2)(vi).

139. Treas. Reg. § 1.904-4(f)(2)(vi)(A).

140. T.D. 9882, 84 Fed. Reg. 69,022, 69,031 (Dec. 17, 2019).

141. For this purpose, the disregarded payment must be determined in a manner that results in the attribution of the proper amount of gross income to each of a foreign branch and its foreign branch owner under the principles of section 482. *See* Treas. Reg. § 1.904-4(f)(2)(vi)(E).

142. Treas. Reg. § 1.904-4(f)(2)(vi)(F). This Service explicitly refused to apply a netting rule. T.D. 9882, 84 Fed. Reg. 69,022, 69,032 (Dec. 17, 2019).

143. Treas. Reg. § 1.904-4(f)(2)(vi). In this regard, a disregarded payment from a foreign branch owner to its foreign branch is treated as additional foreign branch income to the foreign

from the sale of property, the regulations require a computation of the amount of disregarded gain that is associated with the disregarded sale.[144] For a disregarded sale from a foreign branch owner to its foreign branch, the disregarded gain with respect to the transferred property is sourced and categorized based on the proportion the disregarded gain bears to the total gain recognized on the future regarded sale or exchange of the transferred property.[145] A symmetrical rule exists when the foreign branch sells property to its foreign branch owner in that the disregarded gain of the foreign branch is treated as foreign branch income in the same proportion that the disregarded gain bears to the total gain recognized on the future regarded sale of the transferred property for purposes of determining the sourcing and foreign tax credit basket of the disregarded gain.[146] Special timing rules are then set forth for payments subject to the disregarded payment rule.[147] The disregarded payment rule, however, does not apply to any disregarded payments between a foreign branch and its foreign branch owner that relate to disregarded interest payments, branch remittances, branch contributions, or any disregarded payment that could result in the attribution of gross income to a foreign branch (such as the sale of a partnership interest by the foreign branch to its branch owner) unless the sale occurs in the ordinary course of business.[148] With respect to the transfer of intangible property from a foreign branch owner to its foreign branch, the principles of section 367(d) and section 482 apply to determine the disregarded royalty between the foreign branch owner and the foreign branch.[149]

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branch, and the associated expenditure by the foreign branch owner is allocated and apportioned in the same manner as a deduction, if regarded, would have been allocated and apportioned under section 861. *See* Treas. Reg. § 1.904-4(f)(2)(vi)(A) and (B)(1)(i). Disregarded payments from a foreign branch to its branch owner are allocated to the gross income of the foreign branch to the extent that a deduction for that disregarded payment, if it had been regarded, would be allocated and apportioned to gross income attributable to the foreign branch under the general principles set forth in the regulations under section 861. *See* Treas. Reg. § 1.904-4(f)(2)(vi)(B)(1)(ii).

144. *See* Treas. Reg. § 1.904-4(f)(2)(vi)(B)(2)(i). Technically, this regulation only applies to the sale of non-inventory property, but Treas. Reg. § 1.904-4(f)(2)(vi)(B)(2)(iii) says that the principles of Treas. Reg. § 1.904-4(f)(2)(vi)(B)(i) apply to the sale of inventory property to the extent that disregarded payment, if regarded, would be subtracted from gross receipts which would occur when inventory property is sold.

145. *Id*.

146. *Id*.

147. The regulations provide that disregarded payments arising outside the context of a sale of property are to be included and regarded in the year that a disregarded payment, if it had been regarded, would be taken into account as a deduction or would increase cost of goods sold. *See* Treas. Reg. § 1.904-4(f)(2)(vi)(B)(3)(i). As to the timing rule for disregarded sales of property, the gross income attributable to the foreign branch is adjusted in the taxable year when the property with an adjusted disregarded basis is actually sold in a regarded transaction. *See* Treas. Reg. § 1.904-4(f)(2)(vi)(B)(3)(ii). Thus, with respect to the sale of property, the regulations provide a rule that is akin to the matching and acceleration rule that exists in the consolidated return context with respect to property that is sold among affiliated members and then later sold outside of the consolidated group. *Cf.* Treas. Reg. § 1.1502-13(c)–(d).

148. Treas. Reg. § 1.904-4(f)(2)(vi)(C).

149. Treas. Reg. § 1.904-4(f)(2)(vi)(D).

After setting forth disregarded payments rules in Treas. Reg. section 1.861-20(d)(3)(iv) and Prop. Treas. Reg. section 1.954-1(d), the government set forth proposed regulations under section 904 to harmonize the disregarded payment rules utilized in section 904 with the approach taken under other regulations issued under other Code provisions. The proposed regulations move the exclusions for income arising from U.S. activities and stock to another subparagraph.[150] The proposed regulations then clarify that such excluded income is excluded from the foreign branch basket even when that income is attributable to a foreign branch.[151] In addition, the proposed regulations include a new rule to address the effect of disregarded payments made and received by non-branch taxable units.[152] Under the new rule, the proposed regulations specify that the disregarded reallocation payment rules of Treas. Reg. section 1.904-4(f)(2) also applies in the case of disregarded payments made to and from a "nonbranch taxable unit."[153] The proposed regulations clarify that the reattribution of gross income by reason of disregarded payments is capped at the amount of current gross income in the payor foreign branch or foreign branch owner.[154]

Several examples are set forth in the proposed regulations to illustrate these principles.[155] Taxpayers falling into these facts patterns will need to read the regulations carefully, but one representative example may be helpful to illustrate the principles that are involved. In the below diagram, there is a single payment that is made in each of the three diagrams. In the far left diagram, a payment is made to a disregarded entity that is a foreign branch from its U.S. branch owner. In the middle diagram, the foreign branch makes a payment to its U.S. branch owner. In the far right diagram, a payment is made from a controlled foreign corporation to its U.S. parent corporation.

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150. *Compare* Treas. Reg. § 1.904-4(f)(2)(ii)-(iii), *with* Prop. Treas. Reg. § 1.904-4(f)(1)(iii)–(iv).

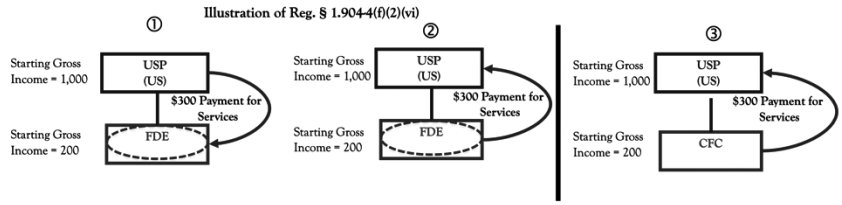
151. Prop. Treas. Reg. § 1.904-4(f)(1)(iii) (stating with respect to income from U.S. activities); Prop. Treas. Reg. § 1.904-4(f)(1)(iv) (stating for income from stock of a corporation). The preamble to the proposed regulations asserts that the government believes that this new technical modification represents a clarification and does not represent a substantive change in the intended application of the existing regulations. *See* Notice of Proposed Rulemaking, REG-101657-20, 85 Fed. Reg. 72,078, 72,099 (Nov. 12, 2020).

152. Prop. Treas. Reg. § 1.904-4(f)(2)(iv)(G).

153. Prop. Treas. Reg. § 1.904-4(f)(2)(iv)(G)(1). A non-branch taxable unit is now defined in the proposed regulations to have the same meaning of provided in Treas. Reg. § 1.904-6(b)(2)(i)(B). *See* Prop. Treas. Reg. § 1.904-4(f)(3)(xi).

154. Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(A).

155. *See* Prop. Treas. Reg. § 1.904-4(f)(4)(xiii)–(xv), Examples 13–15.



In the first scenario, the disregarded payment from the foreign branch owner (USP) to the foreign branch (FDE) causes the gross income attributable to the foreign branch owner to be decreased, and the gross income attributable to the foreign branch is increased by the same amount. However, this $300 amount in the first scenario that is received by FDE could represent U.S. source income in the foreign branch. This is counter-intuitive, but it demonstrates that the sourcing rule is not based on where the FDE performed its services but instead is based on the sourcing of the reattributed income. In the second scenario, the disregarded payment from a foreign branch (FDE) to the foreign branch owner causes the gross income of the foreign branch to be decreased and the general category gross income attributable to the foreign branch owner is increased by the same amount. This is true even if the sourcing would have otherwise been U.S. source services income because the reattributed income retains its sourcing characterization in the hands of USP. In the third situation, the gross income in USP is increased by the $300 payment, but now the sourcing depends on the sourcing of service income earned by USP and not based on a reattribution sourcing. In addition, in the third situation, the gross income in the CFC is not decreased by the $300 payment. Instead, the CFC has a deduction from its gross income of $300 to arrive at taxable income. Thus, the above example illustrates at least two key principles in these rules. First, the amount of gross income is different in the first two scenarios where there is a disregarded payment versus the regarded payment in the third scenario. And second, the sourcing for the reattribution payment is done by preserving the sourcing of the income that is the subject of the disregarded payment whereas in the third situation the regarded payment is a separate category of gross income that has its sourcing that is not sourced by reattribution. As a result of these rules, even though net taxable income is the same in all three cases, the gross income reattributed from a branch may have a different source (i.e., U.S. vs. foreign) compared to a similar payment from a controlled foreign corporation (CFC). Furthermore, in terms of applying the various expense apportionment rules, the adjusted branch gross income that in turn can implicate gross-based expense apportionment methodologies including interest expense and research and experimentation expense apportionment.

There is much that could be said about these regulations, but *simple* is not one of the adjectives that apply. In point of fact, these rules create divergences and considerable complexity exactly because the regulations attempt to walk back the divergences that the elective entity classification regime can create but does so only selectively so that mismatch asymmetries remain. As previously mentioned, the elective entity classification regime was adopted based on a policy goal of promoting simplification and reducing the need for taxpayers and the government to thoroughly examine foreign law, but the resulting foreign branch basket regulations demonstrate that this stated policy goal has not been realized. A careful review of the foreign branch regulations leads one inexorably to this insight: U.S. law would be simplified if the United States would simply conform its treatment of foreign entities to the manner in which the jurisdiction in which the entity is formed treats that entity.

But even so, the complexity and asymmetrical outcomes afforded under the regulations are only the penultimate problem. The ultimate problem is that these regulations are attempting to prescribe workaround measures to define foreign branch basket income because of the specter of hybrid entities. Even if one accepts that these workaround rules are reasonable proxies, the reality is that these outcomes may not be commonly understood or agreeable to other jurisdictions that don't see the transactions or entities similarly. The Treasury Department, in its approach, has attempted to differentiate between fiscally transparent entities from nontransparent hybrid entities in an effort to better conform its regulatory approach to how the foreign situs jurisdiction classifies its own entity. Seen in this light, the regulations demonstrate that an important design parameter is to minimize instances where its definition of foreign branch basket income was inconsistent with how other jurisdictions defined that same foreign branch income, but having said that it should then be stated that the best means to accomplish that conformity would be for the United States to adopt an entity classification regime for foreign entities that conforms to how the foreign situs jurisdiction classifies its own entity or branch located or created in its own jurisdiction. The above example demonstrates that the regulations still create anomalies for the treatment of a hybrid entity versus how a true CFC would have been treated. These inconsistencies are likely to make it more difficult to achieve a common understanding with foreign situs jurisdiction on what income exists and which entity earned it and from where. If the United States simply conformed its treatment of entities based on how the foreign situs jurisdiction treated its entities, the areas of nonconformance could be minimized.

D. Application of the High-Tax Exception and the Elective Classification Regime

The elective classification regime has also created considerable complexity in the application of the high-tax exception under section 951A because mismatched income and foreign taxes must be "re-matched" in some manner so as to determine whether the income (as understood by the U.S.) was subjected to high-tax. The OECD has recognized that the U.S. CFC regime under section 951A is a blended CFC regime that requires an allocation of income and taxes, and the OECD has set forth mechanical rules on how to allocate income and taxes of blended tax regimes.[156] However, the starting point for such allocation is a determination of income and taxes by jurisdiction. Because the existence of hybrid entities and hybrid payments create mismatches in the income and taxes from a U.S. perspective, this issue remains an area where a common understanding is made difficult because of the mismatch in the treatment of entities and transactions. The regulations under section 951A seek to harmonize these mismatches in ways that are far more granular than what the OECD has set forth, and so it remains to be seen how these mismatches will be addressed in forthcoming guidance because the entity classification mismatches make this determination more complex.

As with the other areas discussed earlier, the regulations start with the foreign law characterization of income, not the U.S. tax law characterization. In this regard, under the regulations that implement the high-tax exception, the taxpayer must identify tentative gross tested income. A CFC's tentative gross tested income item is the aggregate of all items of gross income of the controlled foreign corporation attributable to a *tested unit* that otherwise would be gross tested income apart from the GILTI high-tax exclusion.[157] The tested unit concept is new and generally exists to the extent an entity, or the activities of an entity, are actually subject to tax as either a tax resident or a permanent establishment (or similar taxable presence) under the tax law of a foreign country.[158] Again, the regulations require the taxpayer to start with the concept that the foreign entity is afforded separate classification status as a separate "tested unit" even if the entity is classified as a disregarded entity under the United States elective entity classification regime. Using that guidepost, the final regulations provide three categories for a tested unit. First, a tested unit includes a CFC if the

156. *See OECD Administrative Guidance*, *supra* note 38, at art. 2.10 at 67–70.
157. Treas. Reg. § 1.951A-2(c)(7)(ii)(A).
158. T.D. 9902, 85 Fed. Reg. 44,620 (July 23, 2020).

CFC has no other tested units.[159] Second, a tested unit also includes an interest in a pass-through entity held, directly or indirectly, by a CFC.[160]

A CFC's interest in a pass-through entity (or the activities of a branch) that is not a tested unit is a "transparent interest."[161] The preamble to the final regulations explains that the treatment of interests in a pass-through entity as a separate tested unit is appropriate if the pass-through entity is treated as a separate entity for purposes of a foreign tax law but is not appropriate if the pass-through entity is fiscally transparent (and thus not a tax resident) for purposes of the tax law of a foreign country.[162] In other words, the regulations are working hard to create a workaround that attempts to treat the entity as a tested unit (or not) based on how the foreign situs jurisdiction treats its own entity. This is what the U.S. entity classification regulations should have done in the first place but didn't do, and as a result, the regulations require complex workarounds.[163]

Finally, a tested unit includes a branch, or a portion of a branch, the activities of which are carried on directly or indirectly by a CFC, provided that either (i) the branch gives rise to a taxable presence in the country in which the branch is located or (ii) the branch gives rise to a taxable presence under the owner's tax law and the owner's tax law provides an exclusion, exemption, or other similar relief (such as a preferential rate) for income attributable to the branch.[164]

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159. Treas. Reg. § 1.951A-2(c)(7)(iv)(A)(1). If a CFC is considered to be the tested unit, then the GILTI high-tax exclusion is applied with respect to all the tentative gross tested income items of the CFC.

160. Treas. Reg. § 1.951A-2(c)(7)(iv)(A)(2). For this purpose, a pass-through entity is defined to include a partnership or a disregarded entity. *See* Treas. Reg. § 1.951A-2(c)(7)(ix)(B). More specifically, a CFC's interest in a pass-through entity is a tested unit if the pass-through entity meets one of two requirements: (i) the CFC's interest in the pass-through entity is a tested unit if the pass-through entity is a tax resident of a foreign country because, in these cases, income earned by the CFC indirectly through the pass-through entity may be subject to tax at a rate different than the rate at which income earned by the CFC directly is subject to tax, or (ii) the CFC's interest in the pass-through entity is a tested unit if the pass-through entity is not subject to tax as a resident but is treated as a corporation (or as another entity that is not fiscally transparent) for purposes of the CFC's tax law because in these cases income earned by the CFC indirectly through the pass-through entity may not be subject to tax in the foreign country of which the CFC is a tax resident. *See* Treas. Reg. § 1.951A-2(c)(7)(iv)(A)(2).

161. Treas. Reg. § 1.951A-2(c)(7)(ix)(C).

162. *See* T.D. 9902, 85 Fed. Reg. 44,620, 44,624 (July 23, 2020). The preamble to the final regulations also explains that an interest in an entity, rather than the entity itself, is treated as a tested unit (or a transparent interest) because the entity may have multiple owners and the characterization of the interest as a tested unit may depend on each holder's tax treatment with respect to the interest in a pass-through entity with the consequence that less than the entire entity may be characterized as a tested unit or a transparent interest. In addition, different interests in an entity held directly or indirectly by the same CFC may be characterized differently.

163. Treas. Reg. § 1.951A-2(c)(7)(iv)(A)(3). In these cases, the income indirectly earned by the owner through the branch may be subject to tax at a rate different than the rate at which income directly earned by the owner is subject to tax, and so this branch tested unit designation prevents inappropriate blending of taxes in a more targeted manner than the qualified business unit (QBU) standard that was utilized in the 2019 proposed regulations.

164. T.D. 9902, 85 Fed. Reg. 44,620, 44,624 (July 23, 2020).

The attempt to conform the U.S. treatment of the tested unit to how foreign law treats the entity is made unmistakably clear at this point as well as one must constantly refer back to the tax law of the foreign country.[165]

The final regulations make clear that tested units are determined independently of one another. For example, even though a CFC is itself a tested unit, the CFC may have other tested units, such as a permanent establishment or an interest in a disregarded entity that must be treated separately for purposes of the GILTI high-tax exclusion.[166] The final regulations also provide a rule that addresses cases where the same item is attributable to more than one tested unit in a tier of tested units. This may occur, for example, if an item is properly reflected both on the separate set of books and records of one tested unit and on the separate books of a lower-tier tested unit that is owned (directly or indirectly) by the first tested unit. In such a case, the final regulations provide that the item is considered to be attributable only to the lowest-tier tested unit.[167]

The final regulations allow the taxpayer to combine testing units to apply these rules on a consolidated testing unit basis for the CFC for tested units (other than non-taxed branch tested units) if each of the combined tested units were subject to taxation on a residency basis in the same foreign country.[168] In general, a non-taxed branch-tested unit is a branch-tested unit that does not give rise to a taxable presence under the tax law of the foreign country where the branch is located but gives rise to a taxable presence under the tax law of the foreign country where the home office of the branch is a tax resident and such tax law provides an exclusion, exemption, or similar relief for purposes of taxing income attributable to the branch.[169] The final regulations do not allow a non-taxed branch to be combined with another tested unit,[170] and the preamble to the final regulations explains the exclusion of non-taxed branch tested units from the tested unit combination rule on the grounds that a non-taxed branch tested unit is not subjected to any meaningful level of taxation in any foreign country. Thus, its combination with other tested units could give rise to inappropriate blending.[171] However, the combination rule applies without regard to whether the tested units are subject to the same foreign tax rate. In

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165. For purposes of the tested unit rules, references to the tax law of a foreign country include statutes, regulations, administrative or judicial rulings, and treaties of the country. *See* Treas. Reg. § 1.951A-2(c)(7)(iv)(A)(2),(3) (cross-referencing definitions in regulations under section 267A that incorporate the definition of the tax law of a country in Treas. Reg. § 1.267A-5(a)(21)).

166. Treas. Reg. § 1.951A-2(c)(8)(iii)(D).

167. Treas. Reg. § 1.951A-2(c)(7)(iv)(B).

168. Treas. Reg. § 1.951A-2(c)(7)(iv)(C)(1).

169. Treas. Reg. § 1.951A-2(c)(7)(iv)(A)(3).

170. Treas. Reg. § 1.951A-2(c)(7)(iv)(C)(2).

171. *See* T.D. 9902, 85 Fed. Reg. 44,620, 44,625 (July 23, 2020).

addition, the combination rule is not conditioned on the tested units having the same functional currency. Finally, the combination rule is mandatory, not elective.

Once tested units are identified, then the tentative gross tested income of the tested unit must be determined. The final regulations generally provide that items of gross income of a CFC are attributable to a tested unit of the CFC to the extent they are properly reflected on the separate set of books and records[172] of the tested unit.[173] This rule starts with the items of gross income of the CFC for federal income tax purposes and then attributes those items to the CFC's tested units to the extent the items are properly reflected on the separate set of books and records of the tested units (with certain adjustments, such as to account for disregarded payments). For example, if a CFC owns a partnership interest that is a tested unit, the items of gross income that the CFC derives through the partnership interest are attributed to the CFC's interest in the partnership to the extent that the items are properly reflected on the separate set of books and records of the partnership. Thus, this approach first gives effect to the rules that determine the items of gross income of the CFC and then attributes those items to the tested units of the CFC depending on whether the items are properly reflected on the separate set of books and records of the tested units.[174]

The final regulations provide a special booking rule that applies to a transparent interest, that is an interest in a pass-through entity (or the activities of a branch) that is not a tested unit. This rule generally treats items properly reflected on the separate set of books and records of a transparent entity interest as being properly reflected on the books and records of a tested unit that holds the transparent entity interest.[175]

After the items of tentative gross tested income are allocated among tested units based on the books and records of the tested units,[176] the separate books and records must be adjusted to take into account payments that are treated as disregarded payments for U.S. tax

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172. Treas. Reg. § 1.951A-2(c)(7)(v)(A). The final regulations define a "separate set of books and records" by reference to Treas. Reg. § 1.989(a)-1(d). The final regulations include a rule that applies if a separate set of books and records is not prepared for a tested unit or transparent interest. In this scenario, the items of tentative gross tested income must be determined in a manner that properly reflects those items on the separate set of books and records of the appropriated tested unit are properly reflected. See Treas. Reg. § 1.951A-2(c)(7)(v)(B) and (D).

173. Treas. Reg. § 1.951A-2(c)(7)(ii)(B).

174. For a regulatory example that illustrates this approach, see Treas. Reg. § 1.951A-2(c)(8)(D), Example 4.

175. Treas. Reg. § 1.951A-2(c)(7)(v)(C). The preamble to the final regulations noted that this rule is consistent with the rule in Treas. Reg. § 1.1503(d)-5(c)(3)(ii) (addressing similar interests for purposes of the dual consolidated loss rules). T.D. 9902, 85 Fed. Reg. 44,620, 44,626 (July 23, 2020). This treatment is appropriate because income earned by the tested unit directly, as well as income earned by the tested unit indirectly through the transparent interest, is expected to be subject to residence-based tax in only the tested unit's country of residence (or location) and, as a result, it is unlikely that blending of income subject to different foreign tax rates would occur by reason of the tested unit's ownership of the transparent interest.

176. Treas. Reg. § 1.951A-2(c)(7)(ii)(A), (B)(1).

purposes but are treated as regarded payments for local tax purposes. In this process, the payments that are disregarded payments that are regarded for local tax purposes are treated as appropriate deductions and appropriate income with the consequence that any such payments are taken into account in order to derive the tentative gross income items of the tested units.[177] Thus, foreign law is looked to in terms of determining the tentative gross tested income of the tested units. The methodology then switches to using U.S. concepts, not foreign law, for purposes of allocating and apportioning deductions to arise at tentative net tested income.[178] Moreover, the method of allocating current-year foreign tax credits is done using U.S. concepts except that any foreign taxes imposed on disregarded payments that are "regarded" in the calculation are treated as a foreign tax payment of the tested unit to which the "regarded" disregarded payment relates.[179] After these steps, then the effective foreign tax rate is determined by dividing the allocable foreign taxes (as adjusted for taxes attributable to disregarded payments) by allocable tentative gross tested income (as adjusted for disregarded payments) net of allocable deductions.[180]

Much could be said about these regulations, but *simple* is not one of the adjectives that apply. In point of fact, these rules create considerable complexity exactly because the regulations attempt to walk back the divergences that the elective U.S. entity classification regime created in the first place. As previously mentioned, the elective entity classification regime was adopted based on policy goals of promoting simplification and reducing the need for taxpayers and the government to thoroughly examine foreign law, but the computation of the high-tax exception for section 951A demonstrates that these stated policy goals have not been realized. Again, the need to recast the relevant building block as a "tested unit" creates a fictional construct that should be based on the entity classification. If the United States simply conformed its treatment of foreign entities to the manner in which the foreign situs jurisdiction treated the entity, then the ability to determine what income is high-tax and low-tax could be made consistent with how the foreign jurisdiction treated the income and entities.

The efforts utilized by the United States to reassociate "unmatched" foreign taxes with "tested income" in "tested units" may well utilize reasonable proxies, but these workaround rules are complex and may not be commonly understood or agreeable to other jurisdictions that don't see transactions or entities similarly. The development of the GloBE rules and the need for a country-by-country

177. Treas. Reg. § 1.951A-2(c)(7)(ii)(B)(2).
178. Treas. Reg. § 1.951A-2(c)(7)(iii)(A).
179. Treas. Reg. § 1.951A-2(c)(7)(iii)(B).
180. Treas. Reg. § 1.951A-2(c)(7)(vi), (vii).

determination of income and the covered taxes attributable to that income requires countries to have a common understanding of where income is earned and which juridical person paid those taxes. If such an agreement were not reached, then the United States would be potentially disadvantaged if its taxation of low-taxed income under section 951A did not align with how other jurisdictions determine the minimum tax computation under the GloBE rules. Seen in this light, an important design parameter would be for the United States to minimize instances where the GILTI high-tax determination aligns with how other jurisdictions determine low-taxed income, and the best means to accomplish that conformity goal would be for the United States to adopt an entity classification regime for foreign entities that conforms to how the foreign situs jurisdiction classifies its own entity or branch.

E. Hybrid Dividends Under Section 245A(e)

Section 245A(e) explicitly addresses mismatches created by the inconsistent treatment of entities and transactions. A hybrid dividend is an amount received from a controlled foreign corporation for which a section 245A foreign dividends received deduction would otherwise be allowed and for which the controlled foreign corporation received a deduction (or other tax benefit) with respect to the payment of its income (a hybrid deduction).[181] Section 245A(e) provides that the section 245A deduction is not available to a domestic corporate U.S. shareholder if the dividend is a hybrid dividend.[182] The goal behind this denial of the section 245A deduction for a hybrid dividend is to neutralize the double non-taxation of amounts that are both deductible in a foreign jurisdiction and would otherwise escape taxation in the United States. To compound the punitive measures against a hybrid dividend, no foreign tax credit or deduction is allowed for any taxes paid or accrued (or treated as paid or accrued) with respect to any hybrid dividend received by a U.S. shareholder or included in the U.S. shareholder's income.[183] The mismatches that result from inconsistent entity classification are a key potential source for transactions that create an inconsistent treatment in how payments or entities are treated among the United States and the foreign situs jurisdiction.

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181. I.R.C. § 245A(e)(4); Treas. Reg. § 1.245A(e)-1(b)(2). The regulations take into account certain deductions or other tax benefits allowed to a person related to a controlled foreign corporation (such as a shareholder) including, for example, certain tax benefits allowed to a shareholder of a controlled foreign corporation. *See* Treas. Reg. § 1.245A(e)-1(d)(2)(i).

182. I.R.C. § 245A(e)(1). The denial of a section 245A deduction for a hybrid dividend is consistent with Action 2 of the OECD's Base Erosion and Profit Shifting project. *See* OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (Oct. 5, 2015), http://dx.doi.org/10.1787/9789264241138-en; OECD, *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS* (July 27, 2017), http://dx.doi.org/10.1787/9789264278790-en.

183. § 245A(e)(3); Treas. Reg. § 1.245A(e)-1(b)(1)(ii).

Under the regulations, only deductions or other tax benefits that are "allowed" under the relevant foreign tax law may constitute a hybrid deduction.[184] Thus, for example, if the relevant foreign tax law contains hybrid mismatch rules under which a controlled foreign corporation is denied a deduction for an amount of interest paid with respect to a hybrid instrument, then the payment of the interest does not give rise to a hybrid deduction because the deduction is not "allowed."[185] The resolution of how close a connection a disallowance provision must have to the hybrid deduction in order for it to be a foreign law disallowance regime is a question that invites its own set of complexities.[186] For a deduction or other tax benefit to be a hybrid deduction, it must relate to an instrument of the controlled foreign corporation that is treated as stock for U.S. tax purposes.[187] However,

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184. Treas. Reg. § 1.245A(e)-1(d)(2)(i)(A). The regulations define a relevant foreign tax law as any regime of any foreign country or possession of the United States that imposes an income, war profits, or excess profits tax with respect to income of the controlled foreign corporation, other than a foreign anti-deferral regime under which an owner of the controlled foreign corporation is liable to tax. *See* Treas. Reg. § 1.245A(e)-1(f)(5). Thus, for example, a relevant foreign tax law includes the tax law of a foreign country of which the controlled foreign corporation is a tax resident, as well as the tax law applicable to a foreign branch of the controlled foreign corporation. *See* Treas. Reg. § 1.245A(e)-1(f)(5)(i) and (ii).

185. Treas. Reg. § 1.245A(e)-1(d)(2)(ii)(B). However, after stating this organizing thesis that a dividend payment gives rise to a hybrid deduction only when it provides an allowable deduction, the regulations then depart from this normative goal in key ways. First, the disallowance of a deduction by reason of a foreign hybrid mismatch disallowance rule is not to be considered if the dividend is paid more than 12 months after the time in which the deduction is disallowed. *See* Treas. Reg. § 1.245A(e)-1(d)(2)(ii)(B). In addition, the denial of a tax deduction by reason of a thin capitalization regime does not represent the type of disallowance that is considered as a foreign law disallowance regime for purposes of this exception. See Treas. Reg. § 1.245A(e)-1(d)(2)(ii)(A). In addition, the imposition of withholding taxes on an amount that was afforded a deduction for local purposes is not a relevant fact for purposes of determining whether or not a payment gives rise to a hybrid deduction unless the withholding tax is part of an integrated or imputation tax regime. *See* Treas. Reg. § 1.245A(e)-1(g)(2), Example 2.

186. In the preamble to final regulations, the Treasury Department explained that a thin capitalization regime or similar rule may suspend rather than disallow a deduction and thus may not prevent eventual double non-taxation. In addition, the Treasury Department asserted that it would be unduly complex to determine the extent to which an amount disallowed under such a regime relates to a particular otherwise allowable deduction. Thus, the determination of whether a deduction is considered "allowable" is made without considering the effect of a thin capitalization regime. In addition, even where foreign law provides for a foreign law mismatch regime that disallows a hybrid deduction with respect to a hybrid dividend, the government asserted that there should be a "close temporal connection between the amount giving rise to the deduction or other tax benefit and the payment of the amount as a dividend." *See* T.D. 9896, 85 Fed. Reg. 19,802, 19,803 (Apr. 8, 2020).

187. Treas. Reg. § 1.245A(e)-1(d)(2)(ii)(B). Additionally, it includes other deductions allowed with respect to equity under a relevant foreign tax law such as notional interest deductions, unless the deduction is part of an integrated tax regime where the recipient shareholder is a resident of the same foreign jurisdiction and is subject to taxation in the same foreign jurisdiction or is subject to withholding tax if not a resident. See Treas. Reg. § 1.245A(e)-1(d)(2)(i)(B). A hybrid deduction does not encompass an exemption provided to a controlled foreign corporation under its tax law for certain types of income (such as income attributable to a foreign branch) because there is not a connection between the tax benefit and the instrument that is stock for U.S. tax purposes, but a system that provides notional interest deductions on equity or provides a deduction in a foreign branch jurisdiction for a hybrid dividend payment gives rise to a hybrid deduction. See Treas. Reg. § 1.245A(e)-1(g)(1) Example 1(iii) and (iv). Moreover, a dividends paid deduction that effectively refunds the corporate level taxes gives rise to a hybrid deduction, but the regulations provide an

the question of what amount of linkage must exist between a deduction and the dividend distribution is addressed in the regulations by keeping track of "hybrid deduction accounts" of the domestic corporation (or controlled foreign corporation) receiving the dividend.[188] This aspect of the regulations greatly increases the complexity in the application of these rules, but the Service's stated goal is to ensure that dividends are subject to section 245A(e) regardless of whether or not the same payment gives rise to the dividend and the hybrid deduction.[189] A dividend paid by a controlled foreign corporation to a shareholder that has a hybrid deduction account with respect to the controlled foreign corporation is generally treated as a hybrid dividend to the extent of the shareholder's balance in all of its hybrid deduction accounts with respect to the controlled foreign corporation, even if the dividend is paid on a share that has not had any hybrid deductions allocated to it.[190] Once an amount in a hybrid deduction account gives rise to a hybrid dividend, the account is correspondingly reduced.[191]

Section 245A(e)(2) denies the availability of the section 245A foreign dividends received deduction with respect to earnings arising from a tiered hybrid dividend. A tiered hybrid dividend means an amount received by a controlled foreign corporation from another controlled foreign corporation to the extent that the amount would be a hybrid dividend if the receiving controlled foreign corporation were a domestic corporation.[192] Accordingly, the amount must be treated as a dividend under U.S. tax law, meaning that the treatment of the amount under the tax law in which the receiving controlled foreign corporation is a tax resident (or under any other foreign tax law) is irrelevant for this purpose. If a controlled foreign corporation receives a tiered hybrid dividend from another controlled foreign corporation and a domestic corporation is a U.S. shareholder of both controlled foreign corporations, then (i) the tiered hybrid dividend is treated as Subpart F income of the receiving controlled foreign corporation, (ii) the U.S. shareholder must include in gross income its pro rata share of the Subpart F income, and (iii) the rules of section 245A(d) apply to disallow

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example that a withholding tax applied on shareholders in an imputation regime can reduce the amount considered to be a hybrid deduction. *See* Treas. Reg. § 1.245A(e)-1(d)(6).

188. Treas. Reg. § 1.245A(e)-1(b)(2) and (d).

189. A hybrid deduction account must be maintained with respect to each share of stock of a controlled foreign corporation held by a person that, given its ownership of the controlled foreign corporation and the share, could be subject to I.R.C. § 245A when a dividend is paid by the controlled foreign corporation. Treas. Reg. § 1.245A(e)-1(d)(3). The account, which is maintained in the functional currency of the controlled foreign corporation, reflects the amount of hybrid deductions of the controlled foreign corporation that have been allocated to the share. See Treas. Reg. § 1.245A(e)-1(d)(3) through (6).

190. Treas. Reg. § 1.245A(e)-1(b)(2).

191. Treas. Reg. § 1.245A(e)-1(d)(4)(i)(C).

192. Treas. Reg. § 1.245A(e)-1(c)(2).

foreign tax credit relief on the amount included in the U.S. shareholder's gross income.[193]

Much more could be said about these regulations, but again, *simple* is not one of the descriptive adjectives that applies in this context. T rules create divergences and considerable complexity exactly because the regulations attempt to address the resulting hybrid payments created in part by the mismatches that occur when the U.S. classification of an entity diverges from that of the foreign situs jurisdiction. As previously mentioned, the elective entity classification regime was adopted based on a policy goal of promoting simplification and reducing the need for taxpayers and the government to thoroughly examine foreign law, but the resulting hybrid dividend regulations demonstrate that this stated policy goal has not been realized. Again, the hybrid dividend regulations provide unmistakable evidence that the United States is no longer agnostic in terms of the outcomes of entity classification mismatches. The normative implications of the elective U.S. entity classification regime are clear: the United States should simply conform its treatment of foreign entities to how the jurisdiction in which the entity is formed treats that entity. This conformity might not eradicate all hybrid dividends from the system, but it would take away a significant spawning ground for them. Seen in this light, an important design parameter should be for the United States to minimize instances where its definition of foreign branch basket income is inconsistent with how the foreign situs jurisdictions define their own foreign branch income, and the best means to accomplish that conformity would be for the United States to adopt an entity classification regime that conforms to how the foreign situs jurisdiction classifies its own entity or branch.

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193. Treas. Reg. § 1.245A(e)-1(c)(1). This treatment applies "notwithstanding any other provision of the Code." *See id*. Thus, for example, exceptions to Subpart F income such as those provided under Section 954(c)(3) ("same country" exception for income received from related persons) and section 954(c)(6) (look-through rule for related CFCs) do not apply. As additional examples, the gross amount of Subpart F income cannot be reduced by deductions taken into account under section 954(b)(5) and Treas. Reg. § 1.954-1(c), and it is not subject to the current earnings and profits limitation under section 952(c). Under section 964(e)(1), gain recognized by a controlled foreign corporation on the sale or exchange of stock in another foreign corporation may be treated as a dividend. In this regard, when section 964(e)(4) applies, it operates as follows: (i) treats the dividend as Subpart F income of the selling controlled foreign corporation; (ii) requires a U.S. shareholder of the controlled foreign corporation to include in its gross income its pro rata share of the Subpart F income; and (iii) allows the U.S. shareholder the section 245A(a) deduction for the foreign source portion of the Subpart F inclusion. As is the case with the treatment of tiered hybrid dividends, the treatment of dividends under section 964(e)(4) applies notwithstanding any other provision of the Code. The regulations coordinate the tiered hybrid dividend rules and the rules of section 964(e) by providing that, to the extent a dividend arising under section 964(e)(1) is a tiered hybrid dividend, the tiered hybrid dividend rules, rather than the rules of section 964(e)(4), apply. Thus, in such a case, a U.S. shareholder that includes an amount in its gross income under the tiered hybrid dividend rule is not allowed the section 245A(a) deduction, or foreign tax credits or deductions, for the amount. *See* Treas. Reg. § 1.245A(e)-1(c)(4).

V. CONCLUSION

A critical design challenge in terms of United States law is to ensure that the classification of foreign entities aids the policy goals of the United States and its treaty partners and does not hinder those goals. There was a time when the United States did not believe that it had any vital interest in how a foreign entity was characterized. Given this ambivalence of attitude, it is unsurprising that the United States would simply cede the decision of a foreign entity's classification to that of taxpayer choice. Ever since that fateful decision, imaginative taxpayers have created entity classification mismatches resulting in double nontaxation that frustrates the goals of a coherently functioning system of international taxation.

Times have changed markedly. Today, it matters how foreign taxes are assessed under foreign law and on what items those taxes are levied as the allocation of any U.S. foreign tax credit to various baskets requires this determination. It matters a lot whether foreign taxes are considered paid by the same person who actually earned the income as a mismatch in that regard creates splitter events that the U.S. law has evolved to minimize. It matters a lot whether income has been subject to a sufficiently high level of taxation to properly apply the GILTI rules under section 951A, and so a mismatch in how the U.S. and another jurisdiction view the nature of transactions matters in terms of matching any taxes to the correct income. Mismatches that create hybrid dividends are objectionable from a U.S. tax policy perspective under section 245A(e), and again, those mismatches most readily occur when the U.S. and another jurisdiction take inconsistent views on the classification of an entity.

The resulting mischief spawned by the entity classification mismatches impeaches the original simplicity rationale for allowing taxpayer choice in entity classification. The repeated need for workaround rules in the regulations provides a constant reminder that the elective entity classification regime hinders the conformity policy goals of this era. As a result, it is now time for the United States to promote the conformity goals that are currently relevant by requiring foreign entities to be classified for U.S. tax purposes in conformity with how the foreign situs jurisdiction classifies its own entity. When the foreign situs jurisdiction treats the entity as a foreign corporation, the United States should also treat the foreign entity as a foreign corporation for U.S. tax purposes. When the foreign jurisdiction treats the foreign entity as a flow-through entity and subjects the owners of the entity to taxation, then the United States should treat the foreign entity as a foreign partnership (if owned by two or more persons) or a disregarded entity (if owned by a single owner). This entity classification conformity is equally as simple in terms of the elective classification regime, but more importantly, the conformity advocated

by this article has the added benefit of promoting the harmonization of U.S. international taxation with its treaty partners by minimizing instances of mismatches in classification from the outset. The Treasury Department should be commended for finding workarounds in its regulations to deal with mismatch concerns, but the time has now come for the United States to simply conform its classification of foreign entities with how the foreign situs jurisdiction classifies their own entities as the best means for achieving overall simplification and for achieving a common understanding among the United States and its treaty partners. This straightforward and "simple" reform proposal would do much to alleviate the pernicious impacts that mismatches of entity classification can and do create and would serve to better promote the tax policy goals of the United States and its treaty partners.

THE FINAL FRONTIER: A LOOK AT PRIVATE MINING RIGHTS IN SPACE

By: Tyler Burdon[*]

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I. INTRODUCTION

The Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space (the Outer Space Treaty) is the current master document outlining international space law.[1] Subsequent treaties and U.N. resolutions have followed, further defining the scope of the Outer Space Treaty, but the Outer Space Treaty remains the foundation for each new piece of space legislation.[2] Each nation signatory interprets the principles of this legislation and applies them to their respective domestic law.[3] This process has effectively created a "soft law" that does not directly address commercial interests.[4] Instead, the Outer Space Treaty provides that "[o]uter space, including the [M]oon and other celestial bodies, is not subject to national appropriation by claim of sovereignty, by means of use or occupation, or by any other means."[5]

At the time of the Outer Space Treaty's conception, State Parties did not account for the privatization of space, and as such, the treaty is silent on commercial operations. However, Moon and asteroid mining presents an incredibly profitable business venture for resource gathering. Asterank, a scientific and economic database cataloging over 6,000 NASA-tracked asteroids, estimates mining just the top ten most cost-effective asteroids would produce a profit of around $1.5 trillion.[6] These asteroids contain both industrial metals and precious metals, as well as ice that can be converted into drinking water, breathable air, and rocket fuels for use in a future space economy.[7]

This paper argues that the current domestic and international legal framework insufficiently addresses private industry's resource-gathering rights on the Moon and other heavenly bodies. This paper seeks an alternative to the existing framework through the passage of new treaties advocating alienable property rights and using a bottom-up approach to governance before establishing international regulatory bodies to oversee these rights.

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1. Henry Hertzfeld, *Current and Future Issues in International Space Law*, 15 ILSA J. OF INT'L & COMPARATIVE L. 325, 328-29 (2009).

2. *Id.*; *see also* Loren Grush, *How an international treaty signed 50 years ago became the backbone for space law*, THE VERGE (Jan. 27, 2017, 10:14 AM), https://www.theverge.com/2017/1/27/14398492/outer-space-treaty-50-anniversary-exploration-guidelines.

3. Hertzfeld, *supra* note 1, at 330.

4. *Id.* at 330-31.

5. Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space, Including the Moon and Other Celestial Bodies art. II, Jan. 27, 1967, 18 U.S.T. 2410, 610 U.N.T.S. 205 [hereinafter Outer Space Treaty].

6. Shriya Yarlagadda, *Economics of the Stars: The Future of Asteroid Mining and the Global Economy*, HARVARD INT'L REV. (Apr. 8, 2022, 9:00 AM), https://hir.harvard.edu/economics-of-the-stars/.

7. Andy Greenspon, *Precious metals in peril: Can asteroid mining save us?*, HARVARD UNIV. THE GRADUATE SCH. OF ARTS AND SCI.: SCI. IN THE NEWS (Oct. 25, 2016), https://sitn.hms.harvard.edu/flash/2016/precious-metals-peril-can-asteroid-mining-save-us/.

Part II of this article discusses the current legal framework surrounding space. It addresses the burgeoning private space industry and its property rights under the Outer Space Treaty and subsequent treaties. Part III of this article highlights current international property rights frameworks and United States domestic property rights analogous to extraterrestrial mining, including high seas fishing, high seas mining, and United States mining law. Part IV of this article examines the need for new multilateral treaties to advocate for private resource-gathering rights, filling the void in the existing legal framework surrounding space, and describes how a bottom-up approach to governance should be used before regulatory bodies can be shaped to manage these resource-gathering rights. Part V of this article recommends solutions to the current legal framework and advocates for the passage of new treaties and legislation promoting a defined system of alienable resource-gathering property rights before establishing international regulatory bodies to oversee these rights.

II. CURRENT LEGAL FRAMEWORK OF SPACE

Humanity has once again set its sights on space.[8] United States President Joe Biden has committed to NASA's Artemis Program, which will land the first woman and first person of color on the Moon.[9] Similarly, China landed a probe on the far side of the Moon in 2019, and Russia is attempting to resurrect its lunar program.[10]

Technological advancements in rocket recovery and reusable launch systems have significantly decreased the costs associated with rocket launches.[11] Private companies have been at the forefront of developing these reusable rocket systems.[12] To reap these cost savings, NASA has increasingly turned to public-private partnerships to achieve its goals in space.[13] But, as space becomes commercialized, questions remain unanswered regarding private resource rights on heavenly bodies.[14]

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8. Kate Evans, *Hear Ye! Hear Ye! A Declaration of the Rights of the Moon*, EOS (July 20, 2021), https://eos.org/features/hear-ye-hear-ye-a-declaration-of-the-rights-of-the-moon.

9. *Id.*

10. *Id.*

11. Steinar Lag, *Reusable rockets: revolutionizing access to outer space*, DNV (last visited May 22, 2024), https://www.dnv.com/to2030/technology/reusable-rockets-revolutionizing-access-to-outer-space.html.

12. *Id.*

13. Michael Sheetz, *NASA awards Blue Origin, Northrop Grumman and Nanoracks with contracts to build private space stations*, CNBC (Dec. 2, 2021, 3:20 PM), https://www.cnbc.com/2021/12/02/nasa-private-space-station-contracts-blue-origin-nanoracks-northrop.html.

14. *See* Nahal Toosi, *Who owns the moon?*, POLITICO (June 13, 2019, 4:59 AM), https://www.politico.com/agenda/story/2019/06/13/space-travel-moon-resources-000899/.

The 1950s started the "space race" between the United States and the Soviet Union.[15] Nations became fearful of nuclear weapons and the militarization of space.[16] In 1960, President Eisenhower recommended that the principles surrounding the Antarctic Treaty of 1959 be applied to space and celestial bodies.[17] Then, in 1965, the United States proposed a treaty to the United Nations outlining the peaceful use of space.[18] This proposal culminated in the Outer Space Treaty and was opened for signature in the United States, the United Kingdom, and the Soviet Union in January 1967.[19] The Outer Space Treaty entered into force in October 1967.[20] Borrowing from its predecessor, the Antarctic Treaty, the Outer Space Treaty stressed that no nation could claim ownership over any celestial body in space.[21] Today, this treaty has 114 State Parties.[22]

The Outer Space Treaty contains seventeen articles, five articles being particularly pertinent for analyzing property rights.[23] Articles I and II generally claim that space belongs to humankind, not nations, and space exploration and use shall be carried out to benefit all countries.[24] Article IV prescribes that such use shall be entirely peaceful.[25] Article VI holds that State Parties bear responsibility for national activities in outer space, and the activities of non-governmental entities shall require authorization and supervision by their respective State Parties.[26] Article VIII states that each party who launches an object into outer space retains control and jurisdiction over the object.[27] Article XII provides that all stations, installations, equipment, and space vehicles on the Moon and other heavenly bodies shall be open to representatives of other State Parties to the treaty.[28]

The Outer Space Treaty has provided the basis for all subsequent space legislation.[29] The Agreement Governing the Activities of States on the Moon and Other Celestial Bodies (Moon Agreement) was adopted by

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15. Bailey DeSimone, *How the Antarctic Treaty of 1959 Influenced the Outer Space Treaty of 1967*, LIBR. OF CONG. (Jan. 28, 2022), https://blogs.loc.gov/law/2022/01/how-the-antarctic-treaty-of-1959-influenced-the-outer-space-treaty-of-1967/.

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*; *see also* Outer Space Treaty, *supra* note 5.

22. *Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space, including the Moon and Other Celestial Bodies*, UNODA, https://treaties.unoda.org/t/outer_space (last visited May 22, 2024).

23. Outer Space Treaty, *supra* note 5.

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

29. Grush, *supra* note 2.

the U.N. General Assembly in 1979 and entered into force in July 1984.[30] The Moon Agreement reaffirms and elaborates on many of the provisions of the Outer Space Treaty as applied to the Moon.[31] Article 11 provides that the Moon and its natural resources are the common heritage of humankind and shall never become the property of any State, non-governmental organization or entity, or natural person.[32] However, the United States is not a signatory to this treaty.[33]

Recent domestic United States law suggests that the U.S. recognizes that private U.S. companies have property rights to the resources they gather in space.[34] For instance, the U.S. Commercial Space Launch Competitiveness Act (the SPACE Act) directs the President to "promote the right of United States citizens to engage in commercial . . . recovery of space resources."[35] However, this remains untested; NASA has contracted with several companies to mine the lunar surface for lunar soil, but these projects are not yet underway.[36]

The most recent United States legislation concerning the use of outer space is the Artemis Accords.[37] The Artemis Accords are an international agreement recently put forth by NASA between the United States and several partner nations, governing space exploration cooperation among nations participating in NASA's twenty-first century lunar exploration plans.[38] These Accords come on the heels of NASA's anticipated Artemis program, which would culminate in a crewed Moon landing mission, a new space station in lunar orbit, a habitable Moon base, and a crewed Mars landing mission.[39]

While the Artemis Accords expressly state its principles provide for the operational implementation of obligations contained in the Outer Space Treaty, it also clarifies property ownership in space.[40] Section 10

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30. *Agreement Governing the Activities of States on the Moon and Other Celestial Bodies*, UNOOSA, https://www.unoosa.org/oosa/en/ourwork/spacelaw/treaties/intromoon-agreement.html (last visited May 22, 2024).

31. *Id.*

32. *Id.*

33. *Outer Space Law*, UNIV. OF CONN., https://libguides.law.uconn.edu/c.php?g=1047257&p=7603529#s-lg-box-25700934 (last visited May 22, 2024).

34. *See* H.R. 2262, 114th Cong. (2015) (enacted).

35. *Id.* § 51302(a)(3).

36. Christian Davenport, *A dollar can't buy you a cup of coffee but that's what NASA intends to pay for some moon rocks*, THE WASH. POST (Dec. 3, 2020, 3:23 PM), https://www.washingtonpost.com/technology/2020/12/03/moon-mining-contracts-named/.

37. Media Note from the Off. of the Spokesperson, *First Meeting of Artemis Accords Signatories* (Sept. 19, 2022), https://pl.usembassy.gov/artemis/.

38. Press Release, NASA, NASA, International Partners Advance Cooperation with First Signings of Artemis Accords (Oct. 13, 2020), https://www.nasa.gov/news-release/nasa-international-partners-advance-cooperation-with-first-signings-of-artemis-accords/.

39. *Follow the NASA Artemis missions*, ROYAL MUSEUMS GREENWICH, https://www.rmg.co.uk/stories/topics/nasa-moon-mission-artemis-program-launch-date (last visited May 22, 2024).

40. *Artemis Accords Principles for Cooperation in the Civil Exploration and Use of the Moon, Mars, Comets, and Asteroids for Peaceful Purposes,* NASA (Oct. 13, 2020), https://www.nasa.gov/artemis-accords/.

governs space resources and states, "the extraction and utilization of space resources, including… from the surface or subsurface of the Moon, Mars, comets, or asteroids, should be executed in a manner that complies with the Outer Space Treaty."[41] It further states that "the extraction of space resources does not inherently constitute national appropriation under Article II of the Outer Space Treaty."[42] Like the Outer Space Treaty, the Artemis Accords are silent on resource rights to private individuals.[43] As of September 19, 2022, twenty-one countries have signed the Artemis Accords.[44]

III. CURRENT INTERNATIONAL AND UNITED STATES DOMESTIC PROPERTY RIGHTS

Private companies will not invest the capital needed to mine heavenly bodies without legal certainty of their ownership rights in those resources.[45] Scholars argue that a traditional right to property does not exist under international law; instead, property rights only arise under the domestic law of a particular nation.[46] A global right to property has been debated for decades but has ultimately been deemed "extremely difficult" to establish as it would require a right "(1) incorporated into 'the national law of all states' and (2) 'capable of being given the same weight in domestic courts.'"[47] The legal uncertainties posed by the Outer Space Treaty leave the question: Can we analogize any current legal framework to mining in outer space?

A. High Seas Fishing

Previous NASA director Jim Bridenstine has likened lunar resource extraction to rules governing the sea, stating, "[w]e do believe we can extract and utilize resources of the moon, just as we can extract and utilize tuna from the ocean."[48]

The United Nations Convention on the Law of the Sea provides a comprehensive regime of the laws that govern the world's oceans.[49] This

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41. *Id.*
42. *Id.*
43. *Id.*
44. Media Note from the Off. of the Spokesperson, *supra* note 37.
45. *See* JP Floru, *Mining the Moon: How Private Property Rights in Space Bring Limitless Opportunities*, ADAM SMITH INST. (Dec. 17, 2019), https://www.adamsmith.org/blog/mining-the-moon-how-private-property-rights-in-space-bring-limitless-opportunities.
46. John G. Sprankling, *The Global Right to Property*, 52 COLUM. J. TRANSNAT'L L. 464, 465, 470 (2014).
47. *See id.* at 470.
48. Christian Davenport, *NASA announces it's looking for companies to help mine the moon*, THE WASH. POST (Sept. 10, 2020, 2:00 PM), https://www.washingtonpost.com/technology/2020/09/10/moon-mining-nasa-search/.
49. U.N. Convention on the Law of the Sea, Dec. 10, 1982, 1833 U.N.T.S. 397, https://www.un.org/depts/los/convention_agreements/texts/unclos/unclos_e.pdf [hereinafter UNCLOS].

convention entered into force on November 16, 1994, and is globally recognized as the leading source of all matters relating to the law of the sea.[50] This treaty creates a multitude of zones that extend outwards from each coastal State into their surrounding water.[51] The "territorial sea" is defined as the zone extending beyond a state's land territory into the sea to a limit not exceeding twelve nautical miles.[52] Sovereignty of this area extends to both the airspace and the sea bed and subsoil.[53] The "exclusive economic zone" is the sea beyond and adjacent to the territorial sea and extends outward from the territorial sea for no longer than 200 nautical miles.[54] While a State has full jurisdiction over its territorial zone, a State only has jurisdiction over the resources within its exclusive economic zone.[55] These resources include fish, offshore oil, and gas.[56] Each State has the jurisdiction to govern the use of these resources within its exclusive economic zone, including issuing licenses, setting catch limits, or banning activities entirely.[57] The area outside the jurisdiction of signatory parties is considered the "high seas."[58] However, the treaty provides that "[a]ll States have the right for their nationals to engage in fishing on the high seas."[59]

The ability to fish on the high seas may not be as simple as Bridenstine suggests. First, the 1982 U.N. Convention on the Law of the Sea (UNCLOS) lays out obligations for high seas fishing to comply with the treaty.[60] UNCLOS requires that nationals comply with their respective State's treaty obligations, cooperate with other State Parties to the treaty, and do so in an environmentally conservatory manner.[61] Second, international law puts significant limits on States' rights to authorize their nationals to fish on the high seas.[62] High seas fisheries are often overseen by regional fisheries management organizations (RFMOs).[63] These international bodies consist of countries interested in

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50. *Id.*

51. *Id.*

52. *Id.* at 27.

53. *Id.*

54. *Id.* at 44.

55. R. Hannesson, *The Exclusive Economic Zone: What It Is*, SCIENCEDIRECT (2013), https://www.sciencedirect.com/topics/earth-and-planetary-sciences/exclusive-economic-zone.

56. *Id.*

57. Kimbra Cutlip, *Who Owns the Fish: High Seas and the EEZs*, Global Fishing Watch (July 1, 2016), https://globalfishingwatch.org/fisheries/who-owns-the-fish-high-seas-and-the-eezs/.

58. *See* UNCLOS, *supra* note 49, at 57.

59. *Id.* at 65.

60. *Id.*

61. *Id*. at 46–49, 65–66.

62. Stefán Ásmundsson, *Freedom of Fishing on the High Seas, and the Relevance of Regional Fisheries Management Organisations (RFMOs)*, CONVENTION ON BIOLOGICAL DIVERSITY, https://www.cbd.int/doc/meetings/mar/soiom-2016-01/other/soiom-2016-01-fao-18-en.pdf (last visited May 30, 2024).

63. *Id.*

managing fish stocks in a particular region.[64] The U.N. Fish Stocks Agreement (UNFSA) makes RFMOs relevant to all States, not just the members of the specific RFMO. Article 8(4) of UNFSA provides that "[o]nly those States which are members of such an organization or participants in such an arrangement, or which agree to apply the . . . measures established by such organization or arrangement, shall have access to the fishery resources to which those measures apply."[65] This bright-line rule makes it apparent that if States do not explicitly abide by either of these conditions, they do not have the freedom to fish on the high seas.[66] Article 8(5) of UNSFA goes further and provides that if there is no RFMO, relevant coastal States and States fishing in the region shall cooperate to either establish an RFMO or come to an agreement to ensure the conservation and management of the fishing stock.[67] UNSFA currently has more than eighty parties, including most major fishing States.[68]

There are many parallels between the high seas and space. Both areas have valuable resources, and neither can be appropriated by any sovereign under relevant international agreements. High seas fishing has existed much longer and is much more practical than outer space mining, which has led to a desire for regulatory bodies to oversee high seas fishing ventures. This desire for a robust regulatory approach to high seas fishing is apparent from the formation of RFMOs. While the lack of international regulatory bodies for outer space mining may suggest that this mining would not potentially conflict with international law, it does not mean there would be no blowback from the international community echoing a similar desire for regulation as seen in high seas fishing.

The sentiment that the Outer Space Treaty allows private individuals to mine outer space, expressed by the United States in the SPACE Act, is not reciprocated entirely internationally.[69] Notably, Russia has condemned asteroid mining as violating the Outer Space Treaty.[70] But, Russian private tech companies, such as Dauria Aerospace, are involved in plans for drilling rigs, space stations, and water extraction

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64. *FAQ: What is a Regional Fishery Management Organization*, THE PEW CHARITABLE TR. (Feb. 23, 2012), https://www.pewtrusts.org/en/research-and-analysis/fact-sheets/2012/02/23/faq-what-is-a-regional-fishery-management-organization.

65. Ásmundsson, *supra* note 62, at 1–2.

66. *Id.*

67. *Id.* at 2.

68. *Id.*

69. Cecilia Jamasmie, *Russia slams Trump's order to spur mining on the moon*, MINING.COM (Apr. 9, 2020, 3:53 AM), https://www.mining.com/russia-slams-trumps-order-to-spur-mining-the-moon-asteroids/.

70. Paul Ratner, *Who owns space? Here's what laws govern space exploration*, INTERESTING ENGINEERING (Apr. 23, 2022), https://interestingengineering.com/science/who-owns-space-exploration.

stations on the Moon.[71] Actions from other nations have expressed a more favorable outlook on public and private outer space mining.[72] Luxembourg looks to become the hub for European space mining as the country plans on creating a European Space Resources Innovation Centre.[73] Luxembourg looks to collaborate with the European Space Agency in using space resources such as water on the Moon and minerals found in asteroids.[74] It also looks to support commercial initiatives and start-ups, and has announced the opening of a $225 million line of credit for private space companies to set up their European headquarters within Luxembourg.[75]

With so many international actors interested in pursuing privatized space mining, each with varying interpretations of how mining may be conducted, experts are concerned with its environmental impact.[76] Due to the decades of lightly regulated space activities, space debris already threatens crew and satellites in low-earth orbit.[77] Some experts fear that lunar pollution may be next.[78] Others see a significant upside in the lack of environmental impact here on Earth.[79] Conducting mining in outer space would help supplant the need for traditional in-the-ground mining methods here on Earth that release toxic chemicals like arsenic and lead into our waterways and contribute to acid mine drainage.[80]

Regardless, a lesson must be taken from using RFMOs in deep-sea fishing. As discussed, there is no doubt that States and their private actors currently disagree on whether celestial bodies are subject to mining. When the time comes, there will likely be disagreement on the proper policies and procedures surrounding the mining process, such as waste disposal. If mining operations are to be conducted peacefully and safely in space, the international community will surely want some guiding legal framework. Eventually, regulatory bodies overseeing different regional mining practices may prove useful. Having different regional bodies, rather than one large body to oversee all mining operations, may prove especially useful when dealing with terrain such as the Moon's and the difficulties it will take to traverse it. These bodies would be more familiar with the terrain surrounding their respective mining operations. They would be better suited to decide which places

71. *Id.*

72. Cecilia Jamasmie, *Luxembourg to set up Europe space mining centre*, MINING.COM (Nov. 18, 2020), https://www.mining.com/luxembourg-to-create-space-resources-centre/.

73. *Id.*

74. *Id.*

75. *Id.*

76. Alex Gilbert, *Mining in Space Is Coming*, MILKEN INST. (Apr. 26, 2021), https://www.milkenreview.org/articles/mining-in-space-is-coming.

77. *Id.*

78. *Id.*

79. Yarlagadda, *supra* note 6.

80. *Id.*

are to be off-limits for mining for purposes such as conserving geological formations or preserving historic landmarks.[81]

B. High Seas Mining

Though NASA has likened outer space mining to high seas fishing, high seas mining laws may serve as a better comparison. UNCLOS also provides the current legal framework for deep seabed mining.[82] It states, in relevant part, "[n]o State shall claim or exercise sovereignty over any part" of the deep seabed.[83] Similar to the Outer Space Treaty, it also prescribes that the deep seabed and its resources "are the common heritage of mankind."[84]

The United States has neither signed nor ratified UNCLOS.[85] This wariness for ratification comes from fears among conservative members of Congress that UNCLOS would "undermine U.S. sovereignty by transferring 'ownership' of the high seas to the United Nations."[86] Instead, the United States entered multilateral agreements with other nations, adopting the Deep Seabed Hard Minerals Resources Act (DSHMRA) in 1980.[87] DSHMRA established a licensing regime for deep seabed mineral resources, emphasizing the conservation and protection of the marine environment.[88] The act provides access to U.S. citizens for the extraction of "deep seabed resources" and "assur[es] that any mining activities that U.S. citizens engage in prior to the signing of any international regime will be allowed to continue."[89]

On the other hand, UNCLOS established the International Seabed Authority (ISA), which regulates and controls deep seabed mining activities.[90] The ISA comprises three "organs," the Council, the Assembly, and the Secretariat, each with separate functions.[91] The Council administers regulations for deep-sea mining, the Assembly issues decisions on sharing mining revenues, and the Secretariat carries out administrative functions.[92] Entities pay a $500,000 application fee

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81. *See generally* Sophie Fessl, *Should the Moon Landing Site Be a National Historic Landmark?*, JSTOR (July 10, 2019), https://daily.jstor.org/should-the-moon-landing-site-be-a-national-historic-landmark (noting that anthropologist Beth O'Leary proposed Tranquility Base become a National Historic Landmark).

82. UNCLOS, *supra* note 49.

83. *Id.* at 52.

84. *Id.* at 50.

85. Anya Wahal, *On International Treaties, the United States Refuses to Play Ball*, COUNCIL ON FOREIGN RELS. (Jan. 7, 2022), https://www.cfr.org/blog/international-treaties-united-states-refuses-play-ball.

86. *Id.*

87. Laura C. Byrd, *Soft Law in Space: A Legal Framework for Extraterrestrial Mining*, 71 EMORY L. J. 801, 811 (2022).

88. *Id.*

89. *Id.*

90. UNCLOS, *supra* note 49.

91. Byrd, *supra* note 87.

92. *Id.*

to the ISA, which approves these applications on a first-come, first-served basis.[93] Approved applicants must set aside areas for future use by the commercial arm of the ISA, the Enterprise.[94] The Enterprise may conduct mining operations on its own, as well as "act as a partner in joint ventures with licensed contractors."[95]

The differences in how the United States and the international community view outer space mining are paralleled by their treatment of deep-sea resources. The United States maintains an "America First" stance with its refusal to ratify UNCLOS, instead opting for more domestic-favoring legislation with DSHMRA. This position translates to outer space mining with America's stance outlined in the SPACE Act, which was then followed up with the Artemis Accords. Both acts maintain a firm stance that the United States does not interpret private commercial space resource extraction as national appropriation in conflict with the Outer Space Treaty.[96] The international community tends to express a desire for an international regulatory body when dealing with matters not strictly located within a State's well-defined borders. This is evidenced through the use of UNCLOS to establish RFMOs for deep-sea fisheries and the ISA to regulate deep-sea mining endeavors.[97]

This is an important takeaway for the United States if it seeks to permit privatized space mining without stepping on the toes of the international community. Even if the United States were to give the green light to U.S. corporations to mine, the resources obtained may end up in global commerce. Corporations will not put forth the money to fund such endeavors if nations outside the United States contest their absolute property rights to these resources. These multinational corporations will likely not want to disregard the sentiment of the rest of the world when conducting these operations, especially if the international community views these actions as illegitimate or in conflict with existing international law.

C. Current U.S. Domestic Property Rights

The United States is broadly understood to possess a strong interest in private property, which has been a driving force behind its economic and political systems.[98] This sentiment is apparent in its system of mining rights.

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93. *Id.* at 811–12.
94. *Id.* at 812.
95. *Id.*
96. *See generally* H.R. 2262, *supra* note 34; *see also* Artemis Accords, *supra* note 40.
97. *See generally* UNCLOS, *supra* note 49.
98. Harvey M. Jacobs, *U.S. Private Property Rights in International Perspective, in* PROPERTY RIGHTS AND LAND POLICIES 53 (Gregory K. Ingram & Yu-Hung Hong eds., 2008).

Mining rights in the United States are conferred through "[a]n Act to promote the Development of the mining Resources of the United States" (the General Mining Law).[99] Under the General Mining Law, both individuals and corporations may prospect and stake claim to mineral discoveries on public domain lands.[100] The Congressional Research Service has defined public domain land as lands "'retained under federal ownership since their original acquisition by treaty, cession, or purchase as part of the general territory of the United States.'"[101] Public domain lands differ from acquired lands, which the federal government obtains through gift, purchase, or condemnation from a state or private owner.[102]

Under the General Mining Law, a United States citizen, or those who have declared their intent to become a United States citizen, "may 'locate' (or stake)" a claim on a valuable mineral deposit.[103] Private U.S. companies may also stake claims.[104] These claims are either "unpatented" or "patented" mining claims.[105] A patented mining claim is one for which the United States Federal Government passes its title to the claimant, giving the claimant private ownership of the land and the minerals.[106] Unpatented mining claims give mineral possessory rights to the claimant if minerals are discovered, but the claims do not convey land.[107] After 1994, the United States Congress imposed a moratorium on any new mineral patent applications, leaving unpatented mining claims as the primary method for acquiring new mining rights.[108] Under an unpatented mining claim, active work must continue yearly, or the land will revert to the public domain.[109] The General Mining Law defines active work as at least $100 of labor expended or $100 of improvements made on a yearly basis.[110]

However, when extrapolating, the General Mining Law conflicts with the Outer Space Treaty. The General Mining Law constrains its

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99. Heather Feeney, *Lode & Placer: 150 years of mining claims on public lands*, BUREAU OF LAND MGMT. (May 10, 2022), https://www.blm.gov/blog/2022-05-10/lode-placer-150-years-mining-claims-public-lands.

100. *See General Mining Law of 1872*, BALLOTOPEDIA, https://ballotpedia.org/General_Mining_Law_of_1872 (last visited May 22, 2024).

101. *Id.*

102. *Id.*

103. Christopher J. Reagen & John D. Fognani, *Mining rights and title in USA*, LEXOLOGY (July 4, 2019), https://www.lexology.com/library/detail.aspx?g=4903337f-9524-45e3-84fe-80b5580a830d.

104. *Id.*

105. *Id.*

106. *Resource Brief: Mining Claims*, NAT'L PARK SERV. (Feb. 2015), https://www.nps.gov/sagu/learn/historyculture/upload/Mining-Claims-Brief.pdf.

107. *Id.*

108. Reagen & Fognani, *supra* note 103.

109. Jeff Kohler, *Lesson 2.3: The General Mining Law of 1872 (as amended)*, PENN STATE COLL. EARTH AND MIN. SCIS., https://www.e-education.psu.edu/geog000/node/8 (last visited May 22, 2024).

110. *Id.*

application to public domain lands. Article II of the Outer Space Treaty provides that outer space is not subject to national appropriation. For resource-gathering property rights to vest in a United States entity mining celestial bodies, the United States must have first "retained under federal ownership" the land "as part of the general territory of the United States."[111] As Article II of the Outer Space Treaty prohibits national appropriation, the United States does not have the authority to grant mining claims in outer space in the same fashion as the General Mining Law. Therefore, the General Mining Law does not provide a purely domestic avenue to grant mining rights to private entities in the United States. However, there is a lesson in the method by which the General Mining Law conferred mining rights: an unpatented claim only provides rights in the resources mined on federal land.[112]

A significant point of contention on the international scale comes from compliance with the Outer Space Treaty provision that outer space is "not subject to national appropriation by claim of sovereignty."[113] It is established in the text of the Outer Space Treaty that Articles VI and VIII grant jurisdictional control over space objects to their respective State Parties.[114] Jurisdictional control does not amount to real property rights in space or celestial objects; instead, it provides protection against the loss of ownership of space objects launched or constructed.[115] Put simply, the Outer Space Treaty grants the right for non-governmental entities to bring equipment to mine, and these non-governmental entities do not lose jurisdictional control of the equipment.

Further, by using a grant of mining and mineral rights only and not a grant in the land, similar to an unpatented mining claim, there is an argument that there is no exertion of sovereignty. This argument has sparked general inconsistencies in the interpretation of the Outer Space Treaty and subsequent legislation that has followed.[116] Domestically, an approach similar to the unpatented claims in the General Mining Law looks promising, but as the document currently stands, it does not provide a foolproof avenue for private companies to conduct mining operations in outer space.[117] Given the amount of U.S. corporations operating internationally, a new international regime is needed to give private property rights to reassure these entities. Only then will we see the necessary capital invested to spur privatized space mining.

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111. Kohler, *supra* note 109; Outer Space Treaty, *supra* note 5; *General Mining Law of 1872*, *supra* note 100.

112. Outer Space Treaty, *supra* note 5; Reagen & Fognani, *supra* note 103.

113. Outer Space Treaty, *supra* note 5.

114. *Id*. at art. VI & VIII.

115. Andrew R. Brehm, *Private Property in Outer Space: Establishing a Foundation for Future Exploration*, 33 WIS. INT'L L. J. 353, 360-61 (2015).

116. *See generally id.* ("…[O]ne interpretation of the Outer Space Treaty holds that any allocation of private property rights, including allocation based on jurisdiction and peaceful use, would amount to a national appropriation.").

117. *See General Mining Law of 1872, supra* note 100.

IV. A NEW TREATY AND REGULATORY BODIES REGIME

A. New Multilateral Treaties

How will these property rights vest? Wayne White proposes a multilateral treaty governing property rights in space and argues that Article VIII of the Outer Space Treaty expressly authorizes jurisdictional sovereignty over space objects.[118] White uses this authorization of jurisdictional sovereignty as a vehicle for further property rights.[119] When proposing legislation to govern space mining, it is important to delineate between property rights on the surface of the body being mined and property rights in the resources themselves.

White discusses the property rights that would spawn from the treaty in paragraph 11 of his proposal.[120] White's treaty provides that each nation signatory retains jurisdiction and control over the space objects on its registry, limited safety zones surrounding these objects and facilities, and formal recognition of "real property rights" in private entities if they "inhabit, maintain and/or operate a space facility for a period of at least one year."[121]

These "real property rights" include the right to exclude persons and legal entities from the facilities, the right to be free from interference, the right to control activities within the facility, the exclusive right to appropriate resources within the space facility, and the right to sell the real property rights.[122] These rights are contingent upon the consistent use of the facilities to prevent a State from staking a claim and then maintaining property rights in perpetuity.[123] It would, effectively, permit private property rights in outer space only after an entity has made effective use of the property and continued to do so in a way that allows for free and open use of outer space.[124]

Brehm outlines several advantages that a proposal such as White's would bring. First, this system would incentivize those already in space exploration by expanding their ability to obtain real property rights.[125] Second, this system would create legal certainty in two ways: (i) it would clarify the ambiguity in the Outer Space Treaty, and (ii) it would legally guarantee several valuable property rights and protections for private

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118. Brehm, *supra* note 115, at 367.

119. *Id.* at 368.

120. Wayne White, *Proposal for a Multilateral Treaty Regarding Jurisdiction and Real Property Rights in Outer Space*, SPACE FUTURE, https://web.archive.org/web/20221119145410/https://www.spacefuture.com/archive/proposal_for_a_multilateral_treaty_regarding_jurisdiction_and_real_property_rights_in_outer_space.shtml (last visited Feb. 16, 2024).

121. *Id.*

122. Brehm, *supra* note 115, at 368.

123. *Id.*

124. *Id.*

125. *Id.* at 368–69.

spacefaring entities.[126] Third, it provides a limit on private property rights, which encourages and facilitates free and peaceful use and exploration of space.[127] Fourth, a proposal such as White's would be advantageous to non-spacefaring countries, as it allows for the alienation of these property rights.[128] Fifth, this proposal has great precedential value for future treaties and legislation on outer space mining.[129]

New multilateral treaties could pave the way for the necessary upfront costs of developing a space mining economy. These new treaties do not necessarily need to be the final set of legislation concerning space mining. A treaty such as White's provides a framework for space mining that can later be expanded upon once the mining is underway. Space mining is a new venture, and arguably, neither States nor private entities have the requisite experience to define a comprehensive regime to govern these ventures. Instead, emphasis should be placed on the United States getting its foot in the door and giving that initial incentive to spur future innovation. This sentiment is echoed by some scholars who argue that a final set of legislation is not necessary initially and advocate for a soft law system instead.[130]

A soft law approach would center around the notion that countries could develop a set of evolving laws based on best practices in an industry that humankind is nearly entirely new to.[131] Such an approach could borrow from an unpatented mining claim outlined by the General Mining Law, which would confer rights only to the resources.[132] Private property rights in the area surrounding these mining operations could then be implemented under a proposal such as White's, where rights are contingent on maintaining efficient use of the land.[133] Should an international body be responsible for granting these unpatented mining claims and the resulting property rights?

B. Potential Pitfalls with a New Regulatory Body

There are primarily two competing schools of thought for governing areas beyond national jurisdiction: a top-down approach and a bottom-up approach.[134] A top-down approach favors an international

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126. *Id.* at 369.
127. *Id.*
128. *Id*. at 370.
129. *Id.* at 371.
130. *See* Byrd, *supra* note 87, at 830–32.
131. *Id*. at 831, 834.
132. *See General Mining Law of 1872*, *supra* note 100.
133. *See* White, *supra* note 120.
134. Mark T. Imperial, *Implementation Structures: The Use of Top-Down and Bottom-Up Approaches to Policy Implementation*, OXFORD RSCH. ENCYCLOPEDIA (Jun. 28, 2021), https://oxfordre.com/politics/display/10.1093/acrefore/9780190228637.001.0001/acrefore-9780190228637-e-1750.

regulatory authority that mandates rules through the careful specifications of procedures.[135] When analogizing to space mining, the closest existing example of a regulatory body that would oversee such initiatives is the International Seabed Authority.[136] The ISA has been primarily deemed a failure.[137] The current ISA model took nearly 30 years to develop and come into force.[138] Further, in its operation, it has yet to produce resource mining of the seabed.[139]

Conversely, a bottom-up approach allows policy to be adapted at the local institutional level.[140] The United States has had success with a bottom-up approach to seabed mining in the form of customary international law (CIL). In 1945, President Truman issued an executive order declaring that the United States owned the resources on the continental shelf contiguous to the United States.[141] Other nation-states soon followed suit, and within five years, thirty other coastal states made similar proclamations.[142] This bottom-up framework set out by Truman led to CIL within five years, was codified in thirteen, and still contributes to millions of jobs and billions of dollars annually.[143]

This bottom-up approach is more consistent with U.S. sentiment that is hesitant to submit to any international authority out of respect for U.S. interests.[144] But, this approach is not as easy to implement in outer space. The Truman Proclamation related to the continental shelf adjacent to the United States—a much easier extension of territory than outer space.[145] Further, not every country is spacefaring. These coastal countries that followed suit had access to their seabed. Non-spacefaring nations may feel disadvantaged or even slighted if spacefaring countries were to take this approach.

V. SOLUTION

There is no single solution to governing extraterrestrial mining. It must be a multi-faceted approach. The current legal framework is unworkable and has led to several interpretations from many experts from different States. The Outer Space Treaty, as it stands, gives no

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135. *Id*.

136. UNCLOS, *supra* note 49, at 81.

137. *See generally* Alfred B. Anzaldúa & Cristin Finnigan, *From the Truman Proclamation to the Artemis Accords: Steps Toward Establishing a Bottom-Up Framework for Governance in Space*, SPACE REV. (Oct. 26, 2020), https://www.thespacereview.com/article/4053/1.

138. *Id.*

139. *Id.*

140. *See* Imperial, *supra* note 134.

141. *See* Anzaldúa & Finnigan, *supra* note 137.

142. *Id.*

143. *Id*.

144. *See generally* Wahal, *supra* note 85 ("The United States consistently prioritizes its perceived national interests over international cooperation, opting not to ratify to protect the rights of U.S. businesses or safeguard the government's freedom to act on national security.").

145. Anzaldúa & Finnigan, *supra* note 135.

explicit authorization for private entities to mine in space. But there is no explicit bar on privatized mining either. States that argue that the treaty does not permit private mining inaccurately claim it would be an exercise of sovereignty. On the other hand, States that claim it does permit private mining argue that the treaty's lack of an express renouncement is an implied grant to mine.

While the United States possesses the requisite intent to get private entities into space, as illustrated in the SPACE Act and the Artemis Accords, this legislation does little on the international stage. The number of State Parties to the Artemis Accords is small compared to the number of signatories to the Outer Space Treaty. Further, this approach has upset spacefaring nations such as China and Russia.

The prevailing theme here is that every country wants to participate in this mining if other States are also mining. States will condemn the U.S.' actions by claiming it is a violation of the Outer Space Treaty but they will still pursue private space mining with the companies located inside their borders.

For these reasons, a new set of multilateral treaties must be created to govern extraterrestrial mining. Given the hesitancy of the United States to enter into international treaties, U.S. acceptance of these treaties will likely hinge on how much involvement the U.S. has in drafting them and how favorable they are to U.S. policies. Unfortunately, pro-U.S. sentiment may pose a significant burden when attempting to get States like Russia and China to sign such a treaty. But, if enough parties adopt this treaty through a forum such as the U.N., it may be enough to bring these hesitant States to the table as they do not want to disadvantage themselves.

This treaty should emphasize the alienability of property rights, similar to the treaty proposed by White, so companies in non-spacefaring States are given a chance to participate. Further, the treaty should only confer these rights if there is productive use of the land; this will be useful to curb States' worries that powerful State companies will oversaturate extraterrestrial land by staking a claim and leaving.

States should exercise caution when establishing regulatory bodies to oversee new mining operations and the mining process. Using a bottom-up rather than a top-down approach to conferring mining rights will be important to avoid the pitfalls that made the International Seabed Authority a failure, with its slow movement and lack of transparency. It is essential to spur confidence in these private entities to mine, and inspiring private entities to invest the necessary capital to reach outer space will be pivotal in encouraging others to follow suit. Once the mining is conducted, subsequent treaties and CIL should guide the mining operations to ensure they are both properly zoned and done in a way that minimally impacts the environment of the celestial body. One day, forming an overarching regulatory body to oversee the

operations may be wise. However, creating such a body too soon and imposing stringent guidelines may chill potential attempts for innovation. If regulatory bodies are established, it would be better to do so on a regional level similar to RFMOs.

Given this growing interest in developing the means to mine in outer space, developing a working framework to guide this industry is more imperative than ever. The framework of the Outer Space Treaty and subsequent legislation do not give private entities the proper reassurance in their resource rights that the entities need to spur on these mining operations. As such, States should look to the successes of previous treaties and legislation related to outer space to pass new treaties that establish a clearer system of alienable resource-gathering property rights and use a bottom-up governance approach to adapt to unforeseeable scenarios in this new industry.